Major Economies Business Forum: International Offsets

KEY MESSAGES

- BizMEF supports the use of international offsets as a means to lower the cost to society of meeting environmental objectives and to promote actions in developing nations. Offsets can facilitate access to private capital and technology, enhance the integration of greenhouse gas (GHG) markets where applicable, and enable access to least-cost sources of abatement in a variety of policy frameworks, including bilateral agreements.

- BizMEF supports continuation of the Clean Development Mechanism (CDM) under the Kyoto Protocol, but would like to see it fundamentally reformed both to reduce the costs and bureaucracy involved in the current process and to expand the scope of projects eligible for investment.

- BizMEF also supports the development of new mechanisms under the Long-term Co-operative Action negotiations that can expand the potential and further lower the cost of environmentally effective actions. These could take a number of forms and might be linked, for example, to sectoral approaches such as Reducing Emissions from Deforestation and Forest Degradation (REDD+), new sectoral crediting or trading programs or to Nationally Appropriate Mitigation Actions (NAMAs).

- A potential example could be a bilateral offset mechanism, whereby developed countries, through bilateral consultations with a developing country, could develop energy-efficient/low-carbon projects tailored to that country's needs and in turn project participants could use the emission reductions achieved to help meet commitments in developed countries.

- Such schemes would recognize GHG reductions made possible, for example, through funding and use of advanced management and technology or investments that promote better forest management. Specifically, they could undertake and quantify GHG cuts achieved by projects meeting certain requirements, such as the use of energy-saving devices and facilities, and create mechanisms, such as offset allowances, to count these reductions as a contribution to commitments made by developed countries.

IMPORTANCE OF OFFSET MECHANISMS

Offset mechanisms can play a critical role in facilitating emission reductions at the lowest cost. They enable countries and firms whose marginal abatement cost is relatively more expensive to contribute to reduce GHG emissions at lower costs on a global scale. If designed properly, emission-reduction projects in developing countries provide credible options to meet a part of emission reduction targets in developed countries. In so doing, they accelerate diffusion of low-carbon technologies at a global level, including to developing countries, and contribute towards the goal of sustainable development. Moreover, they have the potential to unleash innovative business responses to reduce emissions.

Importantly, offsets provide developing countries with support for climate-change mitigation efforts and related measures. In addition, they serve as a tool to provide incentives for mitigation and capacity building and may contribute towards the greater integration of national and regional carbon markets where applicable. Moreover, they can work in a variety of settings, including regulatory approaches and bilateral arrangements, to limit GHG emissions.

CDM AND ITS CHALLENGES

Since its establishment, the CDM has contributed significantly to the integration of national and regional carbon market. However, it has not been without its challenges, particularly in terms of its design, the limited scope of eligible activities, and the environment within which it operates. Over recent years, significant criticism has been levelled at the CDM's complexity, which renders it less effective than it might otherwise be. Users have noted that CDM procedures are often burdensome—it is not uncommon for the CDM project review, approval, and credit process to take two years or more to complete.

More specifically, the application of major clean and energy saving technologies, such as high efficiency coal power plants and carbon capture and storage, could provide more flexibility to the operation of the CDM. The cost-effectiveness of the CDM needs to be increased and the scope of investments expanded, for example through standardization, which can be an effective tool for certain sectors.

Uncertainty regarding the post 2012 arrangement has also taken its toll. As the primary market for offsets, the annual investment in CDM projects has decreased to $1.5 billion per year from $7.4 billion in 2007 as project developers become more risk adverse in light of the growing uncertainty.[1]

Fundamental reform of the CDM is required going forward and some steps are being taken in this direction. Business does not want to dismantle the CDM; rather a clear and positive vision for the CDM post-2012 is urgently required. This will provide a platform on which to refocus the CDM and build upon its positive elements. This would facilitate a degree of continuity during a gap between global agreements and provide a

[1] All dollars figures in USD.

"bridge" to other market-based mechanisms as they are developed.

