ELECTRIC LIGHT&POWER

Bilateral Emission Offset Mechanisms Might Eclipse CDM

Global Cap-and-trade Regime to be Built Bottom-up

by Allan Marks and Jeff Rector, Milbank

The establishment of an international regime big enough to have a meaningful mitigating impact on greenhouse gas (GHG) emissions would result in the creation and transfer of a tremendous amount of value exceeding hundreds of billions of dollars annually. This would require much international cooperation to preserve the system's sustainability.

Creating such a system of value and exchange is similar to creating an international currency. Given the value at stake, it is unsurprising that the community of nations has been unsuccessful in developing workable rules since the 1997 Kyoto adoption for the minting and distribution of new wealth created from thin air.

There are too many parties—193—with too divergent of interests—rich nations, poor nations, heavy emitters, light emitters, island nations, drought-vulnerable nations, flood-vulnerable nations, oil-exporting nations, oil-importing nations, nations with resource rights under ice, etc., and too much value at stake—hundreds of billions of dollars annually—to realistically expect existing international political institutions to be capable of developing and agreeing upon a global cap-and-trade mechanism from the top down.

Any international regime must be built gradually, step-by-step, in the way it took 50 years for the General Agreement on Tariffs and Trade (GATT) to become the World Trade Organization (WTO) and for the European Coal and Steel Community to become the European Union.

Two Big Holes in the Boat. The world's two biggest emitters, China and the United States, are not bound under the Kyoto Protocol, which expires at the end of 2012. Renewal or re-adoption of the Kyoto Protocol in Copenhagen at the 15th annual Conference of the Parties (COP15) to the United Nations Framework Convention on Climate Change (UNFCCC) depended on the participation of these two nations, and they failed to step up. November election results in the United States and unprogressive COP16 meetings in Cancun made 2010 a dismal year for those hoping for the establishment of an international carbon regime. The Kyoto Protocol has not been pronounced dead, but the patient has no pulse and is as cold as what is left of the polar ice caps.

Global Commons Problem. When a country imposes a GHG emissions cap on its nationals, it is, at least in the short term, imposing a concentrated cost on its constituents in exchange for an uncertain and widely dispersed benefit shared by those who enjoy a habitable climate. No matter how overwhelming the physical scientific evidence supporting anthropogenic global warming theory might be, political science has not yet provided a road map for coordinated global action to solve this global common problem; and therefore, even in countries that accept the science and are highly vulnerable to climate change effects, imposition of additional costs to economic activities is a difficult sell during good and bad times.

CDM's Track Record. Billions of dollars from developed nations already have been transferred to developing nations under the clean development mechanism (CDM), the global regime for capping carbon and trading related emissions credits under the Kyoto Protocol. Most of this money has been transferred from the EU because it is the only significant jurisdiction that has imposed on its constituents a carbon cap covering the electrical utility and industrial sectors. Japan, however, also has been a significant purchaser of certified emissions reductions (CERs), the carbon credits under the CDM. The CDM has been criticized for funding the wrong projects, flowing funds to countries that do not need financial support, being unnecessarily bureaucratic and administratively burdensome, and failing to support sectors that could reduce emissions significantly and promote export from the funding nations.

More than 50 percent of the CERs that have been issued in uncapped states are for the destruction of industrial gases—especially HFC-23—that could have been avoided at a much lower cost than the price of carbon dioxide equivalent and that ought to be regulated under simpler international or national regimes. Excessive profits earned by developers of HFC-23 destruction projects and emissions data that seriously undermine claims of additionality of HFC-23 destruction projects put into question whether some of the issued HFC-23-related CERs were illegitimate and significantly disturbed the price of carbon in late 2010.

Authors

Allan Marks is a partner in the Global Project Finance Department of Milbank, Tweed, Hadley & McCloy LLP in Los Angeles. Reach him at amarks@milbank.com.

Jeffrey Rector is a project finance associate at Milbank in Tokyo. Reach him at jrector@milbank.com.

