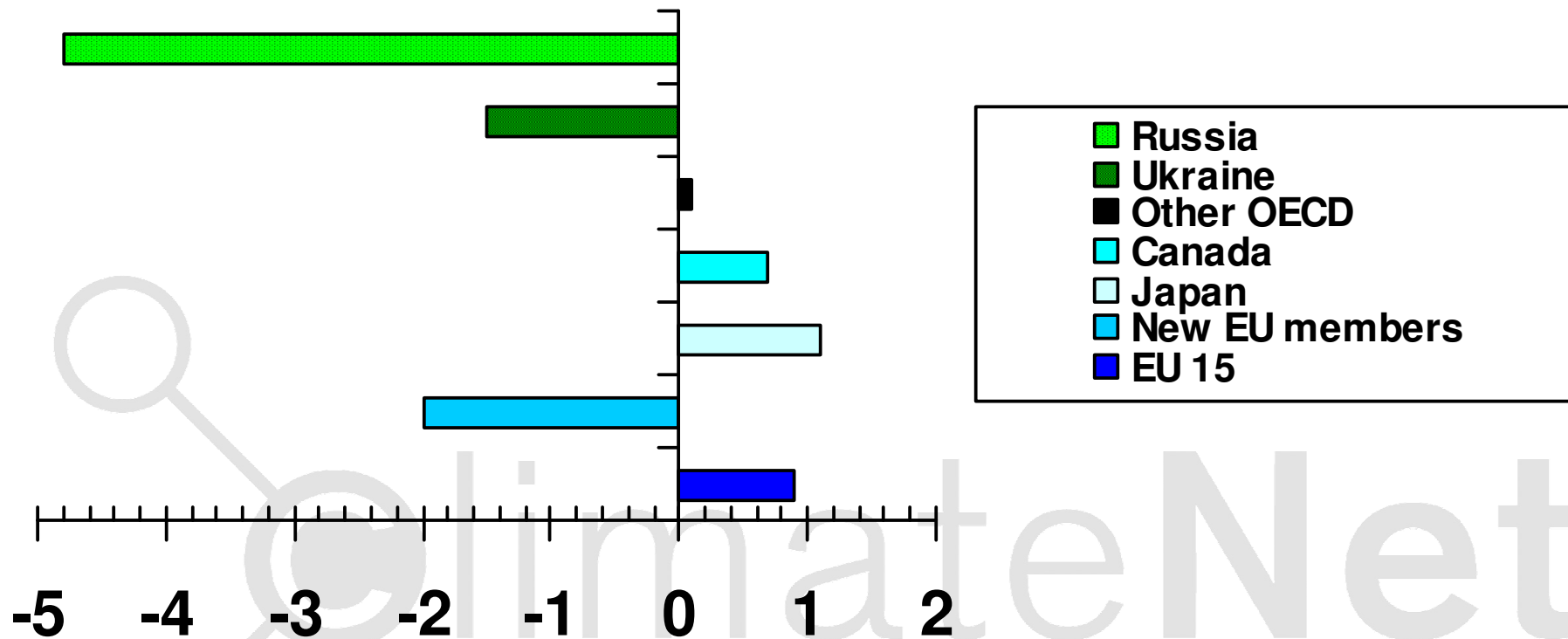

CDM: the reality behind the rules

Axel Michaelowa

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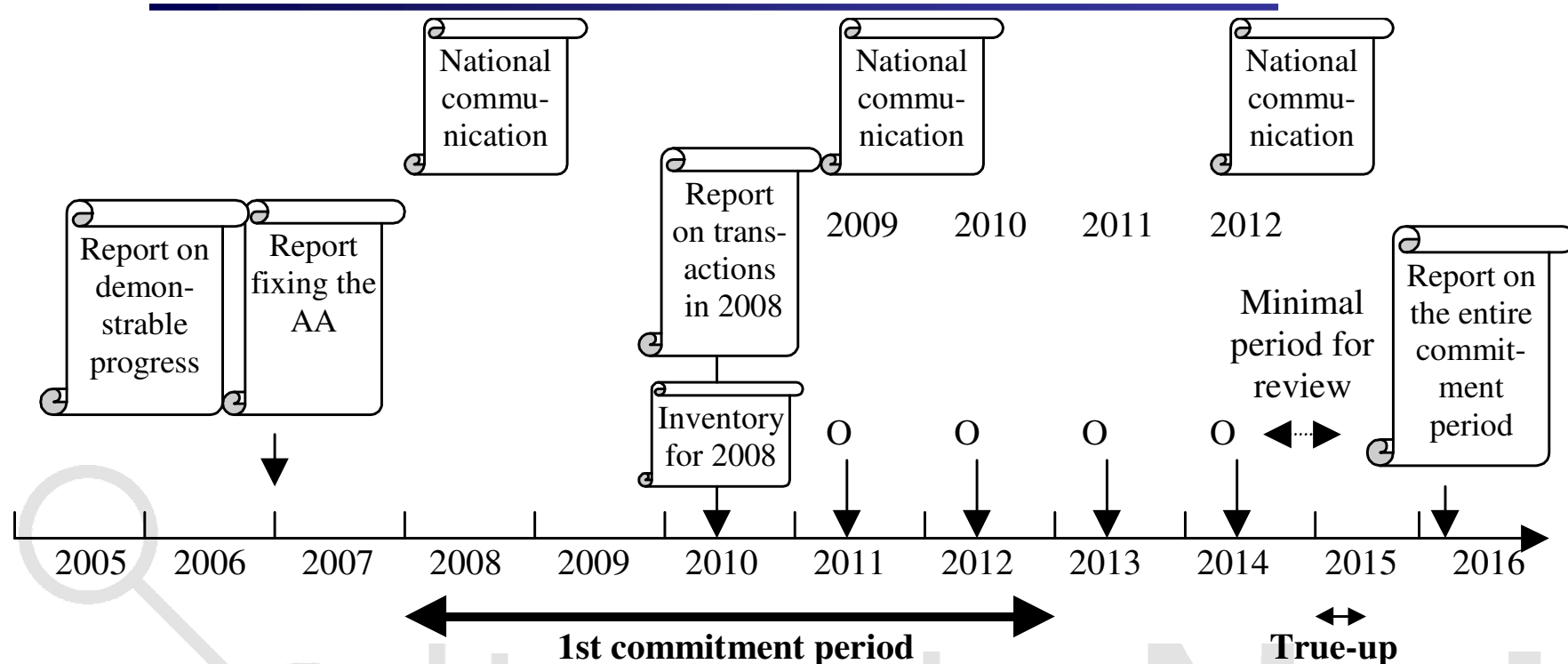


Supply and demand (billion t 2008-2012)



