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RESPONSES TO G-77/CHINA QUESTIONS ON FLEXIBILITY MECHANISMS
September 10, 1998

The following document is a set of answers, submitted by Australia, Canada, Iceland, Japan, New Zealand, Norway, Russian Federation, Ukraine, and the United States to questions posed by the G-77 and China in FCCC/SB/1998/MISC.1/Add.5. It represents the preliminary views of these countries, and is submitted with a view to facilitating further discussions on these important issues.

General

1. **What are the points of difference and points of similarity among the three mechanisms provided for in the Kyoto Protocol to the Convention?**

Key similarities:

- All three voluntary market-based mechanisms work to the benefit of the environment, because they will assist Annex I Parties in meeting their emissions targets and, in the case of projects under Article 6 (hereafter joint implementation -- JI) and project activities under Article 12 (hereafter the Clean Development Mechanism -- CDM), provide an additional incentive to develop and transfer technologies and practices that will reduce emissions.

- Moreover, all three mechanisms will help Parties to meet their emissions targets cost-effectively.

- All three mechanisms ultimately involve adjustments in the assigned amounts of Annex I Parties.

- All three mechanisms will provide opportunities for potentially significant technology and resource transfer, from both the public and private sector, to countries with economies in transition and developing countries.

- All three mechanisms permit private sector participation, with responsibility for meeting Protocol obligations remaining with governments.

Key differences:

- International emissions trading (IET) and JI will involve transactions among Annex I Parties and entities, whereas the CDM will involve transactions among Annex I and non-Annex I Parties and entities.

JI and the CDM both involve specific projects, while IET does not.

- With respect to JI and the CDM, there may be similarities with regard to types of projects and methods for measurement of emissions reductions. However, there are also differences, given that JI reductions are ultimately subtracted from the assigned amount of a Party with a national target, whereas CDM reductions are not; therefore, additionality criteria are particularly critical to the integrity of the CDM.

- IET and JI involve reallocating assigned amounts, with the aggregate remaining constant; in contrast, CDM units are "extra-budgetary," adding additional units to the original Annex I aggregate assigned amount.

- IET, JI and the CDM are mechanisms to assist Annex I Parties in meeting their emissions targets. However, the CDM also serves as a mechanism to assist in achieving sustainable development in Parties not included in Annex I by encouraging investment and transfer of technology.

- Of the three mechanisms, only the CDM calls for the establishment of an Executive Board and requires certification by internationally selected operational entities.

- In terms of decisions on any rules/guidelines, the COP is to make such decisions regarding IET, whereas the COP/moP is to make such decisions regarding JI and CDM.

- Article 12 (CDM) requires further rules regarding project certification, whereas Article 6 (JI) does not necessarily require them.

- Apart from any similarities and differences among the three mechanisms, all should be implemented so as to minimize complexity, provide cost-effective opportunities for meeting emissions targets, keep transaction costs low, and support fungibility of credit units.

2. **How to ensure that domestic actions by developed countries are their primary means of GHG limitation and reduction, and that the overseas mechanisms remain supplemental to such domestic actions by developed countries for the purpose of meeting their quantified emission limitation and reduction commitments?**

- Articles 6 and 17 of the Kyoto Protocol require that JI and IET are to be "supplemental to domestic action" for the purpose of meeting commitments under Article 3. However, it should be noted that the Protocol does not call for domestic actions to be the "primary means" of limiting greenhouse gas emissions. As will be recalled, proposals related to JI and IET that would have required domestic actions to be the "main means" of meeting Article 3 targets did not command consensus and were not included in the Protocol.

- Annex I Parties are undertaking, and planning to undertake, significant domestic action to reduce emissions. (Please refer to national communications for examples of Parties' domestic actions.)

  - Several Parties have taken on and/or announced specific measures to begin domestic actions to encourage early reductions of greenhouse gases through better diffusion of existing technology, to fund additional research to develop new technology, to continue or enhance the use of economic incentives, and to implement national greenhouse gas emissions trading systems.

  - Parties' domestic actions will be examined through the process for in-depth review of national communications.

- Concerning the suggestion that the carefully negotiated compromise term "supplemental" in Articles 6 and 17 be quantified, such an approach is neither authorized nor required by the Protocol.

  - As indicated in the Non-Paper on Principles, Modalities, Rules and Guidelines for an IET Regime (FCCC/SB/MISC.1/Add.1/Rev.1), IET will be more effective in achieving emissions reductions at lowest cost if there are no restrictions on the quantity of assigned amounts units able to be transferred or acquired to contribute to compliance with a Party's assigned amount. If the flexibility inherent in these mechanisms is restricted, the result would increase substantially the cost of achieving our environmental objectives.

  - Such a quantitative restriction on IET would be technically difficult to define and design, and could require an administratively burdensome government monitoring and approval regime to implement, adding significantly to transaction costs.

3. **How can it be ensured that these mechanisms lead to real and verifiable limitation and reduction of GHG emissions by developed countries**?

- The Kyoto Protocol establishes legally binding emissions commitments for Annex I Parties. As a result, accurate measurement and reporting will be critical to the successful implementation of the Protocol, regardless of the extent to which Parties elect to use the flexibility mechanisms.

