



International Chamber of Commerce

The world business organization

**Discussion
Paper**



Prepared by the ICC Commission on
Environment and Energy

ICC Discussion Paper on Market Mechanisms in the post-2012 GHG Regime:

*Role and Shape of Future Greenhouse Gas and
Carbon Markets*

Highlights

- Finance is crucial for post-2012 framework
- Market based approaches are an important option to address climate change
- Continuity of existing market mechanisms is important
- New mechanisms could emerge but require basic conditions and design considerations

I. INTRODUCTION

Climate change is a global problem that requires a global solution. Greenhouse gas emissions today are growing in many countries - most rapidly in developing nations. Stabilization of carbon dioxide, in particular, will require emissions to peak and decline globally— ultimately to very low levels.

The flexible mechanisms introduced under the United Nations Framework Convention (UNFCCC) Kyoto Protocol as well as new ones that are now under discussion allow nations to meet their obligations through actions outside their own borders. In general, they include emissions trading and utilization of investments in international offsets.

These are market-based approaches that help to limit the overall cost to society of achieving climate objectives. By themselves such market-based international mechanisms do not provide a complete solution. They must work in conjunction with national policies and in the framework of other international policy, such as policies governing trade and investment. They are necessary but not sufficient.

ICC supports a UNFCCC post-2012 agreement that provides a clear and predictable framework in which business can contribute solutions and considers that appropriately designed market-based and market approaches to address emissions can make a major contribution to that goal, in the context of other policy approaches and enabling frameworks.

We support efforts to expand the scope, simplify and improve procedures in the Clean Development Mechanism (CDM), and are ready to work with governments and negotiators to seek effective new ones as well as other market-based approaches. New mechanisms could bring value. This paper will discuss the ICC's view on the role of market mechanisms in the post-2012 regime in general, but will focus on the role, shape and conditions for the deployment of carbon markets.

II. FINANCE IS CRITICAL

Finance¹ is one of the key issues that must be resolved to reach a successful agreement for post-2012 international cooperative actions. Flexible effective financing arrangements are essential to effective functioning of market and market-based mechanisms. It will be essential to realize the broad and growing range of new investments that are needed. Public sector finance will play an important role, especially in meeting adaptation objectives and in building capacity to create an improved framework to leverage private investment.

Nonetheless, the majority of funds required to develop and deploy currently non-commercial technologies on the scale necessary to affect global greenhouse gas emissions will have to be mobilized through the private sector. According to the UNFCCC and the International Energy Agency (IEA), USD 1 trillion a year would be required to fund global mitigation and adaptation activities to halve global emissions by 2050, and the private sector would be responsible for over 80% of that total investment.

Private sector investments work best through market-based approaches which allow governments to establish goals and criteria and allow the private sector to compete through innovation to invest and meet objectives in the most effective fashion.

III. KEY ROLE FOR MARKET BASED APPROACHES

ICC believes that market based approaches, in general, will have a key role in addressing climate change in those countries and regions that choose to use them. Critical components that will enable a response to climate change will first of all include technology evolution— deployment of existing efficient and low emitting technologies and practices— and revolution— creation and deployment of

¹ Please see ICC Public Policy Roadmap on Finance and Climate Change for more information

Market Mechanisms in the post-2012 GHG Regime: Role and Shape of Future Greenhouse Gas and Carbon Markets

innovative, currently non-commercial technologies on a global scale. Stabilizing greenhouse gas concentrations at the ambitious levels under consideration will require acceleration in the pace of technological advancement and diffusion. Given the size of the climate challenge, as well as other societal needs and priorities, achieving such an ambitious objective will require an efficient means of allocating resources, for which cost-effective use of capital is critical.

Market approaches to address climate change and promote movement towards energy generation and use with higher efficiency and lower greenhouse gas emissions, may take a number of forms depending on national circumstances as well as the sector of economic activity to be addressed. In general, ICC advocates the use of economy wide approaches because they offer the lowest cost to achieve a given objective. Promoting innovation requires consideration of different stages of development of a technology. Research and development (R&D) and pilot and demonstration phases, for example to improve carbon capture and storage (CCS), will require strong public-private partnerships, while the technology deployment stage should rely more on pure market signals. In this context, greenhouse gas markets will be an important tool in the tool box.