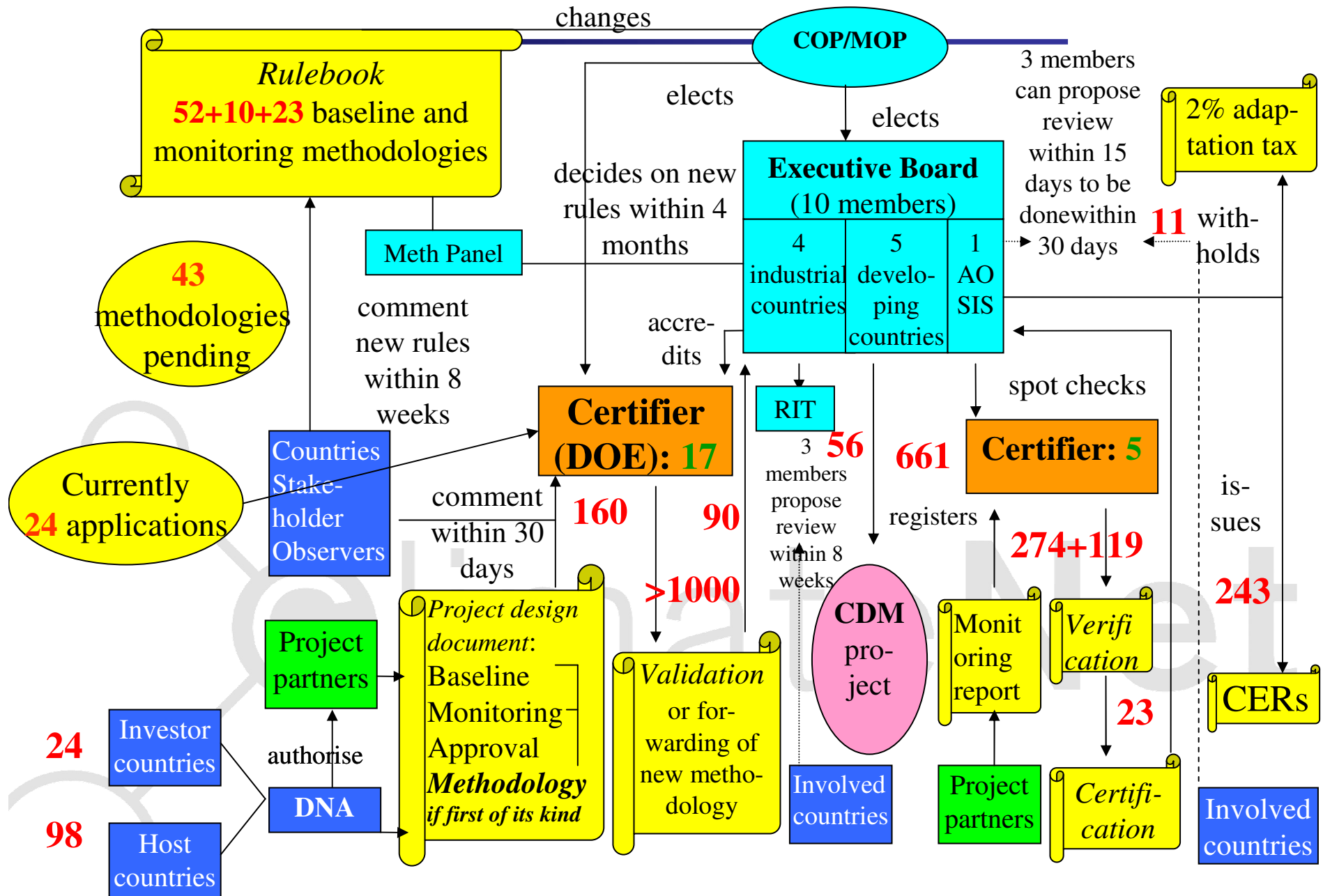
Source: Point Carbon

Detailed reporting requirements

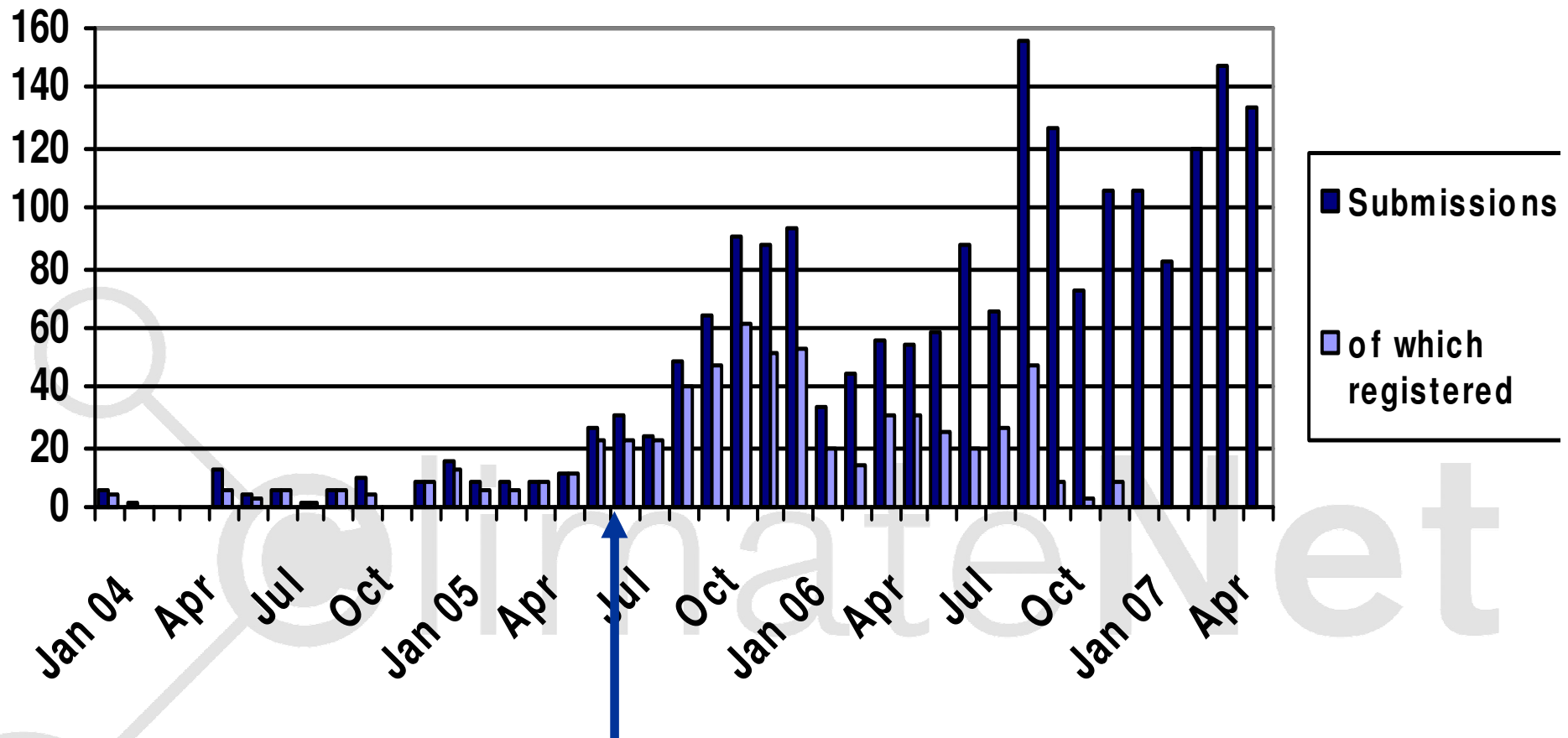


- All reports are reviewed by expert panels that suggest corrections. If correction values surpass certain thresholds, reporting rules are deemed as violated
- Trading and JI 1st track require compliance with reporting rules

