Subject: IETA response to call for input from EB 56 regarding the "Draft procedure regarding the correction of significant deficiencies and the excess issuance of CERs"

8 October 2010
UNFCCC Secretariat
Martin-Luther-King-Strasse 8
D 53153 Bonn
Germany

Dear Mr. Mahlung,

I am writing to you on behalf of the International Emissions Trading Association (IETA) in response to the call for input issued at EB 56 on the "Draft procedure regarding the correction of significant deficiencies and the excess issuance of CERs" released as Annex 1 to the annotated agenda for EB 56.

In addition to all of the points expressed below, IETA is also concerned about the fact that these procedures set in place a system that could lead to the *deregistration* of projects. In many cases, investors make their investment decisions based on CDM registration. To create a process that allows the deregistration of a project that has already made its way through the time consuming, tedious CDM process will send a very negative signal to a struggling market. In general, IETA believes that the desire to limit excess issuance must be balanced with the desire to see continued DOE and investor interest in the CDM. IETA encourages the Executive Board to consider both the need to ensure environmental integrity and the need to ensure continued interest in the CDM as they work to design a balanced regulatory approach.

The following comments attempt to answer the specific questions put forward in the call for input.

(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;

IETA does not believe that this is the correct question to be asking. The draft procedures may "comply" with the CMP in the strict sense of the word, but the CMP text provides space for the CDM Executive Board to apply their own judgment with respect to how the CMP requirements are implemented. The draft procedure introduces "*strict liability*" as basis for liability, which in IETA's view is not and has never been the common interpretation of the existing decisions. Indeed, IETA believes that the procedure, as currently laid out, to implement the requirements is *definitely not required* by the CMP decisions. If this procedure were implemented it would place an unnecessarily extreme burden on DOEs and would be detrimental to the market. We elaborate further below.

(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;

IETA would recommend four revisions/additions to the decisions of the CMP.

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1. **Ensure review cost borne only when deficiencies found & cap maximum costs borne***:* Para 24 of the CDM Modalities and Procedures currently states that the costs of the audit/review to determine excess issuance should be borne by the DOE under suspension. This stipulation could entail potentially extremely large financial liability given the fact that the appointed DOE has been asked to re-validate and/or verify all of the selected projects, including supporting documentation. As such, IETA believes that the total costs of this review process which the DOE may be required to bear should be capped. IETA also believes that it would be unfair for the costs to be borne by the DOE in situations where it is found that excess CERs were not issued and/or where excess issuance is not found to be the result of DOE negligence. The CDM M&Ps should be amended as follows: *"Any costs, not to exceed a reasonable maximum established by the CDM Executive Board, relating to the review referred to in paragraph 22 above shall be borne by the designated operational entity whose designation has been withdrawn or suspended, if excess CERs are found to have been issued.*

2. **Allow expert reviewer to undertake review:** Para 24 of the CDM Modalities and Procedures currently states that a different designated operational entity should undertake the review of cases of possible significant deficiencies. Utilizing a DOE for this work, however, may not be the best choice in many, if not all, cases. First, IETA believes it is inherently problematic to have another DOE review the work of the DOE in question. Not only are DOEs competitors and thus the reviewing DOE would have a conflict of interest with respect to the DOE being reviewed, but doing so would entail the release of confidential commercial information to a 3rd party entity to which the project participant does not have a contract. Assigning another DOE to such review cases could also possibly remove significant resources from the DOE pool thereby increasing the timelines for validation and verification and possibly leading to increased validation and verification costs. IETA believes that the CDM M&Ps should be amended as follows: *"…In this case, the Executive Board shall decide whether a different designated operational entity or an independent expert, as appropriate, shall be appointed to review, and where appropriate correct, such deficiencies."*

3. **Provide the CDM EB a mandate to develop an additional risk management mechanism:** Para 4 of the draft procedures states the following: "In accordance with decisions of the CMP, the DOE who was responsible for the preparation of validation, verification, or certification report that led to the excess issuance of CERs is strictly liable for the issuance of excess CERs, i.e. regardless of its intent or its degree of negligence." IETA disagrees with this interpretation of para 22 of the CDM Modalities and Procedures.

   To explain, it is important to remember the context in which this procedure will be triggered. It will be triggered by the suspension or withdrawal of a DOE/AE, which will be the result of a finding of fault on their part. IETA believes, therefore, that the CMP Guidance did not mean to have these procedures apply in a situation where information becomes available that was not and could not have expected to have been available to DOEs *or* was withheld from DOEs by project participants at the time the validation or verification decision was made. IETA believes, therefore, that the DOE should be held liable only in cases of fraud or negligence. IETA believes that an alternative mechanism must be created by the CMP to ensure environmental integrity of the CDM in the case that excess issuance can not be attributed to DOEs fraud or negligence. More information on the type of mechanism we believe is needed can be found under section (d) below.

