THE

CLEAN DEVELOPMENT MECHANISM

DIALOGUE PAPERS

Developing Terms of Reference for the Clean Development Mechanism Executive Board and Operational Entities

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Center for Clean Air Policy

September, 2000

BRIDGING THE GAP

DEVELOPING TERMS OF REFERENCE FOR THE CLEAN DEVELOPMENT MECHANISM EXECUTIVE BOARD AND OPERATIONAL ENTITIES

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The Clean Development Mechanism (CDM) Dialogue Papers

The *CDM Dialogue Papers* are intended to help advance the design process for the Clean Development Mechanism. The concepts developed and opinions expressed in these papers are those of the Center for Clean Air Policy (CCAP) or the Foundation for International Environmental Law and Development (FIELD), although these views have been informed by extensive interactions with participants in the "CDM Dialogue." Since May 2000, CCAP, in partnership with FIELD, has facilitated three meetings of the dialogue, which brings together a group of high-level climate negotiators from European Union, Umbrella Group and G-77 countries. The process gives participants a chance to informally discuss different approaches to the design of the CDM in a relaxed, off-the-record, non-negotiating setting. Financial contributions for these meetings were provided by the European Commission Directorate-General for Environment, the Canadian Department of Foreign Affairs and International Trade, the United Kingdom Foreign and Commonwealth Office, the Danish Ministry of Environment and Energy, the United States Environmental Protection Agency, the Netherlands Ministry of Housing, Spatial Planning and the Environment, the Australian International Greenhouse Partnerships Office, and the German Federal Ministry for the Environment, Nature Conservation and Nuclear Safety.

The *CDM Dialogue Papers* do not reflect consensus recommendations of the participants; rather, they are an attempt to harvest the thoughts and discussions that have been part of the process.

The papers in this series include:

- *Developing Terms of Reference for the CDM Executive Board and Operational Entities* (CCAP)
- *Implementing the Additionality Requirement & Ensuring the Stringency of Project Baselines under the CDM* (CCAP)
- *The Eligibility of Land Use, Land-Use Change and Forestry Projects under the CDM* (CCAP)
- *Sharing the Benefits: Mechanisms to Ensure the Capture of Clean Development Mechanism Project Surpluses* (CCAP)
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- *Defining and Distributing the "Share of the Proceeds" under the CDM* (FIELD)

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The Foundation for International Environmental Law and Development (FIELD) was founded in 1989 to tap the potential of law at the international, regional and domestic level, to encourage environmental protection and sustainable development. FIELD's work in the area of climate change has focused on conducting research and on providing legal and policy advice and assistance to developing countries, as well as intergovernmental and non-governmental organizations involved in the climate change process. FIELD lawyers have participated directly in the negotiations of the 1992 United Nations Framework Convention on Climate Change and the Kyoto Protocol, where they have been providing legal advice and assistance to the Alliance of Small Island States.

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The development of a functional structure for governing the Clean Development Mechanism (CDM) and the allocation of governance responsibilities among the COP/MOP, the Executive Board (EB), Operational Entities (OEs), and potentially other entities are essential prerequisites to the implementation of the CDM, which could begin as early as the year 2000. The governance structure must accommodate the anticipated volume of CDM transactions and must ensure the efficient and cost-effective administration of the CDM, the environmental integrity of certified emission reductions, and the accountability of governing bodies to the COP/MOP. This paper defines the project cycle that must be governed under the CDM, and proposes terms of reference for each of the bodies that must govern this cycle. The paper also identifies two mechanisms for streamlining the governance process: (1) using the OE validation report as the basis for project approval by the host and investor Parties as well as registration by the EB, and (2) merging the functions of verification and certification into a single step. Finally, the paper examines possible mechanisms for accrediting and auditing OEs and for enabling public oversight of OE activities.

I. Introduction

Article 12 of the Kyoto Protocol defines the Clean Development Mechanism (CDM), which has the dual goal of assisting non-Annex I Parties in achieving sustainable development and Annex I Parties in achieving compliance with their quantified emission limitation and reduction commitments. This article contains the following provisions for governing the CDM:

- Article 12.4: The CDM shall be subject to the authority and guidance of the Conference of the Parties serving as the meeting of the Parties to this Protocol (COP/MOP) and be supervised by an executive board (EB) of the CDM.

- Article 12.5: Emission reductions resulting from each project activity shall be certified by operational entities (OEs) to be designated by the COP/MOP.

