DOE/AIE COORDINATION FORUM

SUBMISSION FROM THE DOE/AIE COORDINATION FORUM TO THE CDM EXECUTIVE BOARD TO THE CALL FOR PUBLIC INPUTS CONCERNING THE 'DRAFT PROCEDURE REGARDING THE CORRECTION OF SIGNIFICANT DEFICIENCIES AND THE EXCESS ISSUANCE OF CERS'

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Chair, DOE/AIE Coordination Forum
8th October 2010

Mr Clifford Mahlung
Chair, CDM Executive Board

Dear Chair, Vice-Chair and Honourable Members of the CDM Executive Board,

The DOE/AIE coordination forum would like to thank the Board for the opportunity to comment publicly on the '*Draft procedure regarding the correction of significant deficiencies and the excess issuance of CERs*' and decision 3/CMP.1, annex, paragraphs 22 and 24; and decision 3/CMP.1, annex, appendix D, paragraph 8, and would like to provide the following inputs, organised according to the questions raised by the Board.

(a) Whether the draft procedure complies with the decisions of the CMP. If stakeholders consider that the provisions of the procedure do not comply with decisions of the CMP, a detailed explanation should be provided;

(i) The scope and degree of liability in the procedures goes beyond the provisions of the CMP decisions

- Paragraph 22 of FCCC/KP/CMP/2005/8 is short and non-specific and there have not so far been any cases (to our knowledge) where this paragraph has been applied. The common understanding by DOEs is that existing rules require the identification of negligence on the part of DOEs, rather than holding DOEs liable for situations that they could not have reasonably done anything about.
- The draft procedure introduces the term "strict liability" as basis for liability, which goes above and beyond the wording of the CMP decisions and is not in compliance with common interpretations of the liability concept. Strict liability implies liability regardless of the culpability of the entity, and implies that even if the entity acted in good faith and took all reasonable precautions, it remains liable anyway. Strict liability is appropriately applied in situations such as product liability, where a manufacturer or producer of a product is held responsible for serious harm to individuals that the product has caused, regardless of whether the manufacturer acted negligently. It is not normally applied to auditors or quality assurers, since the ultimate responsibility for the product lies with the producers, and it is not normally applied in situations where the product does not have a direct and serious harm upon an individual or group of individuals. In essence this provides for a scale and extent of liability that is impossible for auditing entities to manage.

- The use of the wording 'regardless of the intent or degree of negligence' also introduces a new concept that is not mentioned in the CMP decisions and fails to incorporate the concept of fault, for example if the over-issuance of CERs was the result of
    - the DOE having been provided false information by project participants or from recognised third party sources such as national authorities,
    - facts that are known today which were not known and could not be reasonably known to the DOE at the time of validation,
    - deficiencies with the applicable methodologies or tools, or if standards or interpretations/clarifications of rules have changed since the validation, verification or certification was completed.
- Given that validation, verification and certification is based on the application of professional judgement, it is inappropriate to impose responsibility for excess issuances based on strict liability 'regardless of its intent or its degree of negligence'. Rather liability should be assessed based on principle of negligence i.e. wilful neglect or misconduct. Liability should also not be assigned on the basis of the current interpretation within the CDM system of 'incompetence', since the term is interpreted very broadly by the Board, with for example more than 50% of projects regularly being subject to a request for review on the grounds of 'incompetence'. Given that the modus operandi of the CDM has been 'learning by doing' and that rules and requirements have been subject to varying interpretation over time, it would not be fair to impose liability on the grounds of the current interpretation within the mechanism of 'incompetence'. 'Negligence' implies wilful and gross incompetence. Therefore in order to prove negligence there must be wilful neglect or misconduct on the part of the entity.

(ii) The procedures introduce new definitions of 'deficiency' and 'significant deficiency' that do not fit with the standard dictionary-based definition of the term 'significant' and go above and beyond the understanding created by the CMP decisions

- The definition under the draft procedure of "significant deficiencies" has been defined very broadly as effectively *any* deficiency in a validation or verification report, and does not take into account the seriousness and impact of the deficiency, or whether the DOE was actually negligent. The term "significant" should indicate, from a linguistic perspective, something more than just any deficiency. The term 'deficiency' is also too loosely worded and this could lead to inconsistent application. Terms that are not properly and narrowly defined create subjectivities and differences of interpretation that result in non-equitable, inconsistent application of the procedures.

