Bad Vilbel
29. September 2010

Position Paper: EU Quality Restrictions on Specific Project Types

The Post 2012 EU ETS directive foresees the possibility to set restrictions on credits from certain project types. This clause of the directive has created substantial uncertainty among CDM project developers and investors.

First Climate recognises that the EU is using these quality restrictions to gain leverage in the international climate negotiations and is strongly supportive of the EU Commission's endeavours to reach a comprehensive climate agreement. However, First Climate welcomes the statement of Climate Commissioner Hedegaard on 25 August 2010 that the EU Commission is preparing a regulation on possible restrictions on CERs from industrial gas projects in order to bring investment certainty to the CDM market.

In order to avoid regulatory overlaps, the CDM should ideally be regulated only at the UN level. As the UN process is currently not advancing fast enough, some EU regulation are justified. However, in order to avoid unintended consequences, special care should be taken when designing the EU restrictions as a separate layer of CDM regulations.

First Climate would like to draw the Commission's attention to the following three issues, which are of central importance to ensure the proper functioning of the CDM in presence of EU restrictions.

1) Separate treatment for each industrial gas

Restrictions should apply only to project types which generate large windfall profits, such as certain industrial gas projects. However, industrial gas projects use different technologies and methodologies, as these gases come from various sources. Thus, when setting restrictions, each industrial gas as well as each methodology should be considered separately in order not to render certain projects economically unviable just because they are labelled as industrial gas projects.

First Climate believes that the only projects with windfalls high enough to justify any discounts are, firstly, abatement of HFC-23 in the HCFC-22 industry and, secondly, abatement of N_2O in the adipic acid industry. These two project types are estimated to account for three quarters of all CERs issued to date.

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A discount - not a ban

Any quality restrictions should take the form of a discount, not an outright ban of the credits. The discounts should be proportional to the windfall, such that the remaining CDM revenues continue to justify the cost of abating the relevant greenhouse gases, taking into account both initial investments as well as operation and transaction costs. In contrast, an outright ban of industrial gas credits would remove the only economic incentives to make investments in new abatement projects and to keep the destruction equipment running and would thus be counter-productive from an environmental perspective.

Discount on either UN or EU level - not both

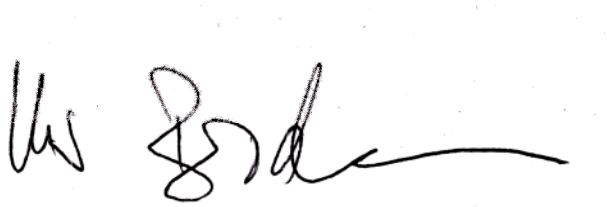
Should considerable downward revisions of baselines of CDM projects by the CDM EB upon renewal of crediting periods take place, or should new projects follow a methodology which prevents such large windfall profits to be generated, then the EU should refrain from applying the restrictions on CERs from such projects.

Regarding the last point, there are proposed methodologies for industrial gas projects which would address the issue of windfall profits by decreasing the project baseline considerable after the first years of operation or upon renewal of the crediting period.

First Climate developed a methodology for N2O abatement in new adipic acid plants where the baseline would be discounted by 90% after the first five years of operation. The methodology, which would address all the issues that have surfaced in the current HFC discussion, has, however been awaiting for guidance from CoP/MoP. A short description of the methodology can be found as an annex of this position paper. The adoption of such a methodology would address the windfall issue at the UN level, where it should be addressed ideally to preserve the global character of the CDM mechanism.

Should you have any further questions on any of these issues, please don't hesitate to contact me at any point of time.

Sincerely,



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Annex: N_2O Destruction in New Adipic Acid Plants
Methodology Revision AM_REV_0110
Submitted by First Climate

Production of adipic acid is major source of N2O. Global production of adipic acid is growing as new plants are being installed. However, N2O abatement in new adipic acid plants is currently excluded from the CDM.

In 2009, First Climate submitted a methodology proposal (AM_REV_0110) to the CDM Executive Board aimed at expanding the applicability of the relevant methodology (AM0021) to new adipic acid plants. The proposed methodology included extensive safeguards to ensure environmental integrity and prevent shifts of adipic acid production from Annex-1 to Non-Annex-1 countries.

As a key element, First Climate proposed that the baseline for N2O emissions from new adipic acid plants should be discounted by 90%, from 0.25 to 0.025 t N2O per t of adipic acid, after the first five years of the crediting period of each project.

In its response, the CDM Methodologies Panel recommended that for practical reasons, the baseline should instead be set flat at 0.05 t N2O for the entire crediting period. This corresponds to a discount of 80% against the current baseline for existing adipic acid plants.[1]

Rather than following the Meth Panel's decision, the CDM Executive Board, in its 48th meeting in July 2009, decided not to accept any further proposals relating to new adipic acid plants until further guidance would be obtained from the CoP/MoP (see EB-48 §27-28). Unfortunately, the matter was not tabled at the Copenhagen summit. All attempts to curb N2O emissions from new adipic acid plants through the CDM have remained blocked since then.

Despite the recent lack of progress, we believe that this example demonstrates that environmental and other concerns relating to industrial gas projects can and should be addressed at the source, i.e. at the level of the UN. Provided that the level of discount of such methodology would be acceptable for the EU, another layer of discount at the EU level would be rendered unnecessary.

In general, the CDM EB should be encouraged to accept such methodologies in order to ensure that industrial gas projects are developed also in the future and could bring environmental benefits without generating large windfall profits.

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[1] The proposed revision AM_REV_0110 and the CDM Meth Panel's response are available at: http://cdm.unfccc.int/methodologies/PAmethodologies/revisions. The revision was formally rejected by the CDM Executive Board in its 48th meeting.

A short description of the methodology revision AM_REV_0110

At its 35th meeting, the CDM Methodologies Panel adopted a draft Guidance on the expansion of industrial gas methodologies to new facilities.[2] The guidance lists key concerns to be addressed, such as: increased production of main products (such as adipic acid) to maximize CER revenues, and shifts of production from the Annex-1 to the Non-Annex-1 region. Building on this guidance, First Climate submitted a revision (AM_REV_0110) to expand the methodology AM0021 to new adipic acid facilities.

The proposed revision includes several strong safeguards to tackle the issues addressed in the draft Guidance. In particular:

- The consumers of the adipic acid must be included in the project boundary and monitored;
- The adipic acid must be sold at a price which covers the full cost of production. Any amounts of adipic acid sold at a price below the full cost of production will be discounted in the calculation of CERs.
- Adipic acid exported to Annex 1 countries is not eligible for CER generation and will be discounted in the calculation of CERs.
- A safety discount on CERs is introduced (90% discount on baseline emissions from Year 6 onwards), to account for the maximum possible leakage that could occur if all other safeguards aimed at preventing production shifts fail.

Taken together, these safeguards will ensure that only about half of the actual emission reductions achieved by N_2O abatement projects in new adipic acid facilities will be credited to the project proponent (after fully discounting any CERs for adipic acid exported to Annex 1 or sold at dumping prices). The proposed methodology revision is therefore very conservative and meets the highest standards of environmental integrity. At the same time, it still ensures adequate incentives for adipic acid products to install N_2O abatement equipment.

[2] See MP-35 Annex 12, available at http://cdm.unfccc.int/Panels/meth/meeting/mp_08.html#035.
This guidance was in part adopted by the CDM Executive Board at its 46th meeting (EB-46 Annex 10).