

**Some form of a sectoral-based mechanism is looking increasingly likely to be adopted post-2012, but policy-makers need to ensure they get the framework right to attract the needed private sector investment, say MILES AUSTIN, ANTHONY HOBLEY and ANNA LEHMANN**

# Pathway to sectoral success

**T**he likelihood that some permutation of a sectoral scheme will be adopted in advanced developing economies within the next decade is growing rapidly. There are several proposals on the negotiating table, which differ in substance and in structure, and it is uncertain which approach will be agreed to by negotiators, much less adopted by domestic policy-makers. However, it is hoped that the political momentum generated by the international community will result in an endorsement of one of these proposals in Copenhagen. The favoured sectoral scheme, no doubt general at the outset, will be developed and refined in the coming years by the international community, before it is finally adopted by national governments.

But international political momentum is not enough. As estimated by both the World Bank and the UN, approximately 85% of the financing required for the transition to a low-carbon economy will need to be provided by the private sector. This is not to be taken for granted – the private sector responds to specific signals and these signals must be given to attract investors.

The success of a sectoral scheme will be measured by how effective it is at mobilising large-scale private capital. And a number of characteristics are needed to provide a strong incentive for investors to deploy their capital while ensuring the environmental integrity of the programme.

The first key element is to guarantee the continuity of the carbon market: before capital is deployed for any purpose, a risk assessment is undertaken and the continuity and stability of the intended market is a fundamental part of that analysis. As such, if existing investments in the Clean Development Mechanism (CDM) and Joint Implementation (JI) markets – which totalled some \$6.8 billion last year, according to the World Bank<sup>1</sup> – are not protected, the task of mobilising such investment a second time, not to mention scaling it up to the levels required, will be considerably harder; market confidence in the stability and reliability of such policy-driven markets will have suffered significantly.

**T**here must be clearly defined rules for the transition phase – an evolution, rather than a revolution – of current market structures in order to maintain investor confidence. Arbitrary cut-off dates should be avoided, since they would likely result in a drought of investments between the exit of the old and the entry of the new. Early crediting should be allowed during the transition phase, to incentivise early investments.

To ensure environmental integrity in any sectoral mechanism, any benchmarks or estimates of current and future emissions must be based on conservative values derived from sound and independent data collection and modelling. All ongoing monitoring, reporting and verification procedures must be via an independent, accredited third party – similar to the set-up for the CDM and JI.

But it is important that the crediting of projects and or installations is not dependent upon an entire sector achieving a common target, as the EU has proposed. This exposes investors to a host of risks that cannot be reasonably managed, including the possibility of a competitor deliberately failing to achieve the target in order to disadvantage its rivals. Baselines determined by aggregate

or other industry averages must recognise variations within sectors, particularly those with diverse levels of emissions intensity and varying access to technology and financing. Differentiated baselines for 'sub-sectors' could take this into account.

Private investment capital is unlikely to be attracted to mechanisms under which the receipt of credits is subject to the implementation of a sectoral scheme by a host-country government. Private actors would struggle to bind a sovereign government in a contractual agreement, unless the agreement was guaranteed by a trustworthy third-party agency. This is not intended to bypass sovereignty: for instance, the CDM requirement for host country approval has functioned well as it avoids the level of bureaucratic burden on host governments that has slowed JI progress.

Control or taking security over future credits is also critical to securing investment. The CDM allows for this by defining a "focal point" for each project, and this has resulted in demonstrably higher third-party investment in CDM projects than under JI. The scheme

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should also expressly and unequivocally allow private investors to own and transfer credits without the risk of the credits being revoked or cancelled.

Needless to say, a sectoral programme also needs to create internationally fungible units if it is to attract the needed amounts of investment. These credits will need to be verified to internationally recognised standards by accredited independent auditors – whose certification must be a priority to allow for early action.

Key to the success of such a market-based mechanism is the creation and guarantee of demand; investors need the demand for credits to be predictable in the medium term. The new scheme should operate with a determined long-term horizon (to 2050) but be accompanied by medium-term targets to provide shorter-term certainty. If the scheme is based on successive periods, the criteria for the renewal of any crediting period should be clarified expressly.

The regulatory structure and governing authorities for a sectoral programme will play a vital role in determining its success, or otherwise. To this end, there should be non-bureaucratic, clear and efficient structures and procedures for investor requests. Decisions should be made public, since certainty in the integrity of the market is critical to investors seeking to assess and quantify risk, and they should not be arbitrary but consistent with previous decisions on the same or similar types of projects or issues. Strong commitments must be given by the regulatory agency on timelines for project registration and review. All of these are problems which have plagued the CDM in recent years.

The rules of natural justice are critical to investor confidence, and

<sup>1</sup> *State and Trends of the Carbon Market 2009*, World Bank, May 2009.

there needs to be mechanisms for parties to seek independent hearings and reviews. This can be designed to be simple and effective. Any government review of projects must be impartial and rules-based. And the scheme should not discriminate against international investors nor limit or restrict the participation of international, in favour of domestic, parties in the scheme or in projects.

Similar to the CDM, a sectoral scheme should be supported by sufficient funding to construct the required IT and institutional infrastructure. This could come from either government donations or from fees charged to project participants, or a combination thereof.

**W**e are at a critical juncture in global efforts to mitigate the effects of climate change. The G8 has called for an 80% emissions reduction on the part of developed countries, and a halving of aggregate global emissions by 2050. Indeed, there has been much rhetoric on what needs to be done, but less elaboration on how it can be achieved. Estimates of the financial flows required to meet the G8 goals amount to \$20 trillion by 2020<sup>2</sup>, which governments alone will not be able to provide.

The carbon market is unique in that it is created entirely by policy-makers and is dependent on their mandate. It is hoped that existing mechanisms will be significantly scaled up, and new sectoral mechanisms instituted to harness the private sector capital required by 2050 to achieve international goals.

However, the environmental integrity of a new agreement is threatened by the creation of a mechanism that fails to mobilise sufficient capital, and would thus fail to achieve the scale of emissions

<sup>2</sup> Key Elements of a Global Deal on Climate Change, Sir Nicholas Stern, May 2008

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reductions required. Success lies in creating a clear value proposition, on the foundation of the aforementioned elements which balance both risk and reward.

Active and robust private sector involvement via financing and investment mechanisms is crucial as we move to mitigate climate change and its effects. Colossal amounts of private sector capital must be mobilised both for mitigation efforts and sustainable development programmes in developing countries, and to assist in the economically feasible transition of developed nations to low-carbon economies. For this to occur, a synergy must be found between the scientific imperative to act, the private sector means to provide, and the regulatory framework within which to move forward. **CF**

*Miles Austin is head of European regulatory affairs at EcoSecurities, Anthony Hobley is a partner at Norton Rose and Anna Lehmann is senior climate change officer, policy and regulatory affairs, at Sindicatum Carbon Capital. E-mails: miles.austin@ecosecurities.com; anthony.hobley@nortonrose.com; anna.lehmann@carbon-capital.com*

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