Subject: IETA Response to the Call for Input on establishing a reserve/pool structure to complement the draft procedure for addressing significant deficiencies in past validation, verification and certification reports (draft Procedure)

August 9, 2012

CDM Executive Board
UNFCCC Secretariat
Martin Luther King Strasse 8
P.O. Box 260124
D-53153
Germany

Dear Mr. Duan Maosheng,

I write to you on behalf of the International Emissions Trading Association (IETA) in response to the call for input issued at EB 68 on the draft guidelines for establishing a reserve/pool structure to complement the draft procedure for addressing significant deficiencies in past validation, verification and certification reports (draft Procedure).

IETA would like to submit the following comments on the draft guidelines as a whole. These comments will highlight experiences IETA's members have had in addressing significant deficiencies during the validation, verification and certification process. IETA has benefited from the contributions of its members in creating this input to the Executive Board.

It should be first noted that while IETA supports discussions affecting an appeals process, IETA hopes that any discussion around a reserve/pool structure for significant deficiencies would fall under the same appeals process as other structures that currently exist as per previous guidance provided to the Executive Board by the CMP.

IETA strongly recommends that there be just one appeals process for all CDM functions regardless if the appeals are related to significant deficiencies in past validation, verification and certification reports or during the registration and/or issuance process. IETA recognizes the following CMP 7 guidance-Article 14, Section 2--issued in Durban in December of 2011:

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14. Also requests the Executive Board, in consultation with stakeholders, to revise the draft procedure based on its findings, taking into account conclusions, if any, on the appeals process in the Subsidiary Body for Implementation, with the aim of avoiding duplication and promoting efficiency, for adoption at the eighth session of the Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol;

IETA requests that the Executive Board when taking into consideration various inputs related to a reserve/pool structure understand that one of the most important aspects of a functioning market for the CDM is one single appeals process for all CDM functions.

The latest Concept Note on the draft procedure (Annex 19 of the Agenda for EB68) contains reasonable measures that IETA supports:

- First, that deficiencies are only measured from the point at which the rules were clear enough and the CDM had advanced beyond the early stages of learning-by-doing. This point is reflected inter alia through the introduction of the VVM (in 2008).
- Secondly, that the motivating factor for an investigation and potential damages should be such that it is a 'last resort' measure in the most extreme cases. The CDM has adequate processes for dealing with mistakes and errors (e.g. DOE audits, the accreditation process, completeness checks) and request for reviews for the DOE's. Only in cases where acts of fraud or malfeasance are suspected to have occurred should these measures be exercised.

In responding to the questions posed by the UNFCCC Secretariat below, this submission highlights two risks that would undoubtedly raise transaction costs to an unsustainable level for project participants as well as impose risks that could weaken a functioning market:

1. A low threshold for significant deficiencies that leads to many cases and many claims for CERs to be replaced through an environmental integrity fund
2. A significant increase in DOE fees to implement and maintain a reserve/pool

The future of the CDM must continue to be shaped around keeping transaction costs low in order for investors and industries to remain active and involved in the mechanism. Moreover, IETA strongly supports a functioning and robust carbon market. If a reserve/pool were created and the long-term results were such that the costs of a reserve/pool raised transaction costs and fees for participating in the market to an unsustainable level, then the mechanism and the market's function would be significantly weakened. As a consequence, we hope that in analyzing and implementing policies related to significant deficiencies and appeals, the CDM

Executive Board will recognize efficiency in such an appeals process and to keep reasonable transaction costs as key considerations in its decision-making.

1. The purpose of such a reserve/pool:

a. Is it a form of mutual insurance for Designated Operational Entities?

IETA envisages that a reserve/pool could serve the function as a mutual insurance set-up with the DOEs acting as the policy holders. Given the fact that DOEs all fall under under the same accreditation process, there is a possibility that DOEs may be able to organize such a set up. However, it must be pointed out that the costs involved in such a mutual insurance policy would be very high for the DOEs and those costs would in turn be passed on to PPs in the fees placed upon them. As such, project participants are not in favor of any such structure that will or potentially would impose additional fees on CDM transactions-especially given the current negative market and outlook for CERs and the CDM.

b. Is it an "environmental integrity fund" compensating for excess issuance outside of the Draft Procedure?

