Building a post-2012 global climate regime

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Reforming international carbon market mechanisms

- *Putting a price on carbon through the use of market mechanisms is imperative to drive low carbon investment and reduce global emissions cost-effectively*
- *An expanded international carbon market could generate up to €38 billion a year in additional financial flows to developing countries by 2020*
- *The CDM and JI need to be reformed to strengthen their effectiveness and environmental integrity. The participation of LDCs in the CDM should be increased*
- *The EU proposes the creation of sectoral carbon market mechanisms to promote greater emissions mitigation, in particular by more advanced developing countries*

Putting a price on GHG emissions through cap-and-trade systems and other market-based mechanisms is imperative for driving low carbon investments and achieving global mitigation goals cost-effectively.

The international carbon market has proven an effective tool for leveraging private sector investment in developing countries. It should be one of the main sources of mitigation finance for developing countries post-2012.

The European Commission estimates that an expanded, ambitiously designed international carbon market could generate up to **€38 billion** a year in additional mitigation finance for developing countries by 2020 (see EU information sheet *Scaling up climate finance for developing countries)*.

The European Union wants the two project-based market mechanisms established by the Kyoto Protocol - the **Clean Development Mechanism (CDM)** and **Joint Implementation (JI)** – to be reformed. The CDM should gradually be replaced by **sectoral carbon market mechanisms.**

Reform of the CDM and JI is needed to strengthen their effectiveness, efficiency, environmental integrity and governance.

The **CDM and JI** are market mechanisms through which approved emission-reducing or sink-enhancing projects generate credits that governments or companies in developed countries can use to offset part of their emissions.
CDM projects are carried out in developing countries and **JI** projects in developed countries. Together the two mechanisms currently account for around 12% of the international carbon market.

Standardised methods and tools should be developed to calculate emission baselines and reductions and to further ensure that CDM and JI projects lead to genuinely additional emission savings. This **standardisation** would improve the mechanisms' environmental integrity, streamline the project registration process and reduce transaction costs.

The participation in the CDM of in particular the Least Developed Countries (LDCs), which have less possibility to finance low-carbon investments, should be strengthened.

The Copenhagen agreement also needs to go beyond project-based mechanisms by establishing **sectoral crediting and trading mechanisms,** to be applied in particular to major emitting sectors in the more advanced developing countries.

Sectoral crediting

- The developing country sets a sectoral emissions threshold below the business as usual trend.
- For all emission reductions achieved beyond the threshold, the country receives credits that can be sold to developed countries as offsets. These revenues finance mitigation in the developing country.
- Thresholds are 'no lose', ie there is no penalty if they are not met (but no credits are generated either).

The broader scope of sectoral mechanisms will deliver bigger emission savings than the project-based CDM and thus generate higher revenues from the sale of offset credits to finance mitigation action in developing countries.

Sectoral trading

- The developing country sets a sectoral emissions target below the business as usual trend.
- The target defines a cap on the number of tradable units, which are created in advance.
- If emissions are reduced below the target, the developing country has excess tradable units and can sell the excess to developed countries as offsets. These revenues finance mitigation in the developing country.
- If the sector emits more than the cap allows, the developing country must buy credits to make up the difference.

The EU is willing to facilitate the sectoral mechanisms by allowing the credits and tradable units they will generate to be used in the **EU Emissions Trading System** (EU ETS), at the appropriate time.

The Copenhagen agreement should initiate an orderly transition to the sectoral mechanisms to provide clarity to investors and ensure the continuing stability of the international carbon market.

More advanced developing countries should set ambitious emission thresholds and targets for specific sectors as part of their **low-carbon growth plans**. The thresholds and targets should reflect countries' respective capabilities. The EU is willing to work with these countries to identify appropriate sectors.

The CDM should be phased out for the sectors and countries that participate in the sectoral mechanisms but existing CDM investments would be honoured.

Building an international carbon market

The EU wants to see the creation of an OECD-wide carbon market by 2015 through the linking up of the EU ETS with other cap-and-trade systems that are comparable in ambition and compatible in design. The EU ETS accounts today for 80% of the international carbon market.
The sectoral mechanisms to be established should serve as a stepping stone to the introduction by more advanced developing countries of domestic cap-and-trade systems. By 2020 the OECD carbon market should be extended to these.

An **indicative timeline** for introducing the new mechanisms in the sectors and countries concerned should be agreed by COP-16 in November 2010. The timeline should include a date after which the chosen sectors in these countries would no longer be able to register CDM projects.

A robust system of **measurement, reporting and verification (MRV)** of the sectoral mechanisms must be put in place to ensure only real emission reductions are recognised. Developing countries will require additional capacity building support for their participation in the carbon market, including MRV. This is particularly the case for the participation of more advanced developing countries in the sectoral carbon market mechanisms and of LDCs in the CDM.

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