

NOTE ON THE COP7 DECISIONS ON MECHANISMS ELIGIBILITY AND EMISSIONS TRADING

(Based on Part J, sections 1, 2 and 4 of the advance version of the Marrakech Accords – relevant text annexed at end)

1. Key issues to be decided at COP7

Eligibility criteria

The mechanisms eligibility criteria refer to a series of requirements that (Annex 1) Parties) must fulfil before being allowed to make use of the Kyoto mechanisms. The logic underlying these requirements is twofold:

- To ensure that any allowances or credits that are traded are backed by sound reporting, monitoring and verification and a robust regime for dealing with non-compliance.
- To provide additional leverage for Parties to comply with their non-Article 3.1 commitments, including under Articles 5, 7 and 8, and to agree be bound by the Protocol's compliance regime.

After COP6bis the only criteria that had been agreed were that a Party should:

- a) be a Party to the Protocol;
- b) have satisfactorily established its assigned amount;
- c) have its national system in place; and,
- d) have its national registry in place.

Even these were still debated in terms of whom they should be applied (buyers, sellers, both) to, while the link to the compliance regime and reporting requirements (especially with regard to sinks) were the cause of considerable conflict. The Umbrella Group demanded minimal preconditions to mechanisms use, in particular that there should be no explicit requirement that a Party be subject to the compliance regime, whereas the EU and G77 – albeit for different reasons – argued for tighter requirements. CAN additionally argued that maintenance of the Commitment Period Reserve at its stipulated level, satisfactory demonstrable progress and supplementarity reporting should also be included.

An additional outstanding issue were the criteria that would be waived for Parties hosting projects under the Joint Implementation second track. The main concern here was that relieving Parties of the need to back their credits with sound monitoring, reporting and verification would open the door to the laundering of unsubstantiated sinks credits, especially in the absence of strict rules for baselines and additionality.

Emissions Trading (Article 17)

Of the three mechanisms, despite the remaining conflicts over the eligibility criteria, fungibility/transferability and to a lesser extent the Commitment Period Reserve, Article 17 had the fewest outstanding issues going into COP7. While the JI and CDM texts were both long and contained numerous technical and institutional details, emissions trading us conceptually and practically simpler than the two project mechanisms and other difficult issues, such as supplementarity, had been resolved in Bonn. Other than the eligibility criteria the only remaining issue was the Commitment Period Reserve.

The Commitment Period Reserve emerged as the result of a compromise between the main negotiating groups at COP6bis over the need to prevent the overselling of assigned amount by Parties, and the appropriate mechanism for doing this. The CPR satisfied nobody and

was further weakened by ambiguous language in the Bonn Agreement about how it was to operate. The text stated that

each Party *shall* maintain....a commitment period reserve which *should* not fall below 90% of [its] assigned amount.

Clearly this left open the interpretation that while a Party was obliged to have a CPR, the requirement to hold 90% of its assigned amount in it was at best a moral one and legally unenforceable. In this scenario the CPR would effectively be voluntary and provide no safeguard against overselling. Therefore, it was hoped that mechanisms could be introduced that, while leaving the Bonn Agreement text intact, would make the 90% level mandatory. The preferred solutions for the majority of NGOs were for it to be directly linked to eligibility to use the mechanisms and some sort of filter in registries or the transaction process.

2. COP7 decisions

Eligibility Criteria

The eligibility criteria were one of the major obstacles to reaching an agreement at COP7, with the link to compliance in particular being one of the last to be overcome. The issue of sinks reporting was also almost a stumbling block to a final deal, with Canada resorting to some last minute “editorial changes” to the final text, which were inexplicably gavelled through without further discussion. Reporting on complementarity and demonstrable progress were abandoned early on, although references still appear in the preambles to the mechanisms decisions. The criteria already agreed in Bonn and listed above were confirmed.