(iii) Retroactivity

- Because the draft procedure significantly builds and expands upon requirements that have previously only been sketched out in broad terms, and more importantly because it

goes beyond the provisions of the CDM M&Ps themselves, the application of this procedure to past validations or verifications would not be appropriate nor fair.

- It is the DOE Forum's view that the draft procedure is not simply a clarification of a previous CDM requirement but is a new procedure developed in response to a CMP decision (even though the CMP decision was made several years previously). It is noted that the CMP decision FCCC/KP/CMP/2008/11/ Add.1 para 14 requested the CDM Executive Board to adhere to the principle that any decision, guidance, tool and rule should not be applied retroactively, and therefore application of this procedure to validations or verification activities competed before the procedure was published does not appear to be in compliance with this rule. Furthermore, on a practical level, it will be very difficult if not impossible for DOEs to ensure that their liability insurance providers cover old validations or verifications that have already been completed, against the new liability rules. The insurers only undertook to provide insurance coverage against the rules (CMP text on liability) that existed at the time.

(b) Specific suggested revisions to the decisions of the CMP. In particular, the provisions for identifying and correcting significant deficiencies contained in validation, verification and certification reports;

(i) Clarifying and restricting DOE Liability to situations of negligence

- DOEs should not be held liable for excess CER issuance unless they are guilty of negligence i.e. wilful neglect or misconduct. The concept of negligence would imply that the DOE would have to be guilty of either not having the required competence to carry out the work that it undertook (according to the requirements in place at the time) or of not exercising due care in carrying out its activities. In order for DOEs to be held liable the excess issuance must be reasonably foreseeable by the DOE, it must be the result of the DOEs actions or neglect, and it must be fair, just and reasonable to impose liability upon the DOE. The DOE cannot reasonably be liable for excess CERs if this was the result of the DOE being provided false information by PPs or from recognised third party sources such as national authorities, if the facts that are known today were not known and could not reasonably have been known at the time of validation, if there were deficiencies with the applicable methodologies or tools, or if standards or interpretations of rules have changed since the validation, verification or certification was completed. This should be addressed specifically in the CMP decisions.

(ii) Imposing a limitation on liability

- The DOE Forum proposes that a limitation on the maximum amount of liability faced by DOEs should be imposed, linked to a requirement that all entities be required to source insurance cover up to this limit – please see point (d) (vii) below.

- Furthermore, entities believe a time limit on this liability should also be imposed. The framework of the CDM business is constantly developing and changing. A review of projects carried out at a much earlier stage will inadvertently be influenced by the understanding and new interpretations brought about by subsequent experience. Therefore a limitation should be introduced on the period of time in which DOEs are held liable for past validation and verification activities. Without a time limitation on liability it becomes very difficult to manage and insure against the liability and also undermines the ability of the CDM mechanism to recoup excess issued CERs, since entities may no longer be accredited, staff and management structures at entities may have changed, or the DOE entities might have gone out of business.
- The DOE Forum proposes that, since the conformance of the project description in the registered PDD is reviewed by the verifying DOE at the first verification, liability for validation reports should expire after the first issuance has been successfully completed, and that liability for verification reports should expire after three subsequent issuance requests have been successfully completed.
- Furthermore, the criteria by which the DOE's validation or verification/certification reports are assessed should be those available at the time of the original validation/verification/certification. Clarifications issued after the validation/verification/certification took place must not be used to prove non-compliance with a CDM rule.

(iii) Institution of an appeals process

- To ensure due process there needs to be an appeal mechanism. It is important that any private organisation facing this level of liability and penalty should have the right of appeal to an independent body. This is not currently provided for within the framework of the CMP decisions or CDM rules adopted by the EB, although the Board is currently developing procedures for this, and appeals by DOEs against decisions relating to liability must be included within the scope of the appeals procedures. This is a fundamental right and secures the parties' access to justice. Such a mechanism should be introduced in the relevant UNFCCC procedures.