- Having said that, there are ways that the mechanisms can be structured so as to provide additional incentives for accurate measurement and reporting:

  - Article 6 (JI) already provides that an Annex I Party cannot acquire emission reduction units if it is not in compliance with its obligations under Articles 5 and 7.

  - As indicated in the Non-Paper on Principles, Modalities, Rules and Guidelines for an

IET Regime (FCCC/SB/MISC.1/Add.1/Rev.1), we support linkages in the IET rules between the ability to engage in trading and compliance with Articles 5 and 7.

- Concerning CDM, Article 12 reflects the importance the Parties put on the need for ensuring real reductions. CDM projects will be verified on the basis of agreed guidelines for calculation of project or technology baselines, measurement of emissions reductions resulting from the project, and transparent reporting of results, open for third party evaluation. The experiences gained during the AIJ Pilot Phase may provide valuable information on useful methodologies in this respect.

4. **How to ensure that the COP or COP/mop will maintain the responsibility for every stage of defining, developing, structuring, and institutionalizing the mechanisms?**

- Under the Protocol (and as noted in part above), the COP and COP/moP have different functions with regard to the three mechanisms. For example, elaboration of the CDM will require substantial COP/moP decision-making with respect to both substantive and institutional issues. In contrast, JI under Article 6 could be implemented without further decisions by the COP/moP (i.e., because the Article provides that the COP/moP "may" further elaborate guidelines). Concerning Article 17, IET is not legally dependent upon the adoption of guidelines although, once adopted, any principles, rules and guidelines adopted by the COP would govern IET from that point.

5. **What are the specific roles of the SBSTA and the SBI with regard to these mechanisms?**

- The SBSTA and SBI will continue to serve the function of recommending decisions to the COP or COP/moP to facilitate the implementation of the Protocol, taking into account the submissions of Parties, the FCCC Secretariat, other international bodies, and the input of non-governmental organizations. Specific roles will be identified as progress is made.

6. **What will be the systems for ensuring independent auditing, verification, and accountability of the working of the mechanisms?**

- As noted above, the three mechanisms have different provisions when it comes to such issues as verification, auditing, etc.

  - Article 6 (JI) and Article 17 (IET) authorize, but do not require, further guidelines on verification and reporting.

  - Article 12 specifically provides for "independent auditing and verification" of project activities.

- Accurate measurement and reporting (including guidelines for standardized reporting) will be critical to the integrity of the Kyoto regime, given that the key obligations involve legally binding emissions limitation targets.

- Depending upon the particular mechanism and its requirements, the use of existing mechanisms in the private sector (for tasks such as auditing and accounting) could be advisable, given that many such mechanisms have already been tested in the demanding private sector markets.

- The expert review process of implementation of Article 3 obligations (to which all three mechanisms relate) will also play an important role in promoting the integrity of the mechanisms.

- Finally, public dissemination of emissions and assigned amount data, through appropriate reports on the Internet for example, can help to ensure transparency.

Article 6 Projects

1. **What will be the elements of the guidelines for projects under Article 6, in particular, for ensuring transparency, accountability, reporting, and verification?**

- Article 6 contains key criteria and guidelines for cooperative activities.

- Articles 3.10. and 3.11 of the Protocol establish that emission reduction units transferred between Annex I Parties as a result of projects under Article 6 are to be added to or subtracted from Parties' assigned amounts. Thus, activities under Article 6 will not change the total assigned amounts of Annex I Parties, only the distribution of these amounts among individual Parties.

- Changes in assigned amounts will be reported annually and can be tracked on this basis. In this regard, it would be useful initially to consider the Uniform Reporting Format from the AIJ Pilot Phase.

- Guidelines providing for the use of simplified, standardized methods to assess additionality (such as thresholds for specific projects or sectors) could promote transparency.

- It should also be noted that the overall expert review process (including expert review of inventories) regarding compliance with Article 3 (of which JI is a component) will necessarily play a role with respect to accountability and verification.

2. **What will be the criteria for deciding the baseline of projects?**

- Article 6.1(b) requires that a JI project "provide[ ] a reduction in emissions by sources, or an enhancement of removals by sinks, that is additional to any that would otherwise occur."

- The AIJ Pilot Phase and related work have provided considerable information on how to establish baselines.

- The basic criterion is to establish a baseline to enable measurement of the effect of the project activity compared to business-as-usual. This baseline could vary between different sectors and countries.

3. **How can compliance with Articles 5 and 7 of the Protocol be ensured, and how is this related to the work to be accomplished under Article 18?**

- Accurate measurement and reporting are critical to the integrity of the Protocol generally, given the nature of the target obligations.

- Article 18 may ultimately be relevant to promoting compliance with Articles 5 and 7.

- However, it would not appear helpful to rely exclusively on Article 18, particularly given that the Article 18 procedure may require amendment to the Protocol and therefore potentially substantial time to become operative.

- Rather, the flexibility mechanisms themselves should be structured to provide their own relevant incentives to comply with Articles 5 and 7.

- In the case of JI, the Protocol itself (through Article 6.1(c)) provides that an Annex I Party may not acquire emission reduction units if it is not in compliance with its obligations under Articles 5 and 7. Such a provision should provide a useful incentive for Annex I Parties, at least for those interested in using JI, to comply with the Protocol's measurement and reporting provisions.