An 'environmental integrity fund' (the fund) could be feasible under a scenario in which the UNFCCC or a UNFCCC sponsor acted as its manager and custodian, utilizing a portion of the registration/issuance fees as a collateral to establish the fund. According to Article 6c of the draft procedure, DOEs could buy CERs from the fund if an over issuance was caused by their negligence or fraud. However, DOEs would only buy CERs from the fund if the prices were below the market price. Therefore, the UNFCCC would need to administer a reserve pool of credits that might never be sold. This scenario puts the UNFCCC (or a UNFCCC-sponsored fund) as a market actor and the UNFCCC should refrain from such market activities.

The DOEs could in theory operate their own reserve from which members could pull from. However, given the costs of a DOE-based reserve (as opposed to a mutual insurance pool), this would likely impede future revenue generating activities for the DOEs (if they agreed to participate). Conflicts of interests and moral hazards would also arise as the reserve would buy CERs which are verified by the DOEs themselves.

The only feasible solution that would not add transaction costs to project participants or unreasonable insurance policies taken out by the DOEs would involve a 'rolling CER pool' to which each project would have to contribute issuances to. Such a pool would involve each project having to subject a fixed percentage of its issuances into a CER pool that could be used by DOEs in the case of a significant deficiency where CERs would need to be replenished. The CERs that would be placed into such a pool would be removed as soon as the pool was replenished by a subsequent issuance.

As an example:

Project A issues 10,000 CERs, 500 of which go into the CER pool for a short period of time. At the end of that time period if there was no case of a significant deficiency was found, Project A would receive the 500 credits into the project participants' account.

In a scenario whereby there is a significant deficiency when Project A's 500 CERs are being held in the pool, the CERs would be returned as soon as the pool was replenished again enough to distribute the CERs equally to each project that was contributing to the pool during the time at which point those CERs were used as a result of the deficiency. The CERs that would needed to be drawn from the pool in the case of the deficiency should be sourced as equally as possible from all the projects that are currently contributing to the pool. Such a rolling CER pool would impact all CDM projects. While this scenario would represent a further delay by the project participant in receiving the 500 CER's than in a scenario whereby there is no deficiency, there is still no rise in transaction costs or DOE fees as the CERs would eventually be distributed to the project participant.

c. Is there another associated rationale?

Various scenarios involved in an 'environmental integrity fund' all lead to situations and circumstances that would greatly alter the role and function of both the DOEs and the UNFCCC. As such, the implementation and consequences of establishing such a fund should be thought through very carefully.

2. How could the reserve/pool could be created?

An independent body separate from the UNFCCC would most likely be required in order for the reserve/pool to be created without any conflicts of interest to arise. Undoubtedly the costs involved in the creation, operations and maintenance of a reserve/pool would be high given the legal issues and rules that would be required (membership, fees, policy/premium increases after claims etc.).

3. Who should manage the reserve/pool?

The UNFCCC should not be involved in a reserve that would need to purchase CERs and be active in the CDM market. DOEs could effectively manage their own liabilities and if they so choose, their own reserve. However, the conflicts of interest and moral hazards with a DOE-managed reserve do pose risks.

4. How can moral hazards in the use of the reserve/pool could be avoided?

Independent bodies that have no conflict of interests with regards to CDM assurance or governance must come into operation in order to avoid moral hazards in the use of the reserve/pool to be effectively avoided. However, the costs involved in this would be exceedingly high.

The best option in terms of controlling moral hazards and costs would entail a rolling CER pool as highlighted earlier in this submission. The management of the rolling pool should be shared both by the UNFCCC and a rotating DOE 'Chair' managing liabilities based on observations of actual cases, internal risk management and an assessment of liabilities since the introduction of the VVM.

IETA greatly appreciates the opportunity to provide an input on this issue. Please do not hesitate to contact IETA's Director for International Policy, Jeff Swartz at swartz@ieta.org should you have any questions regarding this letter.

Thank you for your consideration.

Dirk Forrister

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President and CEO, IETA