(iv) Costs of the process

- The costs of reviewing (i.e. re-validating or re-verifying) a large number of projects will be very expensive. Under the draft procedure, the DOE would be liable for the full costs of the review even if it was not found to be liable for any excess issuance. If the DOE being reviewed is found not to have acted negligently, it should not have to suffer such large financial penalties in this way. This should be clarified in the CMP decisions.

(v) Use of a second DOE – Conflict of Interest

- The CDM Modalities and Procedures provide for review of selected validation, verification or certification reports by a second DOE. However in the context of DOEs competing against one another in a market environment it is difficult to see how any DOE would not have a conflict of interest, given that they would effectively have significant influence over the accreditation, the ability to operate, and even the financial viability of a competitor entity. Maintenance of impartiality, and the perception of impartiality by all parties, is vital. Furthermore, review of the selected validation / verification / certification activities by a second DOE would necessitate review of DOEs' internal and proprietary tools and templates that represent commercially sensitive intellectual property that must not be released to competitors or misappropriated, and would allow the second DOE, with whom the PP does not have a contract, to review confidential information from the PP.
- However the DOE Forum also recognises that the only bodies that have the experience of CDM validation/verification needed to carry out the reviews are, by definition DOEs, or individuals working for DOEs. Therefore the DOE Forum proposes that instead of a second DOE, a panel of experts should be appointed consisting of competent individuals from different DOEs, plus representatives of the UNFCCC and/or RIT and, if it is considered necessary, other external organisations. The panel would be appointed by the UNFCCC independently and the DOE under review would have the right to object to the appointment of any of the panel members (on the grounds of conflict of interest, lack of competence, or other valid reasons). Each member of the panel should have to complete a conflict of interest declaration and the procedures should stipulate how potential conflict of interest is avoided and/or mitigated (such procedures should be in line with the accreditation standard requirements for DOEs). This proposal would also address serious concerns over the impact of the draft procedure on already constrained resources.
- There are severe capacity constraints upon DOEs currently, and this will severely limit the availability of a second DOE to undertake the reviews. A further concern is that if a second DOE is found that is competent to undertake the review, the process is so extensive that this will divert resources away from the validation and verification of new projects.

(vi) Definition of terms

- Either the CMP decisions, or the procedure itself, should clearly define terms such as 'deficiency' and 'significant deficiency' and these definitions should be based on a commonly acceptable definition of the term 'significant' i.e. conveying the magnitude, extent, duration, and frequency of the deficiency, and its impact.
- The definition of 'significant' should be linked to a de-minimis threshold which could be similar to the materiality approach defined in the recent draft '*Standard on the use of the concept of materiality and level of assurance in the Clean Development Mechanism*'. If the scale of the potential deficiency is not defined a situation could arise where the costs of

the review process for small deficiencies could supersede the market value of over issued CERs by several times.

(c) Market implications if the draft procedure was adopted. In particular, any increased costs of conducting validations and verifications, including an explanation for the opinion;

(i) Perverse incentives

- The procedure does not recognise the common and shared responsibility of all parties, including the PPs and UNFCCC/EB, and in particular does not address situations where the PP has provided false or misleading information. The draft procedure, and the CMP decisions, in effect provide a strong perverse incentive for project participants to engage in 'gaming' of the system or to provide misleading or fraudulent information in order to enable a project to pass validation or verification, since they bear no liability or responsibility, their issued credits will not be affected, and the DOE will bear 100% of the liability and financial costs. This is a fundamental threat to the environmental integrity of the mechanism.