- Article 12.7: The COP/MOP shall, at its first session, elaborate modalities and procedures with the objective of ensuring transparency, efficiency and accountability through independent auditing and verification of project activities.

The development of a functional structure for governing the CDM and the allocation of governance responsibilities among the COP/MOP, the EB, OEs, and potentially other entities are essential prerequisites to the implementation of the CDM, which could begin as early as the year

2000. Part Two of the Chairmen's *Consolidated Text on Principles, Modalities, Rules and Guidelines* (UNFCCC, 2000b) includes individual sections with consolidated Party proposals for the role of the COP/MOP, the EB, an "accreditation body," and designated OEs in governing the CDM. Governance processes are also addressed further in the sections on financing, validation, registration, monitoring, verification, certification, and issuance of CERs. There remain some significant differences among the Parties regarding the governance of the CDM. These differences relate primarily to three issues: (1) the delegation of authority for the development of policies and standards among the COP/MOP and the EB, (2) the oversight of OE activities by the EB and/or other accreditation or auditing bodies, and (3) the structure and composition of the EB.

This paper provides an overview of the key governance issues that remain to be resolved by the Parties, and proposes terms of reference for governing the CDM. These terms of reference are largely the product of two meetings of the CDM Dialogue, a project undertaken by the Center for Clean Air Policy in association with the Foundation for International Environmental Law and Development. The CDM Dialogue brought together a select group of negotiators from the Umbrella Group, the European Union, and non-Annex I Parties to hold informal, off-the-record discussions on the CDM. While this paper was informed by the outcome of the CDM Dialogue meetings and often reflects areas of general agreement among participants, the views presented in this paper should not be construed as the consensus views of all of the CDM Dialogue participants. The paper begins with a brief discussion of the CDM project cycle and proceeds to address the terms of reference for the COP/MOP, the EB, OEs, and the accreditation body.

II. The CDM Project Cycle

In order to construct a governance framework for the CDM, it is important to first identify the overall goals of this governance structure and the individual stages of the CDM project cycle that will need to be governed. The governance structure must accommodate the anticipated volume of CDM transactions. It must also ensure that the CDM is administered efficiently and cost-effectively, that the certified emission reductions (CERs) awarded to projects have environmental integrity and are sufficiently verified and documented, that the share of proceeds for adaptation and administration is collected and distributed appropriately, and that the governing entities are accountable for their actions to the COP/MOP.

With regard to the efficiency of operation, the governance structure will need to be designed to support a CDM institution whose size remains difficult to predict. The demand for CERs will be driven by the total emission reductions needed by Annex I Parties to meet their commitments; by the relative costs of emission reductions under the CDM compared to those from domestic measures, Annex I joint implementation under Article 6, and international emissions trading under Article 17; and by any supplementarity restrictions agreed to by the Parties. The total demand for emission reductions by Annex I Parties during the first commitment period could range from 600 to 1,350 million metric tons of carbon (Mt C) per year, with IEA estimating 1,036 Mt C per year in 2010 (Figueres, 1998). If the CDM were to account for one third of Annex I emission reductions, then the volume of CERs could range from 200 to 450 Mt C per year. Erik Haites of Margaree Consultants Inc. has estimated that a CER volume of 330 Mt

C/year (1.2 billion tons of CO_2-equivalent per year ±75%) with an average project size of 0.027 to 0.081 Mt C per year (100 to 300 kt CO_2-equivalent per year) would require 4,000 to 12,000 active projects. With an average project lifetime of 16.5 years, 200 to 800 new projects would need to be approved per year (Haites, 2000). Designing a CDM governance structure that can efficiently handle this volume of project transactions and ensure the environmental integrity of CERs poses no small challenge.

Once each CDM project has been designed by the project participants, it will have to pass through a project cycle that is divided into seven stages in the Chairmen's text. These stages, and their principal components, are as follows:

Financing
- Securing financing through unilateral, bilateral, and/or multilateral mechanisms
- Demonstration that financing from public sources is additional to Global Environment Facility funding, official development assistance, and/or financing from other systems of cooperation

Validation
- Setting and revision of baselines
- Preparation of a project design document by the project participants
- Approval of the project design document by the host Party and other participating Parties[1]
- Validation of the project design document by designated OEs

Registration
- Acceptance of the project by the EB

Monitoring
- Implementation of a registered monitoring plan by the project participants
- Submission of monitoring reports by the project participants to a designated OE

Verification
- OE review of project monitoring reports and submission of a verification report
- Publication of the verification report by the EB

Certification
- Preparation of a written assurance by a designated OE that the project has achieved the emission reductions being claimed by the project participants

Issuance of CERs
- Submission by project participants of a request to the EB for issuance of CERs based on certification by the designated OE

[1] Project approval by the participating Parties could occur before validation by the OE (paragraph 57(a)), and/or after validation but prior to registration (paragraph 62). (Please note that all paragraph references refer to Part Two of the Chairmen's text.)