Reprinted with revisions to format, from the March/April 2011 edition of **ELECTRIC LIGHT & POWER**

While the CDM was supposed to support the development of low-carbon energy infrastructure, less than half of the funds transferred have been for energy projects, and most of these have been built in countries that do not need the financial support (and that are suspected of gaming the additionality requirements), i.e., China. The CDM executive board, a quasi-regulatory body that certifies and registers CERs, has been criticized for creating a process that takes more than two years to register even routine projects.

And finally, the CDM does not recognize nuclear as carbon-reducing technology and only timidly supports the issuance of credit for high-efficiency coal or clean coal. These are all necessary solutions to reduce GHG emissions while maintaining energy density. Removing these technologies from the menu of options is difficult to justify, especially to those nations that are competitive in these sectors and are willing to purchase offsets to meet emissions-reduction commitments.

The Bilateral Offset

Meanwhile, a handful of developed countries or subjurisdictions within them, such as California, remain committed to the Kyoto promises, desire to show reductions in emissions, and are prepared to satisfy such commitments in part through the purchase of international offsets. The political will behind such commitments may come from a diversely held sense of responsibility to mitigate climate change, but more likely is rooted in concentrated support from businesses that are competitive in those clean-tech sectors that would benefit from the policy.

In 2010, Japan, the biggest emitter among Kyoto Protocol-burdened states, publicly announced its categorical opposition to the renewal of the Kyoto Protocol in its current form. Under the leadership of Japan's Ministry of Economy, Trade and Industry (METI), which is tasked with fostering a healthy economy and growth of export-oriented businesses, Japan quietly began pushing for a bilateral offset mechanism that would serve as an alternative to the Kyoto Protocol's CDM. To date, METI has selected 30 trial projects that would generate bilateral offset credits, and the number of projects is expected to grow in 2011. In November before COP16 meetings in Cancun, METI publicly indicated its preference for faster, more flexible schemes that can coexist with the CDM. In February, the Federation of Electric Power Companies of Japan submitted a written opinion advocating a bilateral offset mechanism that could work within the UNFCCC framework. A METI official is reported to have indicated that Japan will conclude an agreement with at least one developing country—perhaps Vietnam—before COP17 this year in Durban, South Africa. Japan is said to be preparing to formally propose integrating bilateral offset mechanisms into the UNFCCC framework at the conference as part of its efforts to declare and meet an emissions-reduction target of 25 percent off its 1990 baseline by 2020.

The advantages of a bilateral offset mechanism are simple. The carbon-capped and capital-exporting nation bypasses the UNFCCC bureaucracy and determines which projects are eligible for the credits and establishes its own rules for certification. To enhance international credibility, bilateral mechanisms likely will track calculation methodologies and auditing mechanisms analogous to those employed for CDM. Because the capital-exporting country can pick which technologies are targeted for the credits, the bilateral offset mechanism can be used as a tool for domestic industrial policy, thereby securing more sustained domestic political backing. A key feature of Japan's bilateral offset scheme is the inclusion of nuclear and high-efficiency coal as technologies eligible to earn emissions credit. If adopted, carbon credit for nuclear would prove to be a significant subsidy, and Japan is in negotiations with Vietnam with the intention to make use of such a program to help finance two nuclear reactors in the country.

Japan's moves are only the beginning of what likely will be a significant trend in funding developing countries' energy projects, including renewable energy, high-efficiency thermal, clean coal and nuclear. Existing institutional channels such as export credit agencies will be used as the conduit of these funds; the Japan Bank for International Cooperation likely will play leading role in financing projects benefitting from Japan's bilateral offset program. Other countries should follow suit because it is a convenient way to promote exports, show national reductions in emissions and satisfy Copenhagen Accord commitments to distribute $100 billion annually to support mitigation and adaptation activities in the developing world. Ancillary benefits of bilateral offset mechanisms include the fostering of new technologies and industries, the related promotion of jobs and economic development that is sustainable at a lower cost. ELP