The link to compliance

Japan claimed that this was a ratification issue and, supported by Russia, Canada and Australia, was not prepared to accept any wording that would tie them to accepting a future compliance amendment to the Protocol. While this fell within Japan’s permanent opposition to legally-binding consequences for non-compliance, it was also argued that such a constraint would enable the G77 to pass an amendment with extremely punitive sanctions (including, for example, for not satisfactorily addressing issues under Article 3.14) and thereby leave Annex 1 countries with a choice between accepting such an amendment or not being able to use the mechanisms. Similarly they claimed that making mechanisms use dependent on the adoption of such an amendment, requiring ratification by 75% of Parties, would effectively allow a small group of countries to block its entry into force and, as a result, use of the mechanisms by any Party.

The intransigence of Japan, Russia and other Umbrella Group members on this issue meant that in order to secure an agreement, **the Marrakech Accords failed to establish an explicit link between a Party’s having ratified a compliance amendment containing legally binding consequences and its eligibility to participate in the mechanisms.** Thus a main point of leverage for getting Parties to agree to bring the compliance procedures into force through a formal, legally binding instrument, and to bind themselves to that instrument, has been lost. The proposed text in the Annexes to the mechanisms decisions has been deleted leaving as the only references a *further emphasis* of the fact that:

environmental integrity is to be achieved through sound modalities, rules and guidelines for the mechanisms, sound and strong principles and rules governing land use, land-use change and forestry activities and a strong compliance regime;

and *awareness* of

...decisions -/CP.7 (Article 6), -/CP.7 (Article 12), -/CP.7 (Article 17), -/CP.7 (Compliance), -/CP.7 (Land use, land-use change and forestry) and -/CP.7 (Modalities for accounting of assigned amounts).

Nevertheless, if at COP/moP1 Parties do nothing more than approve the decisions on compliance as recommended by COP7, then Parties will still be subject to the compliance regime and the decisions of the Enforcement Branch. Any Party that has had a question raised with regard to its compliance with agreed mechanism eligibility criteria (either by an Expert Review Team or by another Party) can have its eligibility suspended by the enforcement branch: 1) In the text on compliance/eligibility you say:

A Party included in Annex I with a commitment inscribed in Annex B shall be considered . . . [t]o meet the eligibility requirements referred to [above] . . . unless the enforcement branch of the compliance committee finds, in accordance with decision -/CP.7 (Compliance), that the Party does not meet these requirements . . .

This is reinforced by the fact that all Parties at COP7 accepted that eligibility should be judged by the enforcement branch of the compliance committee and, in the case of Japan, fought for expedited reinstatement procedures, presupposing the Committee's establishment through a COP/moP decision, if not an amendment.

Annual Reporting

The other main controversy surrounded what, how regularly and to what standard, Parties should report as a prerequisite for using the mechanisms. CAN believed that Parties should report on all activities - not only Annex A sources and sinks as proposed by the Umbrella Group - on an annual basis and that review and approval of these reports by Expert Review teams should be a condition for using the mechanisms. This was supported by the G77 and, to a greater or lesser extent, by the EU. If the CAN position had been accepted this would effectively have meant that many countries with poor quality inventories and reporting systems – especially Russia and other EITs - would have been barred from the mechanisms or would have had to abandon their use of LULUCF credits.

After lengthy negotiations, parties agreed on a compromise, under which a Party must submit:

annually the most recent required inventory, including the national inventory report and the common reporting format. For the first commitment period, the quality assessment needed for the purpose of determining eligibility to use the mechanisms shall be limited to the parts of the inventory pertaining to emissions of greenhouse gases from sources/sector categories from Annex A to the Kyoto Protocol and the submission of the annual inventory on sinks

In other words, **Parties will have to submit their annual inventories but the quality of the sinks aspects will be immaterial** in terms of determining mechanisms eligibility, at least for the first commitment period. In conjunction with the last minute Canadian modification to the final sentence of paragraph 26 of the decision on Article 7.4 allowing a Party to issue RMUs from each sink activity on which it has reported adequately rather than once it has had inventories for all its elected activities approved, this means that Parties will be able to trade sinks units despite deficiencies in their inventories and reporting systems.

Link to the Commitment Period Reserve

The other contentious eligibility criterion was the requirement that a Party should have established its CPR at the required level before making use of the mechanisms. This was deleted in Marrakech, and is discussed further below.

