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Summary of the Seventh Conference of the Parties (CoP7) Decisions on the Kyoto Mechanisms

Canada's Clean Development Mechanism
& Joint Implementation (CDM & JI) Office

Department of Foreign Affairs and International Trade
August 2002

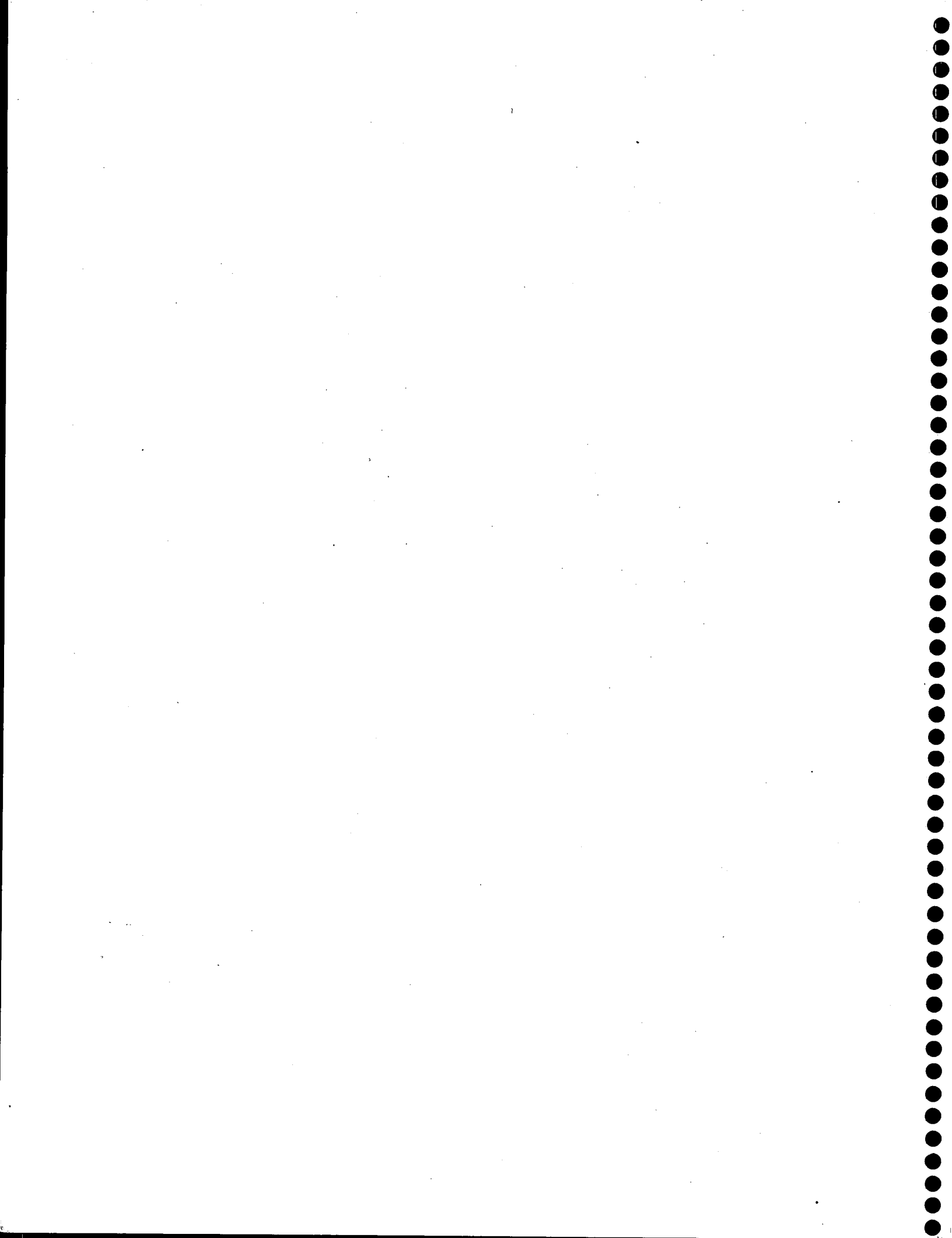
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In this summary, we have described the project cycle and the governance structure for Clean Development Mechanism & Joint Implementation, as well as key decisions related to the Kyoto Mechanisms in general. This summary also highlights the areas where further work is being undertaken by the United Nations framework Convention on Climate Change and the Clean Development Mechanism's Executive Board.

The summary is provided for convenience only, as an easy reference document and is not intended to be an exhaustive, authoritative document on the subject.