4. **Clarify "significant deficiency":** While IETA believes that the CDM Executive Board currently has the authority to provide an alternative definition of the term "significant deficiency" and that the current definition is not reflective of CMP intentions, we believe the CMP could clarify in the *Guidance Related to the Clean Development Mechanism* that "significant deficiency" should be

defined in reference to the thresholds established in the "Standard on the use of the concept of materiality". See comments in (d) below for more explanation.

(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;

The experience with programs of activities (PoAs) over the past few years can be taken as an anecdotal example of market impact when concerns about DOE liability are not taken seriously by policymakers. Given the fact that these draft procedures would impact all projects, not just PoAs, IETA believes that the market implications of the implementation of the draft procedures could be very severe.

Validation and verification costs will increase, as DOEs will have to cover the extra costs of acquiring additional insurance, if it is even available. There is a possibility that the insurance needed will not be available to DOEs, however, due to the extent of liability entailed in these procedures. In this case, DOEs may decide to withdraw from the CDM market due to the inability to manage the risks of participation, which will further limit the resources available to CDM.

There will also be implications for which projects DOEs are willing to validate and verify, with "risky" projects becoming even more difficult to get validated and verified. DOEs will also be unwilling to work on projects if the project participant is unwilling and/or unable to be held contractually liable for the provision of insurance for covering their part of the strict liability. Such a requirement will inevitably leave many project types and project participants out of the market. Finally, given that these procedures were not in place when all past contracts for validation and verification were signed, DOEs will likely face very serious difficulties with respect to managing the liability for existing projects.

(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;

As stated under (a) above, IETA believes that the CMP text provides space for the CDM Executive Board to apply its own judgment with respect to how the CMP requirements are implemented and believes that those requirements are currently applied in the draft procedure in a manner that will be detrimental to the market. Given the market implications explained in the previous section, therefore, IETA would recommend that multiple changes be made in order to mitigate the market implications of adopting the draft procedure.

(1) **Redefine "significant deficiency":** The term is not defined in the CMP text, and the current draft procedure interprets "significant deficiencies" purely in reference to whether or not excess CERs have been issued. IETA believes a more reasonable interpretation would be to apply a threshold below which excess issuance of CERs should not be considered "significant", such as, "Significant deficiency means a deficiency in a validation, verification, or certification report that led to excess issuance above the thresholds established in the 'Standard on the use of the concept of materiality,'" which is to be approved at an upcoming Executive Board meeting.

(2) **Narrow the definition of "deficiency":** The definition currently in the draft procedure is very broad.

In particular, IETA believes that the phrase "incorrectly applying a CDM rule or requirement" is ambiguous in at least three senses: First, it is not clear what sources are encompassed by "CDM rule or requirement." Does this include CMP guidance as well as EB decisions? Information notes

and guidelines as well as rules and methodologies? Second, it is not clear how precise a CDM requirement needs to be to be capable of being misapplied. Some requirements are extremely vague, such as the requirement that a project be consistent with the goals of sustainable development. Third, it is not clear which requirement would prevail where two requirements are in tension with or contradict one another. For example, sometimes clarifications are in tension with a literal reading of the methodology. In such instances, it would not be clear which rule a DOE must follow to avoid liability. Unless clarification is provided for all of these questions, it will be difficult for DOEs to take effective steps to avoid future excess credits or make an informed judgment about the scope of the liability risk they face going forward. Second, it will present substantial difficulties to the DOE or expert reviewer to determine whether or not, in fact, excess CERs had been issued.

IETA also finds the use of the term "facts", as in "Insufficiently validating or verifying a fact or set of facts" or "Providing incorrect factual information to the Board" to be problematic in two ways. First, there is no clear commonly agreed understanding for what a "fact" is in the context of the CDM. For example, in any project submission, the project participants and DOEs make several projections based on available information. It is unclear whether or not these projections are considered facts. Second, it is not clear that "facts" refers to information that was available at the time of the verification or validation, yet obviously the DOE could not present facts that were not available at that time.

IETA believes that the definition of deficiency should be significantly narrowed by more clearly defining the "CDM rules or requirements" that may form the basis for liability. We suggest that the Executive Board consult further with DOEs and project participants as to what appropriate criteria might be. We also suggest that the term "facts" be defined and that it be clarified that the only facts to be considered are those available at the time of the validation or verification.

(3) **Limit auditable validation, verification, and certification reports:** The draft procedures contain no statute of limitations limiting the time which validation and verification reports can be audited. Maintaining the ability to reopen a case at any point in the future is completely out of touch with modern legal systems, where it is acknowledged that facts and evidence are obscured through the passage of time. For the CDM, we can add that the passage of time will lead to changes in Secretariat and RIT staff and EB members, meaning that the rules and requirements and, more importantly, the understanding and correct interpretation of them will have become obscured. Moreover, the omission of a time limit for the re-opening of a project's validation and verification means that DOEs will face not only unlimited but *increasing* levels of liability the longer they remain in the CDM system. Such a situation is unsustainable even over the medium-term, as the most active DOEs take on hundreds and then thousands of projects. IETA believes that there should be a strict statute of limitations on the ability to audit validations and verifications, for examples a two-year or two monitoring period limit.

