The members of the CMIA would like to thank the CDM Executive Board for the opportunity to respond to this Call for Public Inputs.

Introduction

In this response we comment on the questions (a) to (e) raised by the EB. We also comment on a view expressed by EB board members during EB 56 regarding the draft "Procedures for regarding the correction of significant deficiencies and the excess issuance of CERs" (the "**Draft Procedures**"). During the discussion on September 15, members of the EB suggested that on the issue of DOE liability, the Marrakesh Accords can only be interpreted in a specific way: that they necessarily incorporate the concept of strict liability of DOEs (see also page 1 of the Draft Procedures).

Our response to (a) of the request for input deals with that perception. Our comments show that (1) the text of the Marrakesh Accords does not prevent the EB from relieving DOEs from liability if the DOEs are not found to have been fraudulent/grossly negligent, and (2) an analysis of the likely intent of the parties does not favour a strict liability approach.

This submission has a second goal of proposing that the EB establish a "CER Cancellation Pool" as a preferable alternative to the current proposed DOE strict liability approach to recovering non-additional[1] CERs where the DOE has not acted fraudulently or in a grossly negligent[2] manner.

SECTION 1: Response to "(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;"

The CMIA believes that the provisions of the Draft Procedure that mandate strict liability are neither the only nor the most desirable interpretation of paragraph 22 of Decision 3/CMP.1. Part I of this section explains how a fraud/gross negligence-based approach is as consistent with a plain reading of the guidance as a strict liability approach. Part II explains why the CMIA believes that the choice between a strict liability approach and a fraud/gross negligence-based approach should be made on the basis of which approach is most likely to further the overall goals of the regime by *recovering as many non-additional CERs as is feasible*. This frames the structure of our proposal for a fraud/gross negligence-based approach combined with a CER Cancellation Pool, in our response to parts (d) and (e) of the request for input.

Part I – The language of the Marrakesh Accords does not mandate a strict liability rule

(A) Understanding the Draft Procedure's Interpretation of 'Significant Deficiencies' and 'Excess CERs'

Paragraph 22 of Decision 3/CMP.1 states that reviews will be triggered by the identification of 'significant deficiencies in the relevant validation, verification or certification report for which the entity was responsible.' This is vague language, and '*significant deficiencies'* is not clearly defined by the CMP. Later, the guidance states that if "such a review reveals that *excess CERs* were issued", the DOE shall acquire and transfer to a registry an amount of credits proportional to the quantity of excess CERs issued. Once again, the Marrakesh Accords do not explicitly define '*excess CERs*.'

[1] Here "non-additional CERs" are defined as CERs that were issued but do not represent a real reduction, avoidance or sequestration of one tonne of GHG. We use this term differently to 'excess' CERs which, under our proposed interpretation, are both non-additional and the product of gross negligence or fraud on the part of a DOE or PP.

[2] In our view, a DOE has been "***grossly negligent***" where it has committed in an act or omission that no reasonable DOE would have committed, as compared to evidence of the standard industry practice.

The Draft Procedure interprets both terms in reference to whether or not the DOE under review made an error or failed to properly apply a CDM rule or requirement. 'Excess CERs' are defined as those CERs that were issued that would not have been issued if the error had not been made or if the rule had been followed, depending on the circumstances[3]. Consequently, under this interpretation the DOE does not need to have been negligent to some degree for a significant deficiency to have occurred and excess CERs to have been issued.

(B) An Alternative Interpretation

To include a requirement of fraud/gross negligence before imposing liability does not require a dramatic shift in interpretation. Instead, it would simply require interpreting 'significant deficiency' and 'excess' by reference to whether or not the DOE made an error *that would have been avoided by a reasonable DOE* or failed to properly apply a rule or requirement *that would have been properly applied by a reasonable DOE*.

These interpretations are consistent with the common understanding of the words at issue. The Oxford Dictionary of English defines '*significant*' as "sufficiently great or important to be worthy of attention; noteworthy" and '*deficiency*' as "a failing or shortcoming." If we insert these words into paragraph 22, a review would be triggered by *a failing or shortcoming in the validation, verification, or certification report sufficiently great or important to be worthy of attention*. The question is whether or not errors or misapplications that occurred despite reasonable DOEs' efforts to avoid them, should be considered '*significant deficiencies*.'

