Next Steps for Developing Countries: Issues and Options for a “Montreal Mandate”

The first meeting of the Parties to the Kyoto Protocol will take place in Montreal, Canada almost eight years after the Protocol’s adoption on 11 December 1997.

Delegates attending the Protocol’s historic first session will, however, find little time to relax or celebrate their achievements. Opposition to the Protocol from the USA Administration since 2001 remains strong, adding a huge number of political, economic and financial challenges to the issues Parties to the Protocol must deal with at the first meeting of the Conference of the Parties serving as the meeting of the Parties (COP/MOP).

The legal and institutional challenges facing the COP/MOP are also immense. These include how the 156 countries that have ratified Kyoto proceed with complex tasks related to implementation and the evolution of Kyoto beyond 2012, including its relationship to its parent treaty – the UN Framework Convention on Climate Change (FCCC) which has been ratified by 194 countries, including the USA.

This article sets out the biggest legal and institutional challenge facing developing countries in Montreal: whether to sanction “next step” negotiations under the legal auspices of the Kyoto Protocol or under the FCCC or some combination of both.

It outlines key factors relevant to the determination of this momentous procedural choice – a choice that could either help consolidate Kyoto and build upon the achievements of international cooperation over the last 15 years. Or else result in the climate regime standing still or reverting back to the kind of inadequate approaches to Annex I Parties mitigation commitments developing countries worked hard to strengthen through the adoption of Kyoto.

The fast approaching deadlines

The lengthy delay between Kyoto’s adoption and its entry into force means that many of the deadlines Parties agreed in the text of the Protocol back in 1997 are now fast drawing near and require prompt action.

The most pressing deadlines concern issues crucial to the evolution of future climate policy. These include the review provisions set out in Articles 3.9 and 9 of the Protocol. Article 3.9 requires Parties to initiate negotiations on Annex I Parties’ quantified commitments for the post 2012 period by 2005.

The provision in Article 9 gives a little more leeway time-wise but it is also much broader and complicated. Article 9 requires Parties to undertake a review of the Protocol in 2006 in the light of the best available scientific information and assessment on climate change and to coordinate such a review with pertinent reviews under the FCCC.

Kyoto or UNFCCC?

For developing countries, launching “next steps” negotiations under the legal authority of the Kyoto Protocol would carry many advantages.

Historically, developing countries have championed legally binding targets for Annex I Parties – as set out in Kyoto - and worked hard to ensure effective non-compliance procedures and mechanisms are in place to check fulfillment of these commitments.

A prompt launch of second commitment period (SCP) negotiations for Annex I Parties would signal clearly a continuation of this long standing developing country position on multilateral oversight of Annex I Parties targets and timetables.

Crucially, negotiations on the SCP would also help secure continued investment in the Clean Development Mechanism (CDM) – a mechanism that is of direct benefit to developing countries and was invented largely by them.

The Protocol is also a familiar, yet flexible, framework. It can be readily improved to take advantages of lessons learnt since 1997, for example, on how to incorporate flexible approaches for developing countries such as non binding or no-lose “action targets” or to support a better CDM. And critically, the Protocol is currently the only widely agreed up an running institutional structure that currently mandates Annex I Parties continue the kind of deep reductions needed over the next two decades.

The critical disadvantage of launching negotiation solely under Kyoto is that the USA is not a party and there would be no pressure for the world’s biggest GHG emitter to re-engage in “next steps” discussions.

Additionally, as the parent treaty, the FCCC remains the main legal source of many provisions that are significant for developing countries - currently and for the future – covering finance, technology, adaptation, capacity building and national communications/GHG inventories.

Launching negotiations under the FCCC would ensure that the USA engages in devising a future regime it would like to be part of and can provide financial resources in support of technology and adaptation needs.

But the disadvantages of focusing solely on the FCCC as the legal base for negotiations are that even if the USA allows negotiations under the FCCC to proceed at Montreal – and this is a very big if given that it has stated it does not want any future actions discussions at all under the FCCC – as a Party, it has much more legal leverage to block progress any time it chooses.

It could even insist, for example, that the terms of reference for all future negotiations exclude mandatory approaches – a stance that goes against the very basic position of developing countries and one that would damage prospects for the CDM as well as providing no clear signal to industry to develop new technologies much needed by developing countries.

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A combined approach

It would legally and procedurally advantageous for developing countries to devise an institutional process that combines the advantages of the FCCC and Kyoto as legal bases for negotiations by establishing an institutional process that provides a “shared institutional space” for Kyoto and FCCC Parties.

