PROJECT
DEVELOPER
FORUM

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Subject	**Call for public inputs on the draft "Procedures for regarding the correction of significant deficiencies and the excess issuance of CERs"**

Honourable Members of the CDM Executive Board,
Dear Mr. Mahlung,

The Project Developer Forum (PD Forum) would like to express its appreciation that the CDM EB has issued a call for public input of the on the draft "Procedures for regarding the correction of significant deficiencies and the excess issuance of CERs" and is pleased to submit the following comments. The PD Forum has already submitted unsolicited comments in advance of EB56 via our regular letter commenting on the EB's annotated agenda. This input will further expand on those comments by focusing on the questions posited by the Board.

The Board requests input on the following:

(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;

In our opinion, the draft procedures do not comply with the decisions of the CMP in a number of ways:

- The draft procedures fail to adequately define the scope which might be applicable to an audit of validation, verification and certification reports (Paragraph 12). Simply because a DOE is suspected or found to have made a significant deficiency in a recent verification/certification report for a landfill gas project activity should not signify that all previous validation, verification and certification reports be subject to review for similar deficiencies.

    i. Para 12 a) limits it to a situation where accreditation has been suspended or withdrawn. That in itself is not straightforward; because as detailed below, Paragraph 23 of Decision 3/CMP.1 only allows suspension of a DOE after PPs of affected registered project(s) have had a hearing.

    ii. Para 12 b) limits the scope by requiring that significant deficiencies relate to one or more of the non-conformities that formed the basis of suspension or withdrawal of accreditation of the DOE.

The danger lays that a non-conformity against today's requirements will be used as a basis to open up decisions that were most likely made against a different set of rules. Therefore, paragraph 12 must be revised to reflect paragraph 14 of Decision 2/CMP.4 requesting the EB to adhere to the principle that any decision, guidance, tool or rule shall not be applied retroactively, i.e. the scope of an audit of validation, verification and certification reports must be restricted to the version of accreditation standard and any other rule which was in effect at the time that the significant deficiency arose.

In order to minimize the incorrect identification of potential significant deficiencies, the comprehensive list prepared under paragraph 12 shall include all decisions, guidance, tools, rules, and versions of methodologies and templates relied upon by the CDM-AT to identify potential significant deficiencies.

- Paragraph 14 of Decision 2 CMP4 requesting the EB to adhere to the principle that any decision, guidance, tool or rule shall not be applied retroactively: The draft procedures fail to make it sufficiently clear that CDM rules or requirements in effect at the time of the submission shall be applied. This language is included in the definition of a deficiency in paragraph 5, but is missing in, inter alia, paragraphs 7a, 8b, 9, 10, 22, 23c, 24 and Section VII. Furthermore, when selecting an audit team to undertake the review (paragraph 21), the EB should ensure that the selected team has a full history and knowledge of the decisions, guidance, tools or rules which were in effect at the time of the submission of the request.

- The draft procedures have not taken Paragraph 63 of Decision 3/CMP.1 into account. Paragraph 63 of Decision 3/CMP.1 clearly states that the verifying DOE shall certify in writing that the project activity has achieved the amount of verified emission reductions. The action of certifying emission reductions means confirming that they are accurate and true. On this basis, liability for excess issuance of CERs cannot be passed to a validating DOE because they had no direct or indirect role in certifying the emission reductions..

- Paragraph 10 of the draft procedures is in conflict with paragraph 23 of Decision 3/CMP.1. Para 23 states that any suspension or withdrawal of DOE accreditation that adversely affects a registered project activity can only be recommended by the EB after the project participants have had the possibility of a hearing. The identification of significant deficiency associated with a registered project activity will undoubtedly impact adversely upon the project activity and therefore the PPs must have the chance to present their views.

- As an aside, any suspension of a DOE's ability to progress existing verification engagements whilst under suspension will have an adverse impact upon project activities – i.e. those projects which the DOE is working on but cannot submit whilst under suspension. Ergo, it would seem logical that the PPs of all affected project activities indeed be entitled to a hearing before the suspension is confirmed.

- The draft procedures do not address paragraph 42 of Decision 3/CMP.1 which allow projects which are not approved for registration to re-apply after appropriate revisions have been made. This is necessary to deal with situations where paragraph 8b is valid, (ie the DOE validated the project on the basis of an incorrect fact, for example) but the project can still be shown to be additional on the basis of an alternative additionality argument. The procedures developed to deal with post registration changes in project activities may have some relevance to this situation.

(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;

- Considering that the CDM has been widely promoted as a "learning by doing" process, liability for excess issuance of CERs should be based on proven malfeasance or fraud. It is not fair or reasonable, and it will not encourage further development of the CDM, if liability is assigned on the basis of incompetence in a process where rules are made up along the way. Perhaps, when related to incompetence, the CMP should establish a statue of limitations that coincides with the availability of significant guidance to effectively perform verifications/certifications.
- Therefore significant deficiencies should be defined as errors in the issuance of CERs arising from fraud or malfeasance on the part of PPs or DOEs. Incompetence on behalf of the DOEs should not be used as a basis for defining significant deficiencies.
- To help the EB prepare these procedures, the CMP should clarify a statute of limitations based on the period of time during which the versions of relevant tools, guidance, methodologies, rules etc have been enforced.

(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;

- It is likely that DOEs would seek to pass on costs of liability to PPs which would inevitably result in either higher transactional costs or potentially some form of hold back of CERs.

