



## **Host Country Mitigation Share of Proceeds**

**A CDM Reform proposal by the PD Forum**

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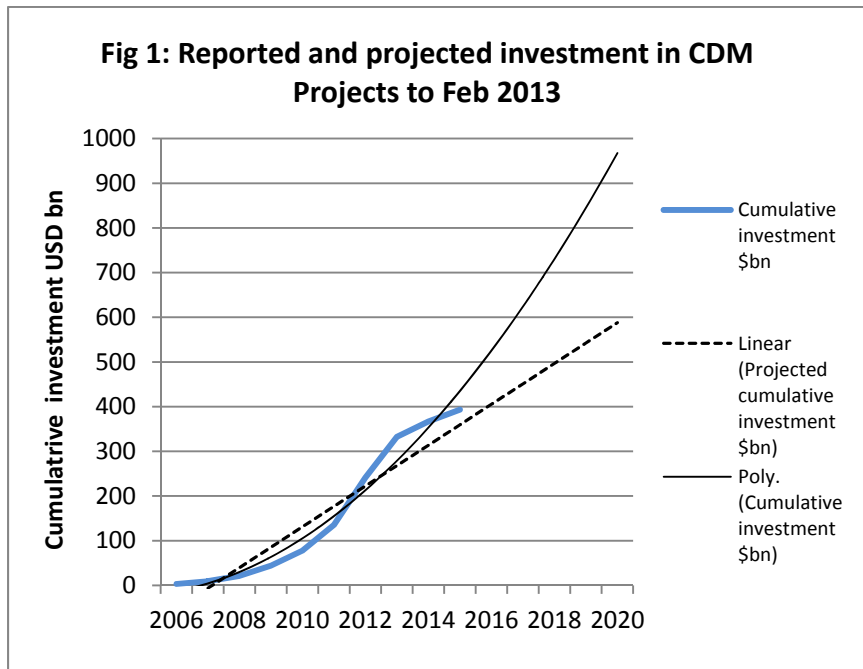
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# Host Country Mitigation Share of Proceeds

## A CDM reform proposal from the PD Forum

### Introduction

The Parties are facing many challenges over how to move forward with the climate negotiations. While it has been reconfirmed that the CDM continues (several times), the future of the CDM is one of those challenges. The CDM has delivered more than USD215bn of investment in clean energy and emission reductions in host countries and was on target for between USD600bn and USD 1 trillion by 2020 (see Figure 1).



SOURCE: UNEP RISOE CDM Pipeline February 2013. Cumulative investment is the sum of investments reported for projects at validation, requesting registration and registered.

However, the CDM has struggled to fulfil stakeholders’ expectations. It is criticized for financing projects that would have happened anyway and only helping to offset emissions in Annex 1 countries. The CDM is both a market based mechanism to find least cost abatement opportunities and a sustainable development tool. Balancing these twin objectives has proved challenging, and recently a third objective has been injected – an expectation that CDM projects will contribute to host country mitigation.

Stakeholders in the CDM have responded to these objectives in various ways including the imposition by buying Parties of qualitative restrictions on market access for CERs, positive discrimination in favour of projects from least developed countries, promotion by the CDM Executive Board of tools such as specific procedures and guidelines for micro scale projects and PoAs to encourage development of projects in rural areas and the scale up of dispersed community level project activities which are considered to promote sustainable development. As evidence of the mechanism’s contribution to mitigation, Project

Developers have pointed to the conservative nature of CDM methodologies. Project Developers and investors have also demonstrated great flexibility in the kinds of projects they have developed, responding to the learning-by-doing environment.

However, the future of the CDM remains unclear as proposals for New Market Based Mechanisms and the Framework for Various Approaches are developed. One suggestion is that **the CDM could act as an open source of methodologies, modalities and procedures, effectively act as an MRV service provider to other mechanisms, whilst contributing to and facilitating localized development of low carbon investments and an element of host country mitigation.**

### How could this work?

The PD Forum proposes the establishment of an optional Host Country Mitigation Share of a CDM project's emission reductions.