Eligibility for Track 2 JI

Many Parties – particularly EITs and potential buyers of ERUs – argued in Bonn that the eligibility criteria for JI need not be as stringent as those for the other mechanisms, in particular that host countries should not be required to meet the prescribed reporting standards, provided additionality and baselines were in order. Some even suggested that there should be no eligibility requirements for host country Parties, effectively allowing JI investment in the US.

Their main reasons included the need to reduce obstacles to investments in renewing the energy and industrial infrastructure of Eastern Europe and the fact that JI projects only imply transfers within the Annex 1 bubble and therefore no leakage. Also, however, it was clear that the requirement that Parties have robust inventories and national systems would bar many potential sources of ERUs from the system, and that mandatory adherence to all the criteria would jeopardise the investments that had already been made by a number of Annex 1 countries.

The draft text coming into COP7 stated that host countries could opt for a Track 2 procedure and be exonerated from the criteria covering inventories and reporting requirements (Articles 5.1, 7.1, etc.). Since the G77 had already agreed to the existence of Track 2 JI at COP6bis, this was never likely to be strengthened, but nor was it weakened in Marrakech. The agreement maintained the text forwarded from Bonn, with host country Parties being required to have ratified the Protocol, have established their assigned amounts and possess adequate registries and national systems.

CDM eligibility

The final issue related to the eligibility criteria was the question of whom they should be applied to: sellers, buyers or both. In the cases of Articles 6 and 17, with the exception of Track2 JI, there was agreement that both acquiring and transferring Parties should be required to fulfil the criteria and this was confirmed at COP7. The draft CDM text, however, stated that a Party using CERs – rather than acquiring or transferring them - to meet its Article 3.1 commitments should meet the criteria.

While developing country clearly cannot be expected to meet standards they have not committed to, the criteria could easily be applied to any acquiring Annex 1 Party and, in the case of fully transferable CERs, to any subsequent acquirer. The same criteria should apply to any party through whose registry a CER passes, as the same need for adequate MRV exists. One obvious implication is that US companies will be able to develop projects and participate in international GHG trading.

While some see this as positive, because it could form part of a bridge to the Protocol and encourage future US involvement, it may also lead to further proliferation of forestry projects – as has occurred with majority of US offset investments to date - and a greater volume of CERs on the market, reducing again the effort required of Annex 1 Parties. It may also weaken the pressure on the US administration by enabling firms to profit from the Protocol without taking on commitments: rather we should be pushing them to advocate re-engagement.

Emissions Trading

The remaining Article 17 issue, the Commitment Period Reserve, was also left to the final negotiations. The eventual compromise involved deleting any reference to the CPR as an eligibility requirement and retaining the text from the Bonn Agreement in its original form, but keeping the paragraph that forbids any transfer that would lead to a drop below the required level:

8. Upon establishment of its assigned amount pursuant to Article 3, paragraphs 7 and 8, and until expiration of the additional period for fulfilling commitments, a Party shall not make a transfer which would result in these holdings being below the required level of the commitment period reserve.

This has been operationalised through the transaction log (Art. 7.4), which notifies Parties that they should terminate a transfer if the CPR limit is breached. In the case of the trade continuing, the units transferred are rendered invalid for compliance purposes until the correct level has been re-established. Additionally Parties are required to report on the calculation of their CPRs as part of the process of establishing their assigned amounts.

While the compromise COP7 was obviously weaker than NGO expectations, especially given that CPR itself represented a major compromise earlier in the process, the provisions agreed in Marrakech should oblige Parties to keep their Reserves in order, provided that the period allowed for returning to compliance (30 days) is kept to.

3. Conclusions

Compared to CAN positions going into COP7, the Marrakech Accords involved a number of important compromises, seen as necessary to obtain the support of the Umbrella group, and reflecting the leverage its members had over the negotiations. In some cases these compromises represent a significant weakening of the Protocol:

- The loss of the link between mechanisms use and the compliance regime through the eligibility criteria, part of an overall de facto decision to leave the entire debate about the binding nature of consequences for non-compliance to COP/MOP1. This may make it less likely that Parties will accept legally-binding consequences through an amendment to the Protocol, but the issue is still unresolved.
- The dilution of the reporting requirements, especially concerning sinks inventories. Again this will reduce pressure on Parties to fulfil their Article 5 and 7 obligations, although they will still have to meet standards in order to issue RMUs.

