IGREC WORKING PAPER | IGREC-16: 2010

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Taking CDM beyond China and India

by

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Abstract

The CDM has performed well with more than 2500 registered projects and an investment of US $ 106 billion likely to generate 1.84 billion CERs before the end of the First Commitment Period with expected revenues in excess of $30 billion. But there is an enormous imbalance in the geographical distribution of projects with 83% of the projects being hosted by just seven countries of which also China and India alone account for about three fourth. Attempts by the Nairobi Framework to address this deep flaw by building capacity, reducing costs and time and improving information sharing and interagency coordination is yet to yield results and can, at best, bring only small incremental relief because they address issues that are peripheral to the core problem of poor and corrupt governance in many developing countries presenting unacceptably high political and sovereign risks to foreign direct investments. Venture investment is risky, poor governance makes it riskier, and if this investment originates from a foreign country the risks can reach unmanageable levels. These risks can be reduced significantly by creating partnerships with host country government and an influential multilateral like the World Bank along with private investors from a consortium of developed countries for CDM investments in Public-Private-Partnership mode. A CDM Initiative Fund could be set up under the aegis of World Bank with the single objective of involving the poorest and the neediest fifty countries in climate Change mitigation for providing loan, insurance and help in capacity building. In exceptional circumstances this Fund can also meet the operational costs of the DNA staff in some of the poorest countries that cannot afford to have a DNA.

Key words: CDM, Nairobi Framework, Political risk, Governance

Citation: Kant, P. 2010. Taking CDM Beyond China and India, IGREC Working Paper IGREC-16: 2010, Institute of Green Economy, New Delhi

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The Kyoto Protocol set up the Clean Development Mechanism with the twin objectives of achieving sustainable development in the developing countries and moving them on the path of mitigation of climate change while assisting developed countries in achieving compliance with their mandatory emission reduction requirements. There is no doubt that the mechanism has taken off with more than 2500 projects registered till date. According to a recent World Bank assessment, the total investments in the CDM projects so far across the world has been US$ 106 billion which is larger than the GDP of more than 136 countries in the world. In the recent past there has been a sharp increase in the CDM projects registered with the CDM Executive Board with as many as 631 projects registered in one year ending October 2010. If all the projects registered so far deliver their projected carbon credits, a total of 1.84 billion CERs would be generated before the end of the first commitment period on 31st December 2012. At an average price of $ 20 per CER, this should generate revenues of $36.8 billion. Even at the lower expected value of $ 15 per CER it would still be a respectable $27.6 billion. But this success story carries a huge geographical imbalance that has the potential of turning the climate mitigation efforts under CDM a failure. Of the more than 2500 CDM projects registered till date, as many as 83% are hosted by just seven countries, namely China, India, Brazil, South Korea, Malaysia, Indonesia and Mexico. And among these also more than three-fourth are located in China and India alone.

And the future does not hold much promise either. Even among the CDM projects in pipeline the situation is not much different. Of the total of 5619 projects at different stages in the CDM pipeline[2] as many as 4631 (82%) belong to the same seven countries with the share of China and India remaining pre dominant within this elite group (UNEP Risoe Center). Few would argue that these seven countries, some of them already developed and the remaining moving rapidly on that path, would not be able to achieve sustainable development without the CDM. They all have the abilities, desire and the resources to do so. It is much of the rest of the developing world that needs to be helped in achieving sustainable development and climate change mitigation and it is in that the CDM has visibly failed. If the stated goals of having CDM are to be achieved, a thorough change in the mechanism, and in the way that it is executed, would need to be brought in.

[2] As on Nov 1, 2010. Does not include projects that have been rejected by DOE or EB or withdrawn by the project proponents.

Nairobi Framework

It is not as if this basic flaw in CDM has remained unnoticed. The United Nations itself has been concerned about this geographical imbalance and its consequences on the global efforts to mitigate climate change as also on meeting the Millennium Development Goals. As far back as 2006, the then Secretary General of UN, Kofi Annan, set up the Nairobi Framework with the express objective of helping the developing countries, particularly those in the sub-Saharan Africa, participate in the CDM Process. The Framework, initiated by the UNDP, has been accorded a high profile with the active partnership of a number of powerful UN organizations including the United Nations Environment Program (UNEP), United Nations Conference on Trade and Development (UNCTAD), United Nations Institute for Training and Research (UNITAR), United Nations Commission for Africa (UNECA), World Bank, the African Development Bank and the UNFCCC.