Disclaimer: Users of this summary should recognize that the summary is based on the original document: FCCC/CP/2001/13/Add.2 available at <http://unfccc.int/> as the COP 7 Report, Addendum 2. As such, the Government of Canada cannot guarantee the information provided in the above cited original document. The summary should not be construed as a legal document. The Department of Foreign Affairs and International Trade assumes no responsibility or liability for the completeness or accuracy of the interpretation of this information.

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Comments or questions should be addressed to:

Sushma Gera
Deputy Director, Kyoto Mechanisms
Head, Canada's CDM and JI Office
Climate Change & Energy Division (AEC)
Department of Foreign Affairs and International Trade
Tel: (613) 944-0051
Fax: (613) 944-0064
Email: sushma.gera@dfait-maeci.gc.ca

For information on the activities of the CDM&JI Office, please contact:

Canada's Clean Development Mechanism &
Joint Implementation Office
International Environmental Affairs Bureau
Climate Change and Energy Division
Department of Foreign Affairs and International Trade
125 Sussex Drive
E-mail: cdm.ji@dfait-maeci.gc.ca
www.dfait-maeci.gc.ca/cdm-ji/
Ottawa, Ontario, Canada
K1A 0G1
Tel.: (613) 944-3039
Fax: (613) 944-0064

A. INTRODUCTION

The Seventh Conference of the Parties (CoP7) concluded on November 10th, 2001 in Marrakech, Morocco, effectively completing the work under the Buenos Aires Plan of Action, adopted at CoP 4. This sets the stage for a decision on ratification of the Kyoto Protocol by Parties to the United Nations Framework Convention on Climate Change (UNFCCC). The decisions reached at CoP7 in Marrakech and at the second part of CoP 6 in Bonn were compiled into a text known as *The Marrakech Accords*. The decisions related to the Kyoto Mechanisms are contained in the UNFCCC document FCCC/CP/13 Add 2¹.

The Kyoto Protocol will enter into force only when ratified by at least 55 countries accounting for at least 55 percent of developed country emissions of carbon dioxide in the base year 1990.

The Kyoto Protocol establishes three market-based mechanisms aimed at achieving emissions reductions cost effectively while at the same time contributing to sustainable development. These mechanisms include:

1. International Emissions Trading - International Emissions Trading (IET) is a mechanism under the Kyoto Protocol that allows Annex I² Parties to engage in international trading of GHG emissions. Under the authority of individual Parties, entities will be able to trade GHG emissions;
2. Joint Implementation which allows an Annex I Party to implement an GHG mitigation project in another Annex I country and to earn emissions credits equal to the resulting reductions;
3. The Clean Development Mechanism (CDM), which has the dual purpose of allowing developed countries to earn emissions credits for undertaking projects that reduce emissions or enhance removals by sinks³ in non-Annex I countries, and of contributing to their sustainable development.

With the agreements in Bonn and Marrakech, the modalities and procedures for the Kyoto Mechanisms are now elaborated. This should provide the public or private sector entities interested in the CDM with the clarity on the rules pertaining to the participation requirements and how to access these mechanisms.

Further technical details related to the CDM such as the simplified procedures for small-scale projects, baseline and monitoring methodologies are being worked out by the Clean Development Mechanisms' Executive Board for adoption at the 8th Conference of the Parties. The elaboration of rules for sinks activities eligible under the CDM, along with the technical details involved with the registries and transactions log, are expected to be worked out by the 9th Conference of the Parties.

¹ Available at <http://unfccc.int/wnew/index.html> as the COP 7 REPORT and ADDENDUM 1, 2, 3, 4.

² Annex I Parties have a quantified emission reduction target. Non-Annex I Parties do not have emission reduction targets.

³ Only Afforestation and Reforestation are eligible under the CDM.

The following text highlights the key decisions pertaining to the Kyoto Mechanisms and identifies issues where further work is underway by the UNFCCC subsidiary bodies and the Executive Board of the Clean Development Mechanism.

B. THE KYOTO MECHANISMS

1. The Clean Development Mechanism (Article 12 of the Kyoto Protocol)

The Clean Development Mechanism (CDM) is a project based mechanism that allows public or private entities to invest in greenhouse gas (GHG) mitigating activities in developing countries and earn abatement credits, which can then be applied against their own GHG emissions or sold on the open market. In addition to reducing emissions, CDM projects have the dual objective of contributing to the sustainable development of the host country.

1.1 CDM Governance

Under the Kyoto Protocol, the Conference of the Parties serving as the Meeting of the Parties (CoP/MoP), the Executive Board (EB), and the designated Operational Entities (OE) are key to the governance of the CDM. Separated by their tasks and responsibilities, each of these institutions is essential for the smooth and equitable functioning of the CDM.