IV. GREENHOUSE GAS AND CARBON MARKETS

Greenhouse gas markets, in those nations and regions that chose to utilize them, can play an important role in creating signals and actions to stimulate technology development and deployment. From a private sector perspective, such markets should be designed to:

- Ensure environmental integrity - which will require a close look at the basis for issuing allowances and qualifying offset investment through measuring, reporting and verification (MRV) requirements;
- Encourage research and entrepreneurship in the business community;
- Provide a clear market signal that will affect the behaviour of consumers and business leading to decisions and actions that mitigate greenhouse gas emissions;
- Ensure that private finance can participate;
- Ensure compatibility with existing and evolving national policies and measures;
- Ensure that policies are consistent with strong protection for intellectual property rights to encourage innovation and deployment of advanced technologies;
- Ensure good market functioning and regulation

V. EXPERIENCE WITH EXISTING MECHANISMS

The Kyoto Protocol created three market-based instruments: the Clean Development Mechanism (CDM), Joint Implementation (JI) and Emission Trading.

The Clean Development Mechanism

The CDM has resulted in clean investments that contribute to sustainable development in host countries and has helped to meet compliance in nations with emissions obligations, but has been hampered by design and operational problems. While it has achieved more than many have expected, it has not, and, under current practice, cannot deliver enough to meet the challenge and make a material difference. In the view of ICC, CDM has been overly cautious in limiting the scope of technologies and projects eligible for consideration, and it requires reform to eliminate high transaction costs and overly bureaucratic, non-transparent decision making.

While CDM has delivered benefits, it has been unable to affect fundamental changes in the energy portfolio, especially because of its project by project approval process and limited scope for eligibility. Moreover, in practice, decision making in CDM has become heavily politicized and now essentially paralyzed. The outcome has been a complex and sometimes inflexible mechanism that has reached its limit.

Market Mechanisms in the post-2012 GHG Regime: Role and Shape of Future Greenhouse Gas and Carbon Markets

Some of the well known issues around the CDM include, but are not limited to:

- Governance issues – more clarity of the governance system to avoid conflicts of interest, and an allowance of appeal to the COP. Operating as an executive organization and delegating rather than managing decisions and project reviews.
- Board capacity – professionalizing the Executive Board (EB) to enable it to act as a global regulator with appropriate expertise within its membership.
- Staff capacity – Further scaling up the UNFCCC staff assigned to serve as Secretariat for the CDM EB to meet the required demand with the necessary expertise.
- Lack of transparency and communication - Establishment of protocols and procedures for transparent and predictable operation. For example, on-the-record interaction with project proponents and stakeholders in general, both at the project level as well as in policy matters.
- Additionality – Ensuring that proof of additionality, the fundamental concept any offset mechanism should possess, is predictable for project proponents.

To become more effective in the post 2012 period the CDM should be significantly improved. A number of steps are proposed in the current UNFCCC negotiating text under the Kyoto Protocol, which details a number of the issues that can be fixed. However, these cannot fundamentally improve the mechanism moving beyond certain inherent limitations outlined above.

Joint Implementation

At the same time, JI, the other project-based mechanism with significant potential, has been very slow to start. In addition to a late start, this has been essentially the result of many of the projects no longer qualifying due to potential host countries joining the European Union (EU) and becoming part of the EU Emissions Trading Scheme (ETS), but also due to politicization of the approval procedures in many of the eligible countries. Generically, this illustrates the need for mechanisms to be able to evolve to account for the evolution of national and regional circumstances.

International Emissions Trading

The third instrument, international emissions trading under Article 17, has only recently commenced, with a growing number of transactions. Green Investment Schemes have become an option for transactions involving Assigned Amount Units (AAUs). However, its future under the current architecture is unclear given the enormous AAU surplus that may be carried forward from the 2008-2012 period.

Emissions trading has also emerged as an instrument at a regional level. Domestic emission trading schemes will continue to be implemented as appropriate by different jurisdictions that wish to avail themselves of it. And they will certainly seek to learn from the experiences with emissions trading to date in the European Union and other jurisdictions.

