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SUBSIDIARY BODY FOR SCIENTIFIC AND TECHNOLOGICAL ADVICE
Thirteenth session
Lyon, 11-15 September 2000
Item 7 of the provisional agenda

SUBSIDIARY BODY FOR IMPLEMENTATION
Thirteenth session
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MECHANISMS PURSUANT TO ARTICLES 6, 12 AND 17 OF THE KYOTO PROTOCOL

Principles, modalities, rules and guidelines for the mechanisms under Articles 6, 12 and 17 of the Kyoto Protocol

Additional submissions from Parties

Note by the secretariat

Addendum

1. The Subsidiary Body for Scientific and Technological Advice and the Subsidiary Body for Implementation, at their twelfth sessions, urged Parties, if they wished to make additional submissions, to do so in succinct, legal language and directly related to the text in document FCCC/SB/2000/4, by 1 August 2000, for inclusion in a miscellaneous document to be issued before the thirteenth sessions of the subsidiary bodies. Submissions received later would be issued at the thirteenth sessions (FCCC/SBSTA/2000/5, para. 23 (d)).

2. In addition to the submissions contained in document FCCC/SB/2000/MISC.4 and Add.1 and Add.2/Rev.1, a further contribution[*] has been received. In accordance with the procedure for miscellaneous documents, this submission is attached and reproduced in the language in which it was received and without formal editing.

[*] In order to make this submission available on electronic systems, including the World Wide Web, it has been electronically scanned and/or retyped. The secretariat has made every effort to ensure the correct reproduction of the text as submitted.

FCCC/SB/2000/MISC.4/Add.3

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COLOMBIA AND GUATEMALA ON BEHALF OF BOLIVIA, ARGENTINA, HONDURAS, COSTA RICA, CHILE, PARAGUAY, ECUADOR, NICARAGUA, URUGUAY, PANAMA

A MORE FLEXIBLE CDM: BILATERAL, HOST-GENERATED AND MULTILATERAL PROJECT FORMULATION AND FINANCE

EQUITABLE PARTICIPATION OF MORE DEVELOPING COUNTRIES AND MORE BENEFITS FOR SUSTAINABLE DEVELOPMENT

LIMITING PROJECT FORMULATION AND FINANCE TO THE BILATERAL MODEL MAY EXCLUDE MANY DEVELOPING COUNTRIES

The recent National Strategy Studies for implementation of CDM from various developing countries[1] all state that host-generated projects should be allowed, to complement the bilateral and multilateral models of project formulation and finance. Restricting the CDM to the bilateral model alone may simply replicate traditional Foreign Direct Investment (FDI) patterns, which have historically favored a select few developing countries and ignored the great majority. Host-generation of projects is proposed as a complement to the bilateral model on the basis of flexibility, inclusion and greater equity for developing countries. Multilateral funds can greatly increase the range of developing countries—especially those less developed--that are included in the CDM and reduce risk and transactions costs to Annex B investors.

The operative requirements, procedures and CER certification rules for host-generated projects are the same as the bilateral model. Emissions baselines must be validated and additionality proven. Operational entities must verify measurement of emission reductions and provide certification to ensure that the CERs generated represent real, measurable, and long-term reductions. Local project developers can identify GHG reduction opportunities and manage local conditions better than many Annex B GHG emitters who have no experience in developing nations, little information and are highly sensitive to investment risks they may perceive. If financing from local, bilateral or multilateral sources can be obtained, countries traditionally avoided by FDI would not be excluded from participating in the CDM. Adding the host-generation option to the bilateral option would include more developing countries, more projects and more project types. It can raise the level of economic, social and environmental benefits from CDM, increase the contribution of developing countries to the mitigation of global climate change, and assist Annex B parties in meeting their commitments.

The studies point out the rigidities and exclusionary nature of the bilateral model, including exclusion by risk, continued north-south dependency, increased transactions costs, adverse effects of imposed projects, and exclusion of small projects, as follows.