The CoP/MoP

The CoP/MoP, composed of delegates from Parties to the Kyoto Protocol, has the overall authority over matters pertaining to the CDM, in that it will provide guidance to the Executive Board, make decisions on its rules of procedure, and see to an equitable distribution of the CDM projects amongst non-Annex I countries.

The CDM Executive Board

The Executive Board (EB) is a 20 member (10 members and 10 alternate members) supervisory body of the CDM established at COP 7 in Marrakech. The composition of its members and alternates is based on a formula that includes members from each geographic region, including one from the Association of Small Island States and two additional members from each of the Annex I and non-Annex I countries respectively. The Executive Board shall meet no less than three times per year.

The mandate of the CDM Executive Board includes:

1. Approving new methodologies for baselines and monitoring.
2. Accreditation of the Operational Entities.
3. Project registration.
4. Issuance of CERs.
5. Reporting on the regional distribution of CDM activities.
6. The development and maintenance of a repository of approved rules and a

database of projects and for the development of a system of accounts designed to facilitate the transfer of Certified Emissions Reductions (CER) known as the CDM Registry (See section 2.1.7).

The Designated Operational Entities

The Designated Operational Entities (OEs) are accredited by the EB to specifically perform the Validation, Verification and Certification functions for a CDM project. The Validation step is required for the registration of projects while the Verification and Certification steps are required prior to the issuance of CERs. Project proponents can select one OE to perform the validation of its project and generally, another OE to perform the verification and certification functions.

1.2 The CDM Project Cycle

1.2.1 Steps Involved in the Registration of CDM Projects

i. Approval by Parties

Participation in CDM projects is voluntary and requires approval by Parties involved in the form of written confirmation. The host country will also make sure that the proposed project is consistent with its sustainable development. The parties involved in the CDM project are required to have a designated national authority.

ii. Validation

Validation is the process whereby an OE reviews the Project Design Document (PDD) that it received from the project participants and assesses whether the project meets all the requirements of the CDM. More specifically, the OE will confirm that the following requirements have been met:

1. The participation requirements have been met.
2. The project contributes to the host country's sustainable development
3. Comments by local stakeholders were invited and taken into account in the Project Design Document.
4. Participants have provided an analysis of the environmental impacts and if these impacts are significant and the host country required an environmental impact assessment, it is included with the validation request.
5. The project will result in anthropogenic GHG emissions reductions that are *additional* to any that would have occurred in its absence.
6. The baseline and monitoring plan comply with established methodologies that have already been approved by the EB. The baselines are project-specific for the CDM and must meet the criteria set out in the Marrakech Accords (See text box below).

Once the OE has evaluated the request for validation, it shall receive and publish, within 30 days, comments on the validation requirements from Parties, stakeholders and UNFCCC accredited non-governmental organizations. The OE will then render a decision on whether or not the project can be recommended for registration to the Executive Board and make its decision publicly available. If rejected, the project proponents may seek validation in the future with revised documentation to address the concerns expressed by the OE.

iii. Registration

If the OE determines a project to be valid, it shall submit a request for registration to the EB. Registration will be considered complete 8 weeks after receipt of the request unless one of the Parties, or at least 3 members of the EB, request a review of the proposed CDM project. The EB will finalise their review no later than at the second meeting following the request.

1.2.2 Monitoring the Project

Before a CDM project can begin, the project participants are required to set up a monitoring plan for the regular assessment of emissions reductions (see text box above).

Once the project has begun its operational cycle, participants need to monitor GHG emissions reductions according to the monitoring plan contained in the Project Design Document. When the participants wish to undergo a verification by a designated OE (see following section), they will need to issue a monitoring report to them that is consistent with the registered monitoring plan.

The issuance of CERs will depend on the participant's adherence to the registered monitoring plan.

The Monitoring Plan

As part of the Project Design Document, participants must include a monitoring plan to explain how they intend to measure the GHG reductions. Such a monitoring plan must be based on methodologies previously approved by the EB and shall include provisions for:

- the collection of data for both estimating anthropogenic emissions caused by the project activities, and determining the baseline
- the collection of data and identification of potential sources of GHG emissions outside the project boundary
- procedures for the periodic calculation of emissions
- documentation of all steps involved

New methodologies can be proposed but they must be submitted to the EB for approval. If revisions to the monitoring plan are required to improve its accuracy, participants will justify their changes and submit them to a designated OE for validation.

1.2.3 Steps Involved in Acquiring CDM Credits

i. Verification and Certification

Verification is the periodic independent review of the project's performance in terms of GHG reductions once the CDM project has begun. It is conducted by the OEs with the purpose of verifying the reductions in anthropogenic GHG emissions resulting from the CDM activity. It can be accomplished through on-site inspections, or by reviewing monitoring results and additional data from exterior sources for comparison. If no problems have been identified, the OE will provide a verification report to the Parties involved, to the participants, and to the EB.

