

How Will Sectoral Credits Affect the CDM Offset Market?

The emerging international agreement anticipates use of sectoral approaches as a way to engage fast-growing emerging economies in making unilateral greenhouse gas emissions reductions in major industrial sectors that are additional to actions taken in developed countries. Sectors adopting sectoral approaches will no longer be eligible for participation in the Clean Development Mechanism (CDM). Instead, countries and sectors that adopt sectoral approaches and reduce emissions below their sectoral targets will have an opportunity to participate in a new sectoral crediting framework for creating offsets that may be sold in international markets. These changes raise questions about the interactions between sectoral crediting and the existing CDM offset market, which will still be in use by less developed countries and by economic sectors that are not covered by sectoral programs. Concerns have been raised both about too much and too little supply of sectoral credits. Some are worried about flooding CDM offset markets with sectoral credits while others worry that offset supply will still be insufficient to meet the growing demand. The reality is somewhere in the middle.

Sectoral approaches were conceived as a way for developing countries to contribute some emissions reductions on their own, and in return receive some up front technological support and financing. The international community will be seeking real contributions to the atmosphere from developing countries, particularly if there are sizeable funds available to incent new actions. Therefore, it is anticipated that a substantial fraction of the cost-effective mitigation opportunities will be used to meet developing country sectoral targets *and may not be sold as offsets*. Only reductions in excess of sectoral targets will be eligible for sectoral crediting, and these reductions are expected to cost somewhat more. CDM offsets, in contrast, take advantage of the lowest cost mitigation opportunities available in the participating countries and sectors.

Initially, there could be a decline in offset investments in countries subject to sectoral actions. These sectors will no longer be able to earn offset credits through the CDM and there will be some uncertainty about whether the new “better-than-business-as-usual” sectoral targets will be met. At the same time, during this early period, more companies will be seeking to purchase offsets as a hedge against mandatory requirements. As a result, there will be a robust and growing market for offsets, particularly from sectors and developing countries still eligible for participation in the CDM program. This growing demand combined with expected streamlining of the CDM approval process will support higher levels of investments in CDM offsets from the least developed countries most in need of new funds.

Starting in 2012 or 2013, the demand for offsets—both CDM and sectoral—is expected to grow significantly as more developed countries implement cap-and-trade programs that allow for use of international offsets. In addition to the European Union, there is a good chance that new carbon markets will emerge in the United States, Australia, Japan and New Zealand. The United States alone could create demand for between 1 and 1.5 billion tons of offsets—roughly seven to ten times the total CER issuance in 2008.

Sectoral crediting provides an important mechanism for expanding the scale of offset production to meet future increases in demand by simplifying the process for offset

crediting. Rather than justifying additionality and offset quality on a project-by-project basis, sectoral crediting establishes a baseline for an entire industry sector in a given country. To the degree that emissions reductions go below the baseline in a given year, the crediting becomes automatic.

However, while the process for earning offsets can be simpler through sectoral crediting and result in higher overall numbers of offsets, it is important to note that the maximum potential number of offsets under sectoral crediting will be *less* than under the status quo where all developing country actions are eligible for participation in the CDM. Further, because some of the low cost mitigation actions will have been used to meet the sectoral targets, the measures that will be used to earn sectoral credits will cost more than the better-than-business-as-usual offsets under the CDM program.

Further, realizing the promise of expanded offset supply through sectoral crediting will require 1) careful policy design at both the national and international levels, 2) technology financing to overcome barriers to low cost control options, as well as 3) capacity building to foster successful implementation of sectoral approaches, including measurement, verification and enforcement. (For ideas on program design to support sectoral offset credits, see the fact sheet, “What sectoral program design features are needed to encourage private sector investment?”)

Even as sectoral crediting begins to ramp up, the traditional CDM market should remain competitive in winning private sector participation. A main advantage involves use of a business-as-usual baseline rather than a baseline that includes unilateral actions, allowing investors to pursue the lowest cost opportunities in these markets. Further, changes underway to streamline the CDM crediting procedures promise to lower transaction costs and improve certainty for future CDM investments.

In sum, rapidly expanding demand for international offsets provides significant opportunity for both sectoral credits and traditional CDM projects. In fact, even with both systems at full operation, it may be difficult to supply the total amount of offsets in demand by developed countries. Policy makers should provide the needed support to both programs to lower transaction costs while ensuring high quality reductions that are additional to sectoral programs and project baselines.

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