BUSINESSEUROPE

POSITION PAPER

21 February 2011

MARKET MECHANISMS IN A POST-2012 UNFCCC AGREEMENT

1. Introduction

COP 16 in Cancun decided to consider the establishment, at its seventeenth session in Durban, of one or more market mechanisms to enhance the cost effectiveness of the greenhouse gas (GHG) reductions. Climate change is a global problem that requires global coordinated action, a truly international carbon market can make a significant contribution. A level playing field for business is key in order not to create competitive distortions and has to be the overarching goal when creating market mechanisms in a post 2012 UNFCCC agreement.

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

New market-based approaches that build on and go beyond the project-by-project approach of the existing Kyoto Protocol flexibility mechanisms could enable further technical and financial business engagement. However, to obtain such engagement and to encourage investment, regulators must work in partnership with the business community including the financial sector to ensure that any new market approaches are robust and predictable, but at the same time flexible.

2. Key role for market-based approaches

BUSINESSEUROPE believes that global market-based approaches if designed properly will have a key role in addressing climate change. Critical components that will enable a response to climate change will first of all have to include technology evolution, including deployment of existing efficient and low emitting technologies and practices and a revolution thereof in the longer term by creating and deploying innovative, currently non-commercial technologies on a global scale. Stabilizing atmospheric GHG concentrations at the ambitious levels under consideration will require acceleration of technological advancement and diffusion. Given the size of the climate challenge, achieving such an ambitious objective will require an efficient means of allocating resources, for which cost-effective use of capital is critical.

Market-based approaches to address climate change and promote movement towards energy generation and use with higher efficiency and lower GHG emissions may take a number of forms depending on national circumstances as well as the sector of economic activity to be addressed. In general, BUSINESSEUROPE advocates the use

AV. DE CORTENBERGH 168
BE-1000 BRUSSELS
BELGIUM
VAT BE 863 418 279

BUSINESSEUROPE a.i.s.b.l

TEL +32(0)2 237 65 11
FAX +32(0)2 231 14 45
E-MAIL: MAIN@BUSINESSEUROPE.EU
WWW.BUSINESSEUROPE.EU

of comprehensive approaches with a view to achieve an economy wide approach rather than project-based approaches because they have the potential to offer the lowest cost to achieve a given objective. In this context, GHG markets will be important tools.

3. Greenhouse gas and carbon markets

GHG markets are – at least in theory – the optimal way to ensure that a given ambition level is achieved at the lowest societal cost, which must be seen as the main objective of such markets. They can also play an important role in creating signals and actions to stimulate technology development and deployment. From BUSINESSEUROPE's perspective, such markets should be designed to:

- Provide an effective tool to achieve a given ambition level in a cost-effective manner;
- Be based on technology neutrality and allow the market to choose specific technology;
- 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;
- Ensure that the private sector financing can be mobilized;
- Ensure compatibility with existing and evolving national policies and measures;
- Ensure good market functioning and regulation;
- Prevent carbon leakage and loss of wealth and employment resulting from cost burden.

While the overall objective of GHG markets is to minimize societal costs to achieve a given target, a value for carbon can also have a positive impact on research and entrepreneurship in the business community and provide a clear signal that will affect the behaviour of consumers and business; leading to decisions and actions that contribute to climate change mitigation.

4. Experience with the Clean Development Mechanism (CDM)

While reform of CDM is necessary to ensure workability and environmental integrity, and to prevent distortion of global competition, their future use in the EU ETS should nonetheless be stimulated and facilitated. The CDM has resulted in emission reduction investments that contribute to sustainable development in host countries and has helped to meet compliance in nations with emissions obligations in a cost-effective way, but has been hampered by design and operational problems. BUSINESSEUROPE has previously noted that the CDM must become more flexible, for example in the scope of technologies and projects eligible for consideration, and requires reform to eliminate high transaction costs and overly bureaucratic, non-transparent decision making. It is vital that these improvements continue and that the CDM remains a major tool in the future.

While CDM has delivered benefits, its project-by-project approval process and limited scope for eligibility has meant that it has had little impact on reducing overall carbon emissions within developing countries or their energy intensive sectors. Moreover, in practice, government involvement in the CDM Executive Board has resulted in a very political decision making process. The outcome has been a complex and sometimes inflexible mechanism that will not meet the requirements for future substantial emission reductions.