This shared space could be in the form of two in-session workshops convened jointly under the authority of the Subsidiary Bodies (SBI and SBSTA) – one to be held at the May/June 2006 sessions of the SB and the second as part of the SB sessions before COP-12/COP/MOP-2 in November 2006.

The first workshop, lasting say 2 days, would have two segments – a Kyoto segment and a FCCC segment which would run seamlessly back to back. The COP/MOP would instruct Kyoto Parties to treat the Kyoto segment of the two in-session workshops as the “space” that is being devised to commence negotiations on Article 3.9. A COP/MOP decision on Article 3.9 to that effect would be adopted that mandates Kyoto Annex I Parties to bring forth their proposals for second commitment period commitments at the Kyoto segment of the in-session workshop.

The COP/MOP 1 decision could also request all other Kyoto Parties, as well as observers states in attendance (e.g. the USA/Australia), to make submissions expressing their views on issues relating to timing, duration, scope, linkages with future negotiations on Article 9 as well as their views on institutional coordination of reviews under Kyoto and the FCCC.

Such a request would put the ball in the court of the FCCC Parties to respond to timing issues – this is important as unlike Kyoto, the FCCC does not have a concrete date to review the commitments of its Parties, but it is something which Parties to the Kyoto Protocol need to know as part of their Article 9 review.

The FCCC segment of the in-session SB workshop would be convened pursuant to a COP decision agreed in Montreal. This decision would note and build on the terms of reference of the successful June 2005 Seminar of Governmental experts (SOGE).

The COP-11 decision would request FCCC Parties to continue such discussions at the UNFCCC segment of the first in-session workshop in May/June 2006.

The COP decision would encourage FCCC Parties to make submissions on how future climate policy could support their current actions relating to, for example, mitigation, adaptation and technology development. Any additional information bearing on the request made by Kyoto Protocol Parties to provide input to the reviews under Article 9 could also be encouraged as FCCC Parties must provide their input to the COP/MOP on this issue.

Future climate policy discussions under Kyoto/FCCC should involve developing countries in the fullest manner possible. But the complexity of the intergovernmental process is growing (FCCC/SBI/2005/10, paragraph 65). Additionally, trust funds for supporting developing country participation in meetings have not been as high as in the past and these need to be secure to ensure developing countries are able to attend current and future negotiations. These considerations must be addressed in a thoughtful manner as part and parcel of the package of decisions on how and when to launch “next steps” negotiations.

Accordingly, the COP-11 decision could also mandate that for the December 2006 session of the workshop, FCCC Parties should provide submissions on how the plethora of deadlines and intersecting timetables under existing agenda items bear on their ability to participate effectively in future climate policy negotiations, including their views on the organization of the intergovernmental process.

To facilitate these discussions, the COP-11 decision should request the secretariat to prepare a document for the December meeting of in-session workshop that outlines how all the deadlines/timetables and various review dates of all current COP work and the COP/MOP’s work intersect for the next five years.

A document setting out all the deadlines and institutional context of meetings to which Kyoto and FCCC Parties are already committed would enable all Parties to work out how they can best structure the content, timing and institutional shape of any subsequent negotiations on “next steps” negotiations.

Such a document would also alert all Parties to the need to secure funding for developing countries to participate in Kyoto and FCCC meetings in a timely manner.

The continuation of the in-session workshop format for next steps discussions beyond COP-11 and COP/MOP 1 would be considered at COP-12 and COP/MOP-2. Parties could then decide what kind of institutional structure might best serve the launch of next steps negotiations (e.g. an ad-hoc temporary group like that used to negotiate Kyoto. Or something more informal not unlike the Joint Working Group on Compliance).

Parties frustrated with the pace, content or format of discussions at Montreal could also then respond by submitting proposals, for example, amendments to the Convention or the Protocol, and/or proposals for a package of legal instruments – just as happened in the run up to COP-1 which saw a large coalition of countries drawn from the EU and developing countries uniting to form a “green group” that played a leadership role in mapping out core tenets of future climate policy.

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CERs after 2012 – legal options for providing assurance

The Clean Development Mechanism (CDM) has attracted a wide and diverse range of interests – governments setting up Designated National Authorities (DNAs), Annex I countries with substantial CDM purchasing programs, as well as business investors and private funds from Annex I and host countries looking to develop CDM projects – all reflecting a real long term interest in the CDM.