The CDM community is already familiar with the concept of a Share of Proceeds (SOP). CDM projects already pay a cash SOP on the issuance of CERs towards the administration costs of the CDM and a CER SOP towards the Adaptation Fund. The Host Country Mitigation Share could be implemented as a Mitigation SOP (MSOP).

It is proposed that infrastructure to support an additional optional share of proceeds is established with the following objectives:

- The Host Country Mitigation Share of Proceeds will be collected at the point of issuance of CERs from CDM projects and transferred into a Host Country Mitigation Account in the CDM Registry, in a transparent manner.
- CERs held in the Host Country Mitigation Account may only be used to surrender against that Host Country's targets or voluntary pledges and reported in the next national communication or national inventor; or converted into allowances for use in the Host Country's domestic emission trading scheme.
- Like Host Country Approval of a CDM Project Activity, the level of Host Country Mitigation Share of Proceeds would be a sovereign decision, communicated periodically by the Host Country DNA to the UNFCCC and advertised on the UNFCCC webpage. Once a project receives its LoA, confirming the application of the advertised MSOP, the MSOP would be fixed for the crediting period of the project in question.
- The level of MSOP within and between Host Countries may be varied by technology, project location and time<sup>1</sup> (age of the project) depending on the host's own support, such as through feed in tariffs or subsidies; or to encourage or relatively discourage CDM investment in sectors and locations; to encourage investment into strongly additional technologies and discourage investment into technologies that are going to happen anyway; to facilitate the integration of

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<sup>1</sup> The size of the MSOP may vary (increase) during the crediting period, but such steps would need to be carefully considered against the costs for project operators to maintain the project performance and MRV infrastructure.

CDM projects with current and future host country E-<sup>2</sup> and GHG management policies; and to guarantee net mitigation.

- Existing CDM projects could voluntarily apply for a revised Host Country LoA containing an updated MSOP in order to meet buyers’ expectations of contribution to mitigation.

There would be no change in the volume of CERs issued, but the net result would be either no change in the number of CERs available in the market (in the case of a zero rated MSOP, for example in an LDC) or a decrease in CERs in the market where DNAs set a higher MSOP. However, the transparent demonstration of the contribution to host country mitigation would increase the quality and value of CERs to buying Parties and lead to the transparent accounting of the full climate benefits of the project.

It would be expected that Advanced Developing Countries would set higher mitigation shares of proceeds compared to Least Developed Countries and Host Countries could also vary the MSOP to reflect contribution to sustainable development; degree of additionality<sup>3</sup>; and interaction with existing E- policies. This variation would reflect the fact that the investment risks in advanced developing countries are significantly different from the risks in LDCs. Table 1 below gives an illustration of how Host Country Mitigation Shares of Proceeds might vary in different types of countries and by different types of projects:

**Table 1: Examples of Host Country Mitigation SoP by development status. Proposed figures are for illustration purposes only.**

Project Type	Host Country Mitigation Share of Proceeds expressed as a % of CERs at issuance		
	Advanced Developing Country <sup>4</sup>	Developing Country	Least Developed country
Low contribution to sustainable development for example projects within an industrial complex	30%	20%	10%
Medium contribution for example renewable energy	20%	10%	5%
High contribution for example biomass cook stoves	10%	5%	0%

<sup>2</sup> E- policies are policies which encourage low emission technologies and practices.

<sup>3</sup> For example, pure abatement projects with no other sources of revenues are strongly additional whilst renewable energy project range from strongly additional to “going to happen anyway” in which case the CDM may serve to advance their implementation by a few years.

<sup>4</sup> A suitable classification system is required to distinguish a 3<sup>rd</sup> group of countries between advanced developed countries and least developed countries.

In addition, DNAs may introduce further variation by region within the country to highlight the different levels of economic development in different regions and they may vary the MSOP over time to, for example, reflect the future implementation of domestic policies such as ETS, taxes or performance standards or the degree of additionality. This would be equivalent to varying the duration of the crediting period but at a region / technology level rather than for example a country level.