- In addition, we believe the COP should focus early attention on elaborating measurement and reporting guidelines called for under Articles 5 and 7. Such work will be important not only for flexibility mechanisms, but for the Protocol generally.

4. **What will be the procedure for transferring or acquiring emission reduction units resulting from projects under Article 6?**

- The transfer of emission reduction units between Annex I Parties, which ultimately results in adjustments in their assigned amounts, will have to be approved and agreed by the involved Parties.

- Based on this approval and agreement, adjustments to assigned amounts will have to be recorded, for example in these Parties' annual inventories and/or national communications.

- The Parties will be subject to any guidelines, including for verification and reporting, that COP/moP may further elaborate.

5. **What will be the system for auditing and verifying projects under Article 6?**

- Each Party involved in JI will have the responsibility to approve, monitor, and report each JI project in which it or one of its legal entities is involved.

- The COP/moP may develop further guidelines concerning the credibility and transparency of national verification systems.

- The extent to which a JI project meets applicable international criteria can also be the subject of the expert review process of implementation of Article 3 obligations, to which JI is obviously related.

6. **How will "legal entities" to be involved in these projects be defined and how will the responsibility of the Party over "legal entities" for the purpose of the projects be ensured?**

- It is up to individual Annex I Parties to decide if and how it will allow its "legal entities" to participate. If it does allow some or all legal entities to participate, it is up to that Party to ensure, through its national system, that such entities participate in a way that is consistent with any relevant Protocol provisions or rules adopted thereunder.

- However, an Annex I Party's national decision to allow private sector participation does not absolve that Party of its obligations, at the governmental level, under the Protocol.

7. **How will the benefits of a project under Article 6 be equitably shared between the participating Parties?**

- The sharing of all of the various benefits of a project are a matter for negotiation between those involved (noting the requirement under Article 6.1(a) that any project have the approval of the Parties involved).

- JI projects could also enhance the capacity of host countries to take national action of their own and could create other secondary benefits in the host country, such as a reduction in local pollution effects.

8. **What will be the reporting criteria of a project under Article 6 to the COP/mop?**

- The COP/moP is authorized, under Article 6.2, to further elaborate guidelines, including for reporting. Thus, reporting criteria could be developed, possibly taking into account the uniform reporting format for AIJ under the pilot phase.

- Reports from Parties should include, at a minimum, information on the project; what baseline emissions and "with-project" emissions were, and how they were determined; and adequate information to demonstrate that the project was accepted by the Parties involved.

Article 12- Clean Development Mechanism

1. **What will be the criteria for ensuring a balance wherein each CDM project attains the objective of assisting developing country Parties in achieving sustainable development in accordance with their national priorities and strategy, and assisting developed country Parties in achieving compliance with their commitments under Article 3?**

- Article 12.5 provides that emission reductions resulting from each project activity are to be certified on the basis of, inter alia, voluntary participation approved by each Party involved.

- Thus, a host country will have the opportunity to ensure that any proposed CDM project in which it is potentially involved respects its national priorities and strategy concerning sustainable development.

2. **How to ensure that the CDM shall be subject to the authority and guidance of the Conference of Parties serving as the meeting of the Parties to the Protocol?**

- Article 12.4 expressly provides that the CDM shall be subject to the authority and guidance of the COP/moP.

- The oversight role of the COP/moP will be carried out through:

  - its mandate for the Executive Board;

- its ongoing review of the operation of the Executive Board and operational entities; and

- its elaboration of the governing modalities and procedures for ensuring transparency, efficiency and accountability through independent auditing and verification of project activities.

- its designation of operational entities.

3. **How to ensure that the Executive Board of the CDM shall function under the authority and guidance of the Conference of the Parties serving as the meeting of the Parties to the Protocol?**

- See the response to question 2 above.

4. **What will be the constitution, character and functions of the Executive Board of the CDM?**

- The constitution, character and functions of the Executive Board will in part depend on the form and functions of the CDM as a whole.

- It is therefore logical and practical to decide first on the functions of the various aspects of the whole mechanism before starting to consider what functions and form the various institutional components might have. We look forward to further discussing this important issue with the G-77 and China, as well as other Parties.

5. **How will the emission reductions of a CDM project be certified? What will be the certification procedure, and by whom will this be accomplished?**

- According to Article 12.5, certification of CDM projects would be based on three criteria: a) voluntary participation approved by each Party involved; b) project activity provides real, measurable and long-term benefits related to the mitigation of climate change; and c) emissions reductions must be "additional to any that would occur in the absence of the certified project activity." Clear and transparent certification procedures for these criteria would need to be developed to provide assurance that CDM investments will yield sound certified emission reductions (CERs).

- Reductions will be determined once they actually occur and will reflect the performance of the project as measured against a set of performance measures. Reporting of CDM activities, both by Parties and by the operational entities, will provide additional information on transfers and acquisitions of certified emission reduction benefits. We have a preference for independent and decentralized operational entities to reduce potential transaction costs.

6. **How to define and quantify "part" in "...part of quantified emission limitation and reduction commitments" in Article 12.3 (b) of the Protocol?**

- Article 12.3(b) provides that Annex I Parties may use the CERs accruing from project activities to contribute to compliance with part of their commitments under Article 3, as determined by the COP/moP.