But a real concern of both sellers and buyers in the CDM market is the lack of certainty as to the continuation of the CDM in its present form and the recognition of Certified Emission Reductions (CERs) beyond 31 December 2012 – the end of the first commitment period under the Kyoto Protocol.

This issue has not arisen because of the lack of any legal basis or framework for recognising CERs post-2012 – as described below, the Protocol contains provisions mandating the commencement of negotiation of a second commitment
period in 2005, as well providing the legal basis for banking CERs for future periods.

The uncertainty is due rather to the lack of political agreement on the nature and timing of a post-2012 framework.

Under the Kyoto Protocol, it is clear that the CDM and CERs have legal validity in any subsequent commitment periods. In line with this, the CDM rules and modalities elaborated in the Marrakech Accords and subsequent decisions of the Conference of Parties provide for the banking of CERs from one commitment period to another, and allow crediting periods with options for renewal extending in some cases up to periods of 30 years.

Moreover, these modalities expressly envisage a review of the rules and procedures of the CDM to be carried out no later than one year after the end of the first commitment period (Decision 17/CP.7, paragraph 4 of the Modalities and Procedures).

Article 12.2 of the Protocol allows Annex I parties to meet their reduction commitments under Article 3, which, in addition to the existing agreed commitments for the first commitment period, includes the legal basis for Kyoto Protocol Parties to agree to commence negotiations in 2005 regarding commitments for a second commitment period (Article 3.9) – a process that would require lengthy negotiations and subsequent ratifications processes in all Annex I Parties.

The later than expected entry into force of the Kyoto Protocol and the lack of political consensus as to the nature and timing of future climate policy has made it difficult for investors to know with certainty how climate policy will evolve in the long term.

One key issue is whether a second commitment period under the Kyoto Protocol can actually be agreed in time to link in a legally seamless manner with the first commitment period.

The deeper political issue relates to how a future framework agreed under Kyoto might relate with other frameworks agreed outside Kyoto, such as the UNFCCC or some other framework, particularly by non-Parties to the Kyoto Protocol that do not currently have international emission reduction targets.

The ensuing investor uncertainty has led to a fragmented CER market, divided somewhat artificially between pre- and post-31 December 2012 delivery obligations.

To date, buyers and sellers have generally dealt with the post-2012 risk under CER sale and purchase agreements in one of three ways:

- the term of the sale and purchase agreement expires after the last delivery of 2012-vintage CERs (this is by far the most common approach);
- the seller grants a call option (generally without a premium) to purchase a certain number of CERs after 2012 to the extent that the CDM is operating and CERs are being issued; or
- the buyer takes some of the risk by agreeing to buy verified emission reductions (or VERs) – either before, during and after the first commitment period, or only after 2012, with the hope that these can then be "converted" into CERs if the CDM is operating after this time.

Many investors are now signalling that the development of CDM projects may drop off significantly after 2007 given that many projects need to be able to forward sell more than a five-year stream of CERs in order to be financially viable.

Most actors engaged in the CDM would generally agree that the best solution for creating market certainty is political agreement by Parties to commit to a second commitment period, or some other framework that incorporates emissions trading and project-based mechanisms like the CDM.

However, the current lack of consensus on both the procedural pathway for negotiations, and differences of views on the substantive nature of any post-2012 framework, means that the CDM market is looking to Parties to provide some kind of formal assurance as to the status of CERs in circumstances where there may be no second Kyoto commitment period and hence no existing legal basis for the continued validity of CERs beyond 2012. Such assurance is seen as a way of alleviating market uncertainty and promoting continued investment in emission reduction projects beyond 2012.

What are the legal options for providing some form of assurance?

A CER is a transferable asset recognised primarily under international law, but in some cases, can also be recognised under domestic law that implements relevant aspects of the CDM.

As such, CERs in existence after 2012 only retain their legal validity, and their market value, to the extent that they continue to be recognised as valid assets for the purposes of meeting emission reduction commitments under the international legal framework in place at that time, or they are recognised separately under domestic law.

Accordingly, there are two possible approaches for Parties to provide CDM investors with some assurance:

- a decision by the Conference of the Parties serving as the meeting of the Parties (COP/MOP) confirming the treatment of CDM projects and CERs after 2012; and/or
- clarification by countries that CERs will be recognised under their own domestic or regional emissions trading schemes, or other climate change policies, irrespective of their international status.