Certification is an extension of the verification step. Once the verification has been completed and the GHG abatement sought has been verified, the OE will also issue a certification report and make it publicly available. This will constitute a request to the EB for issuance of CERs equal to the verified amount of GHG reductions.

ii. Issuance of Certified Emission Reductions

The EB will Issue CERs within 15 days of receipt of the certification report unless one of the Parties involved, or at least three members of the EB, request a review. This review, however, is limited to issues of fraud or incompetence of the OEs in performing their functions. In either case, the EB will decide, at its next meeting, whether the request has merit and if so, perform a review of the OE's work on the project. The review process shall be completed within 30 days of the initial request.

Upon receipt of the certification report, the EB will issue CERs that correspond to the reduction in emissions achieved. After forwarding the share of CERs for administrative expenses⁴ and for the 2% adaptation levy (see section 2.1.8), the EB will deposit the remaining CERs into the appropriate registry accounts as per the participant's request. The share of CERs belonging to the host will be deposited into the CDM registry (maintained by the EB), while the share of CERs belonging to the project proponent will be deposited into its account in its own national registry.

1.2.4 Party Level CDM Participation Requirements

Each of the Parties to the Kyoto Protocol must designate a national authority for the CDM. Canada's CDM&JI Office, located at the Department of Foreign Affairs and International Trade fulfils that role. All Parties to the Kyoto Protocol may participate in the CDM, however, CDM projects can only be hosted by non-Annex I countries.

A Party included in Annex I is eligible to use CERs to demonstrate compliance with its Kyoto Protocol commitments, if it meets the following requirements:

1. It is a Party to the Kyoto Protocol.

⁴ To be determined

2. It has established its assigned amount. The assigned amount in the first five-year commitment period from 2008 to 2012 for Canada is equal to 94% of its 1990 anthropogenic CO₂ equivalent emissions of GHGs times five.
3. It has a national system in place to estimate all sources of GHG emissions and removals by sinks.
4. It has in place a national registry to ensure the accurate accounting of the issuance, holding, transfer, acquisition, cancellation and retirement of ERUs, CERs, AAs, and RMUs;
5. It submits an annual inventory of anthropogenic CO₂ equivalent emissions and removal by sinks. The annual inventory of emissions by Annex A sources/sectors must pass a quality assessment.
6. It submits all supplemental information on its assigned amount including additions to and subtractions from the assigned amount.

Baselines

A baseline is a quantification of the anthropogenic emissions by sources of GHGs that would occur in the absence of the proposed project. Baselines are critical to any CDM project as they provide the basis for calculating the emissions reductions achieved:

$$\text{Baseline} - \text{GHG emissions from project} = \text{Number of CERs from the project}$$

Baselines shall be established by project participants in accordance with methodologies previously approved by the EB and in a transparent and conservative manner. Project participants are not, however, limited to established methodologies on baselines and monitoring. If new methodologies are proposed, the OE will forward them to the EB for an expeditious review (no later than 4 months).

The baseline shall be defined in a way so that CERs cannot be earned for a reduction in a project's activity level due to forces outside the control of the proponents.

The EB has in its mandate to do further work and provide guidelines on baseline methodologies.

Crediting Period

As part of the Project Design Document, participants will need to select between one of two options for the crediting period, which begins after the registration of the project. Depending on the life cycle of the project, participants can select a crediting period of seven years which may be renewed at most two times, or a ten year period with no option for renewals. "Prompt start" of the CDM allows for projects to begin as of January 1st 2000. Any CDM project that has been initiated after 2000 can be registered as a CDM project prior to December 31 2005. The crediting period for these projects may begin prior to the date of registration but not prior to January 1, 2000.

1.2.5 Small Projects

At CoP 6 bis in Bonn, it was decided that the Executive Board would develop simplified procedures for small-scale projects for their adoption at the eighth Conference of the Parties, November of 2002 in Delhi.

The following categories of small-scale project activities are eligible under simplified procedures:

1. Renewable energy projects with a maximum output capacity of 15 megawatts.
2. Energy efficiency improvement projects that reduce energy consumption by up to 15 gigawatt hours per year.
3. Other project activities that reduce anthropogenic emissions by source, which directly emit less than 15 kilotonnes of CO₂ equivalent annually.

1.2.6 Sinks and the CDM

The decision on the CDM affirms the inclusion of Land Use, Land Use Change and Forestry (LULUCF) projects in the scope of the CDM. For the first commitment period, only afforestation and reforestation are eligible under the CDM. CERs resulting from these activities are limited to 1% of the Party's base year emissions for each year in the commitment period.

