Joint Implementation Post 2012

Opportunities and Role of Domestic JI under the Kyoto Protocol

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Executive Summary

The Kyoto Protocol (KP) describes Joint Implementation (JI) as a bilateral mechanism that allows a Party included in Annex I to transfer to, or acquire from, any other Annex I Party emission reduction units (ERUs) resulting from projects.[1] The common understanding of the bilateral character of JI is that JI projects require *a priori* two national project approvals, one from the host Party and the other one from the State Party that acquires the ERUs. The objective of this report is to analyse the limitations and ramifications of the requirement that the acquiring Annex I country has not only to authorize the trade but also approve the JI project activity.

The scope of the approval requirement is essential to evaluate the role JI can play as domestic offset standard. Domestic JI means the unilateral implementation of an emission reduction project *and* issuance of ERUs on the basis of verified reductions to a domestic public or private entity. According to our analysis, Article 6 of the Kyoto Protocol only requires bi-country involvement for the cross-border transfer of ERUs. Its current form would support the unilateral development of JI projects, verification, issuance of ERUs and domestic ERU transaction.

To some extent, unilateral JI is practiced today. Under guidance from the Joint Implementation Supervisory Committee (JISC), the JI Track 2 governance body, JI projects can be developed, registered and operated on the basis of host country approval alone. This is a deviation from the Marrakesh Accords which had considerably reduced the scope for domestic JI by submitting all Track 2 determination (and thus registration) to *a priori* bilateral project approval. This being subsequently remedied by the JISC, bilateral approval remains necessary at the stage of verification. Issuance of ERUs and domestic transactions, thus, are out of the picture under current rules and the current practice. Equally for Track 1 JI, although legally being unaffected from this restriction, countries have followed suit by excluding domestic ERU transactions from the outset.

JI does however require a second Annex I project approval for the transfer of ERUs to another Annex I registry. While such requirement is evident where another Annex I country or an entity from such country has invested in the JI project, it is less convincing (and harder to implement) where it applies to ERUs that have been already traded internally and where the link to the initial project developer is not any longer evident. In these cases ERU trading resembles more International Emissions Trading (IET), which requires the authorization of the trade and participating entity, but not of any underlying project.

There are important arguments for harmonized domestic offset standards within the EU, but also among the EU and other Annex I countries. Such standards facilitate the indirect, and eventual the full, linking of OECD emission trading schemes. In the light of our analysis, this report recommends:

- Secondary ERU trades, including those crossing borders, should be traded like EIT and require entity authorization rather than project approval from the acquiring Annex I Party.

[1] Article 6(1) Kyoto Protocol.

- Parties to accept Track 2 and the JISC as project standard setters and to harmonise the different Track 1 procedures as much as possible, thus securing consistent and reliable environmental integrity.

Legally, these recommendations would translate into a modification of Article 6 KP to eliminate the mandatory requirement for project approval for JI projects by a second Annex I Party. This change should be accommodated by the clarification (on the basis of a UNFCCC decision modifying the Marrakech Accords) that cross border transfers of ERUs from accounts other than project participants require the authorization of both entities involved, but no project approval any longer.

Introduction

The Kyoto Protocol (KP) describes Joint Implementation (JI), as the name suggests, from a bilateral perspective. *"[Any] Party included in Annex I may transfer to, or acquire from, any other such Party emission reduction units resulting from projects [...]"*[2] The use of emission reduction units (ERUs) for compliance should be "*supplemental to domestic actions*". From this wording the conclusion was drawn that domestic actions, i.e. emission reducing activities within a country without any bilateral cooperation, were excluded from the JI mechanism.

JI in its current form seems to require the approval of another Annex I Kyoto Party before the ERUs can be issued. The question that arises relates to the scope and limitations of such requirement. To what extent is bilateral approval a legal precondition for the development, roll-out and crediting of JI projects? If the Kyoto rules do not require bilateral action at all or if they stipulate that the burden of bilateral approval comes in only at a later stage—when ERUs are traded across borders then JI could be used in a much broader form than it is used today. Investors and project developers could engage at the domestic level without the need to find international partners and receive foreign state support through obtaining a second approval letter. This in turn could trigger a new set of domestic offset programmes and projects which could tap the full potential of domestic emission reductions

This paper will begin with an outline of the problem, i.e. the prevailing legal conception of JI as an arguably exclusive bilateral instrument and the interests in implementing domestic JI, on the other (1.). From here we will move to a discussion of the opportunities that come with domestic JI; we will present three case studies, EU, Japan and the US that all address the issue of domestic offsetting as part of their climate change strategies (2.). Our third and final chapter will be dedicated to the establishment of a legal and procedural roadmap for both national and international regulatory action to make domestic JI an effective tool of emission reduction policies in Annex I countries around the globe (3.).