The Oxford Dictionary of English defines the adjective form of 'excess' as "exceeding a prescribed or desirable amount." This shows that 'excess' is not an objective term – it is always determined in reference to a prescribed or desirable amount or baseline. The question then becomes what the prescribed baseline, which is a policy decision. In this case, we believe the choice is whether the baseline for judging '*excess credits*' should be "the appropriately diligent effort a reasonable DOE would make" (a gross negligence-based approach) or "a perfect effort" (a strict-liability approach). The Draft Procedure has adopted the latter approach, but the CMIA believes that the former is a more sensible standard.

Neither interpretation would be stretching the CMP language to a great degree. The language chosen by the CMP implicitly contains some flexibility for the EB to make policy judgments in applying the rule, and this flexibility merits careful consideration.

Part II – Comparing interpretations of the CMP Guidance

In the absence of further guidance from the CMP, how should the EB choose between the two competing interpretations? A first approach would be to try to understand the intent of the CMP in light of the language of the particular provision, the structure of the provision, any relevant *travaux preparatoires*, and common practice among members of the CMP. The second would be to consider which interpretation is more consistent with the broader goals and principles outlined by the CMP. This section focuses on the former approach, leaving the latter for our response to requests for input (d) and (e).
We consider three potential functions of the excess CER rule, in order to understand the intent of the CMP. The first function is to deter DOEs from reckless or deceitful behaviour (A). The second function is to recover all CERs issued for which there are concerns that the emissions reductions represented are not real and additional, with the aim of ensuring that the Annex I countries have not satisfied their commitments with non-additional CERs. (B) The third function is to recover not all non-additional CERs, but only those that can be recovered feasibly or cost-effectively (C).

[3] "Significant deficiency means a deficiency in a validation, verification, or certification report that may lead to, or may have led to, the excess issuance of CERs." (Paragraph 6 of the Draft Procedure.) The Draft Procedure defines 'excess CERs' as "a quantity of CERs, issued by the Board where the issuance was based on a validation, verification, or certification report: (a) That contained an incorrect fact, omitted a fact, or misapplied a CDM rule or requirement; and (b) The consequence of which resulted in the issuance of CERs greater than otherwise would have been issued in accordance with the CDM rules and requirements.

(A) Deterrence: a strict liability rule will not lead to greater deterrence than a negligence rule.

A potential purpose of the rule is to deter DOEs from engaging in otherwise preventable behavior that results in the issuance of non-additional CERs. CMIA fully supports this objective. However, a gross negligence-based rule will be just as effective as a strict liability rule in achieving this goal. A gross negligence standard would impose liability on DOEs for non-additional credits that would not have been issued had the DOE made all reasonable efforts to avoid errors, but would not impose liability for mistakes that occurred despite the DOEs' best efforts to comply with the regulations, i.e. *mistakes that cannot be avoided*.

(B) Recovery of all non-additional CERs: the rule cannot sensibly be interpreted as intended to achieve the goal of recovering all non-additional CERs

The second potential function is to recover all CERs issued for which there are concerns that the emissions reductions represented are not real and additional. This with the aim of ensuring that the Annex I countries have not satisfied their commitments with non-additional CERs. This appears to be the purpose ascribed to the rule by the Secretariat's presentation to the EB on September 15, 2010. However, several factors suggest that this is not an appropriate interpretation:

- **Weak Enforcement Provisions**. The KP and CMP guidance does not contain enforcement provisions that effectively impose liability in order to achieve an objective. In the absence of further language from the CMP or new contractual arrangements with DOEs, it is unlikely that the EB would ever be able to collect replacement CERs from a DOE if it found the DOE to be liable for a large number of CERs. The DOE would likely be able to avoid such liability by exiting the industry. Even if exiting were not an option, the DOE might not have assets sufficient to cover the cost of excess CERs. Either situation would leave the EB without a full remedy if it found an issuance of excess CERs to have occurred. A more stringent regime would be likely to both (a) require DOEs to provide proof some sort of mandatory insurance capable of covering that harm, (b) require DOEs to agree beforehand to the liability risk with forum and applicable law specified, and/or (c) contain effective measures for enforcement of the provision through mandatory co-operation from domestic judicial systems[4]. However, none of those provisions are present.

- **This interpretation is inconsistent with structure of Annex I country obligations**. There is no other mention in the Kyoto Protocol or CMP materials of a desire to correct a situation where an Annex I country uses non-additional CERs to satisfy its commitments. If correcting for such a problem had been a primary objective of the Parties, it appears likely to CMIA that the Parties would have agreed to a backstop measure to correct for non-additional CERs on the market, rather than let such corrections hinge upon the ability to collect sufficient cancellation CERs from a particular DOE.

