
Climate Finance

Regulatory and Funding Strategies for Climate Change and Global Development

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Chapter 6



Expectations and Reality of the Clean Development Mechanism

A Climate Finance Instrument between Accusation and Aspirations

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Key Points

- The CDM has, by many accounts, met its objective in terms of the funds it has leveraged from the private sector to achieve mitigation in developing countries, the capacity it has built, and the awareness it has raised, not to mention the lessons it has provided.
- Despite these successes, the CDM has been roundly criticized from many fronts in terms of its governance practices, environmental integrity, and contribution to sustainable development.
- The CDM has too much experience and future potential to justify abandoning it in the post-2012 climate framework. Much needed reform, focusing on improving the environmental and administrative credentials of the scheme and an expansion of its scope and scale, will transform the CDM into a truly useful tool for sustainable development and climate policy.

Introduction

Born in the last hour of the Kyoto Protocol negotiations with modest expectations, the Clean Development Mechanism (CDM) offers a story of

unprecedented success. By June 2009, the CDM Executive Board (EB) registered more than 1,500 projects that are expected to create 1.6 billion tons of greenhouse gas (GHG) emission reductions by 2013. The CDM has attracted the interest of the private sector in industrialized and developing countries alike and built a global carbon market.

The CDM initiated a paradigm shift in support of developing country action under multilateral environmental treaties. In its design, negotiators relied heavily on experience from the Global Environment Facility (GEF) and the Multilateral Fund for the implementation of the Montreal Protocol. They modeled the EB after the Multilateral Fund's Executive Committee, and introduced the concept of additionality, closely related to the incremental cost principle of the Multilateral Fund and the GEF. At the behest of the US, negotiators however introduced two innovations in the CDM's design, making its operational character fundamentally different from those of the GEF and the Multilateral Fund: (i) investment was linked to tradable emission certificates; and (ii) private entities authorized by State Parties were invited to participate. By involving markets and private actors, the Kyoto Protocol leveraged significant financial resources for low-carbon investment in developing countries. In 2007 and 2008 alone, the CDM mobilized USD 15 billion in primary transactions in Certified Emissions Reductions credits (CERs). In comparison, the GEF—the single biggest environmental trust fund and financial mechanism for four international environmental conventions—received USD 3.13 billion in August 2006 from 32 donor governments for its operations between 2006 and 2010.

Despite these impressive figures, the CDM has not elicited the happiness or pride that one would expect. Instead, it stands in a withering crossfire of criticism. Some complain it funds business-as-usual projects, failing to create real emission reductions. Others assail its governance practices, or claim that its projects are too small to incentivize the more substantive emission reductions needed to shift economies toward a low-carbon development path. It is simultaneously too small and too ambitious, and it targets the wrong emission reductions or does not deliver them at all.

The extent of its success may have contributed to these troubles. The EB and independent verifiers cannot cope with the volume of technically detailed work generated by the flood of projects, and industrialized countries fear that more offsets are produced than their emission trading schemes can absorb, lowering their domestic GHG abatement efforts.

With less than six months before United Nations Framework Convention on Climate Change (UNFCCC) negotiators convene in Copenhagen to decide on a future climate framework, it is time to evaluate which of the criticisms are valid and which are expressions of general discontent with the Kyoto Protocol or the concept of offsetting. In this brief paper, I assess whether the CDM has met the objectives in Article 12 of the Kyoto Protocol and compare its performance with the expectations about the role of the mechanism and what it can deliver. I conclude with a short proposal of the mechanism's role in a post-2012 climate framework, and I present a reform agenda to achieve it.

Evaluation of Performance

The CDM's purpose according to Article 12.2 of the Kyoto Protocol is twofold:

- To assist Parties not included in Annex I to achieve sustainable development and contribute to the ultimate objective of the Convention
- To assist Annex I Parties compliance with quantified emission cuts and reduction commitments under Article 3 of the Kyoto Protocol

Applying the letter of the Kyoto Protocol, both objectives have been met. First, it is a developing country's prerogative to define whether a CDM project falls within its sustainable development strategy when it approves the project. Sustainable development is not defined by the Kyoto Protocol or the decisions of the Meeting of the Parties, so all 1,671 registered CDM projects with host country approval are assumed to contribute to the country's sustainable development. The Kyoto Protocol simply does not leave any room to second-guess the approvals and underlying policy decisions of CDM host countries.