## Implementing a domestic ETS

As an alternative to cancelling the MSOP against existing pledges, and in particular as part of possible future commitments under the Durban Platform, Host Parties may use the MSOP to create allowances for use within a domestic ETS or allow CERs to be used directly in their ETS<sup>5</sup>. Capped schemes benefit from a source of supply of additional emission reductions and therefore Host Parties may turn to (their own) CDM projects to supply these emission reductions. Since a Non-Annex 1 ETS would be a voluntary action, using CERs to offset emissions within a cap would also amount to a voluntary cancellation and would therefore have the same mitigation impact as the MSOP.

Considering the benefits of ETS as an efficient and effective means of reducing emissions, this is a highly desirable step and it would move host parties considerably closer to the goal of global emission management.

## What would be the benefits of such a scheme?

- 1) Host Countries will be able to use the CDM as a very powerful incentive mechanism to direct investment to GHG reduction projects.**

Giving DNAs a means to direct investment into different sectors would immediately increase their importance within host country government and ensure that not only Environment and Energy Ministries take notice, but also Ministries of Economy and Finance. The role of the CDM would change from being an opportunity for external investors to participate and invest in a host country's clean development whilst producing CERs to a becoming a mechanism which host countries can use to actively stimulate investment into specific areas of their economy in order to deliver particular sustainable development objectives, promote the development of technologies which are strongly additional, mitigate host country emissions whilst generating high quality emission reductions for consumption in other countries.

Active participation from host countries to direct investment towards specifically under-developed sectors will allow Governments to attract investors towards areas of the economy where investment is not taking place, where development of projects is not business as usual and where projects would be strongly additional.

- 2) By creating a transparent mitigation mechanism, the Parties would convert the CDM from an offset-only mechanism with claims of mitigation, into a powerful development mechanism with transparent and quantified mitigation benefits.**

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<sup>5</sup> See our submission on the Carbon Market Architecture for a detailed discussion no domestic ETS implementation, under the New Market-based Mechanism.

The CDM is often seen as a purely offsetting mechanism: all the emission reductions generated by registered project activities are in theory destined to offset emissions beyond caps in Annex 1 countries<sup>6</sup>. However in practice, the CDM is first and foremost a mechanism to generate certified emission reductions and report them in a transparent way. It is the use of the emission reductions by consumers which makes it an offset mechanism and this is why it is possible to insert a mitigation function into the CDM in a simple and transparent manner.

Some Parties have criticized the CDM as possibly deterring the transition to net mitigation by Non-Annex I countries. At the same time, Non-Annex I countries have claimed that Annex I countries take the “cheapest” emission reductions in their countries leaving them with potentially more expensive options to mitigate climate change in the future. The Host Country Mitigation SOP would be a way to overcome both criticisms, giving incentives for Non-Annex I countries to engage with domestic mitigation plans in a cost effective manner.

**3) The Host Country Mitigation SOP would promote accurate and transparent accounting of GHG emissions and remission reductions.**

CDM methodologies have been designed to be conservative in order to ensure that excess emission reductions are not issued, and this conservativeness has also been used to explain that CDM projects do contribute to Host Country mitigation. Neither claim is adequate because the extent of the conservativeness is not quantified and varies between different methodologies whilst claims of inherent mitigation are un-reported and un-recognized.

By defining a general approach to conservativeness which can be applied throughout methodologies, it will be possible to quantify the amount of emissions cancelled/not issued to ensure conservativeness. By adding the Host Country Mitigation Share of Proceeds in a transparent manner, all of the emission reductions generated by a project are identified and transparently accounted for, and both conservativeness and host country mitigation can be clearly quantified.

Host Country Mitigation SOP CERs may only be used for cancellation against a Host Party’s pledges or targets, and reported in its next National Communication.