- Article 12.3(b) provides for a determination by the COP/moP regarding how "Parties included in Annex I may use the certified emissions reductions accruing from such project activities to contribute to compliance with part of their quantified emission limitation and reduction commitments under Article 3"; however, we would not agree that the COP/moP should seek to quantify "part of" because, for example:

  - Fewer projects would be initiated and therefore direct benefits (e.g., new technology, investment) to non-Annex I Parties would be reduced.

  - If the "scale" of CDM project activities is diminished, fewer funds would be available for adaptation (Article 12.8) efforts in vulnerable developing countries.

  - Imposing a ceiling on CDM project activities would create implementation problems for individual Annex I Parties. For example, the closer a Party approached any such ceiling, the greater the difficulty the Party, or a private company, would have in assessing whether it could actually count possible CERs toward compliance with Article 3 commitments.

7. **How to ensure the responsibility and role of governments at each stage of the CDM projects?**

- Responsibility for implementing obligations under the Protocol rests with governments.

- To the extent that a Party chooses to allow its private sector to participate in the CDM, it is a matter of national responsibility to ensure that such participation is consistent with any Protocol provisions, or rules/guidelines adopted thereunder.

- Non-Annex I governments will have a key role in determining which projects within their borders are eligible for certification under the CDM and in determining if and how private entities under their jurisdiction will participate in the CDM.

- Within the framework established by the COP/moP (and Executive Board, as appropriate), Parties will have full discretion to determine the extent of their participation in CDM projects and resulting CERs.

8. **How will it be ensured that the operational entity of the CDM, as designated by the COP, functions under the authority of the COP, and that its governance is separate from those of existing institutions?**

- First, the COP/moP will have the role of designating any operational entities of the CDM.

- Second, operational entities will be subject to whatever substantive and procedural rules/guidelines govern operation of the CDM.

- Third, operational entities will be supervised by the Executive Board, which in turn functions under the authority and guidance of the COP/moP.

9. **How will Article 12.6 of the Protocol be implemented? What will be the criteria and processes for the CDM for arranging due funding?**

- In our view, the bulk of CDM projects will be achieved through private investment. In some instances, Parties may participate. Investments will flow based on the availability of qualifying projects, the potential rate of return on investments, and the value of CERs if there is a market.

- In those cases where funding does not exist, the CDM may assist in arranging such funding, for example, by acting as a clearing-house and making widely known the nature of the proposed projects for which funding is necessary.

- While a "process" may be needed to assist in arranging funding (so as, for example, to ensure that there is no potential conflict of interest between institutions that are certifying emission reductions and that may also be arranging financing), it is not clear that "criteria" will be necessary, in that the CDM will not itself be providing funding.

10. **How to ensure the independent auditing and verification of CDM projects activities?**

- Ensuring independent auditing and verification of CDM projects is the very objective of the modalities/procedures to be elaborated by the COP/moP under Article 12.7.

- Auditing and verification rules need to be both robust and cost-effective, inasmuch as any funds spent on auditing and verification will ultimately be drawn from projects -- and will therefore decrease the number of projects undertaken.

- To avoid conflicts of interest, entities involved in auditing and verification should not be the same as those involved in project development or promotion.

- Using existing institutions, including those already in use in the financial sector, may substantially streamline the process, and lead to a robust system built on already proven principles.

- Multiple operational entities may be valuable, as each may develop expertise in individual regions or types of projects that will engender greater confidence in their results.

11. **What will be the criteria for deciding the baseline of projects?**

- The measurement of real, long-term mitigation benefits would require the development of baselines to demonstrate that projects result in actual greenhouse gas emissions that are less than baseline (business-as-usual) emissions. An important question to ensure consistency between similar projects, while minimizing transaction costs, is to determine the appropriate level of detail for developing project baselines (for example, whether to use project-, sector-, or country- benchmarks for emissions baselines). Guidelines for baseline measurement and verification should consider how baselines may evolve in the future.

- One method of establishing baselines (for example, to determine "additionality') is by employing a "benchmark" approach. A benchmark is a standard of performance which can be either historical or forward-looking. This distinguishes between those activities that generate greenhouse gas reductions in excess of baseline reductions and those that do not. Simply put, those activities that perform better than the benchmark meet the additionality criterion. Projects which would not be eligible under the benchmark approach, or for which criteria had not or could not be developed, could be considered separately on a case-by-case basis.

12. **When should the benefits of CDM projects accrue to the participating developed country Parties?**

- Regarding participation by an Annex I Party in the CDM through acquiring CERs, such reductions would be certified as they occur from project activities (including from 2000 to 2008) and could be used during the commitment period to assist in meeting Article 3 commitments.

13. **What will be the action for non-compliance if a CDM project goes against the CDM criteria?**

- This hypothetical situation seems unlikely if a two-step certification process is adopted:

project certification to estimate expected emission reductions for a project to qualify as a CDM project; and

certification of a precise number of emission reductions based on actual emissions monitored after commencement of the project.

- However, assuming such a case, the consequence would be that any reductions achieved from that project could not be used by an Annex I Party to meet part of its Article 3 commitment.

14. **How to define "a share of the proceeds", and how will this share be apportioned between administrative expenses and adaptation?**

- A "share of the proceeds" should be a part of the CERs resulting from a project activity, be determined in advance and be applied on a predictable basis.