Second, the CDM contributes to Annex I countries' ability to meet their emission reduction targets. Since 2000, public and private entities from industrialized countries have used the CDM to lower the costs of compliance with the targets set by the Kyoto Protocol. Most Western European governments have established CER purchase programs or authorized the World Bank to acquire carbon credits on their behalf, and the EU private sector has poured money into the CDM to reduce the costs of compliance with the European Union Emissions Trading System (EU ETS).

Thus, if the CDM has achieved its legally defined objectives, what are the sources of general discontent with the mechanism?

Sources of Unhappiness

A central criticism of the CDM has centered on the nature of sustainable development, and the different understandings of how the CDM can or should contribute to it. Can sustainable development take the form of industrial energy efficiency or landfill gas destruction, or must it be associated with decentralized and small-scale mitigation and renewable energy projects? Does it create unjustified economic rents, or does efficiency in marginal abatement not affect the value of a mitigation action? The most problematic feature of defining sustainable development is that, while the term is widely used, it embodies so many considerations and values that need to be balanced (social, economic, environmental, and ethical) that its substance is often hard to pin down.

As a market mechanism, the CDM searches for the cheapest emission reductions, and it has been more effective in reducing mitigation costs than in contributing more broadly to sustainability. Yet, from a climate change perspective, it is arguably more worrisome that the CDM has not moved developing countries toward sustainable low-carbon development paths. Critics have challenged the prerogative of the host country to define sustainable development and have expressed concern over CDM funds going to projects with little sustainable development benefits (e.g., destroying industrial gases).

A second significant issue is the CDM's climate change integrity. This mechanism's success is dependent upon real, measurable mitigation of GHG emissions. It is crucial that reductions are additional to what would have occurred otherwise. The EB's interpretation of additionality has been debated vigorously. Some authors claim that many registered projects would have occurred in the absence of CDM certification and award of CERs, while others complain that the EB is excessively stringent in its assessment of additionality. The EB's additionality test embodies a counterfactual that can never be conclusively proven. As long as the CDM evaluates additionality through a test that is coupled with a motivation criterion (why did you engage in the project, and did the CDM influence your investment decision?), it is unlikely that a satisfactory solution to these problems will be found. Critics will continue to question the

assertions of project developers that CERs are essential, project developers will have trouble accepting a test which contradicts their entrepreneurial spirit (requiring them to explain why the project will fail without CERs), verifiers mistrust project developers and the EB mistrusts verifiers, and academics will continue to find plenty of reason to challenge the whole system.

To add to these complaints, the CDM does not work efficiently. The approval process is ineffective, slow, and guided by political considerations rather than factual competence. The mechanism has failed to develop a regulatory due process to guarantee fundamental fairness, justice, and respect for property rights. The credibility of the CER market depends largely on the robustness of its regulatory framework and the private sector's confidence in the opportunities provided by the mechanism. This confidence is at risk in the face of mounting complaints about the continued lack of transparency and predictability in the EB's decisionmaking. The governance structure should be reviewed and reformed, taking into account the need to provide private-sector participants (not represented in the Conference of the Parties (COP)/Meeting of the Parties (MOP)) with due process and to ensure the conditions for fair and predictable decisions.

Finally, the CDM has yet to produce the requisite scale of emission reductions. To date, incentives have been too weak to foster the economic transformations necessary to prevent developing countries from following high-emission development paths. While the CDM has worked where carbon can add new sources of finance to investments in private-sector-driven projects, it has failed to mobilize emission reductions for larger policies and programs, including decentralized sources of emissions such as transport or building emissions.

Reasons to Keep the CDM

The CDM has leveraged more finance into GHG emission-reducing projects in developing countries than any other international mechanism, more than its designers ever anticipated. There are other reasons to keep the CDM:

- It enjoys broad support among developing countries. In particular, poorer and smaller countries have established their national CDM

authorities only relatively recently and are just starting to engage with the mechanism. There is a risk of losing goodwill and cooperation of developing countries in abolishing a mechanism that enjoys widespread support and while capacity-building to participate in it is still ongoing.