More significantly these procedures would:

- Act to further limit the capacity of the DOEs to undertake and complete their functions within the indicative timelines established between the EB/DOEs.
- Encourage some DOEs to withdraw their accreditation if they feel the procedures place an unfair amount of liability on their decisions. There has already been discussion on the likelihood of this occurring in several press publications
- If DOEs are suspended because of significant deficiencies, and if under the current procedures additional audits are initiated to identify multiple potential significant deficiencies, then DOEs can conceivably be removed from service for a considerable period of time that could last more than 12 months. The impact on other PPs project activities, now held in abeyance, could be huge. Furthermore, if one or more DOEs are then called upon to review the work of the suspended DOE, which we highly discourage, it will take up further resources. All in all, the availability of DOE resources to move validation and verifications efficiently through the queue will decrease, likely increasing prices and also reducing their ability to register projects and verify CERs.
- It may be difficult to find DOEs who have sufficient knowledge of the rules, guidelines, methodologies etc., in effect at the time of the potential significant deficiency who themselves have not been involved in the prior validation or subsequent verification of the same project – in such cases there would be clear conflict of interest.
- Situations may arise where DOE "A" audits DOE "B" and then DOE "B" is called upon to audit DOE "A". Such a situation presents opportunities for collusion between DOEs or retribution, even if the CMP would accept the underlying principle of one DOE audits another competing DOE.
- DOEs will likely become more selective about which projects they choose to validate and verify with simple projects with simple methodologies (e.g., ACM0002) being much easier and lower risk than, for example, complex methodologies and projects.
- The potential of these procedures to result in the de-registration of a registered project activity (para 37c) will undoubtedly deter further investment in the CDM. From the project developers' and investors' point of view, this amounts to a retrospective removal of registration after the UNFCCC has reviewed and the CDM EB has approved, or at least not disapproved, the

registration of the project activity. It will only take a few examples of investments, which were made on the basis of CDM, losing their right to claim CERs to discourage any further investment in additional projects.

- In the early days of CDM, investors were concerned about the level of risk associated with investment. It was widely felt that risk would be mitigated at validation;
- CDM evolved and the request for review became commonplace. Risk mitigation was no longer considered at validation; rather it was now felt that a project was secure once it achieved registration.
- But the evolution of risk mitigation did not stop at registration as investors soon learned that a issuance could be stopped for a myriad of reasons;
- And now, it is being suggested that a project, after proving that funds from CDM are required to be successful, can lose registration, years after the fact, if an issue is identified during a routine verification.

This persistent shifting of risk seriously undermines investors' confidence in the CDM and in our opinion, would discourage further investment in the CDM.

- Given the recent impact of CDM EB decisions on the CER market, it is possible that all parties involved in the audit of a DOE may gain inside knowledge of facts which may cause further movements in the market. Such knowledge will need to be very carefully managed and if not controlled adequately, it could significantly undermine the integrity of the CDM market.

(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;

- As mentioned above, extending the general principle to cover incompetence on behalf of DOEs is not practical. The CDM is a learning by doing process; the EB themselves make policy on a project by project basis and many historic rules and guidance documents, methodologies and decisions contain contradictory elements; some are still not consistent and are open to project by project review. Documentation approved by the Secretariat, the Board, it panels, DOEs and accepted by Parties still contain errors despite extensive checking and re-checking. Placing all the blame for these upon the DOEs is not equitable and will not encourage DOEs to engage further in this mechanism.
- The general principle to replace excess issued CERs should be addressed towards fraud and malfeasance on behalf of PPs and DOEs, with clear penalties following a transparent appeals process. As suggested below, DOEs should be address via their accreditation contracts. Fraud and malfeasance on behalf of PPs may be addressed via host or non-host country legal channels.
- Over-issuance of CERs due to incompetence will occur, despite the best efforts of all concerned. However, the CDM has the principle of conservativeness at its heart, and there are many examples of emission reducing actions motivated by the CDM which do not result in issuance of CERs. For example, project activities which commence before the start date of the crediting period – these may produce VERs but VERs are not surrendered for compliance purposes; projects which continue beyond the end of a crediting period and remain additional; "positive" leakage whereby technology transfer and good practice influence behaviour beyond the boundaries of the CDM; explicitly conservative default factors, boundaries and soruces in methodologies and tools etc.
- Other legislative processes seldom impose such heavy penalties on the participants.
- It needs to be recognized that the CDM is a market mechanism and its shortcomings should be addressed within this context. If the CMP considers that a penalty for incompetence is

essential, they could consider a fixed penalty of, for example 1000 CERs or "X" amount of USD per infringement entities will be able to manage this risk. Such an approach would also have the advantage of de-linking the size of the penalty from the project. Under the existing draft procedures, two DOEs might make the same mistake but one be "fined" 500 CERs whilst the other be fined 50,000. DOEs would be able to take practical and cost effective steps to protect against such fixed losses. A fixed amount as penalty will have the advantage that it can be managed easily as its value does not change over time, while the value of an amount of CER will depend on market prices and will vary over time exposing DOEs to market movements, a risks they are not equipped to manage.

(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.

- This would amount to malfeasance or fraud. Where the DOE is involved, this should be addressed through the accreditation contract; where the PP is involved it may be addressed through the legal channels of the host or non-host country.

Kind regards,

Leo S. Perkowski
Vice Chairman