Status of the CDM project cycle (16/05/2007)



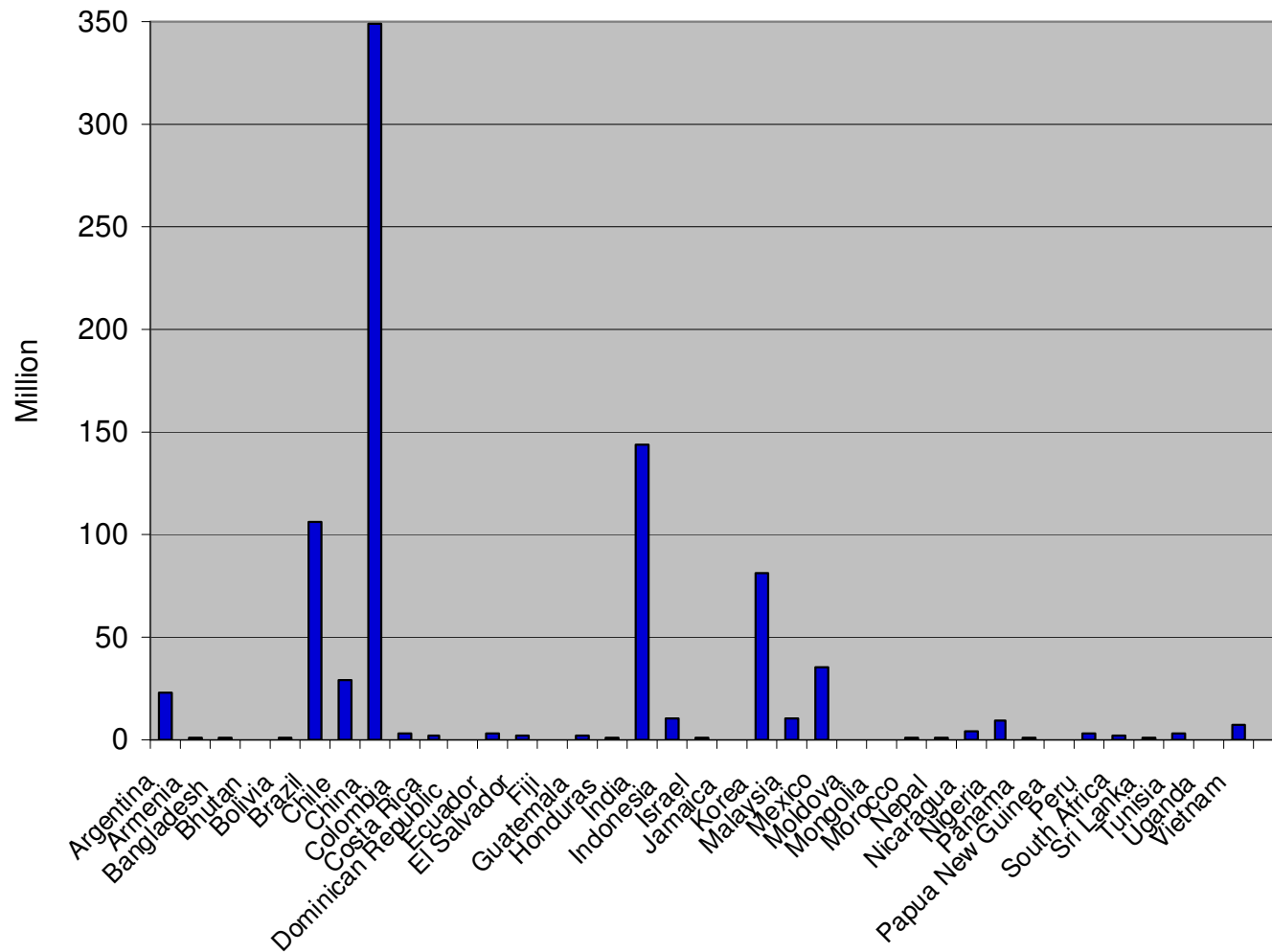
The CDM gold rush since May 2005



First unilateral project registered

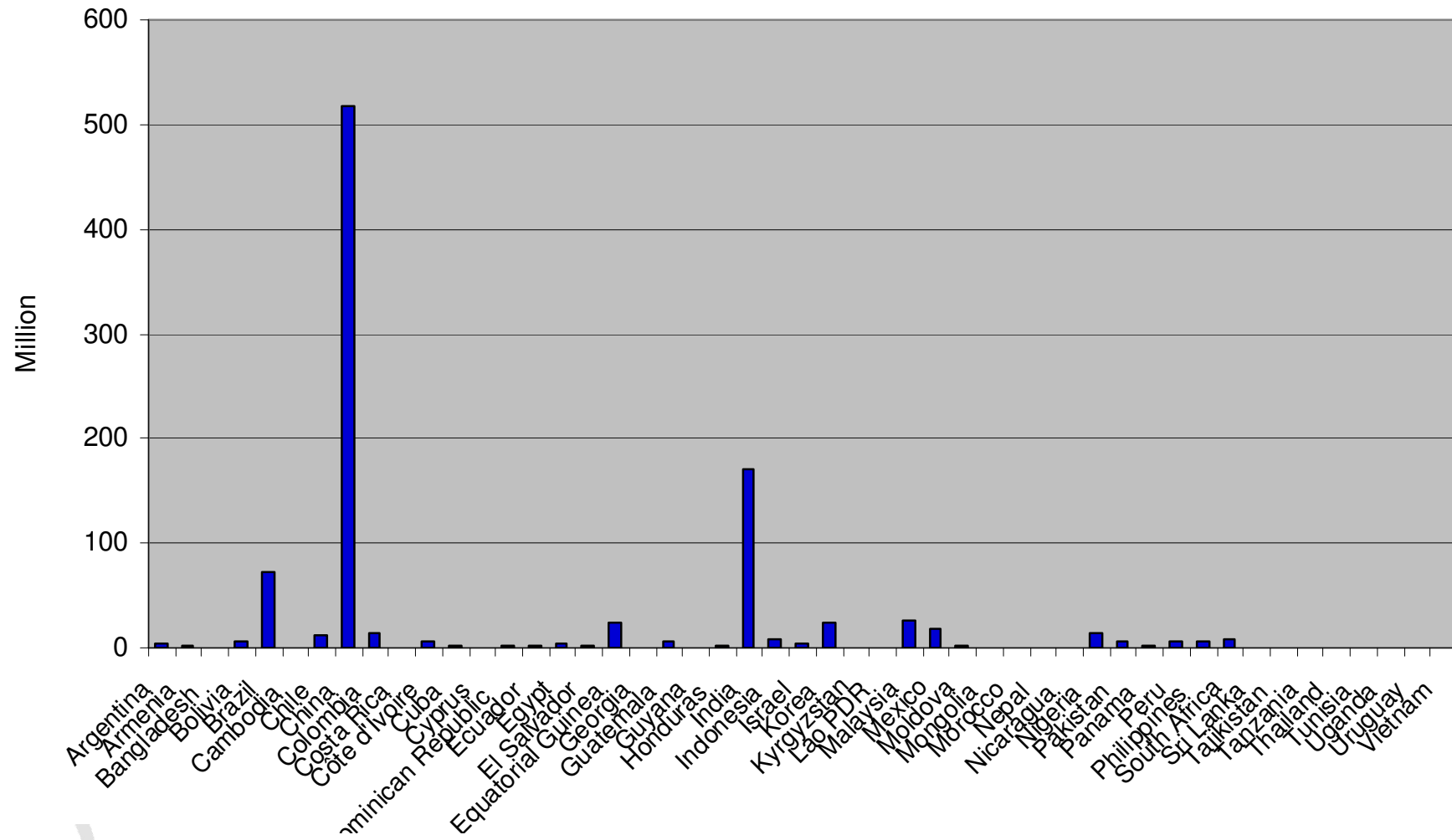
CER supply (host countries)