[2] Article 6(1) Kyoto Protocol.

1 Domestic vs. Bilateral JI

Article 6 KP does not define JI *projects* but the international *transfer* and *acquisition* of the carbon units that result from these projects as being necessarily bilateral. The term 'joint implementation', which is nowhere to find in the text of the Kyoto Protocol,[3] is misleading in this respect. Article 6 rather authorizes bilateral transactions of emission reduction units that stem from emission reduction projects:

> "*For the purpose of meeting its commitments under Article 3, any Party included in Annex I may transfer to, or acquire from, any other such Party emission reduction units resulting from projects aimed at reducing anthropogenic emissions..., provided that... [any] such project has the approval of the Parties involved...*"

This is an important detail. The Kyoto Protocol does not *per se* preclude domestic schemes and execution of domestic emission reduction projects from the JI architecture; instead it only links the cross-border transfer to mandatory bilateral project approval. In other words: Both domestic project execution, issuance to a registry account of the host party and domestic ERU transfer within the host Party are not contrary to Article 6 KP. They are simply not regulated, a fact that shifts our attention to Article 6(2) of the Protocol under which its supreme body, the Conference of the Parties serving as the meeting of these Parties to the Protocol (CMP), is given the mandate to clarify the mechanism's details:

> "*The Conference of the Parties serving as the meeting of these Parties to this Protocol may, at its first session or as soon as practical thereafter, further elaborate guidelines for the implementation of this Article...*"

The CMP issued JI Guidelines with its Decision 9 CMP.1. However, when searching this document for any regulation or the admission of domestic JI, the picture, as will be shown below, is confusing.

1.1 Track 1 and Track 2 Verification

The JI guidelines distinguish between Track 1 and Track 2 project verification. Track 1 verification is a State Party defined process, while Track 2 verification involves a Kyoto Protocol constituted body, the Joint Implementation Supervisory Committee (JISC). A State Party is free to execute Track 1 verification if it can prove that, in addition to having Assigned Amounts recorded and a national registry in place (requirements for Track 1 and Track 2 alike), the following requirements are fulfilled:[4]

- It has a national system for the estimation of emissions installed;
- It has submitted an up-to-date inventory; and

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[3] It came into existence by Decision 10 CMP.1: "The [CMP] Taking note of preparatory work undertaken by the secretariat relating to the implementation of Article 6 of the Kyoto Protocol, hereinafter referred to as *joint implementation*..." (italics added) This Decision is dedicated to Track 2 procedures and sets up the "Joint Implementation Supervisory Committee". Note that different from Track 1 ,Track 2 explicitly excludes domestic JI.

[4] Decision 9 CMP.1, paras 21 and 22.

- It submits supplementary information on the Assigned Amount.

If these requirements are *not* met, State Parties shall follow the Track 2 procedure under the supervision of the JISC. Within Track 2 verification, a non-domestic, bilateral aspect has been made a constitutive element. In order to launch the verification process—it consists of determination of the project and determination of the emission reductions—project participants have to prove that the project has been "*approved by the Parties involved*". The term "Parties involved" is used by the Protocol itself (see quote above), even though its meaning is nowhere explicitly defined. However, from the structure and the context of the provisions it is clear that "Parties involved" refers to both the host country (i.e. where the project takes place) and the sponsoring (investor) country (to where the ERUs will be transferred). Throughout the JI Guidelines there are numerous references to the "host country", while the sponsoring (investor) country has only the indirect reference as "Party involved".[5]

Within Track 1 verification, the requirement of bilateral approval is *not* a constitutive element. Verification then is governed by internal rules of the host country alone:[6]

> "*Where it is considered to meet the eligibility requirements set out in paragraph 21 above, a host Party may verify reductions in anthropogenic emissions… from an Article 6 project as being additional… Upon such verification, the host Party may issue the appropriate quantity of ERUs in accordance with the relevant provisions of decision 13/CMP.1.*"

The independent host Party verification process is not accompanied by any co-verification or other examination process on the part of any other (investor) country. This would suggest that host countries could issue ERUs for unilateral, i.e. domestic, projects.