- Issuance of CERs, including the assignment of a unique serial number to each CER and the transfer of CERs to Party registries
- Collection of the share of proceeds for adaptation and administration

Each of these stages will require an underlying policy framework and associated criteria or standards against which both the implementation and the governance of project activities will be evaluated. As is discussed later in the paper, the Parties are not in full agreement on the breakdown of the project cycle in the Chairmen's text. In particular, some Parties have suggested that the separate stages of validation and registration and the separate stages of verification and certification should each be considered a single stage.

Many Parties have expressed concern about the complexity of this project cycle, and the implications for the efficiency and cost of producing CERs. There is an important trade-off between in-depth project review by multiple levels (e.g., host and investor Parties, OEs, and the EB) and rapid implementation of new CDM projects. The experience gained by the Global Environment Facility (GEF) and by the Parties involved in the Activities Implemented Jointly (AIJ) pilot phase of joint implementation under the UNFCCC substantiates this concern. Under the GEF's climate programs, which focus on supporting renewable energy projects in developing countries, the GEF approved only 41 projects between 1991 and 1999. Preparing a GEF project from initiation through final approval has typically taken up to two years, and implementation of the projects has required several additional years (Martinot 2000). Under the AIJ pilot phase, which began in 1995, Parties had submitted reports on only 140 projects as of June 2000. These projects have been approved by the participating Parties, but have not undergone further review and approval by the UNFCCC Secretariat or other international oversight body (UNFCCC 2000a). Many have not proceeded beyond the design phase due to a lack of interest on the part of investors in the absence of crediting, and therefore have not yet undergone verification by the participating Parties.[2] Based on this experience and given the volume of potential demand for CDM projects, the Parties are looking for ways to streamline the CDM project cycle without reducing the environmental integrity of the CERs.

The Parties must decide which governance functions to centralize at the level of the EB, and which to delegate to designated OEs. Centralization of governance functions at the level of the EB would promote consistency in decision making. However, given the anticipated volume of CDM projects, centralization of the principal decision-making authority at the EB level could create an administrative bottleneck at the stages of project validation/registration and verification/certification/issuance. Allocating the principal authority for these stages to designated OEs would enable the governing system to expand to meet increased demand and expedite project approval, but would reduce consistency in decision making. If the EB were not required to review every project prior to registration and issuance of CERs, it would be very important to implement mechanisms for overseeing the performance of OEs and guarding against conflict of interest. Some Parties suggest that this oversight could be achieved through OE accreditation and auditing procedures conducted by independent entities.

[2] For example, see: U.S. Environmental Protection Agency. 1998. *Activities Implemented Jointly: Third Report to the Secretariat of the United Nations Framework Convention on Climate Change*. Washington, DC: USEPA, 730 pp.

The Parties also question what level of authority should be delegated to the EB for setting the standards for project approval. These standards would need to address project eligibility, additionality, baseline methods, the assurance of consistency with the host Party's sustainable development goals, monitoring, verification of project results, and issuance of CERs. Such standards are likely to include both policy and technical elements. Given the size and infrequent meetings of the COP/MOP, the extent of its other responsibilities, the complexity of the issues, and the level of technical expertise that would be required, the allocation of standard setting to the COP/MOP would slow the implementation of the CDM considerably. However, Parties have expressed concern that the EB should not have the authority to set new policies without oversight by the COP/MOP. Therefore, many Parties would like the COP/MOP to retain the final authority to approve the standards developed by the EB, and to contest EB decisions.

The following section presents further discussion of the allocation of governance responsibilities among the COP/MOP, the EB, designated OEs, and an accreditation body. Each subsection concludes with an italicized summary of our recommendations for the terms of reference for each of these bodies.