Given that interest in the CDM may tail off by 2007 and domestic legal options for recognising CERs after 2012 under domestic or regional trading schemes, such as the EU ETS, may be institutionally complicated and insufficient to provide certainty to globally orientated CDM investors, this article proposes a COP/MOP decision that could be negotiated over the next year or two within the context of the powers and functions of the COP/MOP.

What are the functions of the COP/MOP with respect to the CDM?

Article 12.4 of the Kyoto Protocol confirms that the CDM is subject to the authority and guidance of the COP/MOP and be supervised by the CDM Executive Board. The modalities and procedures for the CDM (Annex to Decision 17/CP.7) reiterate that the COP/MOP has authority over and provides guidance to the CDM as a whole.

While the COP/MOP has delegated a wide range of executive functions to the Executive Board to implement the CDM modalities as agreed by the COP/MOP, the COP/MOP still retains the legal power under Article 12.4 and CDM modalities to remove, limit, expand or otherwise amend the rules and procedures of the CDM and delegated authority of the Executive Board.
Given that the Executive Board has the delegated role of supervising the CDM, and making recommendations to the COP/MOP on further modalities and procedures, it would be possible, subject to the COP/MOP’s approval, for the Executive Board to provide some guidance on the treatment of CERs after 2012 given its fiduciary role in overseeing the CER market.

In the absence of any guidance from the Executive Board, assurance would need to come from a decision by the COP/MOP as the ultimate authority over the CDM.

**What would be the nature and content of a COP/MOP decision?**

Clearly, the best legal means of providing market certainty is for Parties to agree to commitments for a second commitment period at the earliest opportunity.

However, as this is likely to take some time and may not be politically feasible given the uncertainty around a post-2012 framework, Kyoto Parties are likely to be reluctant to play their negotiating hand in the context of a COP/MOP decision exclusively about the future of the CDM.

While all the indications are that a post-2012 framework is likely to include some form of emissions trading and project-based mechanisms like the CDM and JI, an early commitment by Parties that any future framework will include these mechanisms may prove difficult to translate into legal text by way of a COP/MOP decision, especially if parallel negotiations on the post-2012 framework are taking place.

However, the COP/MOP could take a decision confirming their commitment – subject to their subsequent agreement to an international climate change framework that includes the CDM or some similar mechanism – that existing CDM projects and CERs would not be adversely treated under such a framework.

Specifically, such a decision could confirm that in relation to a CDM project registered before 31 December 2012:

- such a project would be recognised as eligible to generate CERs under the subsequent framework and would be counted one-for-one for any new project-based credit generated under the new framework;
- the baselines and monitoring methodologies approved at the time of registration of the project would be the basis on which CERs from the project would be verified and certified (or their equivalent) under the subsequent framework;
- the project would be eligible to generate CERs (or their equivalent) until the expiry of the last crediting period in place as at 31 December 2012, or where that crediting period is eligible for renewal, the expiry of the renewed crediting period; and
- CERs issued by the Executive Board before 31 December 2012 from CDM projects would be recognised and continue to have legal validity for compliance purposes under the subsequent framework.

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**CCLaw Assist Guidebook on CDM implementation under domestic law**

Much of the discussion relating to implementation of the CDM has focused on the international rules and the legal requirements for Annex I and non-Annex I countries to participate in CDM projects.

However, there has been little focus on the relevant domestic legal structures needed in host countries to create a favourable regulatory environment for CDM projects.

As part of CCLaw Assist, Baker & McKenzie is developing a guidebook to identify and analyse the legal issues involved in implementing the institutional aspects of CDM, the development of CDM projects, and the transaction of CERs.

The Guidebook will use case studies from several host countries, including China, Brazil, India and South Africa, to guide governments, DNAs, project developers and investors through the regulatory challenges of the CDM under domestic law.

Specifically, the Guidebook will examine the following areas in the CDM process:

- Environmental and planning regulation requirements
- Property rights and the issue of legal ownership to emission reductions
- Taxation of CERs by host countries and financial services regulation
- Electricity market regulation for energy/renewable energy projects
- Regulatory implementation and function of Designated National Authorities (DNA)
- Role and function of other specific CDM implementing regulations

The Guidebook will be published in mid-2006. Baker & McKenzie and the Yale School of Forestry & Environmental Studies will be seeking input from interested stakeholders involved in CDM implementation through the CCLaw Assist network of legal advisors working on climate change in developing and developed countries.

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