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Subject **Call for inputs on significant deficiencies**

Honorable Members of the CDM Executive Board,
Dear Mr. Duan,

The PD Forum welcomes the call for inputs on this important issue and would like to offer the following comments on both the concept note (published as annex 19 to the annotated agenda for EB68) and the questions raised in the call for input:

- The concept note and call for input reflects the fact that the views of project developers have **not** been taken into consideration in this process. PPs are likely to be directly affected in a number of ways which have been highlighted in our presentations on this topic at the round tables and in our written submissions to the EB. On this basis, we would have expected that our input would have been sought earlier in this process.
- While we welcome the fact that liability of DOEs is capped, we remain concerned that significant financial penalties will not have the desired results as many DOEs will simply go out of business rather than pay for the purchase of significant numbers of CERs. Some DOEs are already shifting the legal basis of their accreditation to entities which can be kept at arm's length and closed without significant consequences. In this event not only is it hard-won DOE capacity that is lost, but the stated objectives of the procedure itself will also fail.
- And for those DOEs that remain in business, an increase in fees for validation and verification is inevitable. The CDM is already under significant price pressure and increased verification costs will only act to reduce the number of verifications, stressing PP and DOE cash flows even further. Further, an increase in DOE fees will have a disproportionate effect on projects in LDCs and other regions that are currently under-represented in the CDM and small and microscale projects.

Considering the concept of the CER reserve, we offer the following comments:

- The concept note suggests that a 'pool' or reserve of CERs is established and is "*funded from various sources and actors within the CDM, including bringing the fund up to an appropriate level by requiring a contribution of a share of each CER at every issuance*". We would highlight the fact that the establishment of a 'pool' or reserve of CERs in this way goes far beyond the mandate given to the EB by the CMP in that this would penalize project developers indiscriminately.
- The PD Forum **strongly resists** any concept of PPs being required to surrender additional allowances or pay additional fees in addition to the SOP Admin fees and the contribution to the adaptation fund. PPs should not be penalized in any way for the erroneous actions of DOEs.

- However, in the event that any new funds are to be collected, they shall be applied to projects submitted for registration after the date at which the procedure is adopted and not applied retrospectively to existing registered projects.

Questions for the Call for Inputs:

1. The purpose of such a reserve/pool:
 - a. Is it a form of mutual insurance for Designated Operational Entities?
 - b. Is it an "environmental integrity fund" compensating for excess issuance outside of the draft Procedure?
 - c. Is there another associated rationale?
2. How the reserve/pool could be created;
3. Who should manage the reserve/pool;
4. How moral hazard in the use of the reserve/pool could be avoided.

The PD Forum suggests that the establishment of a reserve/ pool that acts as an "environmental integrity fund" compensating for excess issuance outside of the draft Procedure is not a practical suggestion. All of the experience that we have now gained from developing and implementing the CDM shows that it would not be possible to correct for every over-issuance in an efficient, fair or accurate manner or indeed to demonstrate with any degree of certainty that an over-issuance has occurred.

As we have previously suggested, we would once again suggest that the Secretariat look at the known conservative elements of the CDM including the grid emission factors, the flaring tool and default factors in some of the industrial gas projects as a source of un-issued CERs which currently stand to the credit of the mechanism.

We understand that some DOEs may support the idea of the establishment of a reserve pool of CERs. In this way, if it were found that an over-issuance was caused by the DOE's professional negligence or fraud, then the DOE in question could purchase CERs from the 'pool' rather than from the market for transfer into the cancellation account.

The PD Forum suggests however that if the DOEs collectively wish to establish a 'pool' of CERs from which individual DOEs can purchase CERs then that is entirely their affair. However, there are a number of alternative (market based) options which DOEs could consider:

- Direct purchase and banking of CERs to be drawn upon in times of need
- Purchase of options to acquire CERs in times of need
- Investment in a fund which invests into CDM projects to generate CERs
- Increase the DOE license fee to establish a set aside to insure in part the value of excessive CERs issued by purchasing CERs and generating a reserve/pool.
- A % of project registration fees could be used to insure the risk of excess issuance of CERs (without increasing these fees).
- Etc.

Furthermore, considerable leverage could be applied to each of the above models by exploiting the fungibility of different kinds of emission reductions. For example, DOEs could in theory surrender ERUs in place of CERs, or surrender industrial gas CERs which are soon going to be long, and some DOEs may be able to access AAUs. The impact of these kinds of actions upon the environmental integrity of the "pool" and significant deficiency process need to be addressed.

Therefore, whilst we maintain that this is not a good way of proceeding, we think that if the EB decides to follow this route, DOEs have a lot of alternatives to consider before deciding how best to manage a pool of allowances and in the process minimize the costs in an increasingly hostile economic environment.

In order to ensure transparency and integrity, the pool should be managed by a DOE trade association or other external body and not the Secretariat.

We assume that the moral hazard to which question 4 refers is that DOEs may become less careful because the costs of their mistakes are borne by others. There is a real risk that a pooled insurance process could create this situation which would further damage the credibility of the CDM. Applying an excess, as in normal insurance policies, may provide some disincentive to act in this way. Alternatively there could be a no-claims bonus scheme.

However, given that the DOE was selected via a rigorous process (high entry barrier) akin to an oligopolistic market, then the DOEs will always pass the costs of additional risks out onto them by the regulator, onto the PPs, even when the risks belong to the DOEs themselves. To counteract this, the EB may consider further regulating the DOE's service fees to costs plus margin or a cap. There are many examples of such behaviour for example in monopolistic sectors of water or power suppliers where entry barriers are very high – Government regulates the way in which they charge their customers. If they regulate the DOEs revenue, then the EB could very effectively penalize underperforming DOEs without impacting unduly upon the PPs.

We thank you for the opportunity to provide our comments on this issue and would be very happy to discuss them with you further,

Kind regards,



Rachel Child
Co Vice Chair, Project Developer Forum