



NATSOURCE® LLC

October 7, 2004

Mr. John Kilani
UNFCCC Cooperative Mechanisms Programme
Martin-Luther-King-Strasse 8
PO Box 260124
D-53153 Bonn Germany

Dear Mr. Kilani:

This letter is in response to the Clean Development Mechanism (CDM) Executive Board's (EB) decision to review AM0001 as part of the review process for registration of a CDM project. We believe that reviewing an approved baseline as part of the registration process is inconsistent with the modalities and procedures governing the registration of CDM projects and that this precedent could undermine market participants' confidence in the mechanism's ability to create necessary supply at a particularly sensitive time.

The following modalities and procedures govern the registration of CDM projects:

In accordance with the modalities and procedures for a CDM (Annex decision 17/CP.7):

"41. The registration by the Executive Board shall be deemed final eight weeks after the date of receipt by the Executive Board of the request for registration, unless a Party involved in the project activity or at least three members of the Executive Board request a review of the proposed CDM project activity. The review by the Executive Board shall be made in accordance with the following provisions:

- (a) It shall be related to issues associated with the validation requirements;
- (b) It shall be finalized no later than at the second meeting following the request for review, with the decision and the reasons for it being communicated to the project participants and the public".

As this language makes clear, reviewing a baseline methodology as part of a registration review by the CDM EB is fundamentally inconsistent with the modalities and procedures governing a CDM project. The modalities and procedures for registration of a CDM project clearly state that should the EB decide to review a project that has requested registration, *such review shall be related to issues associated with the validation requirements*. The role of the validating Operational Entity (OE) is to confirm that the [approved] baseline has been properly applied to the project circumstance. Yet, in this instance the EB is proposing to perform an *ex post* review of an approved baseline methodology.

The OE has *neither the right nor the obligation* to question an EB approved baseline methodology. Similarly, since it is not within the purview of the OE to question an approved baseline methodology when conducting a validation, *an EB review of a registration request must be limited to issues associated with the validation requirements rather than the approved baseline methodology against which such validation is being conducted.*

As discussed above, revisiting a baseline methodology at the registration stage of the project cycle is fundamentally inconsistent with the modalities and procedures for the CDM. The EB has established a specific forum, and a Methodology Panel, for the approval of baseline methodologies that is consistent with the modalities and procedures established by the Parties. Adjustments to approved baseline methodologies, if any, should be carried out in this forum. Even in this forum, any review of a baseline by the EB/Meth Panel and any subsequent adjustment should be limited to the application of the baseline methodology to new projects, not to a project whose baseline has already been validated.

Projects that have secured validation using approved methodologies should not be subject to retrospective adjustments to their baselines under any circumstance and certainly not as an element of the project registration process. Such retrospective adjustment is inconsistent with the modalities and procedures, and international norms and standards. It was also not anticipated by project proponents. We believe such retrospective adjustments will increase the uncertainty surrounding the project approval process and add another element of project risk. The impact of this risk is that project proponents and CER purchasers will not have confidence in the sanctity of validated baselines and therefore may not invest in otherwise beneficial projects.

Natsource is concerned with the impact that this type of action will have on the development of the international greenhouse gas market. We have significant experience in participating in emissions markets for conventional pollutants in the United States and in the international greenhouse gas market. We are one of the largest brokers of environmental commodities in the world and several of our staff have been engaged in the policies that created these markets as senior government officials in the United States and Canada for over a decade. We have seen first hand the environmental and economic benefits that functioning workable markets for such commodities can achieve.

However, the success of such markets is dependent on key conditions. All markets, and in particular those for environmental commodities will be most efficient and achieve the objectives for which they were intended when there is confidence in the regulatory and administrative process governing market institutions. When confidence is undermined through unanticipated action by governing bodies, there is strong potential that markets will not create the benefits for which they were intended. Buyers and sellers will be hesitant to rely upon market mechanisms to achieve their objectives. Those purchasing CERs will be doing so for the purpose of complying with legally binding emission reduction requirements. They will contract for a volume of CERs that they require for this purpose. If they cannot rely on a validated baseline in determining the quantity of

CERs accruing to a project, their confidence in this mechanism will decline. If this occurs, they will seek to achieve their compliance requirements potentially using higher cost methods. Similarly, on the sell side, if project proponents are going to expend the resources necessary to develop a project and develop saleable CERs, they need to believe in the integrity of the project approval process and that it will not be subject to ex post reviews that were not envisioned by the Parties. If they do not have this confidence, we fear that investment will be deterred, adequate supply will not materialize and developing countries will not receive the benefits in the form of technology and cleaner energy that the mechanism was designed to encourage.

The review of this baseline is coming at a particularly sensitive time. It is anticipated that the Protocol will enter into force in 2005. Thousands of entities are in the process of developing and implementing compliance strategies. If confidence in the CDM mechanism is undermined due to inconsistent application of the modalities and procedures established by the Parties, investment in projects and the supply of CERs could be depressed. For these reasons, we would respectfully urge you to carefully consider the impacts of your actions on the future functioning of this important mechanism and on the broader market.

Sincerely,

Richard H. Rosenzweig

Managing Director
Natsource LLC