



Why Discounting of CERs Cuts the Gordian Knot to Save the CDM

Axel Michaelowa

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In just three years, the Clean Development Mechanism (CDM) has mobilized around 5,000 projects of which over 1,500 have been formally registered with the CDM Executive Board (EB), the regulatory body overseeing its rules. More than 2.7 billion Certified Emission Reductions (CERs) under Intergovernmental Panel on Climate Change guidelines are expected to be generated by these projects and over 9 billion Euros have been budgeted for CER acquisition. So far, the CDM has been a pure offset mechanism, where one ton CO₂ equivalent reduction from a CDM project in a developing country (as enlisted in Annex A of the Kyoto Protocol) allows to increase emissions in an industrialized country (Annex B) by the same amount of one t. Theoretically, this is no problem as long as the reduction from the CDM project is real and as long as incentives for introduction of emission reduction policies in developing countries are not distorted.

Up to 40 percent of CDM reductions would have happened anyways

The real character of CERs has recently been the subject of a heated expert debate which even spilled over into mass media. It relates to the so-called “additionality” requirement of CDM projects: CDMs have to stimulate additional low-emitting activities that would not have happened otherwise. Any CDM project that does not create emission reductions beyond a business-as-usual baseline (which may well describe a decreasing trend), has not legitimately earned CER credits. If CDM regulators lose sight of this crucial point, then the CDM will be generating meaningless paper credits that displace real reductions in industrialized countries. Currently, about 20-40 percent of CDM projects are non-additional! This is one of the main reasons why the EU Commission and the European Parliament have asked for a stringent cap on imports of CERs from CDM projects – a cap that would essentially close the European market. It is also the main reason why U.S. lawmakers want to retain control about the quality of international offsets entering the U.S. trading scheme.

To make the CDM palatable to policymakers and to avoid a blunt, inefficient capping of CER imports, a discount should be introduced, so that one ton of emissions reductions

from a CDM project would yield *less* than one CER. The discount factor should depend on the development level of countries, increasing with the level of development of a country. This would reflect the principle of “common but differentiated responsibilities” amongst countries as agreed by the signatories of the United Nations Framework Convention on Climate Change (UNFCCC). A simple development index could be defined as a combination of per capita income and per capita emissions thresholds, so that it captures both ability to pay and the ‘polluter pays’ principle. Both principles should get the same weight as they are equally important and not directly correlated.

A powerful incentive for developing countries to reduce emissions

Such a system would provide an incentive for CDM host countries to take up emissions commitments – the higher, the more advanced its development level. The short-term price that would have to be paid is one of economic efficiency as the system would result in a differentiation of marginal abatement cost of CDM projects according to the discount rate. Any differentiated discount will impact the functioning of the market by introducing a wedge between marginal abatement costs and revenues from abatement. Projects in advanced developing countries will lose competitiveness compared to those using the same technology in less developed ones. On the margin one would see a crowding out of the projects with the highest marginal abatement costs in the most advanced countries. Therefore, on the basis of economic theory, discounting is only a second best solution for global carbon abatement compared to a fully free market where all reductions are credited equally.

This disadvantage would however be more than offset by the improved overall efficiency of emissions reduction due to a higher EU and U.S. import of CERs. In fact, the alternative – e.g. industrialized countries being closed to CER imports – would lead to even lower efficiencies, as no projects with low abatement costs would be mobilized in developing countries. If discounting leads to a higher import threshold in the EU and the United States, it will increase global efficiency because cheaper abatement options will be used compared to a pure protectionist scenario. Thus, discounting will be a better scenario than a “boom and bust” cycle in the case of strict protectionism.

A better chance for poorer countries

In addition, discounting has the benefit of making projects in poor countries more attractive, improving the regional distribution of CDM projects and providing an important reason for these countries to support the CDM. Given the past failure of the CDM to mobilize projects in poorer and smaller countries, one might otherwise expect opposition from these countries against a continuation of the CDM in its current form.

The CDM is a key bridge between industrialized and developing countries and decisive for the post-2012 climate policy regime. To avoid a standoff between the two major blocks, these should assess the shortcomings of the current CDM and develop joint proposals for CDM reform. Discounting would allow the CDM to significantly contribute to global reductions; moreover, its validation and verification rules would fulfill the measurement and verification requirements of a future Copenhagen agreement as they were agreed in the Bali Action Plan. Obviously, the system outlined here will only be acceptable to developing countries if the industrialized countries substantially strengthen their emissions commitments and thus increase overall demand for CERs. Import caps are not the right answer to the current shortcomings of the CDM – discounting is the way to go!

Axel Michaelowa (michaelowa@perspectives.cc) is head of the group on international climate policy at the chair Political Economy and Development, University of Zurich and Center for Comparative and International Studies (CIS) as well as a senior founding partner of Perspectives. He thanks Stefanie Heinig for research assistance.