While the decision in Marrakech endorses LULUCF activities in the CDM, it tasks the Subsidiary Body for Scientific and Technological Advice to work out the methodological issues such as baselines, additionality, leakages and permanence. This work started in April 2002 and will conclude with the adoption of a decision at the ninth session of the Conference of the Parties in 2003.

1.2.7 The CDM Registry

The EB is tasked with the establishment and maintenance of a system of accounts, known as the CDM registry, in which CDM credits (CERs) can be transferred. The EB will also identify a registry administrator to maintain it under its authority. The CDM registry will be composed of the following accounts:

1. *Pending account*: Once the CERs are issued by the EB, they are transferred into this account before distribution into other accounts.
2. At least one *Holding account* for each Party not included in Annex I who is hosting a CDM project or who is requesting an account.
3. At least one *Cancellation account*: If accreditation of an Operational Entity is suspended and it had over-issued CERs, then the equivalent amount of CERs, or any other credit shall be transferred to this account for permanent removal.
4. An additional account (Untitled) to hold CERs to cover administrative expenses incurred by the EB and for the 2% adaptation levy.

Upon being instructed by the EB, the registry administrator shall issue CERs into the pending account then forward them to the Party accounts as they stipulated while deducting the appropriate amount to cover administrative expenses and adaptation.

1.2.8 Share of Proceeds

- The EB will retain 2% of CERs earned through CDM activities for the adaptation fund. The purpose of this fund is to assist developing countries that are particularly vulnerable to the adverse effects of climate change with the costs of adaptation.
- An additional portion of the CERs, which has yet to be determined in negotiations, will also be retained by the EB for the administrative expenses incurred during the project.
- CDM projects in least developed countries are exempt of this levy.

1.2.9 Capacity-Building in Developing Countries

The decisions from the Marrakech Accords recognize that in order to facilitate developing countries' participation in the CDM, there is a need to build their capacity in several areas such as education, training, improved decision-making, and establishing national focal points.

2. Joint Implementation (Article 6 of the Kyoto Protocol)

Joint Implementation (JI) is a mechanism that assists Annex I countries to meet their Kyoto targets by participating in projects with other Annex I countries. Entities may participate in JI projects to generate emissions credits, known as Emission Reduction Units (ERU), in order to use them for compliance with their targets or to sell on the international emissions trading market. JI projects may begin as of the year 2000 but can only generate ERUs beginning in 2008.

2.1 Joint Implementation Governance

The Conference of the Parties serving as the Meeting of the Parties (CoP/MoP), the Article 6 Supervisory Committee, the Accredited independent entities (AIEs), and the host countries each play a key role in the governance of Joint Implementation. For reasons that will be elucidated in the following sections, the Article 6 Supervisory Committee and independent entities will only be required under Track II of JI.

The CoP/MoP

Much like its role under the CDM, the COP/MOP provides guidance on how to implement Joint Implementation and has overall authority over the Article 6 Supervisory Committee.

The Article 6 Supervisory Committee

The Article 6 Supervisory Committee will operate in a way that is similar to the Executive Board under the CDM. It will be comprised of 10 members and 10 alternate members nominated and elected by the CoP/MoP⁵ who will meet at least twice a year. However, the composition of this body differs from the EB; the Article 6 Supervisory Committee is made up of representatives from six Annex I countries (of which three are from economies in transition) and four are from non-Annex I countries.

The Article 6 Supervisory Committee supervises the verification of the Emission Reduction Units that are generated by JI project activities under Track II. Furthermore, it is responsible for:

1. the accreditation of independent entities;
2. the review of standards and procedures for the accreditation of independent entities;
3. the review and revision of the reporting guidelines and criteria for baselines and monitoring;
4. the elaboration of the JI project design document template for consideration by the CoP/MoP; and
5. the review of the determination by the Accredited Independent Entities regarding a project design document or reductions in emissions reported by project participants, should such reviews be requested.

The Accredited Independent Entities

The Accredited Independent Entities are like the designated Operational Entities under the CDM. They are the entities that perform the verification procedure as instructed by the Article 6 Supervisory Committee under Track II.

2.2 Track I and Track II

Since JI activities are limited to Annex I parties with quantitative GHG emissions reduction targets, and the ERUs generated by JI activity are issued from the host Party's assigned amount, there is an incentive for the host Party to ensure that emission reductions are real. (This is frequently referred to as the zero sum nature of JI.) For this reason, an external supervising body is not always needed.