Registered projects (million until 2012)



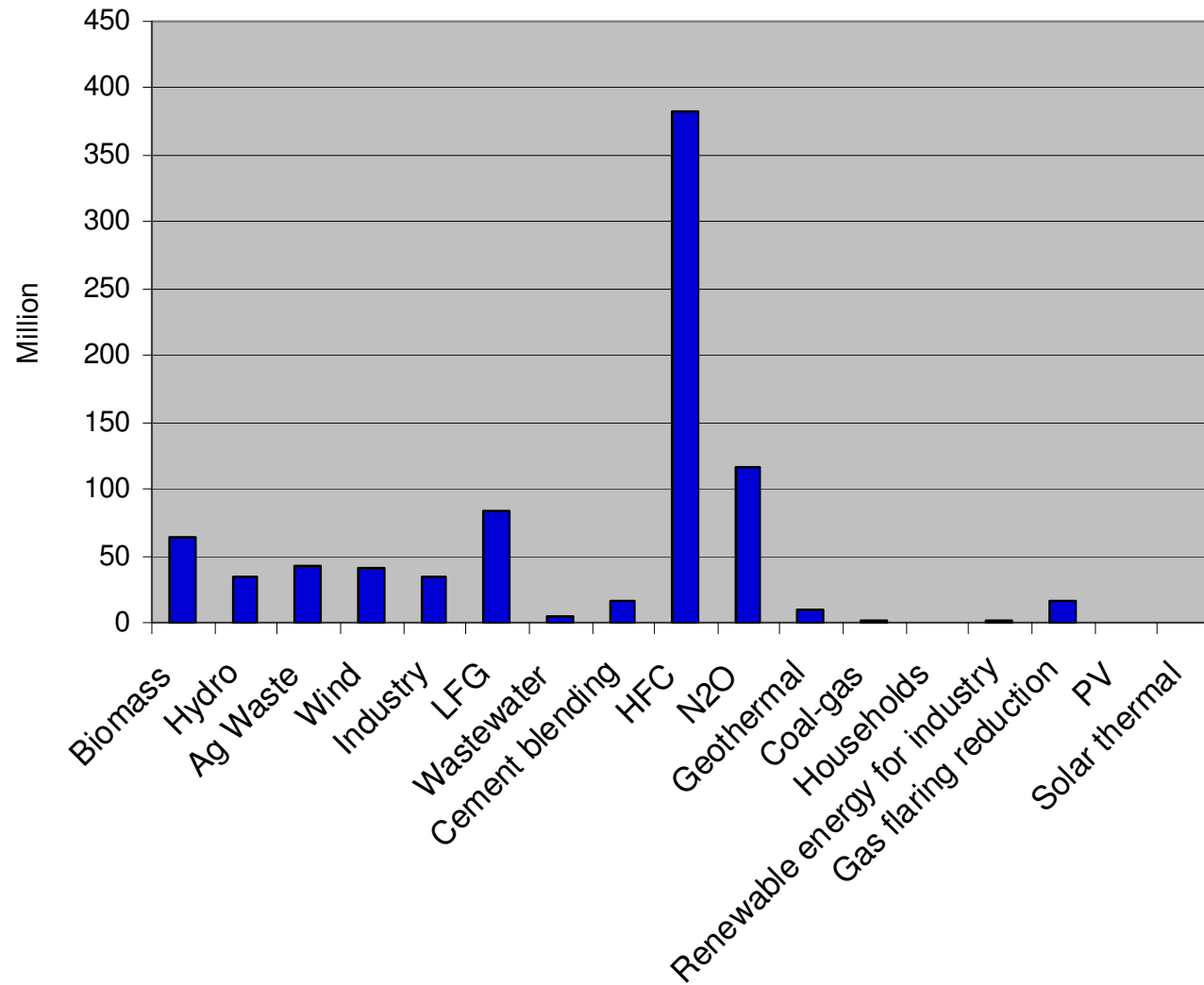
CER supply (host countries)

Submitted projects (million CERs until 2012)



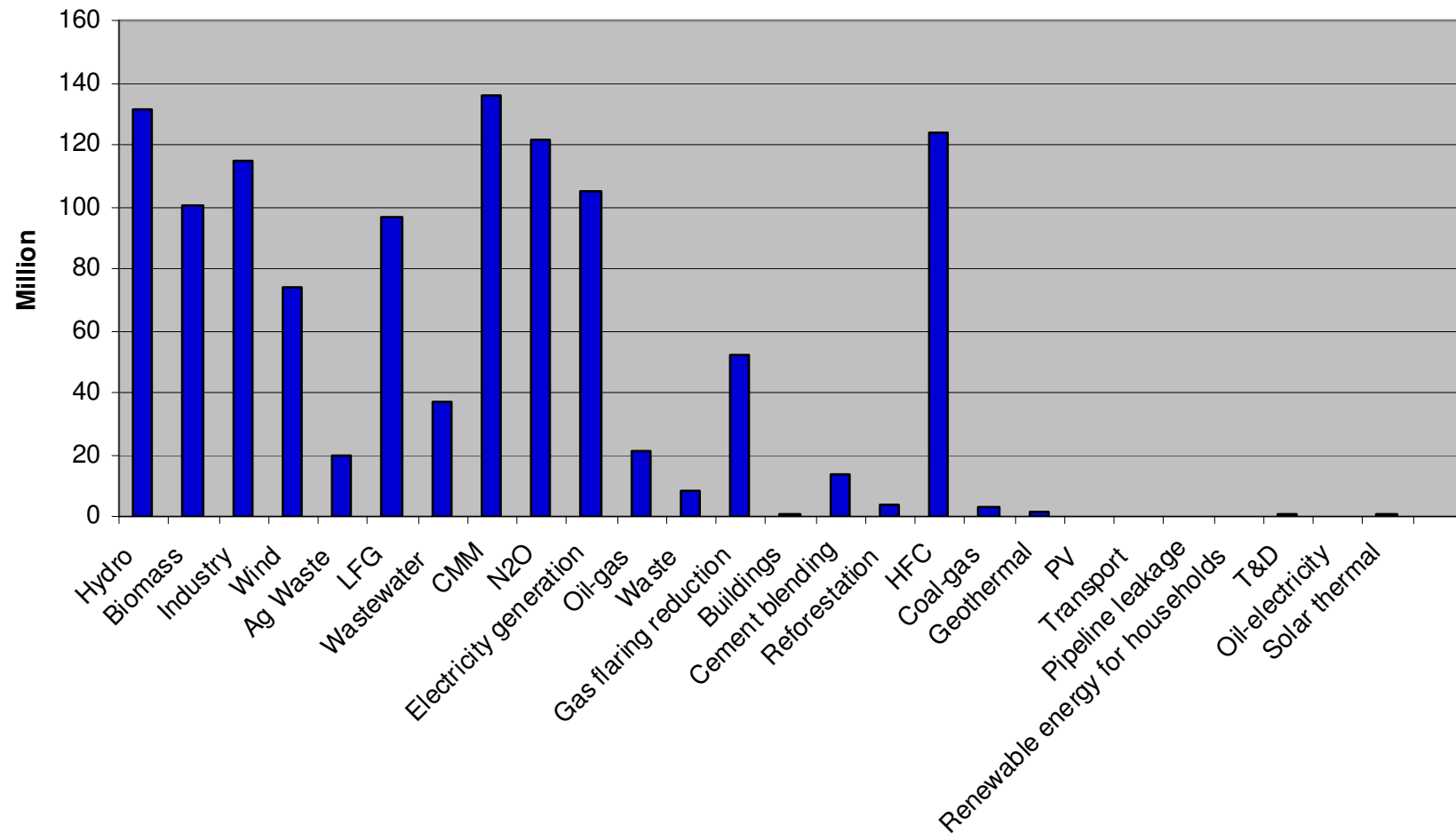
CER supply (project types)