5. New market-based comprehensive approaches

BUSINESSEUROPE considers that global economy-wide approaches ultimately would offer the best opportunity to minimize societal costs of GHG controls. Moving from a project-by-project approach through a more comprehensive approach that could include economic sectors towards an global economy-wide approach could have economic and environmental benefits. Furthermore, it will help address issues related to the project-by-project offset system under the CDM. More comprehensive approaches could provide reduction credits ex-post, calculated as the difference between a crediting baseline and the actual emissions rather than the additionality with respect to the business-as-usual, as in CDM. Clearly, any such approaches must have a sufficient level of coverage, a critical mass of participants if individual sectors, appropriate MRV and enforcement.

For new market based mechanisms for emissions mitigation to be effective they could, for example, potentially include specific sectors currently not covered by the Kyoto Protocol, such as forestry (through REDD[1]+), international marine transport and aviation, or based around specific technology dissemination/deployment. They should build on and not "re-invent" the existing flexible mechanisms. It is essential that global carbon markets are consolidated and that visibility and reliability are generated for investors and companies under compliance obligations. Timelines for the development and operation of more comprehensive market approaches must be developed, in particular, how they interface with the current mechanisms, regional trading schemes and the National Appropriate Mitigation Actions (NAMAs) (and any associated crediting mechanisms) undertaken by developing countries.

Any new market approaches must be sanctioned by international agreement and produce units that are fungible with all other GHG units on the market.

In considering options for more comprehensive approaches that focus on specific sectors, it is important to recognize that firms in sectors compete with one another at the national, regional and global levels. As such, they must be designed to complement and work with existing competition laws and must not provide competitive advantages that encourage carbon leakage. The EU ETS measure against carbon leakage is an example of inclusion of hereof. It must also be considered whether or not this mechanism will be effective and provide the right incentives for individual firms to

[1] **Reducing Emissions from Deforestation and Forest Degradation in Developing Countries** (REDD)

improve their performance and for all companies to participate efficiently and effectively. Actions such as basing crediting on convergence on the same best practice emissions intensity per unit production must therefore be considered, taking into account local circumstances (e.g. location, inputs, energy sources, local technology base etc.). THE CDM has started to move in this direction with discussion of standardized baselines.

Further discussions and negotiations will be necessary, but some basic conditions and design considerations that a sector approach would have to meet can be defined already at this stage.

Basic conditions:

Future mechanisms must:

- Provide incentives for investments by individual firms within sectors;
- 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 ensure access for all firms, foreign or domestic, that wish to participate in eligible activities;
- Ensure that their design moves towards economy wide approaches;
- Ensure that they are linkable and their units fungible;
- Seek to work effectively with CDM and other 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;
- Prevent carbon leakage through appropriate transition measures;
- Ensure that the timing for making them operational is taken into account especially in relationship with the transition from existing mechanisms;
- Establish sound compliance procedures for participating nations and businesses to assure the integrity of domestic and international greenhouse and carbon markets.

Design considerations:

- Comprehensive approaches should be flexible to account for differing national circumstances and priorities;
- In discussing and developing sector approach policy and partnership options, key considerations include:
    - Economy-wide implications, through supply and value chain sector linkages;
    - Implications for imports and exports, trade and investment;
    - National circumstances and priorities in any international approach;
    - How to achieve an inclusive approach avoiding 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 one sector may inhibit or enable change in other sectors.

Procedures to qualify any comprehensive approach 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 agreements would have to be initiated. Given the diversity of national economies, industrial structures, and energy situations, a new international framework must be flexible enough to allow for diversified domestic policy measures to address climate change, so that each country can pursue and learn from different strategies. Expectations should be realistic in terms of what comprehensive approaches can deliver and over what timeframe as part of a post-2012 agreement.

It is essential that Governments that wish to pursue carbon markets as a mitigation option should consider establishing direct and indirect linkages among different markets as a way to reduce the overall costs of abatement, which would build more liquidity and enhance price signals for low-carbon investments.

Finally: in order to ensure the success of future mechanisms, the parties to the Convention must commit to accept the approach agreed in the UNFCCC framework when accommodating international offsets for compliance purposes in their national or regional schemes to (e.g. within GHG trading schemes) without introducing restrictions on a unilateral basis. Also the UNFCCC could serve as a good and constructive platform to evaluate on best practices in the various regional and national market mechanisms that have or will emerge in the years to come. Building on best practical practises will be key for business to engage in these markets and thus to achieve the needed investment momentum.

* * *