1.2 The CDM Precedent

Unilateral action is not alien to the implementation of the Protocol's flexible mechanisms. The Clean Development Mechanism's (CDM) State Party reciprocity is enshrined in Article 12 KP:

> "*Emissions reductions resulting from each project activity shall be certified by operational entities… on the basis of… [voluntary] participation approved by each Party involved..*"

Yet, following delegated guidance from the CDM Executive Board, unilateral CDM projects are admissible:

> "*The Board agreed that the registration of a project activity can take place without an Annex I Party being involved at the stage of registration.*"[7]

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[5] Note that only the primary (first) ERU transfer (from the host to the investor country) falls under Article 6 KP. Secondary ERU transactions are covered by the emissions trading provision, Article 17 KP, see below under 1.3.

[6] Decision 9 CMP.1, para 23.

[7] Executive Board 18th Meeting, Report para 57, http://cdm.unfccc.int/EB/018/eb18rep.pdf, viewed in September 2009.

Thus, CDM projects can be validated, registered and verified, and certified emission reductions (CERs) can be issued into the pending account of the CDM registry and forwarded into the holding account of the project participants without the involvement of another (Annex I) State Party. Only when the CERs are eventually to be forwarded to a registry account of an Annex I Party, the relevant Annex I approval is necessary:

> "*Before an Annex I Party acquires CERs from such a project activity from an account within the CDM registry, it shall submit a letter of approval to the Board in order for the CDM Registry administrator to be able to forward CERs from the CDM registry to the Annex I national registry.*"[8]

Unilateral CDM projects being an accepted procedure, it is noteworthy that the pertinent regulation was made not at treaty level (Kyoto Protocol) nor at CMP level but by the CDM Executive Board. This is all the more remarkable in light of the fact that while Article 6 on JI does not rule on the admissibility of unilateral verification and leaves further clarification JI to the level of delegated legislation, Article 12 on CDM does pronounce on the inherent cooperative nature of CDM: Certification of projects can only happen on the basis of bi-Party approval (cf. quote above), while article 6 only requires such approval as condition for the transfer of units. Thus, subsequent treaty practice has been lenient on the conceptual CDM restriction and has reduced the bi-Party requirement to the sphere of CER transfer.

For Track 1 projects, the JISC followed the CDM precedent by requiring an approval from an Party " other than the host Party" at the moment of verification.

> *"(a) At least the written project approval(s) by the host Party(ies) should be provided to the AIE [accredited independent entity] and made available to the secretariat by the AIE when submitting the determination report regarding the PDD for publication in accordance with paragraph 34 of the JI guidelines;*
> *(b) At least one written project approval by a Party involved in the JI project, other than the host Party(ies), should be provided to the AIE and made available to the secretariat by the AIE when submitting the first verification report for publication in accordance with paragraph 38 of the JI guidelines, at the latest."*[9]

As a result the issuance of ERUs remains subject to approval from a second Annex 1 country.

1.3 Track 1 and State Practice

Interestingly, treaty implementation practice for JI has moved in the other direction. International State Party practice, where it exists, seems to be uniform in applying the JI Guidelines in a way that requires at least bi-Party approval of JI projects as a precondition for ERU issuance. To date only six countries out of 32 eligible Annex I countries have launched domestic Track 1 projects at all: Hungary, Germany, France, New Zealand, Romania, Czech Republic and Ukraine;[10] yet all of these countries appear to rely on a bilateral structure for their JI project approval.

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[8] Ibidem.

[9] Glossary of Joint Implementation Terms, Version 02, page 13

[10] JI Project overview, http://ji.unfccc.int/JI_Projects/ProjectInfo.html, viewed in September 2009.

Under the German legislative scheme, for instance, the letter of approval of the investor State Party must be submitted to the responsible authorities before the project can be registered.[11] The French implementation rules establish a clear restriction to bilateral projects, although here the need for bilateral approval shifts to the stage of ERU issuance. In accordance with the national legislation[12] emission reductions from domestic projects can only generate ERUs when backed by an (even if it is only a pro forma) investor Party and a certain fraction of ERUs is being transferred to a registry of a country other than France. France and most other Annex I Parties however implicitly acknowledge that unilateral generation of ERUs is in line with the Kyoto Protocol by allowing the issuance and forwarding of a portion of the ERUs to domestic project participants having their account in the national registry.

1.4 The Question of ERU Transfer

While the regulatory setting of the Kyoto Protocol, the Marrakesh Accords, and the JI Guidelines allow the development and implementation of domestic JI projects including the issuance of ERUs, the bilateral element comes only in when an ERU crosses the border by being transferred into another national registry. The transfer of ERUs from one national registry into another requires both the approval by the host and the approval by the receiving Party of the project from which the ERUs result (Article 6 (1) (a) KP).