⁵ Report on COP 7 Addendum 2, FCCC/CP/2001/13 Add 2. *Annex to the Draft Decision -/CMP.1 (Article 6)*. Paragraphs 4 to 8, page 9 to 10. January 21, 2002

Track I and Track II are the common terms used to describe the conditions under which Article 6 operates – i.e. when the Article 6 Supervisory Committee and accredited independent entities will be involved in the JI project cycle and when their involvement is not required. Where a host Party meets the participation requirements described in the section below, it may verify the net reductions of GHG emissions on its own and issue ERUs accordingly. This is Track I⁶. However, if the host Party does not meet the participation requirements listed in section 2.2.3 below, a third Party verification procedure is triggered which will necessitate the involvement of both the Article 6 Supervisory Committee and an accredited independent entity. This is Track II⁷. This Verification procedure is described in Section 2.2.4.

It should be noted that a host Party may at any time opt to use the verification procedure.

2.3 Party Level Participation Requirements for JI

Each participating Party must inform the UNFCCC secretariat of its national office responsible for approving the projects. Each Party must also provide the secretariat with its national guidelines for approving JI projects.

Track I

An Annex I Party is eligible to issue, transfer and/or acquire ERUs if it meets the following requirements:

1. It is a Party to the Kyoto Protocol.
2. It has established its assigned amount. The assigned amount in the first five-year commitment period from 2008 to 2012 for Canada is equal to 94% of its 1990 anthropogenic CO₂ equivalent emissions of GHGs times five.
3. It has in place a national system to estimate all sources of GHG emissions and removals by sinks.
4. It has in place a national registry to ensure the accurate accounting of the issuance, holding, transfer, acquisition, cancellation and retirement of ERUs, CERs, AAUs, and RMUs.
5. It submits an annual inventory of anthropogenic CO₂ equivalent emissions and removal by sinks. The annual inventory of emissions by Annex A sources/sectors must pass a quality assessment.
6. It submits the required supplementary information on its assigned amount including additions to and subtractions from said assigned amount.

Track II

If a Party does not meet the above requirements, it must undertake the verification procedure described in section 2.2.4. It should be noted that even if a JI project has undergone the verification procedure, the issuing Party must still meet the requirements 1, 2 and 4 above. In other words, a Party can only issue and transfer ERUs if:

- it is a Party to the Kyoto Protocol;

⁶ Ibid, Paragraph 23, page 13. January 21, 2002

⁷ Ibid, Paragraph 24, page 13. January 21, 2002

- has established its assigned amount; and
- has a national registry in place.

2.4 The Verification Procedure

Verification of the Project Design Document (PDD)

Project participants must submit a project design document to an Accredited Independent Entity (AIE) with the information needed for the determination of whether a project:

- was approved by parties involved;
- would result in a reduction of anthropogenic emissions by sources or an enhancement of removals by sinks;
- has an appropriate baseline and monitoring plan. JI project baselines shall be established on a project specific basis and/or using a multi-project emission factor⁸.

The PDD shall be made publicly available. A period of 30 days is provided for comment by Parties, stakeholders and UNFCCC accredited observers. The AIE shall then determine whether in fact the PDD meets the above criteria and whether project participants have submitted an analysis of the environmental impact of project activity, as required. The AIE shall make their determination publicly available. The determination will be deemed final 45 days after the date it was submitted unless a review is requested by a Party involved, or three members of the Article 6 Supervisory Committee. Such a review should be completed as soon as possible but no later than six months after the AIEs determination was made public.

Verification of ERUs

The AIEs will also make a determination regarding the reductions of anthropogenic emissions by sources or removals by sinks upon receipt of a report prepared by the project participants. At this stage as well, if neither of the Parties involved, nor at least three members of the Article 6 Supervisory Committee request a review of this determination, it will be deemed final 15 days after its publication. On the other hand, if a review is requested, the Article 6 Supervisory Committee shall:

- decide whether to perform a review within 30 days of its request;
- complete the review within an additional 30 days; and
- inform the project participants and publish its decision.

ERUs may be issued and transferred by the host Party once reductions have been verified. The host Party must still, as noted above, be a Party to the Protocol, have established assigned amount and have in place a national registry for tracking the assigned amount

⁸ Report on COP 7 Addendum 2, FCCC/CP/2001/13 Add 2. *Appendix B to the Draft Decision -/CMP.1 (Article 6)*. Paragraph 2(a), page 18. January 21, 2002. Multi-project baselines are standardised baselines that are applicable to more than one project. Their inclusion will serve to lower the transaction costs for JI projects.

Any transfers of ERUs resulting from JI activity that are verified under this verification procedure are not subject to the commitment period reserve requirements (see section 2.3.4).