- The apportionment between administrative expenses and adaptation funds cannot be determined until the institutional and operational structure of the CDM is determined. The lower the administrative costs, however, the greater amount of funds could be available for adaptation.

15. **How will the responsibility of a Party be ensured over the private/public entities authorized by the Party to be involved in CDM projects?**

- It will be up to the national system of an Annex I Party to ensure that any entities it authorizes to participate in CDM do so in a manner consistent with relevant Protocol provisions and rules/guidelines adopted thereunder.

- Responsibility for compliance with Protocol obligations ultimately rests with the Party, not with entities which may have been authorized nationally to participate.

16. **How to ensure that CDM projects are equitably distributed so as to benefit all developing country parties, in particular the least developed country parties, and that the**

distribution of projects does not exacerbate existing regional/sub regional imbalances?

- The Secretariat should be requested to report at regular intervals to the COP/moP on the regional distribution of CDM projects.

- In addition, Parties should be encouraged to assist developing country Parties in capacity-building and other activities to facilitate utilization of the CDM in potential host countries, based on requests for such assistance from such countries. Some such activities are already underway, but further capacity building should be encouraged as the CDM is being further elaborated.

- The CDM is a market-based mechanism, and investment decisions (particularly from the private sector) will influence the distribution of CDM projects. Developing countries can influence the distribution of CDM project activities by promoting an investment climate that will encourage the development of CDM projects within their borders.

17. **How will it be ensured that the financing for CDM projects shall be additional to ODA and other international funding, additional to and separate from the financial obligations under GEF, and additional to the financial obligation of the Parties as provided in the Convention and the Protocol?**

- It is expected that the bulk of CDM financing will come from the private sector, in which case the issue of ODA funding and financial obligations under the Framework Convention does not arise.

- Further, the establishment of the CDM would not alter in any way the funding obligations of Annex I Parties under the Framework Convention. In the case where a Party government were to participate in the CDM, it could not "double count" CDM funding as also in implementation of its funding obligations under Article 4.3 of the Framework Convention.

18. **How will the additional economic benefits, if any, of a CDM project be shared equitably between the participating Parties?**

- It is not entirely clear what is meant by "additional economic benefits" in this question (a term not found in Article 12). However, the share of benefits from project activities is entirely a matter to be resolved through negotiations between the Parties or private entities involved in the specific project.

19. **How will the participating Parties report their CDM projects to the COP/mop?**

- Unlike in Article 6, Article 12 of the Protocol does not specifically address reporting of project activities or CERs resulting from individual projects.

- The use of certified emissions reductions from CDM project activities to meet Article 3 commitments will be reported pursuant to Article 7 of the Protocol; more detailed reporting requirements may be part of the modalities/procedures to be adopted under Article 12.7, to the extent they relate to auditing and verification.

20. **What are the implications of Article 12.10 of the Protocol?**

- Article 12.10 provides for the accrual of credits from 2000 to the beginning of the first commitment period.

- The provision:

  - gives an incentive to Parties and their private entities to start projects early, which would be of benefit to both Annex I and non-Annex I countries, as well as the atmosphere;

  - provides for investments and new technologies in non-Annex I countries earlier than during the first commitment period;

  - will provide a share of proceeds from project activities that will assist vulnerable developing country Parties to meet the costs of adaptation sooner.

- Recognizing that the modalities, procedures, and institutions necessary for the operation of the CDM may not be operational until after the year 2000, it should be made clear that operational entities may retroactively certify emission reductions obtained from the year 2000 resulting from a project activity begun before the CDM is operational, provided the emission reductions meet any applicable criteria.

AIJ Pilot Phase

Although a question section on the AIJ Pilot Phase was not included in the G-77 MISC.1/Add. 5 document, we have provided additional comments on this issue:

What are the next steps for the AIJ pilot phase?

- Parties are in the process of submitting their third report on Activities Implemented Jointly to the UNFCCC. These reports will provide the foundation on which the UNFCCC Secretariat will prepare a synthesis report for consideration at COP4, leading to a decision on the AIJ pilot phase.

- To move toward a decision to continue or end the pilot phase, the following steps are necessary:

  - Prepare a synthesis report on progress of the AIJ pilot phase to include discussion of methodological issues, baseline calculations, potential and actual emission reductions from projects, geographic and sectoral distribution of projects, institutional structures established in Annex I and non-Annex I Parties, and lessons learned;

  - Solicit comments from Parties on the Synthesis report in advance of COP4 and prepare a report on Party submissions;

  - Solicit comments from Parties on the Uniform Reporting Format, and prepare a report for consideration;

  - Between COP4 and COP5, a final assessment of the AIJ Pilot Phase could be carried out to summarize the experience gained. Such an assessment could be carried out by the Secretariat based on a decision by COP4, and should include procedures for further inputs from Parties, as well as from major groups outside Governments.

International emissions trading, Article 17

1. **How will the emission rights and entitlements of developed country Parties be determined and created for trading emissions? Will this be consistent with the principle of equity keeping in view the historical and current responsibility of developed countries to climate change and the ultimate objective of the Convention?**

- The question appears to contemplate some further negotiation concerning the allocations from which IET begins. The allocations from which IET begins are the assigned amounts reflected in the Protocol.