This means that domestic JI projects are in line with the Kyoto Protocol as long as the credits do not leave the boundaries of the State Party involved. If they do, project approval of the receiving Party is a prerequisite. Under the letter of the law this relates to the first cross-border ERU transfer after issuance. Secondary ERU transactions, on the other hand, do not require additional project approvals; they can be performed under Article 17 KP (international emissions trading or IET) and the implementing provisions in Decisions 11 and 13 CMP.1.[13]

The mandatory bilateral approval allows the receiving State to check whether the project at stake meets its JI approval criteria. In line with the rules governing the CDM, JI and international emissions trading any private/public entity level engagement in the flexible mechanisms needs to be supported by an authorisation of the Party which accepts Kyoto units to be transferred to its registry.

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[11] Section 5 of the Act Implementing the Project-Based Mechanisms of the Kyoto Protocol (ProMechG): "Die zuständige Behörde nimmt die Registrierung der Projekttätigkeit vor, sobald… ihr die Billigung des Investorstaates vorliegt."

[12] Art. L. 229-20 Code de l'Environnement; Article 6 Décret n° 2006-622 du 29 mai 2006 ; Art. 15(1) Arrêté du 2 mars 2007 : « La délivrance des URE [ERUs] intervient à la demande du titulaire de l´agrément… Cette demande… précise la répartition des unités de réduction des émissions sur les comptes de chaque participant au projet. L´un au moins des comptes crédites doit être ouvert dans le registre d´un État tiers qui a ratifié le protocole de Kyoto et figure à son annexe B. La première demande de délivrance est accompagnée de la lettre officielle d´agrément de l´activité de projet délivrée par l´Etat responsable du registre national des émissions dans lequel le ou les participants étrangers détiennent leur(s) compte(s). »

[13] There is nothing in these Decisions that would *expressis verbis* exclude the trade with ERUs that are domestically generated. We would argue, though, that to treat a primary cross-border transaction of ERUs under Article 17 KP only would be a legally questionable circumvention of Article 6 KP. The suggestion put forward in this paper: primary transaction to be treated under Article 6; secondary transactions to be treated under Article 17, effectively harmonizes both provisions.

The JI approval goes beyond this requirement when it demands project approval. This requirement finds its explanation in the fact that JI was initially perceived as bilateral investment mechanism: an investor Party (or entities operating under its authority) would invest into a project in a host country. Under this scenario both Parties would be directly exposed to project risks. In practise, most CDM and JI trades are however mere purchase activities where the investor is nothing but a mere purchaser. In the case of domestic or unilateral JI projects, there is no foreign investor or purchaser of the ERUs involved in the project implementation. The sale of ERUs happens upon issuance, not before.

This situation can be compared with the CDM, where project approval is required at the time the CERs are being forwarded to an Annex I registry account. The requirement of project approval relates to the fact that (i) CERs can be used as an offset of Annex I emissions; and (ii) the CERs are transferred to an Annex I registry from where they can be traded under Article 17 KP. The approval requirement ensures that the accepting Party is satisfied by the Project quality and accepts the CERs as offsetting domestic emissions.

As a project-based mechanism JI shares features with both the CDM and IET. It shares with the CDM the concern for quantifiable emission reductions from a project activity. It shares with emissions trading the fact that the transferred credits are accounted for under the overall Kyoto cap; other than CDM CERs they are not offsetting Annex I emissions.

Consequently, there are as many arguments in favour of treating JI like EIT as there are for treating it like the CDM. The requirement for bilateral project approval makes sense where another Annex I entity acts as investor into the project. It also makes sense where ERUs are transferred upon conversion and issuance to a foreign account. The link and the exposure to the project can be clearly established and the partnering Annex I entity can be expected to obtain project approval.

ERUs from domestic projects may however have undergone many trades before they are transferred to another Annex I country. The seller of the ERUs is not any longer the project owner and in itself without control over the project (or even lacking detailed knowledge). In that case the transfer of ERUs to another Annex I country in cases where there is no foreign investor may be compared with Article17 KP rather than CDM transactions. It would therefore be logical to limit the approval requirement in these cases to an authorization to participate in an ERU transaction, analogous to the Article 17 authorisation requirement.

Where Annex I parties have established an entity level emission trading system which allows ERUs but not AAUs as offsets within the system – such as in the case of the EU ETS - , another set of issues needs to be considered. These relate to the fact that Annex I parties may not wish to allow all type of ERUs to be used as offsets within the entity level cap-and-trade schemes. Countries may want to make sure that projects meet certain standards and rigorous criteria. These concerns can be addressed by creating additional conditions for the use of ERUs as offsets under the Annex I trading scheme. It is however important to note that they relate to the national implementation of emission trading schemes rather than to the logic of the Kyoto mechanisms.