III. Terms of Reference for the Governing Entities of the CDM

A. COP/MOP

With regard to governing the CDM, many Parties suggest that the primary functions of the COP/MOP should be the overall design of the CDM and the development of CDM policy. The CDM design functions would include the determination of the composition and rules of procedure of the EB and the qualifications for designated OEs as well as the allocation of governance responsibilities among the Executive Board, OEs, and the accreditation body. The development of CDM policy by the COP/MOP would include the creation of rules, modalities, and guidelines that could be used by each of the governing bodies to carry out their assigned tasks.

The COP/MOP should make the overarching policy decisions regarding which project types are eligible under the CDM;[3] how Parties should determine project compatibility with the host Parties' sustainable development goals; how the "share of proceeds" for adaptation and administration should be defined, collected, and redistributed; and how any supplementarity restrictions on the volume of CDM transactions should be defined and implemented. The COP/MOP should develop mechanisms or issue recommendations for promoting the equitable distribution of projects. When undertaking these decisions, the COP/MOP could request recommendations by the EB. The rules, modalities, and guidelines developed by the COP/MOP should be sufficiently substantive to enable the EB to develop technical standards for project

[3] The Chairmen's text (paragraph 8(b)) includes a provision that would enable the EB to "revise and amend the areas in which CDM project activities can be undertaken and the types of project activities that can be included [and submit recommendations for adoption to the COP/MOP]." Because of the highly political nature of decisions on project eligibility, we recommend that decisions relating to project eligibility would more appropriately be made by the COP/MOP, although recommendations could be sought from the EB.

validation and verification and more detailed guidelines for OE accreditation. The COP/MOP should oversee EB activities, and serve as the final level at which Parties can contest EB decisions.

Therefore, under this framework, the COP/MOP would make the key decisions with important political implications that require the consideration and approval of the Parties. The more technical elements such as the actual setting of standards for project validation/registration and verification/certification/issuance would be delegated downward to the EB but guided by COP/MOP rules, modalities, and guidelines.

Conclusion

The recommended terms of reference for the COP/MOP are summarized as follows:

- *Provide rules, modalities, and guidelines on:*
  - *Terms of reference for the EB and OEs*
  - *Structure and composition of the EB*
  - *Rules of procedure for EB meetings*
  - *OE accreditation standards*
  - *Project eligibility criteria*
  - *Criteria for additionality and baselines, monitoring, verification, certification, accreditation and reporting*
  - *The "part of" budget (supplementarity)*
  - *The "share of proceeds" for adaptation and administration*
  - *Resolution of equitable project distribution issues.*
- *Delegate decision making on technical standards and detailed OE accreditation criteria to the EB. The EB standards should be consistent with the rules, modalities, and guidelines developed by the COP/MOP, and should be subject to the approval of the COP/MOP.*
- *Oversee the operation of the EB, including the review of an annual EB report.*
- *Create and administer an appeals process for EB decisions.*

B. Executive Board

The primary roles of the EB should be to provide recommendations on the policy-making process to the COP/MOP, develop and maintain a CDM reference manual containing technical standards and protocols for project validation and verification and OE accreditation, oversee the accreditation and operation of OEs, respond to appeals of OE decisions, and administer the CDM project registry and the collection and distribution of the share of proceeds for adaptation and administration. The EB should also undertake activities to facilitate project financing and capacity building in non-Annex I countries as well as identify and implement measures for promoting equitable distribution of CDM projects. The discussion below first examines the structure of the EB, and then looks at greater detail into the allocation of responsibilities to the EB.

The Structure of the Executive Board

The diversity of EB responsibilities and the volume of CDM transactions raise important questions about how to design the EB. While major policy decisions are ultimately the purview of the COP/MOP, the EB will still be involved in issuing and responding to policy recommendations. For this reason, the proposals for the composition of the EB presented in the Chairmen's text largely focus on Party representation in the EB in the political terms of Annex I versus non-Annex I Parties and/or geographic allocation. However, the Chairmen's text also contains the provisions that EB members "should possess appropriate technical expertise and shall act in their personal capacity," and that the EB can draw upon outside experts, as appropriate.