Registered projects



CER supply (project types)

Submitted projects



Mistrust in validators

- From late 2004 until early 2006. the EB registered **all** projects that had been validated. Due to lack of budget, it was not able to set up a **post-validator level of scrutiny** as planned
- When budget allowed in March 2006, the **Registration and Issuance Team (RIT)** was set up to double-check PDDs and validation reports
- The RIT **regularly finds flaws** in documentations and thus, the EB has reviewed a number of projects and **rejected 14**

Key categories of flaws

- **Additionality determination is not credible or not documented by sources that can be corroborated**
 - Fake documents (MoM of board) to “prove” that CDM was considered at an early stage of the project
- **Baseline data are not correct**
- **Monitoring plan is incomplete and responsibilities are unclear**
- **Stakeholder consultation is not clearly documented and important stakeholders were not involved**

Additionality worldviews

- **NGOs:** no profitable projects should be registered
- **Business:** intent of developer cannot be judged. All projects with emissions below the baseline are automatically additional
- **EB compromise:** Project has to be less profitable than most attractive alternative or overcome prohibitive barriers
 - Initially many projects with doubtful additionality have been registered
 - After setup of the RIT scrutiny has increased and 9 projects rejected due to lack of additionality

The additionality test

- Suggested by EB (autumn 2004), but **not mandatory**
- Key question: Would the project have **happened otherwise?**
- **Key steps** in the consolidated test
 - Identification of **alternatives** to the project
 - **Investment analysis**
 - Determine that the project is **not the most economically or financially attractive**, or
 - **Proof of prohibitive barriers**
 - **Common practice analysis**
 - Tricky because needs complete market overview
 - **Impact of CDM registration** on overcoming barriers

Case study from India: I

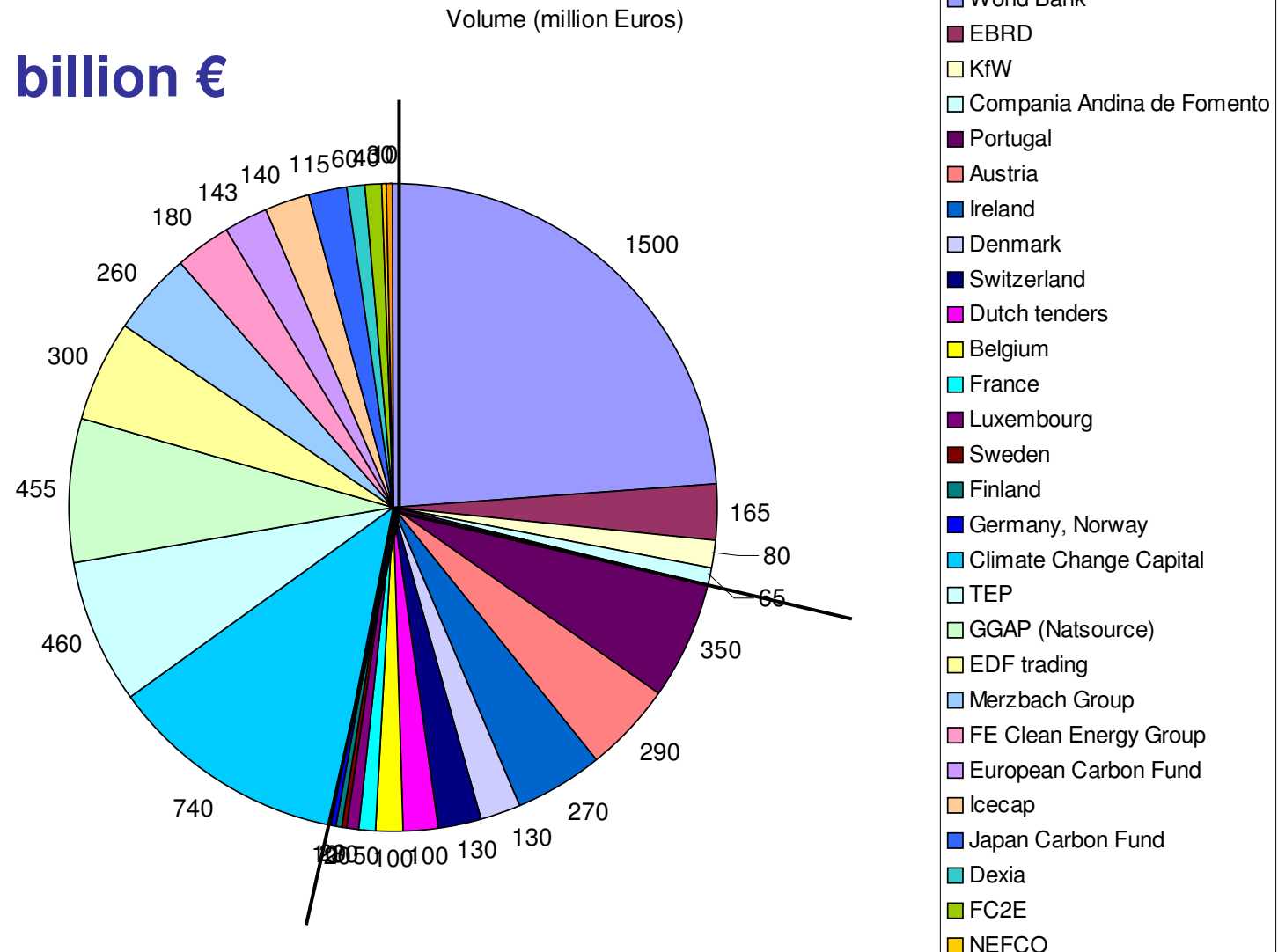
- JSW Vijayanagar Steel plant waste gas utilisation for electricity production
 - JSW Steel operates **steel plant**, JSW Energy the **power plants** (490 MW, 3 million CERs p.a.)
 - JSW Steel charges JSW Energy a **fictitious transfer price** for the waste gas (=coal price)
 - Investment in the gas storage tank of power plant 1 (260 MW) **pays off after just 100 GWh** of electricity produced from waste gas