VI. CONTINUITY OF EXISTING MECHANISMS

One critical issue that can and should urgently be addressed at the UNFCCC 16th session of the Conference for the Parties in Cancun is the matter of the continuity of current Kyoto market mechanisms referenced above.

Recent discussions in the UNFCCC framework, based on legal opinions by the UNFCCC Secretariat, point out that different interpretations exist as to the continuity of these mechanisms in the absence of post 2012 caps. It is becoming clear that this is a matter of political will and interpretation. It will require a COP decision that can clearly assure the continuity of the Kyoto mechanisms in the absence of caps for Annex 1 countries post 2012. CDM should continue to issue Certified Emissions

Market Mechanisms in the post-2012 GHG Regime: Role and Shape of Future Greenhouse Gas and Carbon Markets

Reductions (CERs)² for use by those schemes at the national level that may decide to use them. Emission reduction unit (ERUs)³ can continue to be issued using available AAUs issued for the first commitment period.

A second COP decision should ensure that all agreements at the international level be honored and that no further filters be imposed by Parties in accepting all units issued from internationally sanctioned market mechanisms, such as CDM and JI. Such approaches destroy trust between signatories of any international agreement and significantly reduce the efficiency of the market.

VII. MECHANISMS FOR THE POST-2012 PERIOD

For greenhouse gas (GHG) markets to play an important, relevant and material role in the post-2012 regime, they should:

- build on the experience of the existing market mechanisms;
- be designed to deliver to the level of ambition of post-2012 objectives;
- be efficient and effective;
- provide incentives for the private sector to participate and ensure that they are an effective tool for markets to influence both business-to-business and business-to-consumer transactions;
- provide a clear price signal for investment in low GHG technologies;
- provide flexibility of use for different national circumstances and preferences— they cannot be one size fits all.

VIII. POTENTIAL NEW MECHANISMS

New market mechanisms for emissions mitigation could include specific sectors, such as REDD⁴+, market mechanisms to address emissions from international marine and aviation activities, as well as sectoral crediting, sectoral trading, nationally appropriate mitigation actions (NAMAs) and other innovative ones. These new mechanisms must be sanctioned by international agreement and produce units that are fungible with all other GHG market units on the market. For purposes of this paper, ICC will focus primarily on sectoral crediting and trading, proposals currently being discussed in the UNFCCC post-2012 negotiations.

Sectoral Crediting and Trading

ICC considers that economy-wide approaches offer the best opportunity to minimize societal costs of GHG controls. However, sectoral crediting and trading represent a step in the right direction from a project-by-project approach towards an economy-wide one. Sectoral crediting and trading are market mechanisms which must be seen as intermediary steps for a move by developing countries, in the future, toward more inclusive, economy-wide programs. They are intended to, and will help address, issues related to the project by project offset system under the CDM. However, they are neither able, nor intended, to address issues of competition.

In considering options for sectoral crediting and trading, it is important to recognize that firms in sectors compete with one another at the national and global levels. As such, they must be designed to complement and work with existing competition laws. Another issue that needs to be considered in judging whether these mechanisms will be effective and provide the right incentives, is whether these approaches will be able to provide transparent incentives for individual firms to improve their

² **Certified Emission Reductions (CERs)** are a type of emissions unit (or carbon credits) issued by the Clean Development Mechanism (CDM) Executive Board for emission reductions achieved by CDM projects and verified by a DOE under the rules of the Kyoto Protocol.

³ The **Emission reduction unit (ERU)** is a trading unit under the Kyoto Protocol representing a reduction of greenhouse gases under the Joint Implementation mechanism, where it represents one tonne of CO₂ equivalent reduced.

⁴ **Reducing Emissions from Deforestation and Forest Degradation in Developing Countries (REDD)**

Market Mechanisms in the post-2012 GHG Regime: Role and Shape of Future Greenhouse Gas and Carbon Markets

performance and for all firms to participate efficiently and effectively in sectoral trading.

Energy intense sectors appear to offer the greatest potential for mitigation as they tend to produce goods and services that compete in international markets. Consequently, the implementation of sector crediting or trading in one nation may affect the economic competitiveness of firms in other nations. For these sectors, in the short term, it is unlikely that sectoral crediting or trading approaches will meet some countries' expectations to significantly "level the playing field". Therefore, further discussions and negotiations will be necessary, but some basic conditions and design considerations that these mechanisms would have to meet can be defined.

