

## **Post Durban: Moving to a fragmented carbon market world?**

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**T**he agreements recently struck during the COP 17 global climate change negotiations in Durban, South Africa, from November 29<sup>th</sup> to December 9<sup>th</sup>, bring us to a new crossroads.

The outcome of Durban will influence whether the initial Cartesian vision of a global carbon market and one single price for carbon, which emerged from the Kyoto Protocol but was never accomplished, is to receive a new impetus, or whether we are heading towards a long period of building through a bottom-up approach, which may or may not lead to a unitary carbon market in the future.

The emergence of greenhouse gas (GHG) emissions markets was the direct result of the United Nations Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol (KP), which included in its provision three articles that provided for the creation of offsets and the trading of these units:

- Article 12, the Clean Development Mechanism (Certified Emissions Reductions or CERs),
- Article 6, Joint Implementation (Emissions Reduction Units or ERUs) and
- Article 17, emissions trading for Assigned Amount Units Assigned (AAUs), which are emissions rights that are allocated to the Parties to the KP. They are good for Parties to comply with the KP and good for corporate obligations in Japan, but they are not valid compliance instruments under the EU Emissions Trading System (EU ETS).

In order to meet KP obligations, the EU set up the EU ETS, a domestic cap and trade system for about 15,000 installations inside the EU that were constrained in their CO<sub>2</sub> emissions, and which could also use some KP units, CERs and ERUs under certain conditions, to meet their obligations.

Focusing on the initial vision of a global carbon market, what has emerged so far is the beginning of a fragmented carbon market. The activities of the EU and Japan in the carbon market and their use of Kyoto Protocol-recognised units were driven by their obligations stemming from the Protocol. Thus, trade in EUAs, CERs, ERUs and AAUs, representing the vast bulk of GHG market activity, was largely confined to the EU, Japan and the developing countries.

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The decision of the US not to ratify the KP, accompanied by a long delay by Australia and an official policy of inaction by Canada, led to the emergence of a Voluntary Carbon Market. The latter is best exemplified by the Voluntary Carbon Standard (that emerged as an effort of the business community) as well as compliance standards in other trading systems, such as the greenhouse gas cap-and-trade and regulatory system emerging in California and the Regional Greenhouse Gas Initiative (RGGI) undertaken by the states in the Northeastern United States and the provinces in Eastern Canada.

The fact that the US never ratified the KP also made any official use of CDM and JI impossible at the subnational level, as well as the rejection of CERs and ERUs for any substantial use for Corporate Social Responsibility or Voluntary commitments by the corporate community in North America.

We are *de facto* in a world where the KP units have been used for trading and accounting in the EU and Japan while the rest of the world used emerging, and until now, largely voluntary standards, which have little influence on the price for carbon.

At the same time, demand and carbon price, largely defined as the price of EUAs, CERs and ERUs, were largely driven by economic conditions in the EU and Japan, as well as by the efficiency of the UN regulators that are responsible for overseeing CDM and JI.

As the world entered a severe financial crisis affecting the economies of the EU and Japan, which are the main demand centres of GHG compliance instruments, and with no price/demand support from other areas of the world, prices fell to record levels.

In Durban a number of agreements were reached.<sup>1</sup> Under these agreements, the KP was extended to 2017 for those that will ratify it, and all Parties have agreed “to develop a protocol, another legal instrument or an agreed outcome with legal force under the United Nations Framework Convention on Climate Change (UNFCCC) applicable to all governments ” that will be in force by 2020.

From the point of view of carbon markets, there is a set of provisions in these agreements that will need to be defined in the coming year and beyond. How these issues are resolved will determine the future direction of the carbon market.

Based on the outcome of Durban, CDM and JI will continue post-2012, as will efforts to extract increasing efficiency from these initiatives, by ensuring a more efficient and transparent regulation. However, given the conditions associated with EU demand and the potential linkages between the EU ETS and other emerging domestic ETSs, such as the one in Australia, these mechanisms will play a significant supply role only outside the BASIC countries (Brazil, South Africa, China, India) post-2012.

Their units will continue to qualify for compliance under the KP, as well as any domestic action that flows into KP commitments. Their fate post-2020 has not made the object of any significant debate and will largely depend on the outcome of the Durban Platform negotiations.

For the first time, under a provision included in the Durban text under the AWGLCA (Ad Hoc Working Group on Long-Term Cooperative Action), a market mechanism will be created under the UNFCCC, under para 77, which “defines a new market mechanism operating under the guidance and authority of the COP”.

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<sup>1</sup> Draft conclusions by the Chair on the outcome of the work of the AWGLCA to be presented to the COP for adoption at its seventeenth session (FCCC/AWGLCA/2011/L.4) and Outcomes of the Work of the Ad Hoc Working Group on Further Commitments for Annex 1 Parties under the Kyoto Protocol at its sixteenth session FCCC/KP/AWG/2011/L.3.