In order that unilateral JI can develop in a stable environment where the risks of subsequent bilateral rejection are contained or reduced to a minimum, project registration should be submitted to a set of rules that are backed by internationally accepted standards. The Track 2 procedures with the JISC as institutional standard setter have an important role to play in this context. Project developers might indeed wish to resort to Track 2 verification

altogether, given that the harmonised Track 2 procedures guarantee a certain project standard that facilitates access to international carbon markets. However, as explained above, Track 2 is currently not accessible for unilateral JI development. The most effective response to the risk of subsequent rejection on the international markets would be to harmonise the quality and stringency of Track 1 procedures as much as possible. JI project verification has a global tendency already to apply common standards with the JISC functioning as widely trusted standard setter. This bears an effective strategy to accommodate expectations and streamline recognition practices.

2 Potential Use of Domestic JI

The potential for domestic JI relates at least to two factors: First, to its capacity to incentivize national emission reduction activities and thus to bring finance to action; and second, to its ability to identify and implement the most cost-effective way of reducing emissions.

From a microeconomic (project) perspective, domestic JI means direct, project based finance and investment. From a macroeconomic perspective, domestic JI involves screening the whole of the economy, tracing the cheapest emission reduction and implementing it by decentralized means. Domestic JI could tap into the emission reduction potential beyond the sectoral borders of an cap-and-trade scheme. The European Climate Change Programme, for instance, in 2003 identified 42 potential emission reduction measures at a cost below EUR20 per tonne CO2.[14] Finance through EU ETS emissions trading only addresses a handful of such measures. Domestic JI could have covered many more.

From an institutional perspective, for Annex I countries that have not yet established a domestic emission trading scheme, domestic JI would create one. In Annex I (and Kyoto) Parties that do engage in domestic emissions trading—the EU, New Zealand and soon Australia, to a certain extent also Japan—domestic JI would target those sectors that are not covered by the scheme.

The EU ETS covers only 40% of the emission of the EU as a whole,[15] and the use of domestic offsetting schemes does not form part of the EU climate policy. In general, the Exploitation of the opportunities of domestic offset schemes by Annex I Parties has been limited. The United States has however decided to make emission trading its main climate change policy instrument. The U.S. legislator is in the process of adoption of a trading scheme that would cover 80% of the country's emissions and authorise the creation of domestic offsets in the remaining 20% of the economy (most importantly in the agricultural and land-use sector). We will summarize below three examples of domestic offset schemes, in existence or planned in the EU, Japan and the US.

2.1 Domestic Offsets in the EU Framework

With the exception of the land use sector which it excludes altogether for CDM, and special requirements to large hydro projects, the EU ETS Directive allows project-based flexible mechanisms of the Kyoto Protocol, CDM and JI. ERUs that are issued in line with international regulations may be traded into the EU ETS and, subject to the national quotas, be used along with EU allowances (EUAs), for compliance:[16]

> "*All CERs and ERUs that are issued and may be used in accordance with the UNFCCC and the Kyoto Protocol and subsequent decisions adopted thereunder may be used in the Community scheme...*"

Domestic JI is thus admissible under the EU ETS in the same way as it is under the international rules. Prior to a cross-border transfer, unilateral action is possible, while the

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[14] Second ECCP Progress Report - "Can we meet our Kyoto targets?", April 2003.

[15] Cf. EU Action Against Climate Change. Leading Global Action to 2020 and Beyond (2009), accessible via http://ec.europa.eu/environment/climat/pdf/brochures/post_2012_en.pdf.

[16] Directive 101/2004/EC (the "Linking Directive" amending the EU ETS Directive).

need for another country's approval comes in only with the transfer from one registry into another.

The 2009 amended EU ETS Directive mentions domestic offsetting in another context, outside the framework of JI. In Article 24 (a) the Directive reads:[17]

> "[Implementing] *measures for issuing allowances or credits in respect of projects administered by Member States that reduce greenhouse gas emissions not covered by the Community scheme may be adopted.*"

Responsible for any such adoption is the European Commission, acting through comitology procedures.[18] However, to date, concrete legislative actions under this provision are not envisaged and there is very little conceptualisation of domestic offsets in the political discussion. It is noted, however, that under the Effort Sharing Decision of the European Parliament and the Council,[19] which covers Member States emissions from non EU ETS sectors; explicit reference is made to the offsetting tool of Article 24 (a) EU ETS Directive. It is worthwhile to note that Member states may utilise such credits without limit whereas JI/CDM credits from outside the EU are submitted to caps. Supplemental legislation needs to be adopted in order for article 24a to become operative. The legislator may choose to prepare international linkage by aligning the project and credit standards with international formats, the most obvious being JI.