Exclusion by Risk. For countries burdened with high levels of foreign investment risks, a restriction to the bilateral model represents potential exclusion from participation in the CDM, because Annex B investors will prefer to invest in other developing countries with lower levels of perceived risk.

[1] NSS of ZIMBABWE, COLOMBIAN AND ARGENTINA

Under the host-generation option, the formulation, finance and execution of projects may be initiated and realized by public or private entities of non-Annex B parties. Studies point out that South-South financing could support projects that Annex B entities might avoid. For example, investment capital from Johannesburg could be invested in CDM projects in Zimbabwe, given that South African investors understand conditions in Zimbabwe better than their counterparts in most Annex B countries, have better access to local information, and are better able to manage the risks. Similarly, Mexican investors could invest in Colombia, following existing investment patterns, supporting CDM projects where US or European firms may fear to tread.

***Dependency*.** By definition, the bilateral model of project formulation and finance requires two partners, one from Annex B and one from a developing nation. In this model the Annex B partner is the proactive agent, bestowed with the initiative to promote, design and finance projects of its particular interest in a developing nation of its choice. Host countries will be selected that meet pre-established criteria and are willing to accept the investor's terms. With the bilateral model, developing countries are passive agents that must be "chosen" to participate by an Annex B investor. If Annex B investors continue traditional patterns of foreign direct investment, most less-developed countries could be left out, unable to participate even if they have identified and evaluated viable projects.

The host-generation option permits host countries to initiate feasible CDM projects, obtaining access to the stream of economic, social and environmental benefits from their true project potential, even if no Annex B country chooses to participate.

Transactions costs may overburden CDM, discourage its use and minimize resource flows

Excessive transactions costs have been identified as a primary cause of failure of previous project based emissions offsets programs, experiences that have been thoroughly discussed in the country studies. Several studies have identified numerous and burdensome transaction costs as major obstacles to use of the CDM and access to the potential benefits. The potential avalanche of transactions costs, bureaucratic requirements, restrictions and lost time may discourage foreign investors, prompting them to avoid CDM in favor of IET, which is being designed to minimize these factors. One proposal would extract 60% of the value of each CDM project in taxes alone. If this high burden is accepted, it would reduce the net flow of resources to developing countries, the number of projects and technology transfer, and the support for sustainable development at the community level. Projects developed by communities, industry, farm or energy would see most of the value they create from emission reductions extracted by bureaucracy.

Excessive transactions costs would deflect finance and technology flows away from developing countries, and this trade would occur among industrialized countries instead. Clearly, this result would violate the sustainable development objectives of the Convention and the KP, as well constraining developing countries' ability to contribute to GHG mitigation. Table 6 presents the transaction cost load identified by the NSS studies, based on the UNFCCC negotiations to date.

	Table 1: TRANSACTION COSTS UNDER NEGOTIATION	CDM	IET
1	Share of the Proceeds for Administration	Yes: up to 10%	No
2	Share of the Proceeds for Adaptation	Yes: up to 20%	No
3	Share of the Proceeds for host party sustainable development*	Yes: up to 30%	No
4	Annex B partner search costs	Yes- potentially high	No
5	Project pre-feasibility studies	Yes	Yes
6	Travel and communications	Yes	No
7	Negotiation activities, docs.	High costs	Low
8	Legal and Contracting costs	Yes-potentially high	No
9	Project by Project Baseline Calculation	Yes: potentially very costly	No
10	Future baseline revisions	Possibly: costly and risky	No
11	Environ. Additionality certification	Yes: costly	No
12	Financial Additionality certification	Possibly; may be costly	No
13	"Investment" additionality certification	Possibly; may be costly	No
14	Sustainable development certification	Possibly; may be costly	No
15	Initial project validation / registration	Yes: potentially costly	No
16	Annex B party approval process	Yes: potentially costly	No
17	Developing party approval process	Yes: potentially costly	Yes
18	Executive Board Case by Case Approval Process	Yes: potentially costly	No
19	3^{rd} Party Challenges during Approval	Possibly, may be very costly	No
20	National registry costs	Low	Significant
21	Buyer/seller liability	Unclear	Yes?
22	Bi-lateral project management costs	Potentially high	No
23	Ex post leakage challenges	Yes: potentially costly	No
24	Annual Ex post GHG Measurement by Operating Entities	Yes-potentially costly	Random?
25	Annual Ex post Certification CERS by Operating Entities	Yes-potentially costly	No
26	Developing Ky. CDM Institutional fees	Yes-potentially high	No
27	Developing Ky. taxes, charges, vat	Potential for high costs	No
28	Opportunity cost approval time	Yes-potentially high	No
29	Tradability or transferability of CERs	Some arguments to restrict	Yes
30	Fungibility w/other mechanisms	Some arguments to restrict	Yes