The agreements will allow non-KP Parties to use units from the new mechanisms, should they so chose. This is a new and important development. There has always been a desire by some to bring the KP mechanisms under the UNFCCC, but this has not been politically feasible. Now it seems that the situation is reversed.

It must be emphasised that the general approach in establishing the new mechanisms is very similar to the one in the Kyoto Protocol text, where CDM was established. In that case it took a number of years for its modalities and procedures to be defined under the Marrakech Accords.

However, compared to the initial definition of CDM and JI under in the KP text, this mechanism is much less defined, further illustrating the compromise that had to be made to reach an agreement in Durban.

This is the *top-down* element of the new market mechanisms, which almost all Parties accept can go ahead and be defined under the auspices of the UN. Units resulting from this new mechanism, which is expected to take a sectoral form, are well understood to qualify for compliance under the second commitment period (SCP) of the KP and any future UNFCCC obligations.

There is also a *bottom-up* element in the LCA text regarding the creation of new mechanisms. The text notes in the Preamble that: "Parties may ... develop and implement such approaches in accordance with national circumstances."

Para 73 also speaks of the fact that "various approaches, including the opportunity for using markets ... must meet standards that deliver real, permanent, additional and verified emissions reductions". Para 74 refers to a "work programme to consider a framework for such approaches".

In its provisions for the bottom-up approach, the LCA text from Durban is very imprecise, as this was a 'red line' for some Parties, such as the US and Japan, and a compromise needed to be reached. However, it must be emphasised that this is a fundamental matter for the new market mechanisms, as well as the development and evolution of the GHG market post-2012, as discussed below.

One issue was whether mechanisms emerging bottom-up from Parties needed a set of centrally defined 'core elements' or standards that all new approaches aimed at producing units traded internationally and used for compliance with obligations under the UNFCCC would have to observe.

While the discussions are still at an early stage, the core elements that are mentioned most often include MRV, additionality, setting of baselines, etc. In short, something that would ensure that "a tonne is a tonne".

The second issue was squarely whether newly created mechanisms needed to have central oversight to ensure that core elements/standards referred in para 73 are adhered to, and what role, if any, would the UN play in such oversight.

This is a fundamental matter, as it will affect, at least at the beginning, the fungibility of units and market liquidity. There was clear discomfort from some Parties at the prospect of subjecting their bilateral agreements to external oversight. At the other end of the spectrum were other Parties that clearly needed a strong central body for this role. Others felt that a transition period would be needed in which loose or no oversight was needed as an intermediary step in an evolutionary process.

The compromise just postponed these issues, as they will need to be discussed and included in the recommendations to COP 18. The debate surrounding this fundamental issue will be difficult and could also influence, as is often the case in UN negotiations, progress on

negotiations on the carry over of surplus AAUs<sup>2</sup> and very critically, the definition of modalities and procedures for the top-down mechanism and the new established mechanism.

It is important to recognise that many Parties, both Annex 1 and non-Annex 1, have proposals for top-down mechanisms that would need to be accommodated, and visible lack of progress on the definition of the 'framework' would signal the lack of an avenue for the implementation of their own approaches.

At the same time, under provisions of the Durban KP text, units from new market mechanisms under the Convention will qualify for compliance under the SCP of the KP. There were significant efforts in Durban to tie this provision to solving the issue of AAU carry-over from the FCP of KP, with restrictive proposals coming from the ALBA group (Antigua and Barbuda, Bolivia, Cuba, Dominica, Ecuador, Nicaragua, Saint Vincent and the Grenadines and Venezuela) as well as an African proposal, either banning all carry-over or severely limiting the use of carry-over units in future years.

Acceptance of new mechanisms, their implementation under the UNFCCC as well as the link between UNFCCC mechanisms and KP compliance in the SCP are issues that could have deep implications for the supply-demand balance in the GHG market now and post-2012.

As a conclusion, Durban must be seen as a step forward. It has answered questions regarding the continuity of the CDM and JI, but it has little to say about the extent of the demand for units emanating from them, and consequently their future use.

It has finally launched work for a new mechanism under the UNFCCC but has not provided direction on how the new mechanisms that are emerging from the US and Japan, for example, would interact with the emerging international framework. This will prove critical for market dynamics, for demand for units from domestic programmes, such as the one in California or Japanese bilateral programmes, as well as for general market liquidity.

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<sup>2</sup> Surplus AAUs are AAUs that are surplus to meeting KP obligations by Parties in 2012, at the end of the first commitment period (FCP) of the KP, and that can be carried over to the SCP of the KP, that is post-2012.