PRINCIPLES OF OFFSET MECHANISMS

In parallel with the improvement of the CDM, creation of new, independent mechanisms under the UN Framework Convention on Climate Change's (UNFCCC) Ad Hoc Working Group on Long-Term Co-operative Action (AWG-LCA) negotiation track should explore independent mechanisms that would encourage greater adoption of clean technologies, products, carbon sequestration, and infrastructure in developing countries.

Above all, offset mechanisms should be designed to ensure environmental integrity of emissions reductions and to promote the effective diffusion of energy efficient and low-GHG technologies and practices to developing countries. Essential design principles include the following:

- **Environmental integrity:** Offset mechanisms should produce independently verifiable emissions mitigation.
- **Policy flexibility:** The offset mechanisms should be non-prescriptive to allow for diverse domestic policy measures tailored to local, national, and regional circumstances to emerge.
- **Technology neutrality:** Under the offset mechanisms all energy efficient and low- GHG emitting technologies should be eligible.
- **Practicality:** The offset mechanisms should be based on straightforward methodologies and should be designed to avoid bureaucratic red-tape throughout the process of selecting and approving projects and the award and use of emissions credits.
- **Traceability:** Units derived from offset mechanisms should be traceable to their point of origin to facilitate accountability.
- **Tradability:** Offset units created in market-based systems should be tradable among countries with emission reduction targets and businesses and applicable to emission reduction targets.

These elements can emerge with few rules. Indeed, in the proper environment—*i.e*., one that exhibits the rule of law, dependable institutions, low sovereign risk, sound regulatory frameworks, IP protection, *etc*.—innovative and timely use of markets and market mechanisms will develop on their own in response to the right incentives.

Offset credits likely can serve to meet two distinct sets of obligations. The first involves international commitments of countries pledged or established through the UNFCCC and its processes. The second involves domestic emissions obligations of firms where they operate. Business will only invest in and use offset credits that have environmental credibility and can be used to comply with emissions obligations. At a minimum, offset credits should meet the standards necessary to satisfy domestic requirements in the countries where they are used. However, offset credits stemming from bilateral agreements may have to meet additional standards before they can be sold and used in international GHG markets. As with Certified Emission

Reductions under the Kyoto Protocol, market pressures from greater integration of GHG markets and evolving international consultation and analysis and peer review processes under the UNFCCC can increase transparency and help ensure the integrity of offsets.

CHARACTERISTICS OF DIFFERENT OFFSET MECHANISM

Discussions in the AWG-LCA and Ad Hoc Working Group on the Kyoto Protocol (AWG-KP) seek to provide new approaches for offset investments and to reform and expand the Kyoto Protocol's CDM. These new procedures for offsets would recognize reductions made through investments in developing nations as a contribution to meeting emissions obligations in developed nations.

Fundamentally, offset mechanisms should promote emission reductions—for example through forest protection and diffusion of technologies and enhanced management practices to developing countries—and provide lower cost credits to meet mitigation commitments in developed countries.

The swift introduction of such mechanisms will require new and commonly-agreed methodologies to measure and report GHG emission reductions and their basis, accelerated inter-governmental talks aimed at reaching agreements among relevant countries, and the promotion of international understanding of the initiatives taken by these countries.

It is essential to develop markets with transparent and credible rules, and to ensure a level playing field for investors and for companies that wish to use the offsets. The mechanisms described below provide a variety of options to do this.

Bilateral Offset Mechanism: Bilateral offset mechanisms should be explored. These can promote technology transfer, broader investment and GHG reduction. Its bottom-up approach is best characterized by the emphasis on technologies and management practices that tap the potential for GHG reduction. Bilateral arrangements can be faster, more flexible and cover a wider range of technologies and applications than possible under CDM, thus boosting private investment.

Under a well-designed bilateral offset mechanism, through bilateral consultations with a developing country, developed countries would develop energy-efficient/low-carbon and other low GHG projects tailored to that country's needs, for example through forest carbon sequestration. Emission reductions achieved by the project could then be applied to satisfy mitigation commitments in the partnering developed country.

