

The Adaptation Fund

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Agenda Item 5 (e)

ELIGIBILITY REQUIREMENTS FOR ADAPTATION FUND CERS AND EMISSION TRADING

(Prepared by Invited Trustee)

Table of Contents

1. Introduction.....	1
2. Eligibility Requirements for Emission Trading.....	1
3. Transfer and Acquisition of AF CERs.....	2
Eligibility Requirements under Article 17.....	2
Acquisition of CERs by non-Annex I Parties.....	3
4. Conclusion	4
Annex.....	5
Attachment to Annex	6

1. INTRODUCTION

1. At the second Adaptation Fund (AF) Board meeting held June 16-19, 2008, it was recommended, in the document “Monetization of Certified Emission Reductions for the Adaptation Fund” (AFB/B.2/9), that the AF Board seek guidance and clarification from the Conference of Parties serving as the meeting of the Parties to the Protocol at its Fourth Session, as to whether purchasers of the certified emission reductions (CERs) from the AF are subject to any eligibility requirements, including those that apply to Parties or other entities to participate in emissions trading under Article 17 of the Kyoto Protocol.

2. This note further elaborates the issue and recommends the AF Board to seek guidance and clarification from the Conference of Parties serving as the meeting of the Parties to the Protocol at its Fourth Session, so that the AF can ensure that CERs sales transactions and transfer of CERs to purchasers are effected without any impediment.

2. ELIGIBILITY REQUIREMENTS FOR EMISSION TRADING

3. Pursuant to Decision 1/CMP.3, it is proposed that for the purpose of the monetization of the CERs, the CERs collected as a share of the proceeds at an account maintained at the CDM registry for the Adaptation Fund (the AF CDM Account) be sold by the trustee for the Adaptation Fund (the Trustee), in accordance with the guidelines agreed between the Adaptation Fund Board and the Trustee. It is further proposed that the CERs be transferred to the accounts of relevant third party purchasers upon receipt of payment in respect of the same.

4. Transfer of CERs from the AF CDM Account to a purchaser’s account at a national registry is, however, subject to verification by the international transaction log (ITL) of the eligibility of the Party, which maintains the national registry. Before transfer is effected between registries, the ITL will verify the eligibility of the Party involved in the transaction to participate in the mechanisms.¹ Furthermore, the CDM registry administrator may not transfer CERs to any Party or entity, unless such a transfer is permitted under the relevant decisions of the CMP or the Executive Board. This would require the AF Board and the Trustee to monitor eligibility of interested purchasers of AF CERs in order to avoid rejection of any transaction. Therefore, it is important to clarify what eligibility requirements would be applied to monetization of AF CERs.

5. There are two mechanisms to acquire CERs under the Kyoto Protocol: acquisition of CERs from a CDM project under Article 12 of the Kyoto Protocol, and acquisition of CERs from emission trading under Article 17 of the Kyoto Protocol.

6. Under Article 12, acquisition of CERs from CDM project activities are limited to Parties involved or entities authorized by a Party as project participants. CERs issued for CDM project activities (after 2% of the share of the proceeds) will be forwarded by the CDM registry administrator only to the holding accounts of Parties or registered project participants in the CDM registry or their corresponding accounts in the national registry of the Annex I Party that authorized their participation in the CDM project.

¹ Decision 13/CMP.1, Annex, paragraph 42.

7. In addition to acquisition of CERs through direct participation in CDM projects under Article 12, Parties may acquire CERs through emission trading under Article 17 of the Kyoto Protocol. Article 17 states that “[t]he Parties included in Annex B may participate in emissions trading for the purposes of fulfilling their commitments under Article 3.” Paragraph 2 of Annex to Decision 11/CMP.1 sets out the eligibility requirements for such Parties to participate in emissions trading. Paragraph 3 of Annex to Decision 11/CMP.1 provides the procedures for determining the eligibility of Parties. In the event that Parties fail to meet any of the eligibility requirements on a continuous basis, the enforcement branch of the Compliance Committee may determine suspension of Parties’ eligibility to participate in the emission trading.

8. Besides the governments of Parties, businesses, non-governmental organizations and other legal entities authorized by Parties may participate in emission trading under the authority and responsibility of the governments, if the authorized Parties are eligible to participate in emission trading. Under paragraph 5 of Annex to Decision 11/CMP.1, the Parties authorizing participation of legal entities (other than the governments) are responsible for ensuring that such participation is consistent with the rules and guidelines for emission trading. For this purpose, any legal entity which has an account fully operational in a national registry is considered to be authorized by the relevant Party to participate in emission trading under Article 17, as long as the corresponding national registry is established in compliance with Article 7, paragraph 4 of the Kyoto Protocol and Decision 19/CP.7. The legal entities authorized by the Parties to engage in emission trading under Article 17 may not, however, transfer and/or acquire units while the authorizing Party does not meet the eligibility requirements applied to it.