2.5 Sinks and JI

The decision on JI affirms that projects under Article 6 aimed at enhancing anthropogenic removals by sinks shall conform to the definitions, accounting rules, modalities and guidelines of Articles 3.3 and 3.4 of the Kyoto Protocol. In other words, all sinks activities as defined in the decision text on Land Use, Land Use Change and Forestry (LULUCF)⁹, namely afforestation, reforestation and/or deforestation, revegetation, cropland management, grazing land management and forest management are all eligible sinks activities for Joint Implementation projects. With the exception of forest management, there are no quantitative limitations to any of these sinks projects. Forest management credits, including both ERUs issued for projects under JI and RMUs issued for domestic activities under Article 3.4 of the Kyoto Protocol, are limited by a cap on forest management activities for that Party set out in the appendix to Decision 11/CP.7 (for Canada, the cap is 44 Mt CO₂/year).

2.6 Capacity-Building for Countries with Economies in Transition

The Marrakech Accords recognizes that In order to facilitate participation in JI, there is a need to build capacity within the economies in transition in several areas. These include education, training and public awareness, emissions trading, establishing a national system for estimation of GHG inventories as well as modalities for accounting relating to targets, timetables and national registries and reporting obligations.

3. International Emissions Trading (Article 17 of the Kyoto Protocol)

International Emissions Trading (IET) is a mechanism under the Kyoto Protocol that allows Parties to engage in international trading of assigned amount units (AAUs), credits from CDM and JI (CERs and ERUs), and credits from removals by domestic sinks (RMUs). Given the abatement cost differentials among the Annex I Parties and the availability of surplus credits in some countries, IET can result in cost effective emissions reductions. Furthermore, under the authority of individual Parties, entities will be able to participate in international emissions trading.

3.1 Components of Assigned Amount

Under the Kyoto Protocol and the decisions reached at COP 6 bis and COP 7, there are four types of emission reduction units that make up the Assigned Amount:

AAU: Assigned Amount Unit

- serialised units of the assigned amount from a Party's initial allocation.

⁹ Report on COP 7 Addendum 1, FCCC/CP/2001/13 Add.1. *Appendix to the Decision 11/CP.7*. Paragraphs 1(a) to (h) page 56. January 21, 2002.

CER: Certified Emission Reductions

- credits from a Clean Development Mechanism project.

ERU: Emission Reduction Unit

- credits from a Joint Implementation project.

RMU: Removal Unit

- the Marrakech Accords introduced the RMU as part of a Party's assigned amount generated from domestic sinks activities within Annex 1. Under the Protocol, accounting for carbon sequestration activities is handled on the assigned amount side of the ledger rather than the inventory side. For example, if a Party has a net sink of 30Mt, then it "issues" 30Mt of RMUs rather than subtracting 30Mt from its inventory of total emissions.

3.2 Participation Requirements for IET

A Party included in Annex I is eligible to transfer and/or acquire AAUs, RMUs, ERUs, and CERs if it meets the following requirements:

1. It is a Party to the Kyoto Protocol;
2. It has established its assigned amount. The assigned amount in the first five-year commitment period from 2008 to 2012 for Canada is equal to 94% of its 1990 anthropogenic CO₂ equivalent emissions of GHGs times five;
3. It has a national system in place to estimate all sources of GHG emissions and removals by sinks.
4. It has in place a national registry to ensure the accurate accounting of the issuance, holding, transfer, acquisition, cancellation and retirement of ERUs, CERs, AAUs, and RMUs.
5. It submits an annual inventory of anthropogenic CO₂ equivalent emissions and removal by sinks. The annual inventory of emissions by Annex A sources/sectors must pass a quality assessment.
6. It submits all supplemental information on its assigned amount including additions to and subtractions from the said assigned amount.

3.3 Legal Entity Participation

One of the key decisions reached at COP 7 is that entities can participate in international emissions trading. There are two provisions related to entity participation. First, Parties must give authorization to their entities in order for those entities to buy and sell on the international emissions trading market and that a list of those authorized entities must be made publicly available. Second, the IET rules that apply to Parties also apply to its entities. In other words, where a Party authorises entities to trade emissions, that Party shall remain responsible for its Kyoto commitments and shall ensure that the entities adhere to all rules. Also, an entity may not engage in any trades of carbon emissions if its authorising Party fails to meet its eligibility requirements or if it has been suspended.

3.4 The Commitment Period Reserve

As a safeguard against overselling in a seller liability framework for emissions trading, the Marrakech Accord requires that each Party keep a portion of its total assigned amount holdings in reserve which cannot be sold. The mandatory level is set at the lower of 90% of a Party's initial assigned amount or 100% of 5 times its most recently reviewed inventory¹⁰. It is anticipated that the former will apply principally to OECD net buyer countries and the latter to net seller economies in transition. Thus, Canada must hold at least 90 percent of its Assigned Amount in the form of AAs, RMs, ERs, and CERs, at all times.

