

Perverse incentives in the Clean Development Mechanism

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COP15 - further guidance to the CDM

The annual Conference of the Parties (COP) to the United Nations Framework Convention on Climate Change (UNFCCC) also acts as the Meeting of the Parties (MOP) to the Kyoto Protocol (collectively the COP/MOP) and, every year since the inception of the Clean Development Mechanism (CDM), the COP/MOP has provided so-called “Further guidance relating to the CDM”.

Given that the CDM and its institutions are, ultimately, creatures of an international legal instrument (Kyoto) and that the final authority on the CDM is the COP/MOP, the yearly “further guidance” is the formal manner in which the COP/MOP refines the direction being taken by the CDM. COP15, Copenhagen, December 2009, was no exception and certain aspects of the further guidance provided from the Danish capital are particularly relevant to the CDM in South Africa.

Perverse incentives in the CDM

The CDM rules seek to guard against the mechanism becoming a perverse incentive for developing countries to avoid promulgating climate-friendly national policy. If, for example, a developing country was of the view that it stood to gain financially from the CDM, e.g., for the reason that it operates a carbon-intensive economy with good potential for implementing CDM projects and generating and selling carbon credits, such country might decide against the introduction of policies aimed at reducing the carbon-intensity of its economy, in order to preserve the CDM potential. In this instance the CDM would be an incentive not to legislate in an environmentally friendly manner, hence becoming a perverse incentive. The manner in which the CDM rules deal with this scenario is to differentiate between so-called “E+” and “E-” national policies for the purposes of calculating a proposed CDM project activity’s baseline.

“E-” policies are relevant for the purposes of this article and are defined, in the CDM rules, as “national and/or sectoral policies or regulations that give comparative advantages to less emissions-intensive technologies over more emissions-intensive technologies (e.g., public subsidies to promote the diffusion of renewable energy or to finance energy efficiency programs)”. “E-” policies that have been implemented since 11 November 2001 (the date of adoption of the initial set of CDM rules) need not be taken into account in developing a baseline scenario for a proposed CDM project activity. Observers of South Africa’s Renewable Energy Feed-In Tariff (REFIT) are likely to note a correlation between the definition of an “E-” policy and the idea of a feed-in tariff for power generation. REFIT might be characterised as a policy that gives comparative advantage to less-emissions intensive technologies, i.e., renewable energy technologies. It’s for this reason that the 2009 further guidance relating to the CDM is of particular interest.

Clarifications to perverse incentive rules

The further guidance relating to the CDM from COP15:

- affirms that it's the prerogative of a CDM host country, to decide on the design and implementation of policies to promote or give competitive advantage to low greenhouse gas emitting fuels or technologies;
- requests the CDM Executive Board (EB) to ensure that its rules and guidelines related to the introduction or implementation of the abovementioned policies promote the achievement of the ultimate objective of the UNFCCC, i.e., the reduction of human-induced greenhouse gas emissions to levels that would prevent dangerous interference with the climate system, and do not create perverse incentives for emission reduction efforts;
- calls on the EB to consolidate, clarify and revise, as appropriate, its guidance on the treatment of national policies; and,
- directs the EB to work on the enhancement of objectivity and transparency in the approaches for demonstration and assessment of additionality and selection of the baseline scenario for CDM projects inter alia through the development of guidance for the treatment of feed-in tariffs in the additionality analysis for renewable energy project activities.

The further guidance is interesting for, at least, two reasons. Firstly, it seems to clarify that the rules on "E-" policies apply, both, to CDM baselines and additionality whereas there was previously some debate on this dual applicability; and, secondly, it requires the EB to provide guidance on the use of feed-in tariffs in the CDM. This is good news for South African renewable energy investors because recently published draft Rules on Selection Criteria for Renewable Energy Projects under the REFIT Programme indicate that not all renewable energy projects using the identified REFIT technologies, e.g., wind, small hydro, landfill gas, will be eligible for the REFIT subsidy. Consequently, the importance of a carbon finance stream, as might be obtained via the CDM, to those renewable energy projects that are ineligible for REFIT will be an important consideration in the project's investment analysis.

CDM and REFIT

There is also an assumption in the market that REFIT's adverse impact on the financial additionality of renewable energy projects will negate the CDM potential of such projects. Put another way, the assumption is that the cash-flow represented by REFIT will make a project financially viable without the need for carbon finance, consequently removing an underlying reason for the CDM, namely to provide an extra project finance stream. Renewable energy project developers are strongly advised to test this assumption before simply dismissing carbon as a possible project finance stream. The operation of the CDM perverse incentive rules means that REFIT might not need to be taken into consideration in the assessment of a proposed project's additionality and in the demonstration of its baseline. Furthermore, a project's additionality may be assessed in a couple of ways, including using a barrier-test as opposed to via a purely financial analysis. Taken together, these factors mean that it may be possible to implement a renewable energy project as a CDM project and claim, both, REFIT and a carbon finance stream.

IMBEWU Sustainability Legal Specialists (www.imbewu.co.za) is a specialist sustainability legal consultancy providing professional legal consultancy services in the area of environmental, health & safety and climate change law. IMBEWU runs a Climate Change and CDM Specialist Consultancy Unit with the greatest depth of expertise and experience in the South African carbon market. IMBEWU collaborates with Warburton Attorneys (www.warburtons.co.za) in providing CDM project development and contract advice to clients. This article should not be regarded a comprehensive discussion of the topics addressed, and should not be taken as legal advice or relied upon. Those seeking to participate in climate change-related activities are advised to seek specific legal advice. Contact: andrew@imbewu.co.za .