9. It is also noted that while Article 17 of the Kyoto Protocol and Decision 11/CMP.1 regulate emission trading by Annex I Parties, Article 17 does not specifically provide for the participation by Non-Annex I Parties in emission trading.

10. Description of the eligibility requirements applied to emission trading under Article 17 of the Kyoto Protocol is attached hereto as Annex.

3. TRANSFER AND ACQUISITION OF AF CERs

11. In respect of sale of CERs for the AF, it would be necessary to clarify if any eligibility requirements would be applied to transfer and acquisition of CERs from the AF CDM Account.

Eligibility Requirements under Article 17

12. Transfer and acquisition of CERs from the AF CDM Account is likely to be considered as emission trading under Article 17. Paragraph 6 of the Appendix D to Decision 3/CMP.1 provides the basis for transfer of CERs from the AF Account to purchasers’ accounts, as a secondary transfer. Specifically, paragraph 6(b) of the Appendix D to Decision 3/CMP.1 provides as follows:

“Upon being instructed by the Executive Board to issue CERs for a CDM project activity, the [CDM] registry administrator shall [...]

- (b) Forward the quantity of CERs corresponding to the share of proceeds to cover administrative expenses and to assist in meeting costs of adaptation, in accordance with Article 12, paragraph 8, to the appropriate accounts in the CDM registry for holding and transferring such CERs.” (*emphasis added*)

13. Although this does not constitute a transfer and acquisition of carbon units between Parties, a transfer of CERs from the AF CDM Account to a purchaser’s account at a national registry would constitute acquisition of CERs on the part of the Party. Accordingly, monetization of CERs may be subject to the eligibility requirements under Article 17. In other words, AF CERs may not be sold or transferred to Annex I Parties, or legal entities authorized by such Parties (i.e., account holders at national registries), if such Parties do not meet the eligibility requirements under Article 17 or are suspended by the enforcement branch of the Compliance Committee.

14. If the eligibility requirements under Article 17 apply to the monetization of AF CERs, the AF Board and the Trustee would need to ensure that the national registry of the Party where the purchaser’s account is located is in full compliance with the eligibility requirements discussed above. The objectives for the AF CER monetization, set out in Paragraph 28 of 1/CMP.3, include (i) optimization of revenue for the AF, while limiting financial risks, and (ii) monetization of CERs in transparent and most cost effective manners. The above discussed restriction to the monetization of the AF CERs may, however, reduce the opportunity to optimize the revenue, while increasing the costs associated with the monetization of CERs.

Acquisition of CERs by non-Annex I Parties

15. Under Article 12 of the Kyoto Protocol, not only Annex I Parties, but also Non-Annex I Parties or entities authorized to participate in CDM project activities by such Parties may acquire CERs from CDM project activities. Unlike Annex I Parties, however, non-Annex I Parties are not required to establish and maintain a national registry.² Such Non-Annex I Parties or entities may request for permanent holding accounts in the CDM registry, and CERs issued will be transferred from the pending account of the Executive Board to their permanent holding accounts.³ Non-Annex I Parties and project participants from Non-Annex I Parties are permitted to further transfer CERs from their permanent holding accounts in the CDM registry to national registries of Annex I Parties.⁴ However, transfer and acquisition of CERs between holding accounts in the CDM registry is not currently permitted.

² Decision 13/CPM.1 sets out the modalities for the accounting of assigned amounts under Article 7, paragraph 4 of the Kyoto Protocol. Under paragraph 17 of Annex to Decision 13/CMP.1, only Parties included in Annex I are required to establish and maintain a national registry to ensure the accurate accounting of the issuance, holding, transfer, acquisition, cancellation and retirement of carbon units, including CERs. Until the relevant national registry becomes operational, an Annex I Party or project participants from such party may request a temporary holding account in the CDM registry for the purposes of receiving CERs forwarded to them from the Executive Board and for transferring such CERs to accounts in the national registry. *See*, CDM-EB 12, paragraph 35(b).

³ CDM-EB 20, paragraph 69.

⁴ CDM-EB 15, paragraph 33.