(ii) Ability to manage and insure against the liability

- The scale and degree of liability stipulated in the draft procedure is very difficult for DOEs to manage. Given that under the procedures DOEs would be 'strictly liable' 'regardless of intent or degree of negligence', they would be liable even in cases where they performed properly and there was nothing they could reasonably have done, at the time, to prevent the excess issuance. This means that even if DOEs took all reasonable steps and followed all the correct and adequate procedures, they could still be held liable. For insurers, this type of open-ended liability is extremely concerning and there is in effect no way that the risk can be mitigated by the DOE. This means it will be very difficult for DOEs to source insurance coverage, and this would probably have to be sourced on a project-by-project basis, if at all. This would mean that complex or 'risky' projects, or PPs with a higher perceived risk rating, would probably be avoided.
- Furthermore, it will be very difficult if not impossible for DOEs to get their liability insurance providers to cover old projects against the new rules. The insurers only undertook to provide insurance coverage against the rules (CMP decisions) that existed at the time.
- It is essential for DOEs to insure against liabilities otherwise they cannot operate responsibly, cannot meet their liability obligations financially, and cannot provide assurances to their company management that they are not exposing the wider firm to large financial losses or bankruptcy. The costs of insurance, if it was available, would necessarily increase since current insurance arrangements are based on the understanding that negligence would be proven before the DOE can be held liable. These costs would have to be passed on to the PPs and the cost of validations and verifications

would consequently rise, presenting further barriers to entry to the CDM market for project participants.

- Exacerbating the financial risks is the fact that it is unclear from the draft procedures whether the review process will be conducted in closed or open sessions. The spot market value of issued CERs is likely to rise once it is known that a large DOE is being reviewed, based on the expectation of constrained supply and the need for the DOE to buy large volumes, thus placing an even greater financial burden on the entity.

(iii) Transaction Costs

- The draft procedure, as it currently stands, would impose huge transaction costs (costs for the re-validation or re-verification of a large number of projects) upon DOEs, for which they would be responsible even if they were not found liable for any actual over-issuance. These costs alone could put entities out of business or lead to them withdrawing from the market. Imposition of costs when no fault is apportioned is not equitable and is not in conformance with legal norms around the world. Fees should only be imposed where the DOE is found to be negligent, and should be set at reasonable levels and capped, at a level to be determined by the Board based on a thorough analysis of the size of DOE fee levels related to CDM work, to prevent adverse market impacts.

(iv) Resource implications and market participation

- The CDM validation and verification business is, for most entities, a small part of a much larger overall business, albeit a very dynamic and interesting new area that all entities wholeheartedly support. Nevertheless, DOEs are private entities that must maintain their balance sheets and justify their business models to their company management, including the balance of risk and reward. The fee margins and financial rewards of the DOE business are nowhere near the scale to match the degree and scale of liabilities being imposed by this draft procedure and it is consequently inevitable that entities will have to reassess their participation in the market. The imposition of the proposed strict liability requirements would lead to a reduction in the number of entities willing to operate in the market and to remaining entities being much more restrictive about the type of projects and clients they wish to work with. This would not be conducive to promoting CDM projects in LDCs or working with developing country counterparties in general, which is what the CDM is designed to do. This would also be highly damaging given the already existing capacity constraints in the CDM system which may well reach crisis proportions as 2012 approaches.
- Furthermore, the DOE Forum are concerned that the use of a second DOE to undertake reviews will divert resources away from the validation and verification of new projects, in an already severely capacity constrained market.

(d) Specific suggested revisions to the decisions of the CMP and the draft procedure that would lessen the market impact, while upholding the general principle that excess-issued CERs should be replaced;

(i) Remove the concept of 'strict liability' and the wording 'regardless and intent or degree of negligence' from the procedures, specifically paragraph 4, and replace with wording that recognises that DOEs should be held liable only where they are guilty of negligence, which is defined as wilful neglect or misconduct. For more detail, please see paragraph (i) of section (b) above.

(ii) Do not hold DOEs liable if the over-issuance of CERs was not the fault of the DOE, i.e. was the result of:

- the DOE being provided false information by project participants or from recognised third party sources such as national authorities;
- facts that are known today which were not known and could not be reasonably known at the time of validation;
- were deficiencies with the applicable methodologies or tools; or
- standards or interpretations of rules having changed since the validation, verification or certification was completed.

These clauses should be added to the CMP text, and reflected in the procedures.

(iii) Define terms, especially 'significant deficiencies', in a way that recognises the scale and impact of the deficiencies and adopts a materiality threshold.