Reasons for failures

- **Cut-throat competition of consultants leads to assembly-line PDD writing**
 - Consultants 100% success-fee based, meaning that there are no resources for hiring specialists
 - Consultants hide behind the companies implementing the projects (“xxx and associated consultants”, mainly Ernst & Young; India)
- **Cut-throat competition of validators leads to sloppy validation procedure**
 - Validators increasingly rely on untrained local staff to reduce costs

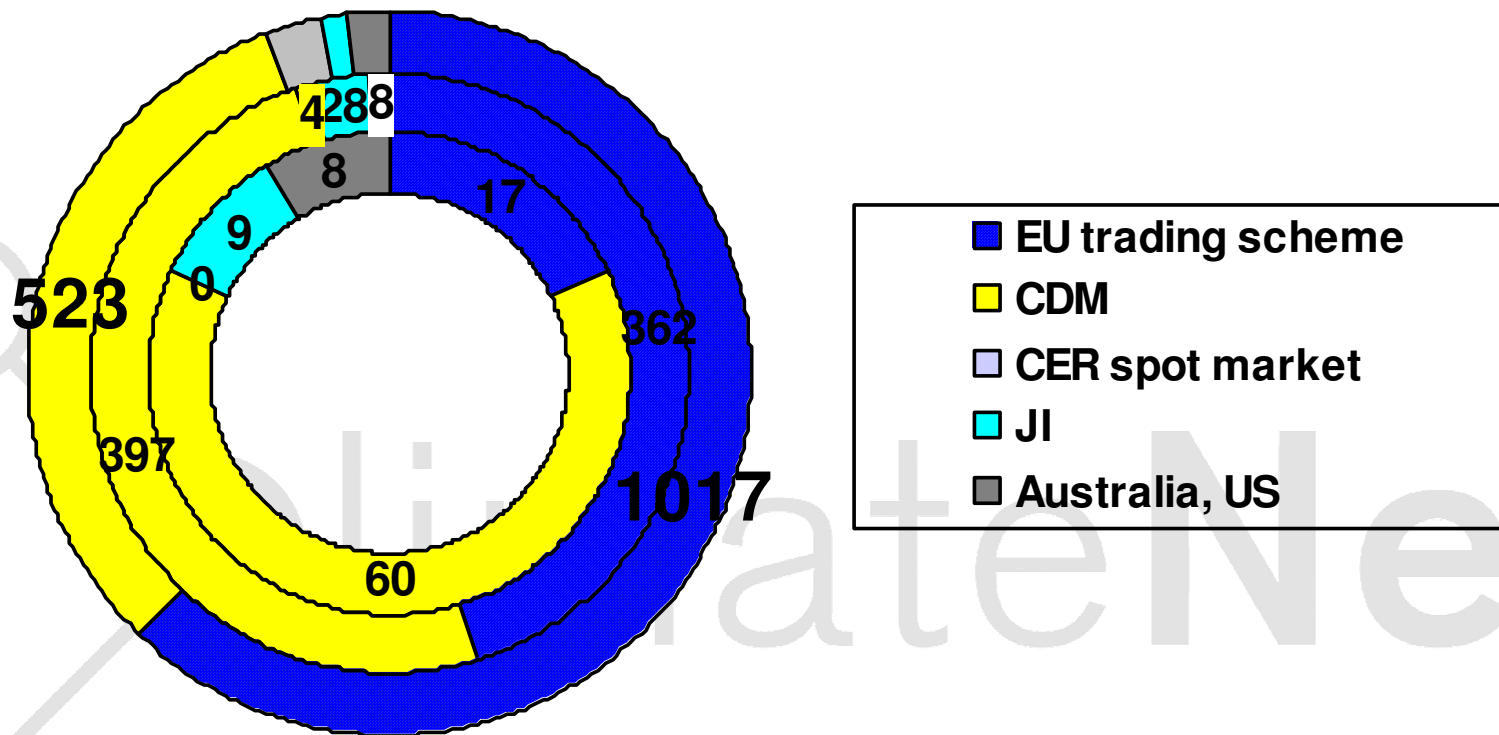
CER and ERU demand (million €)

Total: > 5 billion €



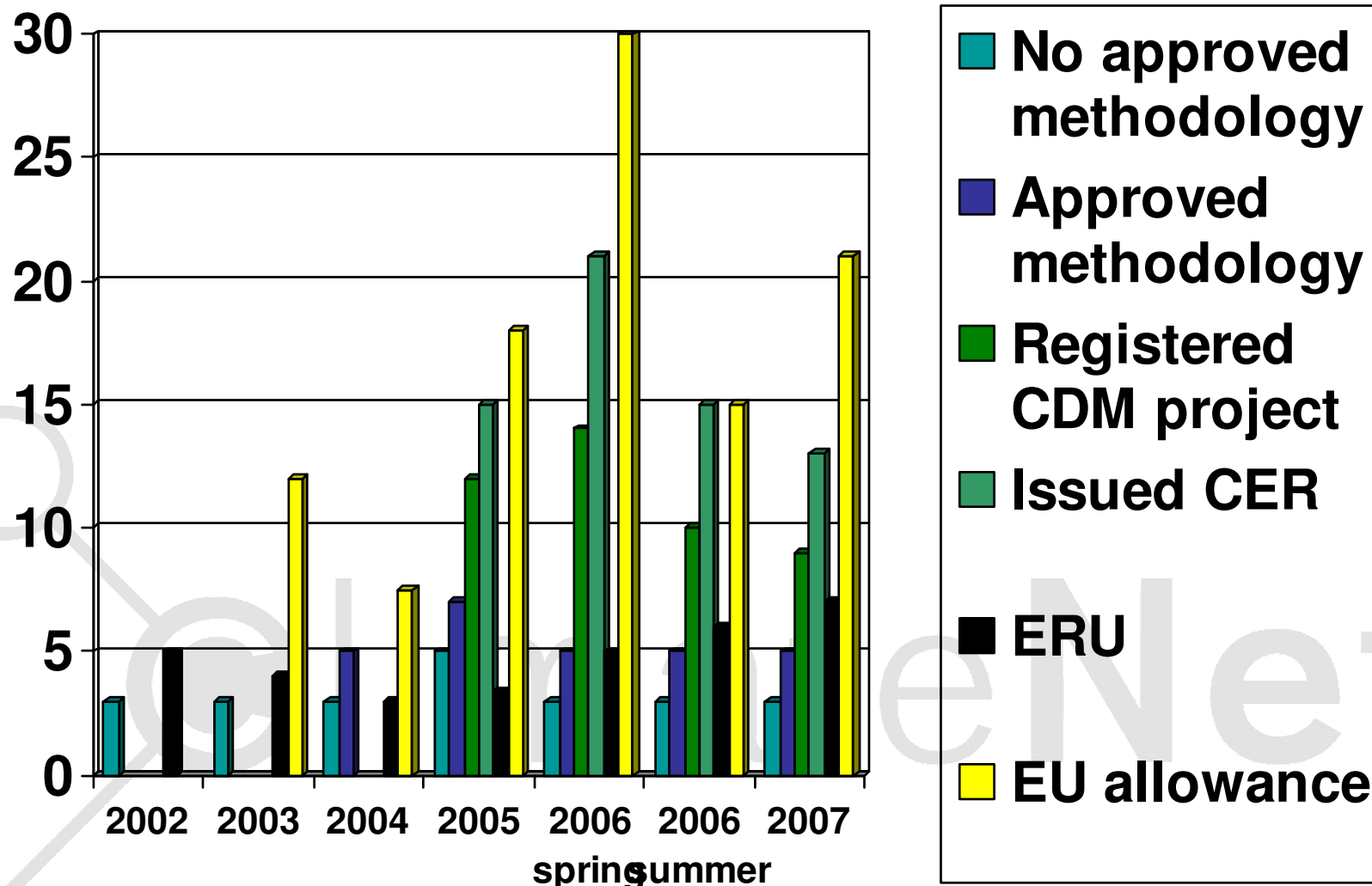
Global transactions 2004-6 (million t CO₂)