16. For the purpose of the monetization of CERs for the AF, Non-Annex I Parties could potentially express their interest in contributing to the AF through purchasing AF CERs. There is, however, no decision by the CMP to address acquisition of CERs by Non-Annex I Parties through a secondary transfer or emission trading. Further, because Non-Annex I Parties do not maintain national registries, if AF CERs were to be transferred to Non-Annex I Parties, CERs would need to be transferred from the AF CDM Account to the permanent holding accounts of Non-Annex I Parties or entities authorized by the relevant Parties for this purpose. Such transfer of CERs could be considered to constitute transfer of CERs between holding accounts in the CDM registry, which is not currently permitted. Therefore, guidance and clarification would need to be sought if Non-Annex I Parties are eligible to acquire CERs from the AF.

17. Additionally, if Non-Annex I Parties are eligible to acquire CERs from the AF, it would need to be clarified if Non-Annex I Parties are subject to any eligibility requirements. As discussed above, the eligibility requirements under Article 17 are aimed to regulate accounting of carbon units, including CERs, towards the emission targets committed by Annex I Parties under Article 3 of the Kyoto Protocol. Therefore, Article 17 eligibility requirements would not be applicable to Non-Annex I Parties. In view of the existing mechanism under Article 12 of the Kyoto Protocol, however, if guidance and clarification by the CMP warrants, AF CERs could be transferred to Non-Annex I Parties or entities authorized by such Parties for this purpose, who hold permanent holding accounts in the CDM registry.

4. CONCLUSION

18. In order to (i) ensure that CERs are delivered to the purchasers' accounts upon completion of the sales transactions without any impediment, (ii) facilitate transactions by providing assurance to potential purchasers and other concerned parties, and (iii) optimize revenue for the AF in transparent and cost-effective manners, it is therefore recommended that the Adaptation Fund Board consider seeking a guidance and clarification from the Conference of Parties serving as the meeting of the Parties to the Protocol at its Fourth Session, as to whether monetization of AF CERs are subject to any eligibility requirements.

19. In particular, the Adaptation Fund Board may wish to (i) invite the CMP to provide clarification on whether the monetization of CERs for the AF will constitute emission trading under Article 17 and therefore transfer and acquisition of AF CERs be limited to Parties and entities authorized by such Parties, who are eligible to participate in emission trading under Article 17, (ii) if necessary, request the CMP to agree on an exemption from Article 17 eligibility requirements for the monetization of AF CERs, so that AF CERs may be freely transferred to any purchasers' accounts in any national registries established in compliance with Article 7, paragraph 4 of the Kyoto Protocol and Decision 13/CPM.1, and (iii) invite the CMP to provide guidance and clarification on (a) whether AF CERs may be acquired by Non-Annex I Parties and transferred from the AF CDM Account to permanent holding accounts of such Parties (or entities authorized by such Parties for this purpose) in the CDM registry, and (b) if so, whether such Non-Annex I Parties are subject to any eligibility requirement.

Eligibility Requirements applied to Emission Trading under Article 17 of the Kyoto Protocol

Article 17 of the Kyoto Protocol allows Parties included in Annex I with a commitment inscribed in Annex B to participate in the emission trading, so that Parties may transfer and/or acquire EURs, CERs, AAUs or RMUs for the purpose of helping to meet their emission targets under Article 3 of the Kyoto Protocol. In order to participate, however, such Annex I Party must meet the eligibility requirements set out in paragraphs 2 and 3 of Annex to Decision 11/CMP (excerpt attached as Attachment). Those requirements include, among others, the following:

- It has ratified the Kyoto Protocol.
- It has calculated their assigned amount in terms of tonnes of CO₂-equivalent emissions.
- It has in place a national system for estimating emissions and removals of greenhouse gases within their territory.
- It has in place a national registry to record and track the creation and movement of ERUs, CERs, AAUs and RMUs and must annually report such information to the secretariat.
- It annually reports information on emissions and removals to the secretariat.

In the event that the Party fails to meet any of the eligibility requirements on a continuous basis, the enforcement branch of the Compliance Committee may determine suspension of Party's eligibility to participate in the emission trading.⁵

Similar eligibility requirements are specified for participation by Annex I Parties in joint implementation projects under Article 6 and use of CERs from CDM projects under Article 12.⁶

The UNFCCC Secretariat maintains a publicly accessible list of Parties that meet the eligibility requirements and of Parties that have been suspended.⁷ The current status of eligibility of the Parties is found at:

http://unfccc.int/files/kyoto_mechanisms/compliance/enforcement_branch/application/pdf/eligibility_list_20_june_2008.pdf

In addition to the governments of Parties, businesses, non-governmental organizations and other legal entities authorized by Parties may participate in emission trading under the authority and responsibility of the governments. However, participation by such entities is limited to the extent that the Party authorizing participation of such entities meets the eligibility requirements referred to above and has not been suspended.⁸

⁵ See, paragraph 5 of Annex to decision 11.CMP.1.

