The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street N.W.
Washington, D.C. 20433
U.S.A.

(202) 473-1000
Cable Address: INTBAFRAD
Cable Address: INDEVAS

October 8, 2010

CDM Executive Board
c/o UNFCCC Secretariat
P.O. Box 260124
D-53153 Bonn
Germany

Subject: Call for public inputs - Procedures for correction of significant deficiencies and the excess issuance of CERs.

Honorable Members of the CDM Executive Board,

We welcome the opportunity to contribute to the "Procedures for correction of significant deficiencies and the excess issuance of CERs". We understand that the stated intent behind these procedures is to implement the requirements of the Marrakesh Accords[1] under decision 3/CMP.1 Para 22 and 24 and decision 3/CMP.1, appendix D, Para 8, which outline the procedures for addressing the excess issuance of CERs in situations of the suspension or withdrawal of a designated operational entity.

While we share the Executive Board's objective to make the applicable procedures as efficient as possible, we believe that the drafted procedures are not consistent with the Marrakesh Accords. In addition, we believe that, as drafted, the procedures are likely to significantly burden the process of implementing CDM projects, increase related transaction costs and invite legal challenges brought against the Board and Secretariat on the decisions pertaining to the correction of the excess issuance of CERs. In this letter, we outline our main areas of concern and make suggestions on how to possibly address such concerns.

1. Issues

Inconsistency with Marrakesh Accords

The draft procedures claim to be based paragraphs 22 and 24 of decision 3/CMP.1 of the Marrakesh Accords. In fact, paragraph 21 indicates there was no intention for a strict liability approach, stating as follows: "The executive board may recommend the suspension or withdrawal of designation only after the designated operational entity has had the possibility of a hearing." Citing paragraphs 22 and 24 as the Board has done appears to write out of existence paragraph 21 of decision 3/CMP.1 and there is no indication that this was the intent of the Parties to the Kyoto Protocol.

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[1] CMP decisions on Suspension or withdrawal of accreditation of DOE cover the aspects related to: the identification of significant deficiencies in validation or verification report; review of the significant deficiencies by a different appointed DOE; the correction of significant deficiencies; the EB to determine if any of the significant deficiencies resulted in excess issuance of CERS and the DOE to acquire and transfer the excess-issued CERs to a cancellation account of the CDM registry.

Application of "strict liability"

Under the draft procedures, the DOE associated with the validation and/or verification of a CDM project is held strictly liable for any deficiency in a validation, verification or certification report that may lead to or may have led to the issuance of excess CERs ('significant deficiency') 'regardless of its intent or its degree of negligence'.

In this context, the draft review process proposes not only the suspension or withdrawal of the affected DOE's accreditation but also holds the affected DOE accountable for its own costs and the costs incurred by the appointed other DOE in relation to the review process – even in cases where the review process concludes that no excess CERs have been issued (para.35). In the event the Board determines that excess CERs have been issued as a result of identified significant deficiencies, the affected DOE also must acquire an amount of carbon assets (ERUs, AAUs, RMUs and/or CERs) equivalent to the amount of excess CERs issued as determined by the Board and has to transfer those assets to a cancellation account in the CDM registry. The requirement to replace CERs translates into unlimited financial liability as the spot price of the secondary CERs used for replacement may be significantly higher than the price of the CERs issued from a project in prior years.

Therefore, regardless of any notion of intentional or negligent behavior, a DOE may face very high associated costs and financial liabilities if it is deemed to incorrectly or insufficiently apply a fact (or set of facts), accreditation standards, a CDM rule based on information that is incomplete, inconsistent or contrary to the validated or verified facts (para.5).

While the notion of 'strict liability' is found in common and civil law systems, it is applied regarding activity considered particularly hazardous or dangerous per se (e.g., operation of a nuclear power station, hazardous waste operations, etc). In other words, a person that takes advantage of being allowed to undertake a particularly hazardous or dangerous activity shall, in return, be held strictly accountable for any damage or loss resulting from such activity. It seems questionable whether the DOE's activity of validating a CDM project and verifying generated emission reductions can be construed as an indemnity that is equivalent to hazardous or dangerous activity that would justify a 'strict liability' approach under the draft procedures.

Due process and need for a right of appeal under the procedures

The notion of 'due process' in law generally reflects the idea that no person should be deprived of life, liberty, property or any right granted by applicable law until they are afforded a fair and just process. A fundamental requisite of 'due process' is the opportunity to be heard, to be aware that a matter is pending, to make an informed choice whether to acquiesce or contest and to assert before a decision-making body the reasons for such choice.

The draft procedures do not provide for any notification, hearing or appeal mechanism that an affected DOE can avail itself to protect its accreditation and property from any decision by the Board with respect to the suspension or withdrawal of its accreditation (para.10), the determination of a 'significant deficiency' (para.20), the appointment of another DOE (para.20), the list of correction measures (para.28) and the determination of the amount of excess CERs issued (para.37(b)).

Taking into account the significant cost and financial liability implications for the affected DOE of the various Board decisions, it seems fair and just to provide for adequate hearing, notification and appeal procedures. In addition, such procedures may be required by the insurance industry to be able to develop related DOE liability insurance products. Without a hearing, notification and appeal process, the insurance industry will likely find this liability risk uninsurable.