- The assigned amounts in the Kyoto Protocol were negotiated so as to reflect enhanced developed country responsibilities (in that they do not apply to developing countries) and to reflect "equity" (in that they are differentiated in light of various equitable considerations).

- If Article 3 principles of the Framework Convention are to be invoked in the context of IET, it should be noted that Article 3.3 provides that "policies and measures to deal with climate change should be cost-effective so as to ensure global benefits at the lowest possible cost."

IET certainly provides the opportunity to implement greenhouse gas emissions targets at the lowest possible cost.

2. **How to ensure that any emissions trading between the developed country Parties shall be supplemental to domestic actions for the purpose of meeting their quantified emission limitation and reduction commitments?**

- Please refer to the answer given for Question 2 in the General Section.

3. **How to ensure that emissions trading between developed country Parties will lead to real and verifiable limitation and reduction of GHG emissions for meeting the objective of the Convention, and contributing to the protection of the environment?**

- Please refer to the answer given for Question 3 in the General Section.

- In addition:

  - Accuracy of measurement and reporting by Annex I Parties is critical to the successful implementation of the Protocol's target obligations, regardless of IET. Prompt work on measurement and reporting guidelines is therefore of high priority.

  - IET will not have adverse environmental effects. Trading will serve to reallocate existing assigned amounts among Annex I Parties, with the aggregate obligation of Annex I Parties remaining constant. Much more likely is that emissions trading will greatly contribute to environmental protection by having enabled Parties to adopt more ambitious targets with trading than otherwise would have been the case, encouraging Parties to ratify the Protocol, and enabling cost-effective compliance with Article 3 commitments.

  - Some have expressed concern that some Parties will have "extra" emissions allowances which should not be traded because that would permit emissions that would not otherwise occur. Apart from the technical and administrative problems that such an approach would entail (and the fact that the Protocol permits such trading), it is simply not true that the trading of such allowances would lead to higher emissions than would be the case in the absence of trading, because a Party with "extra" emissions allowances would in any event be allowed to "bank" such allowances under Article 3.13 for use in a subsequent commitment period.

4. **What will be the environmental or economic impacts in any area due to emissions trading between developed country Parties?**

- The environmental aspects are addressed in the response to question 3 above.

- From an economic point of view, IET among Annex I countries should lead to emissions reductions where abatement costs are lowest, thus minimizing the economic impacts. IET should provide the greatest global benefit by maximizing the use of limited financial resources. The voluntary nature of participation generally in the trading system, as well as in each trade in particular, in effect ensures that each of the participants will be made better off because Parties will only choose to trade if and when it is to their advantage to do so.

5. **How to ensure that any emissions trading between developed country Parties fully reflects the principle of equity between developed and developing countries?**

- IET, in that it only reallocates assigned amounts and does not change the overall assigned amount of Annex I Parties, will not alter the "equity" between developed and developing countries that was established by adopting the Kyoto Protocol.

6. **How to ensure that emissions trading between developed country Parties shall conform to the principles, modalities, rules, and guidelines including any compliance procedure to be defined by the COP?**

- Views on this matter are contained in detail in the Non-Paper, FCCC/SB/1998/MISC.1/Add.1/Rev.1.

- Once principles, modalities, etc. were adopted under Article 17, they would govern IET and Annex I Parties would be bound to follow them.

- To the extent that an Annex I Party chose to allow the participation of its private sector, it would be the national responsibility of that Party to ensure that such participation was consistent with any Article 17 rules, etc.

- Apart from any compliance procedure that may ultimately become effective pursuant to Article 18, the trading rules under Article 17 could (and should) provide appropriate compliance-related elements, in particular for verification, reporting and accountability. For example,

  - there should be linkages between the ability to trade and being in compliance with measurement and reporting obligations under Articles 5 and 7, as well as maintaining appropriate national recording systems;

- there should be annual reporting on trading activity;

- there should be public accessibility to emissions and assigned amount data;

- there needs to be an assessment for compliance at the end of the commitment period, with appropriate disincentives particularly relevant to IET built into the system.

* One disincentive under the trading rules could be to deny or to restrict the right of a Party (and therefore its legal entities) to transfer assigned amounts if it is found to be in breach of the trading rules and/or is no longer in compliance with the conditions for participation in the system.

* We look forward to a full exchange of views on the principles, modalities, rules and guidelines for IET at COP4, as requested by decision 1/CP.3.

U.S. Non-Paper on Emissions Trading Issues

The papers on emissions trading put forward in Bonn by the Umbrella Group and by the European Union reveal a great deal of common ground on how the international emissions trading system should be constructed. It should be possible to work towards Annex I-wide agreement by COP4 on a number of technical issues:

- How to move forward to elaborate additional guidelines under Articles 5 and 7 for estimating and reporting national emissions inventories.
- How to construct national registries and reporting requirements to keep track of transfers and acquisitions of units of assigned amounts.
- How to provide for both governmental bodies and private sector entities to engage in such transfers and acquisitions.
- How to make effective linkages between trading and compliance within the Article 17 rules themselves.

This non-paper suggests how G-8 partners might build consensus on these issues in this group. Progress on these points at COP4 is of great importance in order to sustain momentum within the negotiating process. Specifically, we should strive for Annex I-wide agreement on some or all of these items by COP4 in order to demonstrate continued forward movement. Doing so by then will also address legitimate questions raised by non-Annex I Parties and nongovernmental organizations and put us on a path to adopt rules and guidelines for all the flexibility mechanisms at COP5.