⁶ See, paragraphs 31 and 32 of Annex to decision 3/CMP.1 (Modalities and procedures for a clean development mechanism as defined in Article 12 of the Kyoto Protocol), and paragraphs 21 and 22 of Annex to decision 9/CMP.1 (Guidelines for the implementation of Article 6 of the Kyoto Protocol).

⁷ See, paragraph 4 of Annex to decision 11.CMP.1.

⁸ See, paragraph 5 of Annex to decision 11.CMP.1.

Excerpt of Annex to Decision 11/CMP.1

**Modalities, rules and guidelines for emission trading
under Article 17 of the Kyoto Protocol**

2. Subject to the provisions of paragraph 3 below, a Party⁹ included in Annex I with a commitment inscribed in Annex B is eligible to transfer and/or acquire ERUs, CERs, AAUs, or RMUs issued in accordance with the relevant provisions, if it is in compliance with the following eligibility requirements:
- (a) It is a Party to the Kyoto Protocol
 - (b) Its assigned amount pursuant to Article 3, paragraphs 7 and 8, has been calculated and recorded in accordance with decision 13/CMP.1
 - (c) It has in place a national system for the estimation of anthropogenic emissions by sources and anthropogenic removals by sinks of all greenhouse gases not controlled by the Montreal Protocol, in accordance with Article 5, paragraph 1, and the requirements in the guidelines decided thereunder
 - (d) It has in place a national registry in accordance with Article 7, paragraph 4, and the requirements in the guidelines decided thereunder
 - (e) It has submitted annually the most recent required inventory, in accordance with Article 5, paragraph 2, and Article 7, paragraph 1, and the requirements in the guidelines decided thereunder, including the national inventory report and the common reporting format. For the first commitment period, the quality assessment needed for the purpose of determining eligibility to use the mechanisms shall be limited to the parts of the inventory pertaining to emissions of greenhouse gases from sources/sector categories from Annex A to the Kyoto Protocol and the submission of the annual inventory on sinks
 - (f) It submits the supplementary information on assigned amount in accordance with Article 7, paragraph 1, and the requirements in the guidelines decided thereunder and makes any additions to, and subtractions from, assigned amount pursuant to Article 3, paragraphs 7 and 8, including for the activities under Article 3, paragraphs 3 and 4, in accordance with Article 7, paragraph 4, and the requirements in the guidelines decided thereunder.
3. A Party included in Annex I with a commitment inscribed in Annex B shall be considered:
- (a) To meet the eligibility requirements referred to in paragraph 2 above after 16 months have elapsed since the submission of its report to facilitate the calculation of its assigned amount pursuant to Article 3, paragraphs 7 and 8, and to demonstrate its capacity to account for its emissions and assigned amount, in accordance with the modalities adopted for the accounting of assigned amount under Article 7, paragraph 4, unless the enforcement branch of the Compliance Committee finds in accordance with decision

⁹ In the context of this annex, "Party" refers to a Party to the Kyoto Protocol, unless otherwise specified.

24/CP.7 that the Party does not meet these requirements, or, at an earlier date, the enforcement branch of the Compliance Committee has decided that it is not proceeding with any questions of implementation relating to these requirements indicated in reports of the expert review teams under Article 8 of the Kyoto Protocol, and has transmitted this information to the secretariat;

- (b) To continue to meet the eligibility requirements referred to in paragraph 2 above unless and until the enforcement branch of the Compliance Committee decides that the Party does not meet one or more of the eligibility requirements, has suspended the Party's eligibility and has transmitted this information to the secretariat.

4. The secretariat shall maintain a publicly accessible list of Parties that meet the eligibility requirements and of Parties that have been suspended.

5. Transfers and acquisitions between national registries shall be made under the responsibility of the Parties concerned in accordance with the provisions in decision 13/CMP.1. A Party that authorizes legal entities to transfer and/or acquire under Article 17 shall remain responsible for the fulfillment of its obligations under the Kyoto Protocol and shall ensure that such participation is consistent with the present annex. The Party shall maintain an up-to-date list of such entities and make it available to the secretariat and the public through its national registry. Legal entities may not transfer and/or acquire under Article 17 during any period of time in which the authorizing Party does not meet the eligibility requirements or has been suspended.