Despite being removed from the mechanisms eligibility requirements, the agreement on the Commitment Period Reserve probably does not imply too great a risk to the integrity of emissions trading. The threat of overselling and/or withdrawal of a net seller from the protocol was never going to be addressed adequately by the CPR, although the amount of overselling should be limited.

These results from COP7 are sufficient to allow Parties to ratify and the mechanisms to become operational. However, ensuring their remaining integrity will demand permanent vigilance from the NGO community. Specific tasks will include:

- Keeping up pressure for legally binding consequences for non-compliance at COP/MOP1.
- Ensuring that weaker than hoped-for reporting requirements and the reduced criteria for track 2 JI do not lead to the laundering of RMUs through the mechanisms, both directly and indirectly.
- Lobbying for full transparency of national registries and pushing for commercial confidentiality not to become an excuse for keeping important information away from public scrutiny.

- Ensuring true additionality and quality control in JI and CDM projects, especially those passing through US registries.

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APPENDIX

Text referring to mechanisms eligibility requirements

Decision -/CP.7 (Mechanisms) and Draft decision -/CMP.1 (Mechanisms)

Further emphasizing that environmental integrity is to be achieved through sound modalities, rules and guidelines for the mechanisms, sound and strong principles and rules governing land use, land-use change and forestry activities and a strong compliance regime,

Aware of decisions -/CP.7 (Article 6), -/CP.7 (Article 12), -/CP.7 (Article 17), -/CP.7 (Compliance), -/CP.7 (Land use, land-use change and forestry) and -/CP.7 (Modalities for accounting of assigned amounts),

5. *Decides* that the eligibility to participate in the mechanisms by a Party included in Annex I shall be dependent on its compliance with methodological and reporting requirements under Article 5, paragraphs 1 and 2, and Article 7, paragraphs 1 and 4, of the Kyoto Protocol. Oversight of this provision will be provided by the enforcement branch of the compliance committee, in accordance with the procedures and mechanisms relating to compliance as contained in decision -/CP.7 (Compliance), assuming approval of such procedures and mechanisms by the Conference of the Parties serving as the meeting of the Parties in decision form in addition to any amendment entailing legally binding consequences, noting that it is the prerogative of the Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol to decide on the legal form of the procedures and mechanisms relating to compliance”;

Decision -/CP.7 (Article 6) and Draft decision -/CMP.1 (Article 6) Guidelines for the implementation of Article 6 of the Kyoto Protocol

ANNEX

24. Where a host Party does not meet the eligibility requirements set out in paragraph 21 above, the verification of reductions in anthropogenic emissions by sources or enhancements of anthropogenic removals by sinks from an Article 6 project as being additional to any that would otherwise occur, in accordance with Article 6, paragraph 1 (b), shall occur through the verification procedure under the Article 6 supervisory committee, as set out in section E below. The host Party may however only issue and transfer ERUs upon meeting the requirements in paragraphs 21 (a) to (c) and 21 (e) above.

Decision -/CP.7 (Article 12) and Draft decision -/CMP.1 (Article 12) Modalities and procedures for a clean development mechanism as defined in Article 12 of the Kyoto Protocol

30. A Party not included in Annex I may participate in a CDM project activity if it is a Party to the Kyoto Protocol.

31. Subject to the provisions of paragraph 32 below, a Party included in Annex I with a commitment inscribed in Annex B is eligible to use CERs, issued in accordance with the relevant provisions, to contribute to compliance with part of its commitment under Article 3, paragraph 1, if it is in compliance with the following eligibility requirements:

Decision -/CP.7 and Draft Decision -/CMP (Article 17) Modalities, rules and guidelines for emissions trading