- It is a linchpin of the international carbon market, supporting a community of innovative investors and compliance credit buyers, and providing important lessons for scaled-up carbon trading mechanisms.
- It has been valuable in creating awareness of climate change and capacities to address it among sectors and stakeholders not normally involved in climate policy.
- It remains a useful tool to provide access to project finance for emission reductions in most developing countries, especially those that are poorer or smaller, and for some sectors of emerging economies.

The CDM should therefore not be abandoned without considering the associated political costs. The mechanism certainly needs reform, but should we dismiss it as failed experiment, a corrupt and flawed expression of dysfunctional UN bureaucracy? Or should we engage in a reasonable discussion on a feasible reform agenda and a meaningful future role for the CDM?

The Reform Agenda

The CDM is in urgent need of reform. It needs assistance in creating more ambitious and broader incentives for developing country emission reductions. A second generation of market and non-market mechanisms under the UNFCCC is needed.

CDM reform and expansion should be built on three pillars:

1. The CDM's environmental credibility needs to be strengthened by replacing the EB's additionality test with alternative tools to evaluate emission reductions, including clear criteria, sectoral benchmarks, approved multi-project or sectoral baselines, discount factors, and positive lists for certain project classes or projects in least developed countries. A decision should be taken after the EB or UNFCCC has

commissioned a study on the impact of the various proposals on the supply of emission reductions from particular regions or project classes.

2. If the CDM is to survive beyond Kyoto's first commitment period, its administrative procedure must meet international due process standards. Private economic actor firms will invest time and resources in generating, monitoring, and certifying emissions reductions only if they are assured a reasonable degree of regulatory certainty. The CDM governance will have to be put on the right track for the second commitment period, enhancing the predictability of its decisions and private-sector confidence in the system. Professionalizing the EB is an essential step. Full-time, salaried individuals, selected on the basis of their technical and administrative expertise, with sufficient technically skilled support staff, can give the EB the necessary independence and resources to deal properly and impartially with a growing volume and complexity of work. In addition, a review mechanism of the decisions of the EB should be established. This would give project participants, and other entities with rights and obligations under the CDM, the right to obtain review of EB decisions.
3. Finally, expansion of both the scope and scale of the CDM is vital. As a project-based mechanism, it suffers from inherent barriers in promoting broader policy change, in some instances even creating perverse incentives which delay adoption of much needed environmental regulatory measures that would reduce emissions standards. Therefore the CDM must be supported by more ambitious sectoral and policy crediting mechanisms. In addition, there are a number of steps that can be taken to allow the CDM to benefit rural and poor communities more effectively:
 - Removal of barriers to programmatic CDM projects such as energy efficiency, decentralized electricity, heating and cooking solutions, transport, and agroforestry programs.
 - Removal of limitations on forestry, agricultural, and land-use projects to allow for projects on land deforested after 1990, and expansion of covered activities to include projects that promote sustainable management and restoration of forests, peat, and grasslands.

Conclusions

Cassandra voices predicting the CDM's doom fail to recognize the critical role that project-based offset mechanisms, including the CDM, will play in a future climate regime. They are crucial to expanding the scope of emission mitigation, leveraging private-sector investment, encouraging innovation, broadening global support, and securing a political deal. The CDM remains a valuable tool for incentivizing emission reductions in smaller and low-emitting developing countries, and it should continue in sectors that do not form part of more ambitious GHG reduction efforts in emerging economies. Where projects are implemented in the context of broader GHG accounting programs, existing projects can be converted and follow Joint Implementation accounting rules.

However, to continue past 2012 there must be reforms and improvements in its environmental and operational performance. These are essential to counter an alarming tendency among EU and US policymakers to call for the domestic design of international offset mechanisms. Since the demand for carbon credits is mainly generated by emission trading schemes in industrial countries, these countries have the power to dictate the rules of the game. If they decide to wield this power, not only would developing countries lose much of their influence, but the CDM and the CER market could find itself subject to a multitude of conflicting offset standards from Washington and Brussels.

Too much has been learned, and too much remains viable, for policymakers to abandon a functional project offset system. Outlined above are only a few of the reasons why we should extend the CDM's lifeline and why we should all be interested in a robust, credible, harmonized, and universal international offset standard.

FURTHER READINGS

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