- **Lack of CMP follow-up**. Our review of successive CMP guidance to the EB found no mention of the excess CER issue, suggesting that, at least in the past, it has not been a CMP priority.
- **Rarity of Strict Liability in Domestic Law**. To our knowledge, strict liability for large sums is rarely found in domestic law, except in the context of ultra-hazardous industries (hazardous chemical transportation, nuclear energy, etc.). It is inconsistent to think that the Parties would choose to impose an atypically severe liability regime at an international level without specifying their intent to do so.

- **Concerns about fairness**. One reason that strict liability is found rarely is that it is perceived as often unfair to the parties held liable, since it imposes liability for them in situations that they could not have avoided without exiting the industry.

- **Concerns of National Interest**. Many of the DOEs are large firms providing important and highly specialised services, and their home countries undoubtedly would have reservations about exposing them to new large and unpredictable liabilities.

[4]For two examples of strong international enforcement regimes, please refer to the sources below. Importantly, in both instances the language imposes a clear obligation on States to enforce the international norms.
1) Article 4 of the Convention Against Torture, available at http://www.hrweb.org/legal/cat.html.
2) UN Resolution 1267, available at http://www.un.org/sc/committees/1267/consolist.shtml.

(C)The rule aims to recover as many non-additional CERs as is feasible

As a result of the above, it appears reasonable to assume that the purpose of the provision is to provide a tool to recover only those CERs that can feasibly be recovered, rather than a tool to collect all of them. If so, then the interpretation of 'significant deficiencies' and 'excess CERs' should turn on the feasibility of those interpretations in terms of recovering CERs unduly issued. In other words, the terms should be interpreted to allow for the greatest recovery of CERs that is feasible while being consistent with the goals of the regime. This raises an additional question of what is the greatest recovery of CERs feasible. Once again, an analysis of intent reveals an open-ended policy question. Our response to sections (d) and (e) of the request for input addresses this issue.

SECTION 2: Response to "(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";

(A) The Draft Procedure will create excess pressure to suspend DOEs' accreditation, even in situations where such suspension is inappropriate.

The Draft Procedure grants additional powers to a CDM-AT to audit past validation and verification reports once the DOE has been suspended or withdrawn (see Rule 11 of the Draft Procedure). The CMIA are concerned that this will create an undesirably strong incentive for the EB to suspend a DOE, even in circumstances in which suspension itself is likely to prove of little value independent of the additional investigative powers granted. For example, it makes little sense to suspend a DOE for an error that (a) does not point toward broader wrongdoing on the DOE's part, and (b) the DOE has already taken decisive measures to prevent a repetition of the error going forward.

(B) Suspension of accreditation is a serious concern affecting not only the DOE, but also all project participants that have relied on the DOE to assist them with ongoing services.

Project Participants rely on DOEs to provide highly specialised services, and it is difficult or impossible to replace the DOE responsible for a particular validation or verification task at short notice. As a result, the suspension of a DOE can result in substantial and effectively unavoidable costs and delays for Project Participants that have made no errors. These impacts may be justified by the need to sanction a DOE for fraudulent/grossly negligent behaviour or to prevent the issuance of future non-additional CERs, but are certainly disproportionate where the need is only to carry out a further investigation.

(C) The EB should be allowed to establish a CDM-AT to audit past projects once it has shown that non-additional CERs have been issued as a result of a DOE error in the past

The EB could resolve the above by amending paragraph 11 of the Draft Procedure to replace "*its decision to suspend or withdraw the accreditation of a DOE*" with "*a determination that non-additional CERs have been issued as a result of a DOE error*" (and making any additional revisions consistent with this change). This would reduce the incentive to suspend DOEs unnecessarily while still preserving the EB's ability to authorise audits of past verification and validation reports.

SECTION 3: Response to "(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";

(A) Example of PoAs.

One of the main regulatory barriers to the development and implementation of Programmatic CDM project activities (PoAs) has been the issue of erroneous inclusions of CDM programme activities (CPAs) for which DOEs are liable. In the case of PoAs ,the liability on DOEs was initially justifiable on the basis that CPAs did not have to go through the registration process, and, therefore, responsibility for an erroneous inclusion fell on DOEs. Consequently, DOEs have shied away from fully engaging in PoAs generally, only favouring easy POAs project activities.

The same approach is now pursued in the Draft Procedure and even goes so far as to consider the registration status of the CDM project activity and the possibility of suspending the registration of the project activity.