ANNEX

Modalities, rules and guidelines for emissions trading

2. Subject to the provisions of paragraph 3, a Party included in Annex I with a commitment inscribed in Annex B is eligible to transfer and/or acquire ERUs, CERs, AAUs, or RMUs issued in accordance with the relevant provisions, if it is in compliance with the following eligibility requirements:

- (a) It is a Party to the Kyoto Protocol;
- (b) It has established its assigned amount pursuant to Article 3, paragraphs 7 and 8, in accordance with the modalities for the accounting of assigned amount under Article 7, paragraph 4;
- (c) It has in place a national system for the estimation of anthropogenic emissions by sources and anthropogenic removals by sinks of all greenhouse gases not controlled by the Montreal Protocol, in accordance with Article 5, paragraph 1, and the requirements in the guidelines decided thereunder;
- (d) It has in place a national registry in accordance with Article 7, paragraph 4, and the requirements in the guidelines decided thereunder;
- (e) It has submitted annually the most recent required inventory, in accordance with Article 5, paragraph 2, and Article 7, paragraph 1, and the requirements in the guidelines decided thereunder, including the national inventory report and the common reporting format. For the first commitment period, the quality assessment needed for the purpose of determining eligibility to use the mechanisms shall be limited to the parts of the inventory pertaining to emissions of greenhouse gases from sources/sector categories from Annex A to the Kyoto Protocol and the submission of the annual inventory on sinks”;
- (f) It submits the supplementary information on assigned amount in accordance with Article 7, paragraph 1, and the requirements in the guidelines decided thereunder and makes any additions to, and subtractions from, assigned amount pursuant to Article 3, paragraphs 7 and 8, including for the activities under Article 3, paragraphs 3 and 4, in accordance with Article 7, paragraph 4, and the requirements in the guidelines decided thereunder;

Text on transaction log (Decision on Article 7.4)

42. Upon receipt of the record, the transaction log shall conduct an automated check to verify that there is no discrepancy, with regard to:

- (a) In all transactions: units previously retired or cancelled; units existing in more than one registry; units for which a previously identified discrepancy has not been resolved; units improperly carried over; units improperly issued, including those which infringe upon the limits contained in decision -/CP.7 (LULUCF); and the authorization of legal entities involved to participate in the transaction;
- (b) In the case of transfers between registries: the eligibility of Parties involved in the transaction to participate in the mechanisms; and infringement upon the commitment period reserve of the transferring Party;
- (c) In the case of acquisitions of CERs from LULUCF projects under Article 12: infringement of the limits contained in decision -/CP.7 (LULUCF);
- (d) In the case of a retirement of CERs: the eligibility of the Party involved to use CERs to contribute to its compliance under Article 3, paragraph 1;

43. Upon completion of the automated check, the transaction log shall notify the initiating and, in the case of transfers to another registry, the acquiring registry of the results of the automated check. Depending on the outcome of the check, the following procedures shall apply:

- (a) If a discrepancy is notified by the transaction log, the initiating registry shall terminate the transaction, notify the transaction log and, in the case of transfers to another registry, the acquiring registry of the termination. The transaction log shall forward a record of the discrepancy to the secretariat for consideration as part of the review process for the relevant Party or Parties under Article 8;
- (b) In the event of a failure by the initiating registry to terminate the transaction, the ERUs, CERs, AAUs or RMUs involved in the transaction shall not be valid for use towards compliance with commitments under Article 3, paragraph 1, until the problem has been corrected and any questions of implementation pertaining to the transaction have been resolved. Upon resolution of a question of implementation pertaining to a Party's transactions, that Party shall perform any necessary corrective action within 30 days;
- (c) If no discrepancy is notified by the transaction log, the initiating registry and, in the case of transfers to another registry, the acquiring registry shall complete or terminate the transaction and send the record and a notification of completion or termination of the transaction to the transaction log. In the case of transfers to another registry, the initiating and acquiring registries shall also send their records and notifications to each other;
- (d) The transaction log shall record, and make publicly available, all transaction records and the date and time of completion of each transaction, to facilitate its automated checks and the review under Article 8.