Basic Conditions

- assure environmental integrity of outcomes and actions resulting in issuance of tradable credits or allowances—this will require reliable procedures to design objectives as well as to measure, report and verify actions;
- provide equitable procedures and incentives to assure access for all firms, foreign or domestic, that wish to participate in eligible activities;
- ensure that their design moves us closer towards economy wide approaches;
- ensure that they are linkable and their units fungible;
- seek to work effectively with CDM and other national approaches to prevent double counting of obligations or benefits and to assure a smooth transition and mechanism evolve;
- require comparable economic effort among all sectors and nations that participate—agreements must avoid the creation of hot air or favourable advantage for particular nations or firms;
- ensure that the timing for making them operational is taken into account especially in relationship with the transition from existing mechanisms;
- provides incentives for investments by individual firms within sectors;
- establish sound compliance procedures for participating nations and businesses to assure the integrity of domestic and international greenhouse and carbon markets.

Design Considerations

- Sectoral mechanisms should be flexible to account for differing national circumstances and priorities;
- In discussing and developing sectoral approach policy and partnership options, key considerations include:
 - Economy-wide implications, through supply and value chain sectoral linkages;
 - Implications for imports and exports, trade and investment;
 - National circumstances and priorities in any international approach;
 - Inclusive, and avoid competitiveness distortions in setting objectives, and giving guidance on implementation.
- Economy-wide and trade implications should be assessed taking account of supply and value chain linkages:
 - Sectors often draw on the same pool of limited resources;
 - Changes in a sector may inhibit or enable change in other sectors.

Procedures to qualify any sectoral mechanisms should be rigorous, uniform, transparent and efficient. A number of critical issues concerning environmental and economic integrity, equity, inclusiveness and competitiveness must be resolved. Timing alone will pose challenges, because potentially hundreds of sectoral agreements would have to be initiated to include even a handful of sectors in the many nations that may wish to participate. Expectations should be realistic in terms of what sectoral mechanisms can deliver and over what time-frame as part of a post-2012 agreement.

IX. CONCLUSIONS

For ICC, international market mechanisms are one option from a menu of options that can be used. They are necessary but not sufficient for success. The use of the existing and new mechanisms will also represent a menu in itself and will depend on national circumstances, such as the level of

**Market Mechanisms in the post-2012 GHG Regime:
Role and Shape of Future Greenhouse Gas and Carbon Markets**

capacity for implementation, country preference, economic sector and technology, and fit with domestic policies.

In principle, ICC supports an agreement that makes available to all Parties, but does not impose, the opportunity to utilize a variety of international market mechanisms. For example, these might include: “classic CDM”, programmatic CDM, sectoral CDM, REDD+, sectoral crediting, sectoral trading, and potentially national and regional cap-and-trade. Mechanisms that will be appropriate and effective for each region or nation will become established and used, whilst others will remain unused and fade away.

The International Chamber of Commerce (ICC)

ICC is the world business organization, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world.

The fundamental mission of ICC is to promote trade and investment across frontiers and help business corporations meet the challenges and opportunities of globalization. Its conviction that trade is a powerful force for peace and prosperity dates from the organization's origins early in the last century. The small group of far-sighted business leaders who founded ICC called themselves "the merchants of peace".

ICC has three main activities: rules-setting, dispute resolution and policy. Because its member companies and associations are themselves engaged in international business, ICC has unrivalled authority in making rules that govern the conduct of business across borders. Although these rules are voluntary, they are observed in countless thousands of transactions every day and have become part of the fabric of international trade.

ICC also provides essential services, foremost among them the ICC International Court of Arbitration, the world's leading arbitral institution. Another service is the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice.

Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on vital technical and sectoral subjects. These include financial services, information technologies, telecommunications, marketing ethics, the environment, transportation, competition law and intellectual property, among others.

ICC enjoys a close working relationship with the United Nations and other intergovernmental organizations, including the World Trade Organization, the G20 and the G8.

ICC was founded in 1919. Today it groups hundreds of thousands of member companies and associations from over 120 countries. National committees work with their members to address the concerns of business in their countries and convey to their governments the business views formulated by ICC.



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Policy and Business Practices

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