Total: 94 million t in 2004, 800 million t in 2005, 1.6 billion in 2006



Source: Point Carbon

Prices (€)



Huge gap between different "qualities"!

The role of CERs in compliance

- **Governments**

- Are the **primary users** of CERs for Kyoto compliance
- Have only to comply **by 2013**, possibly **only 2015** (true-up period)
- Have **other options** (AAUs)

- **Companies**

- Are only **secondary users** of CERs, subject to the **Linking Directive**, for compliance with **EU ETS**
- Want to use CERs to **undercut the EU allowance price**
- Need CERs by **2007** or **2012**

The role of CERs in compliance II

- **Governments**

- Like to prepare a purchasing programme, albeit with as little budget as possible
- Can go for the cheapest options available due to the possibility to link deals to political concessions (China)

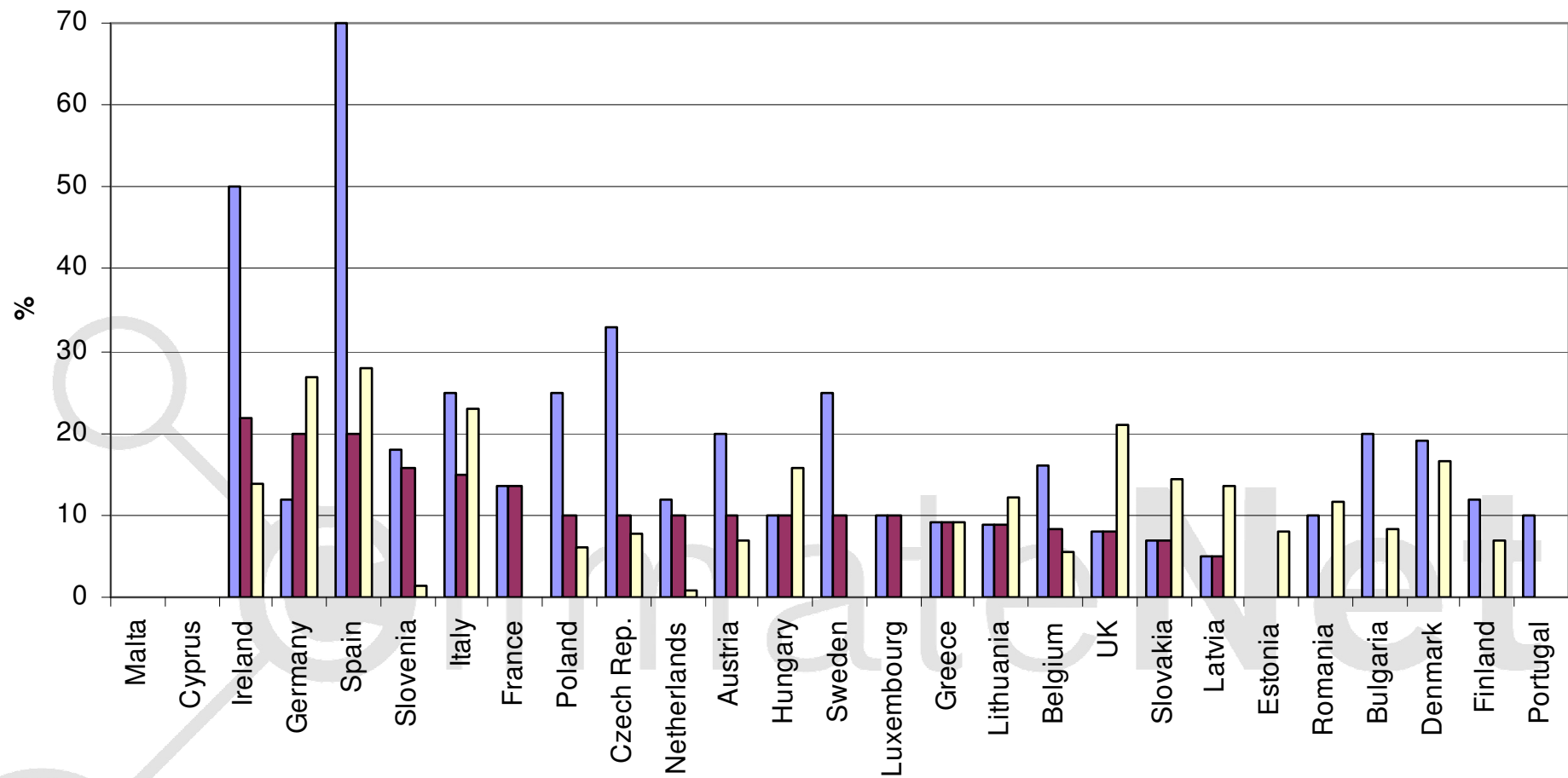
- **Companies**

- Were initially keen to get CERs as a buffer for end-2007 EU allowance quantity risk
- With increasing clarity that there is an overall allowance surplus, this strategy has shifted to a hedge against price risk for post-2007 EU allowances