Specifically, these types of mechanisms could take the form of bilateral agreements and other arrangements to quantify cuts achieved by GHG reduction projects meeting certain requirements (for example for the export of energy-saving devices and facilities) and to create mechanisms for counting these reductions as a contribution to emissions obligations in

a developed country.

Business would gain deeper understanding of the mechanism by conducting feasibility studies for GHG reduction projects.

Sectoral Crediting Mechanism (SCM): A group of projects could be credited on the basis of a sectoral baseline (*e.g.*, Programs of Activities and top-down approaches).

Sectoral mechanisms, if structured properly, might represent a promising way to direct finance to a greater range of emission reduction opportunities. As sectoral mechanisms develop, they should aim to credit directly the point of emission reduction investment in the sector. Investors are more likely to take risks if the creation of carbon credits depends on their individual actions, rather than on the total success of the activities of others, often competitors, in the sector reducing their emissions.

Should the potential of SCM be explored, however, further clarification of its features will be necessary. For instance, any sectoral credits should result in the actual improvement of carbon intensity.

Another concern is that the financial flows from the sectoral crediting of carbon markets could be unfairly used to underwrite the modernization of state-run firms. These competitiveness issues undermine carbon markets by creating an uneven playing field and discouraging private firm participation and should be avoided.

REDD+: REDD+ is aimed at providing incentives in developing countries enhancing carbon stored in forests, reducing emissions from forested lands, and encouraging investments in low-carbon paths to sustainable forest development and use.

Clear decisions are needed on modalities for national reference levels, monitoring systems *etc*. Should REDD+ be connected to the carbon markets it is indispensable to create a rigorous robust, transparent, and common accounting framework.

NAMA Crediting Mechanism: More clarity is needed on how the NAMA crediting mechanism will interact with current markets and other mechanisms. The NAMA crediting mechanisms and Bilateral Offset Mechanism should co-exist and co-operate with each other. (For further information on these issues, see the BizMEF paper on Trade, Investment & Competitiveness.)

MEASURING, REPORTING, AND VERIFICATION

The measuring, reporting, and verification (MRV) methodology regarding the above offset mechanisms should be established in ways that are cost-effective and transparent, guarantee environmental integrity, and avoid double counting. (General BizMEF views on MRV can be found here.)

Australian Chamber of Commerce and Industry
BUSINESSEUROPE
BusinessNZ
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Confederation of British Industry
Confederation of Indian Industry
Confindustria
Dansk Industri
Federation of German Industries – BDI
Iniciativa para el Desarrollo Ambiental y Sustenable S.C. – IDEAS (Mexico)
Mouvement des Entreprises de France
National Confederation of Industry (Brazil)
Nippon Keidanren (Japan Business Federation)
Turkish Industry and Business Association (TUSIAD)
U.S. Chamber of Commerce, Institute for 21st Century Energy
U.S. Council for International Business

ABOUT BIZMEF

The Major Economies Business Forum on Energy Security and Climate Change (BizMEF) is a partnership of major multi-sectoral business organizations from major economies. Modeled after the government-to-government Major Economies Forum, BizMEF is a platform for these groups to:

- promote dialogue and exchange views on climate change and energy security across a broad spectrum of business interests including major developed, emerging, and developing economies;
- highlight areas of agreement among participating organizations on the most important issues for business in international climate change policy forums; and
- share these views with governments, international bodies, other business organizations, the press, and the public.

Organizations that have participated in BizMEF meetings represent business groups in Australia, Brazil, Canada, China, the European Union, Denmark, France, Germany, India, Italy, Japan, Mexico, New Zealand, South Korea, Turkey, the United Kingdom, and the United States. Collectively, BizMEF organizations represent more than 25 million businesses of every size and sector. Because BizMEF partnering organizations represent a broad range of companies and industries—including energy producing and consuming companies as well as energy technology and service providers—the partnership is able to provide robust and balanced views on a range of issues.

For more information on BizMEF, please visit our website at:
www.majoreconomiesbusinessforum.org.