(1) <u>Measurement and Reporting Issues</u>

The Umbrella and EU papers both propose linkages between Parties' eligibility to trade and their compliance with Articles 5 and 7 on emissions measurement and reporting. Both papers thus recognize that a credible international emissions trading system depends on strong national measurement and reporting regimes, and that the trading rules can be used to strengthen incentives for such regimes. Building on this common ground, the most productive step forward would be to work jointly to flesh out the key Article 5 and 7 requirements.

Articles 5 and 7 require the adoption of guidelines for national systems for emissions estimation and guidelines for supplementary reporting, building upon the existing reporting guidelines and IPCC methodologies. In Bonn this June, the SBSTA asked the IPCC to complete ongoing work to refine existing methodologies (especially addressing uncertainties in such methodologies), and to develop a set of recommended "best practices" for emissions inventories. These recommendations could address inconsistencies in Parties' current reports by giving guidance on high-quality approaches to such issues as: monitoring techniques; survey and sampling techniques; development of appropriate emission factors; data quality assurance; documentation; institutional and regulatory infrastructure; and public participation.

G-8 action item: Establish an expert coordinating group to work together on these guidelines within the IPCC workgroup process and SBSTA. The goal should be to complete work by the IPCC and SBSTA in time to adopt Article 5 and 7 guidelines at COP5. A COP4 decision establishing this deadline would be desirable.

(2) National Registries and International Reporting

Both the Umbrella and EU papers identify the need for Parties to adopt national systems for rigorously tracking international transfers and acquisitions, and to make periodic reports on such transactions to the Secretariat or another designated authority.

The system for tracking trade in units or parts of assigned amount should be designed to provide accurate data with low transaction costs. One way to meet this objective would be to require each trading Party to maintain a national registry to record its international transfers and acquisitions. National registries should be computerized record-keeping systems constructed according to a compatible design. The national registry would be the means for keeping an official record of increases and decreases in a Party's assigned amount due to emissions trading. Parties could be required to report these transactions to the Secretariat at least annually (in coordination with Parties' regular annual national greenhouse gas emissions inventory) or even more frequently. The Secretariat should be tasked to synthesize these reports into an aggregate picture, compiling data on Parties' transfers and acquisitions, tracking changes in Parties' assigned amounts, making the resulting balances available for public disclosure and end-of-period compliance determinations.

G-8 action item: The group proposed under item 1 should work towards a common Annex I-wide approach to an appropriate registry system.

(3) Facilitating Private Sector Participation

Both papers support the participation of sub-national entities, including private firms or individuals, in international emissions trading. Both acknowledge that the Parties must retain the obligation to comply with their national targets.

The U.S. believes private sector participation consistent with Party responsibility for national compliance could be achieved using the national registry system and the national emissions measurement system. National registries can be used to record the holdings and trading activity of legal entities that are authorized to control portions of a Party's assigned amount. Specifically, international transfers and acquisitions between legal entities of different Parties would be made by moving specific units from the account of the selling entity in the registry of one Party, to the account of the buying entity in the registry of the other Party. These international transactions would be reported to the Secretariat.

The U.S. believes the same national emissions measurement and reporting systems discussed under item 1 should be used to establish a trading Party's compliance with its assigned amount, as increased or decreased by trading. While international emissions trading will change the size of a Party's assigned amount, it does not change the compliance question: Whether the Party's national aggregate emissions are within its adjusted assigned amount. Thus, it is not necessary for the trading rules to specify any different requirements for monitoring and reporting of emissions than those required under Articles 5 and 7.

G-8 action item: Agree to focus on national registry systems and Article 5 and 7 measurement and reporting systems as the means to ensure accountable private sector participation in emissions trading, and seek agreement on their feasibility for this purpose by COP4.

(4) <u>Making Effective Compliance Linkages Under Article 17</u>

The EU paper suggests that the linkages between emissions trading and compliance issues have to be addressed under Article 18, and that an amendment to the Protocol on binding consequences will be needed before emissions trading may begin. While sharing the same objectives, the Umbrella paper proposes that these linkages can be made effectively in the Article 17 rules themselves, without the unacceptable complexity and delay that attends the Article 18 amendment process.

In the U.S. view, the Article 17 emissions trading rules can create all of the necessary compliance incentives. The threat of losing eligibility to trade can be made to serve as a strong deterrent to non-compliance. Given the importance of trading to buyers as a means of achieving cost-effective compliance, and to sellers as a valuable resource flow, the actual loss of eligibility would have a substantial economic impact. The impact of losing trading eligibility would be larger than most, if not all, potential binding consequences that were discussed prior to Kyoto.

The Article 18 amendment approach would not appear to offer any greater compliance incentives or remedies for non-compliance. Critically, however, it would take much longer to pursue an amendment under Article 18 than to implement effective rules under Article 17.

Clearly, future work will be needed to develop procedures under Article 18 for resolving issues of implementation that may arise from Parties' reports under Article 7 and in-depth reviews under Article 8. These procedures can be adopted by decision and do not require a Protocol amendment.

G-8 action item: Agree that compliance issues related to emissions trading should be pursued in the context of Article 17 rules.