- The definition of the term 'significant' should convey the magnitude, extent, duration, and frequency of the deficiency, and its impact. The definition of 'significant' should be linked to a de-minimis threshold in the CMP text which should be based on the threshold proposed in the draft '*Standard on the use of the concept of materiality and level of assurance in the Clean Development Mechanism*'.
- DOEs must not be held liable unless they have acted negligently. Therefore the definition of the term 'deficiency' with regard to a validation, verification, or certification report must be linked to negligence and should include a stipulation that the DOE acted negligently in producing that report.
- Various other terms in the procedures need to be more clearly defined. For example, 'incorrectly applying a CDM rule or requirement' is unclear in that CDM rules or requirements are not defined properly – these should not include guidelines (which are by definition simply guidance) or 'information notes' if the DOE demonstrated another approach that was appropriate or conservative. In the case of ambiguous or vague rules that are open to interpretation, or where two rules conflict with eachother, the report should not be considered deficient if the DOE came to a reasonable interpretation of those rules based on the information available to it at the time.

(iv) The costs of the process itself should not be passed on to the DOE unless they have acted negligently

- DOEs should not be held liable for the costs of going through the procedure unless they are guilty of negligence, i.e., wilful neglect or misconduct. The costs of the process should be capped at a reasonable level to be determined based on expert input.

(v) Impose a time threshold on DOE liability as stated above

- A statute of limitations should be imposed in the CMP text on the liability of DOEs, considering the fact that facts and evidence will inevitably become obscured over time. As stated in section (b) above, the DOE Forum proposes that, since the conformance of the project description in the registered PDD is reviewed by the verifying DOE at the first verification, liability for validation reports should expire after the first issuance has been successfully completed, and that liability for verification reports should expire after three subsequent issuance requests have been successfully completed.

(vi) Institute a reserve/insurance fund to cover excess CERs

- A fund should be established for cases where the DOE is not responsible and where this cannot be reclaimed from the project against future issuances, or for cases where the entity no longer exists or is unable to buy back the excess CERs e.g. due to bankruptcy. This fund should be administered by the UNFCCC and be funded by a levy on all issued CERs from all projects. If the reserve is never used to replace excess issued CERs, the CERs in the fund could for example be given back to the relevant PPs, sold and used to fund adaptation, or cancelled to reduce GHG emissions.

(vii) Require all entities to meet certain minimum requirements for financial viability and having insurance cover up to a certain amount

- All entities could be obliged to have insurance cover to be able to replace up to a certain percentage of the total credits validated or verified by the entity, provided a time limitation is introduced, ref (v) above. The total liability of each entity should be limited to this specific insurance cover or an equivalent amount. Then if excess issuance beyond the insurance cover was identified, the credits could still be replaced from the reserve fund. This would mean the procedures do not threaten the financial viability of the entities' parent companies, which could otherwise encourage them to withdraw from the market. A strong incentive for DOEs would still exist because such a scale of excess issuance would almost certainly lead to an automatic withdrawal of their accreditation and severe and lasting damage to their company's reputation.

(viii) Institute an appeals process

- An appeals process should be introduced to provide reassurance to entities that due process will be followed and they will have the ability to defend their validation and verification opinions. Such appeals should be made an independent body. This appeal process should enable the DOE to present evidence that it took all reasonable steps to minimise the risk of excess issuances, based on the information/data, understandings and applications in place at the time of validation, verification or certification. In addition, a DOE should be able to defend its report by showing *prima facie* evidence that a public participant provided false or misleading information.

(ix) Do not apply new or expanded requirements retroactively

- Given that the draft procedures go beyond the provisions of the CMP decisions, these should not be applied retroactively, i.e., to validations or verifications that took place before the procedures were adopted. Because the procedures are only being adopted now, applying the procedures to past validations and verifications would also act to severely punish early movers in the market, for example if they had validated a project in 2005 which led to excess issuance they would have to buy back 5 years of credits (or more if the crediting period start date began before the registration) compared to if another DOE made the same mistake in 2009, resulting in only 1 year of excess issuance. Hence the retroactive application of these procedures would not be fair or equitable, and would disproportionately punish early pioneering entities, who helped in no small part to getting the CDM off the ground.