Responsibilities of regulatory bodies

Under the current CDM rules, the Board may subject CDM projects to a review process prior to making decisions on the project registration and issuance of CERs (Existing Review Mechanism). Subjecting CDM projects to multiple review procedures may lead to uncertainties regarding the roles and responsibilities of DOEs, the Board and other regulatory bodies in the validation and verification process. For example, a situation may arise where a DOE follows instructions received in the course of the Existing Review Mechanism which may ultimately prove to lead to 'significant deficiencies' under the draft procedures. The draft procedures do not clarify the relationship among these various review procedures and whether or not previous instructions issued by the Board can impact the DOE's liability under the draft procedures.

Conflict of interest between DOEs

The draft procedures state that one of the considerations in appointing another DOE to review 'significant deficiencies' is whether the other DOE has any conflict of interest with the affected DOE (para.21(b)). Considering the inherent in the nature of the operation of the regulatory mechanism, real or perceived conflict of interest exists among DOEs Is likely to be significant. Thus, it may be questionable whether this consideration is practicable. Furthermore, as currently written, the procedure does not provide sufficient detail on how the conflict of interest issues will be assessed. It should also be noted that due to existing capacity constraints of DOEs, it may not be possible to find other competent DOEs to undertake the reviews. In any case, the affected DOE should have a right to challenge the appointment of another DOE on the conflicts of interest between the DOEs.

Cost and resource implications of the procedures

The cost and financial liability of the draft procedures will further complicate the contracting of DOEs for validation and verification purposes and the allocation of the associated cost and financial liability risks in the contractual arrangements between DOEs and project participants. In the absence of a reasonably priced insurance product for this cost and liability risk, the allocation of these risks in a DOE contract will continue to be difficult. In addition, if a DOE's accreditation is suspended or withdrawn due to 'significant deficiencies', project participants will have to quickly contract another DOE in order to minimize resulting delays in the validation and verification process which may ultimately further delay project registration and issuance of CERs. The search for alternative DOEs may become difficult due to the fact that DOEs may be appointed to review the reports of other suspended DOEs at the same time. Any re-validation or re-verification translates into additional costs for project participants and resulting additional delays in project registration translate into a reduction of available carbon assets from a project and a significant loss of revenue to project participants. The draft procedures are silent on how the interests of affected project participants can be adequately protected.

Therefore, the procedures will divert scarce DOE resources away from the validation and verification of CDM projects, and cause further delays for all the projects associated with the DOEs whose accreditation is suspended or withdrawn.

Learning by doing

CDM process so far has evolved through learning by doing process. All parties involved in the process have witnessed the outcomes of the process. There are several clarifications and revisions approved by the EB to methodologies, guidelines, procedures and processes. If any excess issuance of CERs occurred due to misinterpretation of procedures/guidelines/methodologies due to lack of clarity, it is not clear how the procedures drafted at present addresses these issues. Moreover, the role EB and supporting regulatory bodies in the learning by doing process would need to be also considered as the application of some of the approved procedures could have caused excessive issuance CERs.

2. Implications

The application of draft procedures is likely to have the following implications:

i) The liability requirements could put DOEs under financial strain and limit the ability of DOEs to comply with the regulatory process.

ii) In order to cover the costs of increase liability DOEs will likely increase the prices of validation and verification for all projects significantly. These increased costs will ultimately be borne by the Project Entities. Projects in LDCs will be especially vulnerable to such increases in validation and verification costs.

iii) The overall cost and burden of regulation could increase significantly and adversely affect the market for CDM credits.

3. Suggestions for addressing issue of excess CER issuance

The following suggestions could be considered for addressing the issue of liability for excess issuance of CERs.

i) The draft procedures replace the notion of 'strict liability' with the notion of 'fault based liability'.

ii) The draft procedures include a hearing, notification and appeal procedure which would ensure 'due process'.

iii) The clarifications to the decision 3/CMP.1 para 24 and decision 3/CMP.1, appendix D, Para 8 could include permitting a portion of the DOE license fee to be set aside in an escrow account to cover the costs of review and due process of excess issuance and to insure in part the value of excessive CERs issued.

iv) The clarifications to the decision 3/CMP.1 paragraphs 21 and 22 and decision 3/CMP.1, appendix D, Para 8 could include consideration of excess CER issuance as one of the performance measures for renewal of DOE reaccreditation.

v) A time limit for initiation of the review and period of the excess issuance of CERs should be set so as to ensure predictability of registered projects. The time limit on the period of review with regard to excess issuance could help to limit the insurance costs for the mechanism.

vi) Certain portion of project registration fee could be used to insure the risk of excess issuance of CERs or to build a buffer of CERs that could be used to cover excess issuance so that a part of the liability of the excess issuance could be addressed at the level of the overall mechanism. This will address the criticism that DOEs could be unduly penalized for excess issuance for reasons not under purview, e.g., fraud at the level of project that is difficult to detect at validation and verification, impact of events and country circumstances, and conflicting regulatory procedures and guidance etc.

We will be glad to provide any further information and clarifications as necessary.

With kind regards,

Rama Chandra Reddy
Acting Team Leader, Policy and Methodology
Carbon Finance Unit, World Bank