

New Zealand

A Submission to the Ad-Hoc Working Group on Further Commitments for Annex I Parties under the Kyoto Protocol (AWG-KP)

Improvements to Emissions Trading and the Project-Based Mechanisms

16 February 2009

1. New Zealand welcomes the opportunity to provide input in relation to how possible improvements to emissions trading and the project-based mechanisms, as contained in annexes I and II to document FCCC/KP/AWG/2008/5 and annexes I and II to document FCCC/KP/AWG/2008/INF.3, would function.¹
2. This submission is supplementary to New Zealand's submission to the AWG-KP in October 2008.² This submission summarises New Zealand's views on the proposal in annex II, section III(C) in both documents: "Reduce the commitment period reserve." It also presents New Zealand's preliminary views on other proposals contained in annexes I and II of both documents, including New Zealand's interest in new crediting mechanisms based on sectoral no-lose targets and/or sectoral emissions trading in developing countries.
3. New Zealand supports the agreement in FCCC/KP/AWG/2008/L.19 that further deliberations on improvements to emissions trading and the project-based mechanisms should focus on those in annex I and avoid duplication of work in its consideration of those in annex II. New Zealand believes that the design of the commitment period reserve is important for the effective operation of emissions trading and the project-based mechanisms, and should be carefully considered in light of forthcoming Party decisions on the nature of commitments, the operation of emissions trading and the project-based mechanisms, and compliance procedures and mechanisms.

Proposal to Reduce the Commitment Period Reserve

Background

4. The annex to Decision 11/CMP.1³ provides that each Party included in Annex I shall maintain, in its national registry, a commitment period reserve (CPR) which should not drop below 90 per cent of the Party's assigned amount calculated pursuant to Article 3, paragraphs 7 and 8, of the Kyoto Protocol, or 100 per cent times five times its most recently reviewed inventory, whichever is lowest.
5. The CPR was intended to prevent Annex B Parties from "overselling" units, which could increase the risk of non-compliance with their Article 3 commitments and potentially compromise the environmental integrity of the Kyoto Protocol. The current form of the CPR was designed in the context of negotiations for the first commitment period, with particular regard to the nature of commitments by the Parties in Annex B to the Kyoto Protocol, the design of

¹ FCCC/KP/AWG/2008/L.19

² FCCC/KP/AWG/2008/MISC.7

³ FCCC/KP/CMP/2005/8/Add.2

emissions trading and the project-based mechanisms, and the compliance procedures and mechanisms. While the CPR serves an important function, the current design of the CPR has two shortcomings, each of which is discussed below:

- *First, the current design of the CPR has the potential to constrain the efficient operation of carbon markets in the case where an Annex B Party chooses to devolve Article 17 emissions trading activities to legal entities.*
 - *Second, the current design of the CPR could perversely require an Annex B Party to maintain a reserve greater than its likely emissions.*
6. The Kyoto Protocol enables Annex B Parties to devolve emission trading activities to legal entities, which could help to increase the effectiveness and efficiency of international emissions trading over time. New Zealand supports the ability of Parties to maintain flexibility around the design of their domestic policy settings in response to their international obligations under the UNFCCC and the Kyoto Protocol.
 7. In the case of an Annex B Party that is a net buyer overall and devolves emissions trading to legal entities, it is possible that different legal entities could be either net sellers or net buyers under Article 17. If there is a risk that the CPR could be triggered at any time, thereby halting offshore transfers of Kyoto units, legal entities wanting to sell their units overseas will face uncertainty about their ability to meet future contractual obligations to deliver units. This risk is mitigated by the inflow of removal units or purchased Kyoto units into the registry, and cessation of trading because of triggering the CPR could be temporary.
 8. However, the delivery uncertainty created by short-term breaches of the CPR comes at a cost to both sellers and buyers. Note that this risk applies to trades in assigned amount units, removal units, certified emission reductions, and emission reduction units issued under "Track 1" (i.e., that have not been verified in accordance with the verification procedure under the Article 6 Supervisory Committee).
 9. In the current design of the CPR, there is no practical way to distinguish between Parties that deliberately "oversell" units with a loss of environmental integrity, and Parties that temporarily trigger the CPR because of the relative timing of unit inflows and outflows under a fluid emissions trading regime.
 10. Having evaluated this issue in its own national context, New Zealand has concluded that a CPR of 90 per cent is sufficiently high to constrain emissions trading activity by those Parties that choose to devolve emissions trading to legal entities, or may wish to do so in the future. When the need for the CPR is considered in the context of other compliance procedures and mechanisms, New Zealand believes that the CPR could be lowered while still achieving the original policy intent of guarding against overselling with a loss of environmental integrity. This would reduce the risk of triggering the CPR by Parties looking to conduct legitimate emissions trading activity. It could also contribute to greater liquidity in the international emissions trading market, lowering unit prices and helping to achieve the maximum level of emission reductions for a given level of investment.