*Option 5 of article 131 of the Consolidated text on the Mechanisms FCCC/SB/2000/4 proposes a 60% extraction of value from each CDM transaction: 10% for administration, 20% for adaptation fund, and 30% for host party for sustainable development.

Bilateral model Increases transaction costs. The bilateral model imposes much higher transaction costs on CDM projects than would host-generated projects. The Annex B investor must search for and evaluate potential partners in developing countries, incur high travel and communications costs, evaluate multiple risks and national conditions, negotiate with the partner and the host nation, carry out legal analyses in unfamiliar contexts, assume contracting costs, and administer the project during its useful life, among others. When compared to other compliance options, these high costs may discourage use of the CDM.

With the option of host-generated projects, most of the transactions costs identified in the prior paragraph are eliminated.

Exclusion of small projects. In general, Annex B investors prefer very large projects because the ratio of transaction costs to each CER generated is very low. Under the bilateral model, small projects with high local benefits in the transportation, industrial, renewable energy, farm and watershed restoration sectors, all of them with desirable social development components, will probably not be undertaken because of the high ratio of transactions costs to CER produced.

Host generation of projects eliminates bilateral costs from the total transactions cost, increasing the returns on investment and the net flow of resources to the project level. With this option, local communities may choose to formulate and carry out projects that meet their preferences and maximize collateral benefits. More small projects with high collateral social and environmental benefits could thus be implemented, assisting in sustainable development at the local level.

Adverse effects of externally imposed projects. Under the bilateral model, project design may be imposed by the Annex B partner, which may or may not be favorable to community and environmental conditions in the host nation. The host-generation option would permit local communities and producers to formulate CDM projects that respond to their preferences. Industrial and energy producers can design their projects with the technologies they prefer. Communities can do the same. The Colombian study presents 10 large agro-forestry and silvo-pastoral projects designed jointly with local communities that maximize participation of local labor, raise labor incomes, and diversify production, while promoting conservation of local environmental conditions.

Transferability of CERs is Required for Host-Generated Projects and for Multilateral Finance.

CERs produced in host-generated projects would accrue to host country investors after final certification and approval of the emissions reductions. CDM project owners would then sell their CERs to Annex B entities for use in compliance with their commitments. Upon sale to an Annex B purchaser, the revenues would be used to pay off any debts incurred by initiating the CDM project. Annex B financing of CDM projects thus occurs after project implementation through revenues generated by the sale of CERs, instead of before as with the Bilateral Model. Therefore the legal obligation of Annex B financing of CDM projects is consolidated under both models.

Under a multilateral model of CDM finance, projects would be designed and prefeasibility studies prepared by host developing countries. An array of interested Annex B entities and parties would deposit investment resources for purchase of CERs in a CDM investment fund managed by a multilateral entity such as a regional development bank. The fund would evaluate the available projects presented and manage the investment portfolio, investing the financial resources directly in CDM projects. As CERs are generated and certified, they would be allocated to the multilateral fund, which in turn would have to transfer them to the Annex B investors for compliance.

It should be noted that CERs must be freely transferable from non-Annex B to Annex B parties in order for the host-generation option or the multilateral model to function. A careful review of the Convention and the Protocol found no statement barring transferability of CERs, so it is possible, and should be part of a flexible and inclusive CDM that maximizes participation, equity and benefits to all developing nations.

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