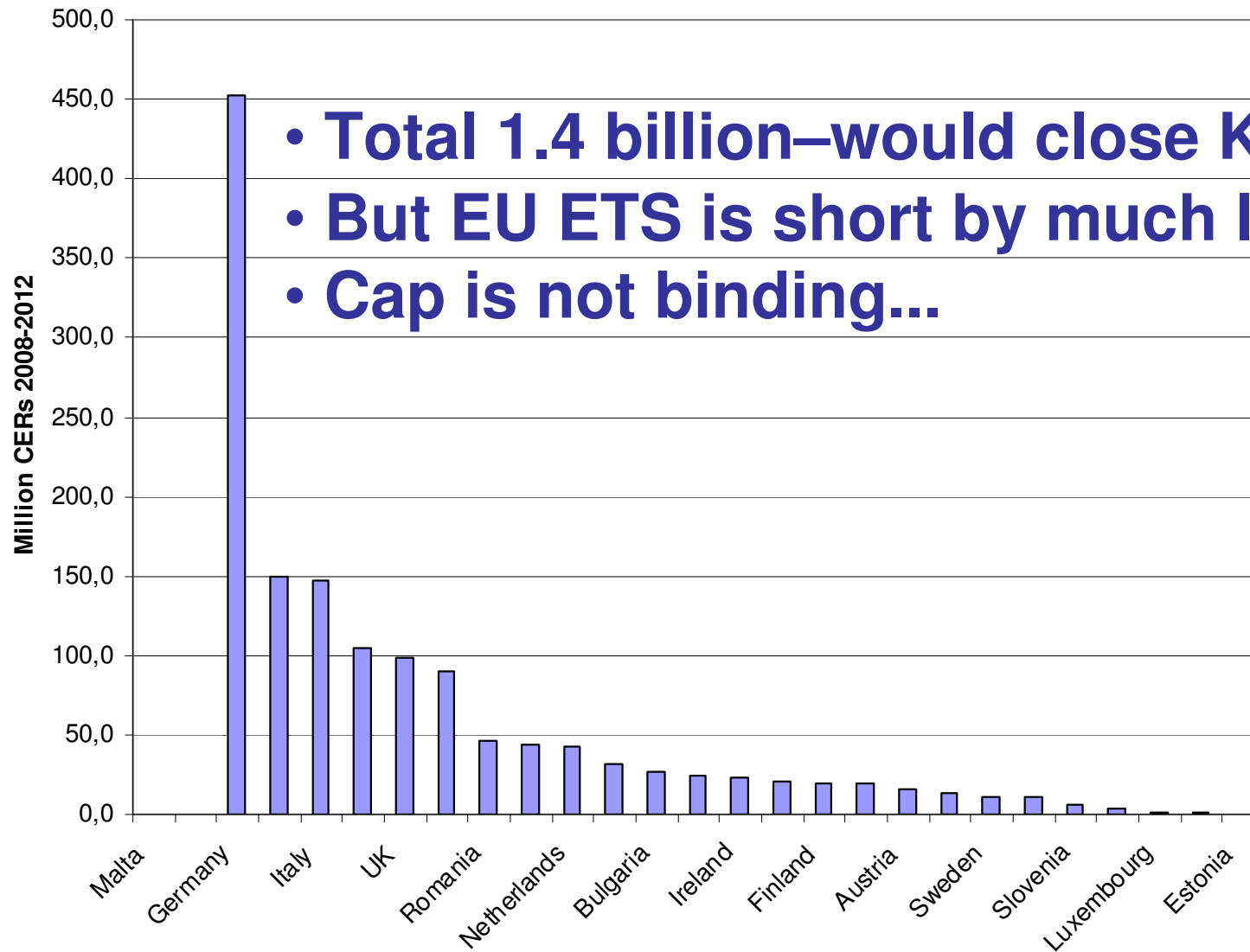
The Commission response

- Any cap up to 10% will be accepted
- Formula to justify cap >10%
 - Calculate difference between the highest emission level reached either in base year, 2004 or projected for 2010 and the Kyoto budget
 - Calculate 50 % of that difference and then deduct annual average substantiated government purchase of CERs/ERUs
 - Divide by average annual ETS allocation

The Commission decision



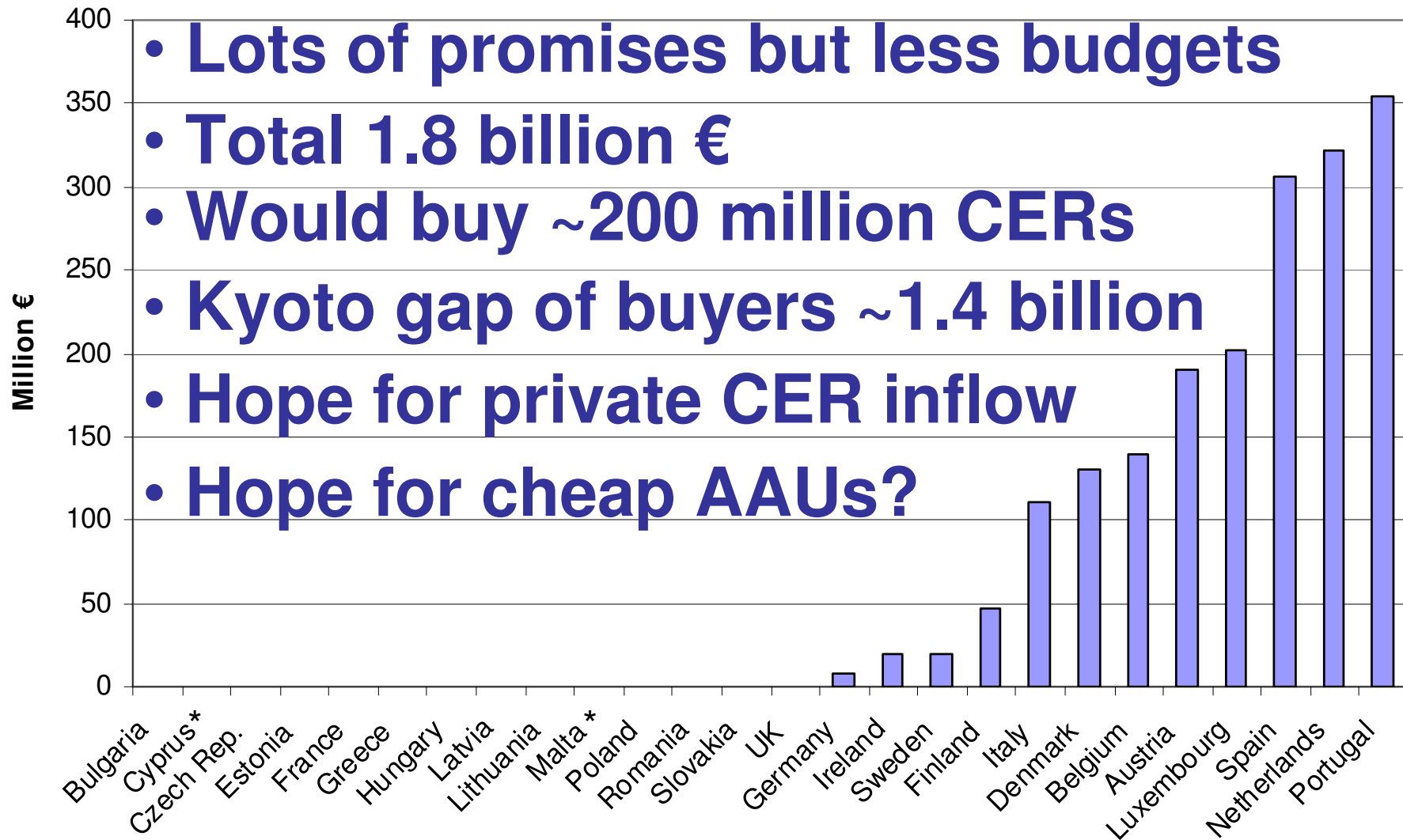
Possible CER import volumes



- Total 1.4 billion—would close Kyoto gaps!
- But EU ETS is short by much less
- Cap is not binding...

et

Government acquisition programmes



Are the caps relevant?

- **The CER caps are not binding as they are much higher than the shortage of EU allowances**
- **The government acquisition programmes fall much short of the needs to close the Kyoto gap**
- **The Commission formula set a perverse incentive to reduce budgets for government CER acquisition**
 - Any higher budget led to a crowding out of private inflow due to reduction of the cap
- **Governments may hope for CER windfall due to private imports**
 - But later reductions will become more difficult due to the higher amount of banked EU allowances

Thank you!

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