11. There is a second shortcoming of the current design of the CPR: an Annex B Party could be required to maintain a reserve greater than its likely emissions. This could occur in the case of a Party calculating its CPR on the basis of its most recently reviewed inventory. In the case where the latest reviewed inventory was higher than the reviewed inventories in the prior years in the commitment period, the Party could be required to maintain a reserve that exceeded its likely emissions. This outcome would be inequitable.
12. It also may be necessary in the future to clarify how the CPR will operate during the transition between commitment periods. Emissions trading activity for compliance with 2008-2012 commitments will likely continue during the time between 31 December 2012 and the end of the true-up period. Emissions trading activity will also be underway in relation to post-2012 commitments. During this time, it is not clear which CPR will apply, and to which unit holdings.

Proposal

13. Clearly, the CPR operates in conjunction with the nature of Party commitments, the operation of emissions trading and the project-based mechanisms, and the compliance procedures and mechanisms. As the Parties move toward agreement on these features for the second commitment period, then Parties should re-consider the need for, and if appropriate the effective design of, the commitment period reserve.
14. If the current rationale for the CPR remains valid after the first commitment period, then New Zealand proposes changing the operation of the CPR as follows:⁴

Each Party included in Annex I shall maintain, in its national registry, a commitment period reserve which should not drop below the lower of either:

- a) *[X] per cent of the Party's assigned amount calculated pursuant to Article 3, paragraphs 7 and 8, of the Kyoto Protocol [where X is a value less than 90 per cent to be agreed by the Parties in the context of quantified emission reduction or limitation commitments, operation of emissions trading and the project-based mechanisms, and compliance procedures and mechanisms after the first commitment period], or*
- b) *The sum of the reviewed inventories reported thus far in that commitment period, plus the most recently reviewed inventory times the number of years remaining in that commitment period.*

⁴ Note that this proposal represents a change from New Zealand's proposal in FCCC/KP/AWG/2008/MISC.7 that "CPR levels be lowered in subsequent commitment periods for Annex I Parties that meet their commitments in the previous commitment period." Upon further reflection, New Zealand has concluded that this proposal is not desirable for two reasons. First, Parties already face consequences (including suspension of the eligibility to make transfers under Article 17 of the Protocol until the Party is reinstated) for non-compliance with their Article 3 commitments in the previous commitment period. Second, the compliance status of Parties for the prior commitment period will not be confirmed until the end of the true-up period, which will be part way through the subsequent commitment period. This timing would create significant uncertainty around the operation of the CPR.

Other Proposals Concerning Emissions Trading and the Project-Based Mechanisms

15. As discussed in its earlier submission, New Zealand considers it important to address three important issues when looking at each proposal:
 - Cost-effectiveness
 - Administrative complexity
 - Potential for perverse outcomes.
16. New Zealand sees particular merit in the potential for new mechanisms based on sectoral no-lose targets and/or sectoral emissions trading in developing countries. It is important for this work to be closely aligned with discussions in the AWG-LCA on nationally appropriate actions for developing countries (which could have a sectoral focus in some cases) and use of the carbon market to enhance the cost-effectiveness of Parties' mitigation efforts.
17. In particular, New Zealand welcomes further discussions by Parties on the potential differences and similarities between sectoral no-lose targets and sectoral emissions trading. New Zealand believes that the proposals to "Introduce sectoral crediting of emission reductions below a previously established no-lose target" and to "Introduce emissions trading based on sectoral targets" contained in FCCC/KP/AWG/2008/INF.3 require further clarification and elaboration.
18. New Zealand is considering Parties' proposals concerning improvements to emissions trading and the project-based mechanisms, and may provide a further submission at a later date.