Given the mandatory nature of the reserve, it was also agreed that if a seller infringes upon its commitment period reserve (ie. sells units from its reserve) then the oversold units are "buyer liability" units and cannot be used by the buyer for compliance with its Kyoto target until the seller replenishes its reserve to the required level.

It was also agreed that the reserve can be comprised of all units – AAs, RMs, ERs, and CERs. It was also agreed to that ERs from JI projects that undergo a CDM style verification procedure under Track II can come out of the reserve, thereby lowering the required level of assigned amount holdings.

C. Other Issues Related to the Kyoto Mechanisms

1. Trading and Banking of AAs, ERs, CERs, and RMs

1.1 Trading

Among the most significant developments in Marrakech was the confirmation of fungibility between the three units generated by the Kyoto Mechanisms (AAs, ERs and CERs) and Removal Units (RMs). The term fungible refers to the exchangeability of one of these credits for another. All four types of individual credit units represent one metric tonne of carbon dioxide equivalent and decisions reached in Marrakech ensured exchangeability of these credits. Fungibility should induce a more liquid market.

1.2 Banking

In the event that a Party has a surplus of units in its national registry at the end of the first commitment period, a portion of these credits may be carried-over to a subsequent commitment period after 2012. This carry-over provision is also referred to as banking of emission units. The opportunity to bank surplus emissions units provides an added element of flexibility to the Kyoto Mechanisms. There are, however, a few restrictions on the number and the type of units that can be banked:

RMs: RMs cannot be banked for future commitment periods.

¹⁰ Report on COP 7 Addendum 2, FCCC/CP/2001/13 Add 2. *Annex to the Draft Decision -/CMP.1 (Article 17)*. Paragraph 6, page 54. January 21, 2002

CERs: for the credits earned through the CDM, banking is limited to 2.5% of a Party's initial assigned amount¹¹.

ERUs: for the credits earned through JI activities, banking is limited to 2.5% of a Party's initial assigned amount.

AAUs: there are no limits to the banking of AAUs.

As a result to these restrictions and to hedge the risk of any entity losing its credits towards the end of the commitment period, an entity or a party would retire those credits with restrictions first in order to demonstrate compliance.

2. National Registries and The Transactions Log

2.1 National Registries

As part of the participation requirements for the Kyoto mechanisms, all Annex I parties must establish their national registries, which is a standardized electronic database under a designated national authority to ensure the accurate accounting of the issuance, holding, transfer, acquisition, cancellation, retirement of all units and the carry-over of ERUs, CERs and AAUs. Each of these emission units, namely AAUs, RMUs, CERs and ERUs shall be held in only one account in one registry at one time.

As part of the national registry, each Party shall have at least one:

- Party level Holding account: this account is mainly designed to hold AAUs, RMUs CERs and ERUs prior to transfer to another account.
- Entity level Holding account: for each legal entity authorised to hold AAUs, RMUs CERs and ERUs.
- Retirement account for each commitment period: Parties will transfer AAUs, RMUs CERs and ERUs into this account for the purpose of demonstrating compliance.
- Cancellation account for each commitment period for:
 - sinks projects that result in net emissions of GHGs,
 - for cancelling emission units if a Party is not in compliance with its commitments from the previous commitment period, and
 - for other, philanthropic reasons.

2.2 The Transactions Log

All transactions involving the AAUs, CERs, ERUs, and RMUs will be recorded by the transactions log. This is an automated electronic database to be monitored by the UNFCCC Secretariat, which will verify the validity of all transactions undertaken by national registries. Prior to the completion of any transaction, the initiating Party must submit a record of the proposed transaction to the transaction log for an automated

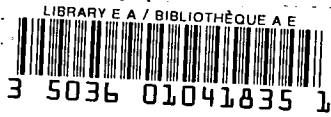
¹¹ Canada's initial assigned amount is 94% of its 1990 GHG emissions inventory.

check. If a discrepancy is found¹², then the transaction log shall direct the initiating Party to terminate the transaction. If the initiating Party does not terminate the transaction, any units transferred in the transaction are "buyer liability" units until the discrepancy is rectified.

3. Work That Remains to be Done

Additional work related to the registries that remains to be completed includes the development of technical standards for national registries; the CDM Registry and transactions log; finalization of guidelines for reporting and review of information on national registries and assigned amount.

¹² Examples of discrepancies can be found in Paragraph 42 of the Annex to Decision 19/CP.7, page 55 of FCCC/CP/2001/13/Add.2 and include, to name a few, units previously retired or cancelled, units existing in more than one registry, units improperly carried-over, units improperly issued, and the authorization of legal entities involved to participate in the transaction.



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