2.2 Domestic Offsets in Japan

To address growing emissions trends in various sectors, Japan has been engaging in domestic offset projects since March 2008. The offsetting scheme is embedded in the Voluntary Action Plan on the Environment (VAP),[20] a program based on voluntary partnership among industry and commerce with emission reduction targets defined as per sector and an overall pledge to stabilize emissions by 2010 over 1990 levels. The VAP has currently 2,136 partner firms.

Offset projects must be designed to reduce energy oriented carbon emissions at small to medium scaled enterprises which themselves are not eligible for emission reduction commitments under the VAP. The institutional and procedural framework is based on that of (small-scale) CDM projects:[21] Projects need to prove additionality[22] in order to be validated by independent validators; validation precedes registration. Registering body is the Domestic Credit Certificate Authority. Project types are the ones allowed under the CDM. In practice, biomass, energy efficiency and renewable to fuel switch projects prevail. The VAP to date has 17 approved methodologies.[23] The basis for credit issuance are monitoring and verification

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[17] Ibid., Article 24 a (1); italics added.

[18] Ibid., para 2 in conjunction with Article 23(3) of Directive 87/2003/EC.

[19] Decision 406/2009/EC.

[20] Keidanren, Outline of the Keidanren Voluntary Action Plan on the Environment, http://www.keidanren.or.jp/english/policy/pol058/outline.html, viewed in July 2009.

[21] For an overview see Mayumi Yoshida, Japan Institute for Overseas Investment, May 2009.

[22] Benchmark is any of the four barriers to project execution: investment barrier, technology barrier, general custom barrier or other barrier. The establishment of a positive list of additional project is planned.

[23] Ministry of Economy, 2008, Trade, and Industry of Japan,

processes. Offset credits are issued only if the project proves to be performed in line with the validated project plan and if real emission reductions could be traced in a measurable way.

As of 16 July 2009, 52 projects out of 118 applied projects have been registered. The Domestic Credit Certificate Authority performed monitoring tests for 8 projects and issued credits worth 1,590 tCO_2e in total. On 10 June 2009, Japanese Prime Minister Taro Aso announced that Japan would reduce national emissions by 15% from 2005 levels without resorting to foreign offset credits.[24]

Considering these figures and the high marginal cost differentiation[25] between emitters, the prospects for domestic offsetting in Japan are high; and different from the European context, a pilot program for the generation and the transfer of domestic offset credits already exists with the VAP.

2.3 Domestic Offsetting at Large Scale: The US Example

The US cap and trade systems that exist or have been schemed thus far at the regional level put a great emphasis on offsetting, domestic and international alike. The Regional Greenhouse Gas Initiative (RGGI), for instance, a regional system involving nine north-eastern and mid-Atlantic states, permits that compliance buyers acquire up to 10% of their quota through offsets.[26] The bill adopted in the House on 26 June 2009, American Climate and Energy Security Act (ACESA or "Waxman-Markey Bill" after its drafters), [27] lays out the basis for regulating international and domestic offsets.

Domestic Offsets under the Bill

ACESA authorizes up to one (1) billion tons annually of domestic offsets with the U.S. Department of Agriculture to establish a program for determining baseline, additionality, leakage, and other requirements.[28] This figure represents a sixth of the country's total energy-related GHG emissions in 2008.[29] The forestry, agriculture and renewable energy sector are expected to take key roles in domestic offset programs.[30]

International Credits under the Bill and ERUs

International offsets of which equally 1 billion tons will be allowed, are grouped under four categories: (a) allowance trading with nations with comparable cap and trade programs; (b) forest credits; (c) sectoral credits; and (d) project credits from non-capped environments conditioned on recognition by a UNFCCC body.

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http://jcdm.jp/process/methodology.html viewed in September 2009.

[24] Cabinet Secretariat of Japanese Prime Minister, Speech on the Environment, http://www.kantei.go.jp/foreign/asospeech/2009/06/10kaiken_e.html, viewed in September 2009.

[25] Research Institute of Innovative Technology for the Earth, July 2008.

[26] http://www.rggi.org/home, viewed in September 2009.

[27] http://www.opencongress.org/bill/111-h2454/text, viewed in September 2009.

[28] Sec 728 (2).

[29] U.S. Energy Information Administration (EIA), 4 August 2009, accessible via http://www.eia.doe.gov/oiaf/servicerpt/hr2454/execsummary.html viewed in September 2009.

