Time to rethink the CDM

Current uncertainty around the Clean Development Mechanism has deeper roots than the EU ETS review – and needs longer-term solutions, says **Jos Delbeke**

The European Commission's recently announced proposal for a revised EU Emissions Trading Scheme (ETS) beyond 2012 provides, for the first time, continuity for Clean Development Mechanism (CDM) projects and an enlarged market until 2020 for the certified emission reductions (CERs) they generate. But we recognise that proposals to set conditions upon CER imports into the EU ETS – ahead of a new international climate regime – have been met with unease by some. Those that make a living from the CDM have claimed that unnecessary "limitations" and "uncertainty" have been created.

However, the source of this uncertainty is not Europe. It is the early stage of the negotiations on a post-2012 international climate change framework that is its main cause.

The international community aims to agree in late 2009 in Copenhagen the way forward in international climate policy. This agreement will determine the political framework for the global carbon market for at least the next decade while, in tandem, concrete regulations will be defined in domestic legislation in an increasing number of countries (US, Australia, New Zealand, Japan etc).

The post-2012 negotiation process and the forthcoming elaboration of federal legislation in the US means the carbon market is likely to enter a period of political uncertainty. Unfortunately, this comes just after the creation, in Europe, of a stable regulatory environment following the process to set the cap for the second trading period of the EU ETS.

The Commission places high importance on providing regulatory stability for the carbon market. However, we can only provide stability for the European part of the market. For the international element – including the CDM, and links to other schemes – the means to provide stability are less in the EU's hands.

To a large degree, emission reduction commitments by developed countries, and the participation of developing countries, are going to determine the future carbon market.

Developing countries have so far participated in the market via the CDM. Simple arithmetic with respect to the CDM tells us the following: were all developed countries to offset all their emissions using CERs, we would not get close to at least halving global emissions by 2050. It also means that, if all developing countries, regardless of their stage of development, continue on a permanent basis to be simply suppliers of CERs, we simply will not arrive at the needed emission reductions.

This leads to a very important conclusion. To tackle climate change successfully, we need to seriously rethink the CDM. In the medium-term, voluntary offsetting mechanisms such as the CDM can only continue for some countries, and eventually only for the least developed countries. A gradual transition from mere project-based offsetting approaches to implementing cap-and-trade systems, first by advanced developing economies and their main sources of emissions, seems to be inevitable.

Once developing countries start to make contributions to cap or reduce their emissions, CER supply will become more limited over time. Countries will transition to participate in the carbon market in different ways. Less CDM as we know it doesn't mean fewer opportunities in the carbon market in developing countries, but it implies an evolution to different, yet-to-be-defined market mechanisms.

Market participants should also take into account the persistent concerns about the environmental integrity of the CDM. This is not a new question. It was at the source of the qualitative and quantitative restrictions on the import of CDM credits into the EU ETS introduced via the EU's Linking Directive, back in 2004. It expresses itself in, for instance, the reluctance of some US senators to recognise CDM credits in a proposed federal carbon market. In the post-2012 negotiations, a solution will have to be found to remedy these concerns.

Furthermore, many developing countries do not see how the CDM actually contributes to their sustainable development, given its limited transfer of new, low-carbon technologies.

The future scale of the CDM, its environmental integrity and technology transfer all need to be addressed during this round of international negotiations. Fortunately, there are many ideas around on reforming and improving the CDM.

One promising avenue would be to turn the CDM from an offsetting into a crediting approach, where crediting no longer takes place from the business-as-usual level, but from an environmentally demanding baseline, or is focused on massively scaling-up deployment of key clean technologies such as renewable energy. This would follow in the tradition of the credit trading approaches pioneered in the US in the 1970s and 1980s. Such a crediting approach would bring increased environmental integrity and facilitate developing country contributions. In practical terms, part of the reductions achieved against business-as-usual could continue to be monetised in the carbon market, while the remainder could count as a developing country action contributing to global mitigation efforts.

Thinking beyond an improved CDM as a project-based, voluntary approach, we need to find other means for scaling up participation among developing countries. Such means could include sector-based approaches such as 'no-lose targets' (where credits are awarded for beating targets, but no penalties imposed for missing them) or binding sectoral targets. Such approaches might be attractive in richer emerging economies, some of which already enjoy a higher income per capita than some EU member states. Ultimately, this should lead to the implementation of cap-and-trade mechanisms like the EU ETS which, in the first phase, can also help advanced developing countries to stimulate the private sector to invest in highly profitable energy efficiency measures with a short pay-back period.

The evolution of the CDM away from a mere offsetting approach is a necessity – and will be a cause of uncertainty over the next 20 months. This uncertainty cannot be resolved in the EU ETS review, but should be an essential part of the global agreement to be concluded in Copenhagen in 2009. EF

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