(B) Registration

Investors have invested in CDM projects on the basis of CDM registration. To place this registration under question in a retrospective manner may have the effect of undermining confidence in the CDM process. Registration of a CDM project is a key milestone of the project cycle that in many cases, triggers further capital expenditure commitment into the CDM project activity. The possibility of an amendment to the registration status and/or suspension of such registration will result in further discount rates applied to CDM projects, with the result that some may no longer be commercially viable.

(C) Liability of DOEs

The proposed additional liability on DOEs increases the risk for DOEs, which will ultimately translate into additional costs for market participants or worse, DOEs exiting the system. Some implications of this policy are:

- The market will discriminate and be biased towards simple, less complex projects.
- DOEs are likely to only contract with players willing to provide a back–to-back full indemnification for correction of significant deficiencies and excess issuance. If project developers are required to indemnify DOEs, only big market players with large or simple projects will be able to participate. The more difficult to run projects, for example in LDCs, and community based projects are likely to lose out – which runs contrary to the international community's efforts to re-focus the CDM towards its sustainable development goal.

SECTION IV: Response to "(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";

Para 8b should read "The validation report of the DOE contained an incorrect fact, omitted a fact, or misapplied a CDM rule or requirement *applicable at the time of registration* that, if corrected, would result in the project being considered not additional;"

Guidance provided later after the registration of the project, e.g. the VVM, cannot be taken into account in the assessment of whether there was excess issuance. The Board has repeatedly expressed that the CDM is a learning-by-doing by doing process. Project participants having developed their projects at an early stage of the CDM should not be penalised by the fact that little guidance and rules were available at that time and retrospectively applying guidance and clarifications in the auditing process.

SECTION (V) Response to "(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".

We propose a CER Cancellation Pool. First, we provide some background on the difficulties of imposing liability on project participants, whether through contractual relationships with DOEs, direct action from the EB, or through the Parties (A). Next we set out the proposal (B) Last we give the CMIA's reasons for believing that the proposal is particularly well-suited to furthering the goals of the CDM regime (C).

(C) The Difficulty of Imposing Liability Upon Project Participants Under the Current Legal Framework

The difficulty raised by the scenario in (e) above stems from the absence of a formal legal relationship between the Project Participant and the EB that would give the EB direct recourse to Project Participants in the event that the Project Participant provided false or misleading information to a DOE that resulted in an over-issuance of CERs. This is explained in more detail below.

Under the Marrakesh Accords, Parties "authorise" and "approve" Project Participants to participate in project activities, and the Parties are the entities that remain responsible for the Project Participant's participation in the CDM. The Party-Project Participant relationship is a public international law/national administrative law one, usually evidenced by a formal declaration from a Project Participant that is binding on it but only enforceable against it by the Party to whom it was made. So Parties do have *direct* enforcement power against Project Participants of some form. However, this power is under national law and varies greatly between countries. As a result, if Parties were to be responsible where the acts or omissions of Project Participants had resulted in over-issuance of CERs, there is no certainty that such national rules could be applied so as to uphold the environmental integrity of the CDM by requiring the Project Participant to purchase CERs to cover the excess amount. Such an approach would also have severe adverse consequences for the approval /authorisation of participation of project activities, with certain Parties becoming reluctant to authorise and approve projects. Making Parties responsible for enforcement does not, therefore, appear to be an attractive option.

Contractual relationships between DOEs and PPs are, unfortunately, not a solution to this problem. DOEs are accredited by the EB, under a quasi public international law/private law process. DOEs enter into private law governed contracts with Project Participants (owners/developers) in which DOEs may pass on their liability under the Marrakesh Accords (if any) contractually. This arrangement may be by design in the Marrakesh Accords, but again, the nature of the liability chain makes it difficult for the EB to directly recover against Project Participants in the event that the acts or omissions of a Project Participant, rather than its DOE, lead to an over-issuance of CERs. It would not, for example be possible for the EB to require the DOE to sue the PP under the DOE–PP contract for the "loss" of the replacement cost of the over-issued CERs.

In relation to the project activity, and its status under the CDM, as referred to in our response to (c) above, any attempt to sanction Project Participants (or DOEs) through de-registration of the relevant project would lead to a very severe loss of confidence in the CDM market for investors of every sort.