[30] http://www.epa.gov/climatechange/economics/pdfs/HR2454_Analysis.pdf., viewed in September 2009.

How JI/ERU credits fit into this scheme is less clear. However, ERUs could be seen as "international emission allowance" which ACESA defines as "*a tradable authorization to emit 1 ton of carbon dioxide equivalent of greenhouse gas that is issued by a national or supranational foreign government*".[31] An ERU has the functional "purpose of meeting [a Party's] commitments" under the Kyoto Protocol[32] and it is transferrable. ERUs may hence be seen as tradable authorizations falling under the meaning of the ACESA. They are also issued by a national foreign government, since for both Track 1 and Track 2 ERU generation it is always the State Party (not the JISC) that issues the relevant units.[33]

There is however another requirement for foreign allowances to be recognized by the US system. They must come from other cap-and-trade programs that impose mandatory absolute targets ("mandatory absolute tonnage limit on greenhouse gas emissions from 1 or more foreign countries")[34] and that are "at least as stringent as [the US system]"[35] including comparable monitoring, compliance and enforcement and quality and restrictions of offsets. The Environmental Protection Agency (EPA), in consultation with the Secretary of State, will make a case-by-case assessment of whether a particular cap-and-trade program meets the US requirements or not. The latter requirement brings in a (political) insecurity which will put pressure on foreign project owners, traders and investors—at least as long as a favourable country vote has not been issued. The former requirement, by contrast, is substantial. It relates to the question of how robust the JI/ERU mechanism is. Looking at the Kyoto country targets, there are some countries with ambitious emissions limits but others where the limits are generous (the surplus AAU countries Russia and Ukraine, for instance). For these countries it is questionable whether the target can be deemed to be as "stringent" as the US one. However, there is a difference between the (AAU) target and the JI mechanism. JI, if the current high standards continue to apply, is a stringent mechanism in which emission reductions must be measurable, verifiable and real (additional) in order to qualify as ERUs. Track 2 ERUs and Track 1 ERUs, if coming from a country that has proven to approve real emissions reductions, the ACESA requirement should be met.

This brings again in focus the importance of the standard setting role of Track 2 procedures and the need for Track 1 procedures worldwide to harmonise its registration and verification rules. If (unilateral and other) JI credits are experienced as a guarantee for real, sustainable and additional project sources, the case-by-case examinations by the EPA should generally not fail. Their success rate would indeed be a critical test for the reliability of JI credits and for the positive investment climate for JI projects across the globe.

[31] Sec 700 (32).

[32] Article 6(1) Kyoto Protocol.

[33] JI Guidelines (Decision 9 CMP.1), paras 23 and 24.

[34] Sec 728 (International Emission Allowances): (a) (1).

[35] Ibid.: (2).

3 The Way Forward: Regulating Domestic JI

The analysis set out above suggests that the Kyoto Protocol does not prohibit the implementation of domestic JI projects. Under these an Annex I Party can determine solely and without foreign interference that a domestic JI project qualifies as an additional emission reduction project and it can issue ERUs for it from its AAU quota. Only where there is a direct transfer of ERUs from a project into the registry of another Annex I Party envisaged, bilateral project approval is required.

However, the potential for domestic offsetting and domestic JI is under-explored. This may be caused, to a substantial degree, by the fact that the same rules that argue for unilateral action under Track 1 procedures, exclude unilateral JI explicitly from Track 2. In addition, countries leave the domestic JI Track 1 option untapped and where they do foresee domestic offsetting mechanisms. Europe may engage in an exclusive mechanism under the newly created Article g24 a EU ETS. Japan practices domestic offsetting projects but in no apparent connection with the international JI/ERU rules and as yet at a small scale. The US is planning to use domestic offsetting as integral piece of its national emission trading scheme. However, it being a non-Kyoto Protocol Party, the synergies with the concept of JI are yet to be established.

To strengthen the role of JI and especially JI in its domestic constellation, certain regulatory actions at both the national and the international level could be taken. In line with our finding we will make a suggestion below how the Kyoto Protocol and the Marrakesh Accords could be changed in order to switch from bilateral JI project approval to a procedure which requires an approval to participate in ERU trading and which resembles the regulatory design enacted under Article 17 KP

Considering that the Copenhagen negotiations may not yet lead to a procedural change of this sort, we will also outline a minimum solution which is confined to facilitating unilateral JI at the domestic (pre cross-border trading) level.