Umbrella Group-EU Points of Convergence on Emissions Trading

This paper seeks to identify apparent points of convergence between members of the Umbrella Group and the European Union regarding international emissions trading under Article 17 of the Kyoto Protocol. The points are primarily derived from official papers prepared by the Umbrella Group and the EU (including non-papers on trading rules from Bonn and responses to questions from the G-77). Clearly, views continue to evolve, including in the context of the Annex I Experts Group and other meetings. These views will need to be reflected in subsequent versions of this paper.

The Tradable Unit

o The standardized tradable unit should be assigned amount units (AAUs). AAUs represent a tradable form of a Party's "assigned amount."

o Assigned amount units traded under Article 17, whatever their source, should be expressed in terms of tonnes of carbon dioxide equivalent (calculated using the global warming potentials defined by decision 2/CP.3 or as subsequently revised in accordance with Article 5) and could be identified by country of origin, serial number, and commitment period.

o Once used to offset emissions for the purposes of compliance, AAUs would be removed from the trading system.

o AAUs can be traded under Article 17 whether they derive from, for example, Articles 3(7), 3(3), 6, and/or 12.

Eligibility of Parties

o Parties eligible to trade under Article 17 should be:

-- Annex B Parties
-- in compliance with Articles 5 and 7 (see below)
-- that have national registry systems (see below).

Participation of Legal Entities

o Each Party may decide whether, in addition to the government, its legal entities (e.g., private firms, brokers, NGOs) may participate in international emissions trading under Article 17.

o The participation of legal entities is desirable.

o To the extent that an Annex I Party chose to allow the participation of its legal entities, the obligation to comply with the Protocol and rules thereunder would remain with that Party; it would be the Party's responsibility to ensure that such participation was consistent with any Article 17 rules.

Registries and Reporting

o International emissions trading should involve:

> -- national registry systems on the part of individual Annex I Parties to record international transfers and acquisitions of AAUs by such Parties and their respective legal entities;
>
> -- regular reporting by Annex I Parties on international transfers and acquisitions of AAUs to the Secretariat or other designated authority; and
>
> -- an international tracking registry maintained by the Secretariat or other designated authority to compile and reflect information reported by Parties on the transfer and acquisition of AAUs.

o National registry/reporting systems will be critical to ensuring transparency and verification. As a result, the rules should provide that an Annex I Party should not be able to participate in international emissions trading if it does not have in place a national registry system, with publicly available records:

> -- to track assigned amount units held, transferred, and acquired (including by its legal entities);
>
> -- to report transfers and acquisitions under Article 17 by itself or its legal entities to the Secretariat or other designated authority; and
>
> -- to retire AAUs, e.g., when used to offset emissions for compliance.

o (Two or more Parties could choose to consolidate their national registries into one registry; in this case, different accounts would be held for each Party and each entity of each Party. Registry consolidation would remain entirely voluntary.)

o In order to promote compatibility among Parties, the COP should request the SBSTA to develop technical guidelines to assist Parties in establishing and maintaining simple national registry systems built on compatible, electronic record-keeping.

o The international registry would have several functions:

-- In order to track the whereabouts of AAUs, it would compile and cross-check reported information.

-- It would make its records publicly available.

-- At the end of a commitment period, the registry would be used, together with end-of-period data on emissions, for compliance purposes (i.e., for tabulating adjustments to assigned amounts under Article 3.10 and 3.11).

Compliance

o There are at least two aspects to compliance:

-- promoting compliance with the trading rules themselves; and

-- promoting, through the trading rules, compliance with other obligations under the Protocol.

o In terms of promoting compliance with the trading rules themselves:

-- Any rules developed under Article 17 would govern international emissions trading under the Protocol; Annex I Parties participating in international emissions trading under the Protocol would be bound to follow them.

-- As noted above, it would be a Party's responsibility to ensure that participation by its legal entities was consistent with any Article 17 rules.

-- The rules could provide that failure to observe such rules would result in, for example, loss of some or all trading eligibility.

o In terms of promoting compliance with other provisions of the Protocol, Article 17 rules could be used -- without prejudice to Article 18 of the Protocol -- to promote compliance with other provisions of the Protocol.

-- In order to discourage overselling (and therefore promote compliance with Article 3), the trading rules could provide that a Party whose cumulative emissions during the period have already exceeded its entire assigned amount (as adjusted under relevant provisions of the Protocol) should be able to acquire, but not transfer, any part of its assigned amount in that period.

-- Given that accurate measurement and reporting of greenhouse gas emissions will be critical to the integrity of the Kyoto regime, the trading rules should be structured so as to provide additional incentives for accurate measurement and reporting. Specifically, there should be linkages between the ability of a Party to engage in trading and its compliance with Article 5 (measurement) and Article 7 (reporting) of the Protocol. We need to move forward with elaborating guidelines under Articles 5 and 7 for estimating and reporting national emissions inventories, taking into account work done within the IPCC and SBSTA. A COP 4 decision could establish a deadline. (Measurement and reporting rules under Articles 5 and 7 should not differ for both trading and non-trading Parties.)

-- The rules also need to address how to allocate the risk that the selling Party may exceed its assigned amount under Article 3. Further consideration needs to be given to this so-called "liability" or "allocation of risk" issue.