The focus of the Nairobi Framework is on building capacity in developing CDM project activities, building and enhancing capacities of the Designated National Authorities in countries that have not yet developed many CDM projects, promoting investment opportunities for CDM projects, improving information sharing and inter-agency coordination.

But the five years of action by such a high power framework has failed to meet the objectives even after spending considerable amount of money, mostly on the salaries and travel of the staff of these international agencies involved in this work. The CDM Executive Board also keeps a constant check on the CDM projects and informs the Parties to the Convention of the progress in meeting the objectives, the difficulties and the possible solutions through its annual reports to the UNFCCC. The current situation with regard to the geographical scope has been reported in its annual report of October 2010 with the EB emphasizing that ensuring the equitable geographical distribution of CDM projects is an important goal with it and that the Board has in particular been examining the impact of its regulatory decisions, and the development of new standards, procedures and guidelines, on this goal.

Two critical institutions for CDM projects are the Designated National Authority (DNA) and the Designated Operational Entity (DOE). There are still many nations that either do not have a DNA established and empowered suitably under national laws or have it only in name, with no staff capable of carrying out its assigned tasks. And the DOE, the international auditors to ensure credibility of litigation credits generated, have priced themselves beyond the reach of the project developers in the poorer countries.

Another crucial aspect of CDM is the baseline and monitoring methodologies suitable to the requirements of the CDM activities. Getting new methodologies approved by the CDM EB costs a lot of money and usually takes a long time. Most developing countries do not have adequate relevant data to construct baseline scenarios or make projections for future emissions and

emission reductions under alternate project scenarios making CDM project preparation extremely difficult. For example, in a biomass based renewable energy project the baseline has to be constructed by projecting the changes in carbon contents of soils and of the various types of existing vegetation in the absence of the proposed project requiring validated data of carbon in soils and in vegetation under a whole range of conditions. The absence of such data, freely available not only in almost all developed countries but even in some of the developing countries, forces the project proponents to invest long time and money in generating baseline data that acts as a huge deterrent. The EB has now proposed to undertake assessment of the functioning of the Designated National Authorities and Designated Operational Entities with respect to the flaws mentioned above. There have also been some efforts to address the limitations imposed by the lack of relevant data and suitable approved baseline and monitoring methodologies. The EB has even recommended a loan scheme for operationalzing CDM in countries with fewer than 10 registered CDM project activities.

Would the steps being contemplated help move CDM beyond the small group of elites? The reasoning that has gone behind is sound and can scarcely be faulted and there should be little doubt that, properly implemented, the suggested improvements would bring positive changes.

The question that should really be asked is whether these steps would succeed by bringing in, say, three fourth of the developing countries within the CDM fold making it a truly inclusive mechanism? Unfortunately, the answer to this query should be a definite no because the best that can come out of these is incremental benefits with a few countries labouring their way into the list.

Core Problem is Poor Governance

This is because the issues that are being addressed, though significant, are secondary to the central problem that plagues a very large number of the developing countries. Poor governance in all its manifestations does not permit venture investments which is what a climate mitigation business essentially is. Venture investment is risky, poor governance makes it riskier and if this investment originates from a foreign country it becomes riskiest. In their risk profile the commercial climate change mitigation projects can be compared with venture capital investments that are characterized by high risks inherent in stepping into the unknown. Risks enhance the costs of production and when they introduce an element of uncertainty in the quality (credibility) of the final product, the CERs in this case, they also lower its market value. So what can be done to attract investments in CDM ventures in these countries?