(4) **Cap maximum DOE liability**: Even if a statute of limitations is inserted into the draft procedure, the liability shouldered by DOEs under these procedures, especially for very large projects, could be extensive and could drive DOEs from the market and/or convince them to refuse to take on very large projects. IETA believes strongly that a maximum cap on liability must be set by the Executive Board, through consultation with DOEs and project participants. If excess issuance exceeds the cap, it should be accounted for through the system-wide excess issuance insurance account (see (7) below).

(5) **Include additional due process requirements:** It is a fundamental principle of justice that parties should receive greater procedural protections as the gravity of the government sanction

they face increases. For example, an individual must have greater opportunity to challenge a jail sentence than a speeding ticket. Because the new procedure threatens to impose a financial penalty rather than simply withholding carbon credits, it has the potential to infringe on property rights in a way that requires greater procedural protections than those provided by the current draft procedure.

IETA believes that greater procedural protections must be added to the draft procedure, including an interim right to make submissions in response to the first report by the Assessment Team and a right of appeal to an independent body against the final finding if the DOE is required to replace excess CERs.

(6) **Provide clarity on how to ensure against retroactive application of rules and guidance:** In the current draft procedures, it states that DOEs can only be held liable for mistakes in relation to the accreditation standards or CDM rules or requirements applicable *at the time of the validation or verification activity*. IETA strongly agrees that this must be the case, but we believe that the implementation of this point will be very difficult in practice, requiring the DOE or expert reviewer, for example, to consider different versions of the VVM when looking at verification reports from different periods and to consider the exact date of issuance of a new rule or requirement and whether or not it had a grace period for application. We also know that the Board occasionally issues "clarifications" stating that a certain interpretation was *always* the case, even if it was clearly not always understood by project participants or DOEs.

IETA believes strongly that a clarification that was issued after the validation or verification was made cannot be used to prove negligence of a DOE. The draft procedures should be amended to make this clear and to more fully elaborate the steps the reviewing DOE or expert reviewer will have to take and the assistance it will have in ensuring that only the relevant rules and requirements, etc. are the basis of the decision about excess issuance. Finally, the CDM process has always been considered a "learning by doing" process, so IETA believes that a review of earlier verification and validation reports must be made with this understanding in mind.

(7) Create and adopt an alternative mechanism to ensure the environmental integrity of the CDM in cases where:

a. excess issuance occurred due to reasons other than the negligence of the DOE, in cases where the project participant can not be found and/or held liable (see section (e) below for more on project participant liability)
b. excess issuance occurred due to DOE negligence but the DOE chooses to exit the system rather than acquire and cancel an equivalent amount of CERs (see note on additional input at the end of this letter)
c. excess issuance occurred due to DOE negligence over and above the cap placed on the liability of the DOE

IETA suggests that this alternative mechanism take the shape of an insurance account of credits to be managed by the UNFCCC CDM Secretariat. IETA believes it would be appropriate to add a levy of [x]% to CER issuance in order to populate this insurance account, similar to the Share of Proceeds. The percentage should be established through consultation with stakeholders and with the aid of an analysis and recommendation by an independent expert. IETA believes it would also be appropriate to conduct periodic analysis of the risks of over-issuance and the needs of the insurance account in order to determine if a percentage of the CERs held in the insurance account could be released to provide additional revenue to the Adaptation Fund.

(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.

As previously stated, IETA believes that DOEs should not be held liable in cases where information becomes available that was not and could not have expected to have been available to DOEs or was withheld from DOEs by project participants at the time the validation or verification decision was made. Where project participants provided false or misleading information to a DOE, the project participant should be held liable under the legal systems of the host and non-host parties. Such a practice is not unprecedented, as UK Letters of Approval already contain liability for false statements. If the project participant, for whatever reason, cannot be held liable under host or non-host party law, then the CERs should be canceled from the system-wide insurance account.

Additional Input:

IETA is also concerned that the provisions allowing for the collection of excess CERs will often be unworkable in practice due to the difficulties of enforcing them. To our knowledge, few sanctions are available to the UN to impose on DOEs other than to suspend accreditation. If a DOE faces a large CER penalty, it will likely prefer to accept suspension and exit the CDM market altogether than to pay the penalty. (IETA believes, however, that it is more likely that DOEs will refuse to expose themselves to this risk in the first place. They will simply exit the system before they are forced to do so.)

In closing, IETA thanks you for your attention to our input to this very important issue, and we remain available for further discussion or clarification at your convenience.

Sincerely,

Henry Derwent
President and CEO, IETA