3.1 National Action

Countries should react fast if new international arrangements regarding unilateral JI-*cum*-cross-border trading will be found (see below). However, even if the international level does not lead to any modifications of the regulatory setting, the Kyoto Parties can take ambitious action under JI Track 1 procedures., As shown above, the establishment of domestic JI schemes and of unilateral project development and project crediting—up to the point when a cross-border trade of the credits involved happens—is a legitimate option they have under the Kyoto Protocol. While making use of this option, countries should aim at harmonising procedures and safeguarding the integrity of JI as much as possible. They can do so by adhering, in qualitative terms, to the model framework set up by the JISC for Track 2 procedures which could thus maintain and strengthen their role as generally accepted and applied standards. The reasons have been set out above: The more Annex I countries are prepared to accept the role of the JISC as standard setter on a variety of issues (such as baseline setting, methodologies and benchmarks for verification, additionality, and leakage), the more there is a reliable JI environment that attracts developers and investors. At the same time harmonisation will help the case of domestic JI from an international trading perspective: In order to facilitate that countries open their national registries and trading schemes for unilateral JI credits, the credit quality should be clear, reliable and transparent.

The more a country's Track 1 procedures reflect the standard of other countries and notably of the JISCS in Track 2, the more quality assurance is given

3.2 International Norm-Setting

As argued above, the most coherent solution would be if the Kyoto Protocol Parties could agree to change Article 6 to make way for a unilateral JI that includes the cross-border trading phase.

A revised Article 6 (1) KP could then read:

> "[...]
> (a) Any such project has the approval of the ***host Party*** involved:
>
> (b) Any such project provides a reduction in emissions by sources, or an enhancement of removals by sinks, that is additional to any that would otherwise occur;
>
> (c) It does not acquire any emission reduction units if it is not in compliance with its obligations under Article 5 and 7;
>
> (d) The acquisition of emission reduction units shall be supplemental to domestic actions for the purposes of meeting commitments under Article 3."

At the level of the Marrakesh Accords the following changes should be introduced: (i) a clarification that in cases where ERUs are first transferred to another Annex I registry, they require project approval if the other Annex I Party or an entity of that Party acts as JI project participants; and (ii) that where ERUs are acquired through secondary trades (from non project participants) authorisation of the public and private entities involved in the trade should replace the JI project approval requirement.

The provision that would need to be changed is Decision 9 CMP.1, paragraph 31 (a), which in its current form makes bilateral project approval mandatory. A new paragraph 31 should read:

> "Project participants shall submit to an accredited independent entity a project design document that contains all information needed for the determination of whether the project:
>
> ***(a)*** Has been approved by the ***host Party*** and ***by another Annex I Party if such Party or authorized public or private entities of such Party participate in the JI project;***
>
> (b) Would result in reduction of anthropogenic emissions by sources or an enhancement of anthropogenic removals by sinks that is additional to any that would otherwise occur;
>
> (c) Has an appropriate baseline and monitoring plan in accordance with the criteria set out in Appendix B below."

The approval for private/public entities to participate in ERU generation, transfer or acquisition, on the other hand, is laid down in Article 6 KP itself (paragraph 3). Additional regulatory instructions at CMP level need not be taken.

The Minimum Solution

A minimum solution would restrict itself to allowing unilateral JI project development and ERU generation under both Track 1 and Track 2. Similar to the CDM regulatory, it appears feasible to change the JI rules at the executive, i.e. JISC, level. The JISC may agree to the following:

> "*The Supervisory Committee agrees that the registration and verification of a project activity as well as the issuance of ERUs can take place with the approval of the host Party only.*"

The bilateral approval would then come in at the registry-to-registry transfer level. Here in order to legitimize a transfer in accordance with Article 6 KP the receiving Party would still obtain project approval. To streamline procedures it would then appear best if the host country registry, in order to execute a request for out-of-registry transfers requires the requesting entity to submit the second approval together with its request for transfer.

If the JISC should find that the procedural modification lies outside of its competence, it should suggest a change to Decision 9 CMP.1, paragraph 31 (a) of the Annex (the JI Guidelines) for consideration of the CMP. The new paragraph 31 (a) could read:

> "Project participants shall submit to an accredited independent entity a project design document that contains all information needed for the determination of whether the project:
>
> (d) Has been approved by the ***host Party***;
>
> (e) Would result in reduction of anthropogenic emissions by sources or an enhancement of anthropogenic removals by sinks that is additional to any that would otherwise occur;
>
> (f) Has an appropriate baseline and monitoring plan in accordance with the criteria set out in Appendix B below."

It is hoped that once these changes are made, there will be an important new incentive for countries and project developers alike to go ahead with JI and to make it an efficient tool for emissions reductions throughout Annex I countries.

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