Attracting Foreign Investments in CDM in High Risk Countries

Foreign Direct Investment (FDI) involves a long-term business relationship of lasting interest, and complete or partial control, by an entity resident in one economy in an enterprise located in

another economy (UNCTAD, 2010). An enabling regulatory framework is a prerequisite for FDI but a country with an excellent regulatory framework but poor economic prospects would still fail to attract FDI. Economic factors are thus the substantive determinant of FDI inflows that need to be facilitated by investment friendly legal and policy framework. The factors that determine the relative attractiveness of an investment destination are the institutional capacity for executing Kyoto compliant transactions like the DNA and DOE, potential volumes of low cost GHG emission reduction or sink enhancement and the general business environment. The CDM EB is already addressing the issues related to the institutions of DNA and DOE. The potential volumes of GHG emission reduction and sink enhancement are a given with very limited options. It is the business environment in countries that is not only crucial but also offers opportunities for huge positive changes as it can respond to innovative interventions. Investors respond to poorer business environments with different strategies. In poor environments without rule based governance and with high corruption levels the foreign investors tend to engage in investments with higher managerial controls leading to centralized management from their offices abroad and lowered efficiency. But there is a threshold of poor governance beyond which even this is not possible and then investments suffer drastically. In the worst governed countries foreign ventures tend to confine themselves to non-equity forms such as management contracts.

Covering Political and Sovereign Risks in CDM Ventures

Many developing countries have political, administrative and legal infrastructures that do not enhance confidence in either their executive decision making process or in the fairness of their judicial systems and they are perceived by investors to be presenting unacceptably large risks, particularly in relation to issues such as monitory and fiscal policies, inordinate currency fluctuations (serving a specific purpose of those in the power rather than a response to the market), creditworthiness, the possible takeover of the assets by the host country and an absence of an efficient legal system in which parties can enforce their contractual rights. Investment in a CDM Project will only occur if the cost of managing or insuring against the sovereign and political risk is acceptable in relation to the expected returns from the project and even then this cost would be reflected in the lowered returns to the host country participants in the project since there is no margin for enhancing the sale prices of the final product, the CERs, where the international demand and supply is the only price determinant.

These risks can be reduced substantially when the host country government is also a participant in the project and on other times an influential outsider, like a powerful regional organization or a multilateral like the World Bank, can act as an arbiter resulting in defacto sovereign risk guarantees.

Beside the political influence that an outside organization may have on the host country, several multilateral institutions and banks such as the European Bank of Reconstruction and Development, the Multilateral Investment Guarantee Agency of the World Bank, the Overseas

Private Investment Corporation of the US Government, and private sector groups such as Lloyds of London and American International Group Overseas Private Investment Corporation provide insurance cover to developmental investments subject to varying conditions that may include inability to transfer earnings, loss of control over the project assets, political upheaval such as nationwide strikes not linked to genuine labor disputes within the project, civil unrest or terrorism; and breach of contract by host government or its entities.

A CDM Initiative Fund

This then offers us a possible way of addressing the core problem of extremely high political and sovereign risks in attracting investment for climate change mitigation activities in poorly governed countries. This could be a CDM Initiative Fund set up by the UN under the aegis of an influential organization like the World Bank with the single objective of involving the poorest and the neediest hundred countries in Climate Change mitigation. In the beginning projects must be taken up in Public-Private-Partnership mode with the host country government and the CDM initiative Fund itself becoming partners along with private investors from a developed country.

In countries where there have been few CDM projects so far, the Fund must initiate pilot projects for atleast the first two years. The Fund should also provide loans for making payment for the services of the DOE which can be recovered from the profits subsequently. The political risks mentioned above should also be covered by insurance from an appropriate institution. Obtaining such a cover at reasonable premium would not be difficult for projects of which the World Bank itself, along with country Governments, is a partner. This Fund should also meet all operational costs, including salaries, of the DNA staff in some of the poorest countries that cannot afford to have a DNA for the first five years till they are able to do it on their own. This should be done on a case by case basis rather than as a matter of right for the poorer countries. This may appear to be a costly proposition. But actually it would cost far less than the cost of efforts made under the Nairobi Framework because a dollar goes a long way in the poorer countries. The only difference would perhaps be that the costs under Nairobi Framework involving eight UN and other international agencies, mostly on salaries and travel of their staff, were hidden, and not separately budgeted, whereas these costs would be upfront.

Acknowledgement: I wish to express my sincere thanks to Miss Swati Chaliha, Research Associate, Institute of Green Economy, New Delhi, for her many contributions in writing this article through unearthing critical information, data collection and analysis and pointing out inaccuracies.

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