(B) The CER Cancellation Pool Proposal

CMIA believes that a practical and proportionate solution to the impact of the absence of any legal relationship between the EB and Project Participants would be to establish a ***neutral pool of CERs***, filled by CERs from a ***levy on all projects*** at the time of issuance. This pool of CERs could then be used to cancel out the effect of non-additional CERs. The burden of filing the pool would fall proportionately on all project participants (owners/developers). The pool would be a form of "safety net" against a situation where, through no DOE intentional default/gross negligence, CERs had been issued that should not have been so issued.

Proposed design:

- Where, factually, there had been found to be an issuance of excess CERs that could not be attributed to the DOE (through its fraud/gross negligence), the pool would be accessed to cancel the necessary CER volume.
- Procedures elaborated by the SEC/EB and approved by the CMP would govern the above process.
- The levy would be a small percentage on all issuances [(excluding those from projects located in LDCs and small projects)], and would become viewed as a transaction cost or a form of insurance by participants in the market.
- A target number of CERs would be set, at the level deemed to be a sufficiently large buffer against the perceived over-issuance risk (for example 10 million CERs).

Once the target number of pooled CERs had been reached there are a number of options available: it could continue to grow; or surplus CERs levied for the pool could be re-channeled into the Adaptation Fund; or surplus CERs could be monetised for Fast Start Finance.

(C) The Advantages of the Proposal

- ***Environmental integrity is upheld***: the pool represents every participant's engagement in the goal of upholding the environmental integrity of the CDM.
- ***Cancellation of volume equivalent to non-additional/excess CERs is straightforward***: where the DOE is found not to be responsible, the pool is accessed without protracted EB processes.

- ***Co-operation from Project Participants and/or DOE would not be required***: the pool can be accessed by the EB immediately following the completion of the necessary procedures. Without such a pool, the EB would be dependent upon the co-operation of the Project Participants and the DOE and/or the DOE's insurer to achieve a timely, or potentially *any* remedy, which may not be forthcoming.
- ***The investigations into fraud/gross negligence of the DOE would be easier to conduct***: If the DOE knows that it will not be liable if it acted as a reasonable DOE would have acted, it is likely that the DOE will be more co-operative in the investigation into the alleged over-issuance. This co-operation better suits the intended role of the DOE as an accredited entity of the EB and is very likely to reduce the cost of EB investigations and increase the likelihood that non-additional CERs will be swiftly identified.
- ***The pool would be less disruptive to the CDM industry than DOE strict liability***: The pool proposal gives the industry predictable, affordable costs. Because DOEs acting to the requisite standard would not be penalised under the proposal, they would not have to face the risk of significant and unquantifiable liability**,** which could cause them to decide not to undertake further CDM work.

(D) Issues relating to the proposal:

- ***Requires a CMP decision***: the pool would require the development of a draft procedure by the SEC, consideration by the EB, stakeholder consultation and ultimately, approval by CMP decision. While this makes it a process-heavy proposal, we believe that it goes a long way to solve a very important issue and that it is, therefore, worth the time commitment. We also feel that as it is fairly neutral from a policy perspective, it is less likely to face opposition from stakeholders.
- ***Increases project costs***. The bigger the percentage of levy on each project at issuance the greater the overall costs are to the project.
- ***Identifying the "right" levy and target size of the pool may be difficult***.
- ***Future application to projects only***. The levy could only reasonably be applied to issuances after the date of the relevant decisions. However, if there was a finding that there were X number of non-additional CERs at a time when the total number of CERs in the pool was less than X, this could be dealt with by cancellation of CERs in the pool as and when they entered the pool, until X was met.

Conclusion

The CMIA welcomes the opportunity to comment on the Draft Procedure and thanks the EB and Secretariat for its continued efforts at improving the CDM processes. In responding to this Call for Public Input we have made the two key points below:

- The CMP guidance does not mandate a strict liability approach. In fact, an analysis of the Parties' intent suggests that an approach based on gross-negligence/fraud is more consistent with CMP guidance.
- A CER Cancellation Pool would be an effective tool for furthering the goal of cancelling excess CERs without having a significant negative impact on the viability of the CDM market.

CMIA is an international trade association representing close to 50 companies that finance, invest in, and provide enabling support to activities that reduce emissions. CMIA's membership accounts for an estimated 75 per cent of the global carbon market, valued at USD 130 billion in 2009. Solely representing organizations that provide services to and invest in the environmental sector, membership does not include any entities with compliance obligations under cap-and-trade schemes. This results in a unique advocacy platform with emphasis on the environmental integrity of market mechanisms and climate change policies.

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