(x) Appoint a panel of experts rather than a second DOE to review the validation and verification/certification report.

- The panel of experts would contain representatives of more than one DOE, plus UNFCCC/RIT/AT representatives and, if necessary, external experts. Conflict of interest provisions should be in place. This would prevent situations where a competitor, who has an inherent conflict of interest, has significant power over the accreditation of a competing entity, and would prevent proprietary, commercially sensitive or confidential information being misappropriated.

(e) Specific suggestions for what should be done in a situation where a project participant provides false or misleading information to a DOE, and that information led to the excess-issuance of CERs.

(i) Require a written undertaking from all PPs

- It is vital that PPs be held responsible if they have misled or defrauded the DOE, DNA or the UNFCCC, otherwise a perverse incentive exists to 'game' the system.

- The UNFCCC should require PPs to provide a signed statement affirming that all information provided to the DOE in the course of validation or verification is an accurate and true representation of the real situation.

(ii) Impose sanctions on PPs if they have misled or defrauded

- The UNFCCC should impose sanctions if there is prima facie evidence that the PP has defrauded or misled the DOE, DNA or UNFCCCC. The most severe sanction could be withdrawal of the registration/stopping all future issuances of the project, or (if the problem is not serious enough to threaten the eligibility of the project to be registered), having excess issuance paid down from future issuances of the same project.

(iii) Liability/responsibility must be imposed on PPs by the CMP/EB/UNFCCC, not by the DOEs

- It is very important to emphasise that liability should be imposed on PPs by the CMP and/or the EB, since it is not within the power of DOEs to impose this on PPs. This is for four main reasons: (1) validation and verification contracts, to date, have not been drafted based on the draft procedures for excess issuance (since they have only just been developed); (2) even if clauses were to be inserted passing on liability to PPs, such contracts may not be enforceable. The DOE forum believes that it would be very difficult if not impossible to enforce such contracts in the legal jurisdictions in many developing countries, legal costs would be prohibitive, and even if a DOE were to win a case it could take many years, including appeals, before a PP was forced to pay out (compared to the need for the DOE to replace credits with 30 days); (3) the project participants may not have the financial resources to pay out (they are likely to have already sold on the credits) and may declare themselves bankrupt; and (4) many projects have more than one project participant and may be difficult to apportion blame or liability properly. DOEs are auditing entities and it is not within their core competencies to pass on legal liabilities to their clients.

(iv) Establish a reserve or insurance fund

- In cases where PPs could not pay back excess credits, a fund as mentioned above could be used to uphold the general principle that excess-issued CERs should be replaced. This fund would act as a kind of insurance policy against over-issuance that was not resulting from DOE negligence.

Other comments

- The DOE Forum would suggest that the procedures recognise the fact that the involvement of the UNFCCC, RIT and EB in the registration of projects and issuance of

credits has changed markedly since the Marrakech Accords were adopted, and therefore procedures for liability for excess issued CERs should take this into account. For instance, if an issue has already been assessed as part of a request for review or review by the UNFCCC and EB, and the issue was accepted by the Board, DOEs should not be held liable for excess issuance resulting from the same issue, unless the DOE acted negligently in its work or in its responses and information provided to the Board. Again, the general principle should apply that the DOE should not be held liable unless it has acted negligently.

- In addition, we would like to emphasise that the CDM has, for the past few years since its inception, operated in a 'learning by doing' mode, and past validation and verification activities (and indeed past decisions by the EB to register or issue projects) should be seen in this light. The CDM has been characterised by a gradual increase in the body of rules and guidelines, and in the early stages it was characterised by a general lack of clarity of procedures and guidelines and by changing interpretations of rules and guidelines that did exist. The interests of environmental integrity are best served by making the mechanism robust and strong for the future and not in imposing such onerous liability requirements on DOEs that they leave the market altogether.

We hope the above concerns will be taken on board in the review of CMP decisions and the draft standard, and we look forward to providing further inputs if requested.

Yours sincerely,

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Chair, DOE/AIE Forum (CDM)

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