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<sup>6</sup> It is possible to argue, however, that CDM is not a pure offsetting mechanism but a net mitigation one: 1) conservative accounting regimes mean that probably about 10% of actual emission reductions are not credited; 2) hundreds of millions of CERs have been generated and not yet used; and 3) recently with the creation of the voluntary cancellation accounts in the CDM Registry, some organizations have started to cancel CERs voluntarily.

#### 4) The Host Country Mitigation SOP is a bridge between CDM and FVA / NMBM.

CDM projects generating emission reductions for sale to capped entities in other jurisdictions are effectively acting in isolation of Host Country policies. By introducing a self-defined Host Country Mitigation SOP, CDM projects start to link with Host Country policies. For instance, when a Host Country sets an SOP for a given sector of its economy, a gateway to the FVA is created. At the pre-defined time, for example at end of its crediting period, the project activity could become fully integrated into policies implemented under the FVA. This is important because it provides a mechanism through which the host country can indicate in advance, when and how it expects facilities to start to contribute fully to host country mitigation actions rather than assisting other Parties and entities in the transition towards low carbon status.

In transitioning from a CDM project to becoming part of a host country FVA or NMBM policy, the existing CDM building blocks can continue to be used, particularly the MRV component. This kind of mechanism would provide transparency and certainty to investors and would encourage the continuation of Private Sector interest in clean development.

#### Examples of setting the MSOP

The MSOP may be determined by a number of factors including the following:

**Host country development status and pledges / targets.** Some developing and advanced developing countries have already made pledges or set targets to reduce GHG emissions or GHG emission intensity. These economies are often relatively developed and the risks for investors are considerably lower than the risks of investing in less developed economies. Host Governments may decide that an MSOP is a reasonable price to charge in return for granting permission to export CERs, and that the MSOP can be used to contribute to the host Party's pledge or target.

**Other forms of financial support for the implementation of the technology from the host country including E- policies.** For example a feed in tariff or renewable energy credits may provide an additional source of revenue working alongside the revenue from CERs to encourage investment in renewable energy. Whilst both streams of additional revenue are necessary for the investment to proceed (if not the project would not be additional), the host government may consider that the host economy is already contributing to the project and that a share of CERs is warranted in return. On the other hand, in a host country where there is no such support, the investors are likely to need to full share of CERs to manage the risk of investment.

Host Governments may plan to introduce other policies and measures in the future which will supersede the CDM status and issuance of CERs – for example, if the country were to introduce a national or region ETS covering the power sector, then renewable energy facilities might be included and either issued with allowances for free, zero rated for carbon emissions or lose their CERs and receive the same number of allowances. Such plans can be communicated and implemented transparently via the MSOP.

Conversely, Parties may wish to encourage investment into relatively under-developed sectors of the economy and they may decide to apply relatively lower MSOP and/or longer crediting periods in order

attract investment into these technologies, sectors or regions. For example, Host Governments are unlikely to be able to regulate domestic emissions from cookstoves whilst CDM Project developers have had significant success in developing such projects. Host Governments may decide that encouraging investment into this sector is attractive whilst investment into the renewable energy sector can be addressed through measures such as an ETS or renewable portfolio standards or feed in tariffs. According, the Government would set a low MSOP for the cookstove sector and a higher MSOP for the renewable energy sector.

## **Implementation measures**

### Host Country DNA

- Give DNAs the authority to set Host Country Mitigation SoP which could vary by technology, geography and throughout the crediting period (although all these variations should be fixed *ex ante*)
- To be communicated to UNFCCC and displayed on the UNFCCC website
- To be inscribed in the Host Country LoA and to be fixed for the duration of the crediting period
- Host Country DNAs to re-issue LoAs to existing CDM projects which voluntarily apply, so that an MSOP can be included.

### CDM Executive Board

#### Registry

- Create Host Country Mitigation Accounts for each country defining a Host Country Mitigation SoP.
- Deduct the Host Country Mitigation Share of Proceeds at issuance
- CERs in the Host Country Mitigation Account may be cancelled against that Host Country's pledges or future targets.