The composition of the EB from a political standpoint is beyond the scope of this paper. However, for the purpose of defining the terms of reference for the EB, it is useful to give further thought to how the EB could be structured internally in order to allow for fulfillment of its responsibilities. Because a smaller EB is likely to operate more expeditiously than a large group, some Parties have proposed that the EB should be on the order of 9-16 members. If these members assemble only periodically (i.e., three or four times per year), they will not have the capacity to issue policy recommendations to the COP/MOP; develop technical standards for baseline methods, additionality assessment, monitoring, and verification; develop OE accreditation standards; accredit and otherwise oversee OEs; respond to appeals of OE decisions; register projects; issue CERs; maintain a registry; manage the share of proceeds for adaptation and administration; and serve as a clearinghouse for facilitating project development and financing. This is particularly true if we assume the operation of thousands of projects at any given time, with a potential influx of 200 to 800 new projects per year. The EB clearly will need to have permanent staff that can handle the routine administrative functions such as maintaining databases of OEs and projects, compiling the CDM handbook, managing the share of proceeds and serializing CERs. To avoid the propagation of bureaucracy, the EB staff could be drawn from the UNFCCC Secretariat.

The EB will also need the capacity to assemble groups of technical experts that could potentially be delegated a broad range of tasks. One way to facilitate this process would be to authorize the EB to create panels on an as-needed basis. For example, separate EB panels could be appointed to develop recommended baseline methods, create protocols for monitoring and verification, develop standards for accrediting OEs, conduct actual OE accreditation, and manage an appeals process.

The concept of convening expert panels to conduct in-depth technical analysis and develop recommended standards for the EB is derived from the Montreal Protocol's Technology and Economic Assessment Panel (TEAP) and its subsidiary bodies. The TEAP and other panels were created explicitly under Article 6 of the Montreal Protocol to provide the Parties to the Protocol with the updated scientific, environmental, technical, and economic information they needed in order to periodically assess the control measures for ozone-depleting substances. The TEAP is assisted in its decision-making by Technical Options Committees (TOCs) and Temporary Subsidiary Bodies (TSBs). The TSBs can be appointed to report on specific issues of limited duration, and dissolved when no longer needed. The members of these bodies are

appointed to ensure expertise and broad geographic distribution. The members must function on a personal basis as experts, and must disclose any activities that could be perceived as constituting grounds for conflict of interest. The reports issued by these bodies are open for public comment (UNEP, Ozone Secretariat, 2000).

The current Chairmen's text does not include an explicit option for the use of EB panels. While it is recommended that this authority should be listed explicitly in the negotiated text, it is not necessary for the nature and role of these panels to be defined at COP6. Instead, the use of panels by the EB should have the flexibility to evolve over time.

The Role of the Executive Board in Project Approval

As discussed above, many Parties recommend that the EB be tasked broadly with the standard-development, OE accreditation/oversight, and administrative processes as well as ultimate project approval in the form of registration and issuance of CERs. To ease the burden on the central EB, the first three sets of processes could be delegated to permanent EB panels and EB staff while leaving all of these processes subject to the final approval of the EB. However, it still would not be possible for an EB of 16 people to conduct substantive reviews of the estimated 200 to 800 new projects per year as part of project registration, or of the potentially thousands of projects requiring issuance of CERs on a periodic basis. For this reason, many Parties suggest that the primary responsibility for project review and approval at the stages of validation/registration and verification/certification/issuance will need to be delegated to designated OEs. Some Parties have suggested that a public appeals process should be introduced between project validation and registration and between verification/certification and issuance of CERs in order to enable Parties and other entities as well as the EB to question the judgment of the OEs and initiate an in-depth review by the EB of those projects. An EB Special Review Panel could be used for appeals.

Our recommendation is that project registration and issuance of CERs should still be conducted by the EB, but should be administrative "rubber stamp" processes requiring no in-depth review by the EB if the project has been approved (either validated or verified/certified) by a designated OE and objections have not been raised during public comment periods. Under this system, the accreditation and oversight of OEs to provide for uniform decision making and guard against conflict of interest will be critical for maintaining the environmental integrity of the CDM. The oversight of OEs is discussed further below in the section on the "accreditation body."

The Role of the Executive Board in Approving Baseline Methods

Emission baselines reflecting the anticipated course of activities under business as usual will be the primary tool used by the Parties to determine the environmental additionality of CDM projects. The development and approval of new baseline methods and multi-project baselines will involve both technical and policy decisions with critical implications for ensuring the environmental integrity of the CDM. For this reason, several Parties have proposed that even if OEs are tasked with the primary responsibility for project approval, the Executive Board should retain the authority to approve new (i.e., "first of their kind") baseline methods and multi-project baselines. This process could potentially be delegated to an EB baseline panel.

The EB approval of new baseline methods and multi-project baselines could be conducted using both top-down and bottom-up processes as follows:

- Under the top-down process, a subgroup of the EB baseline panel would prepare recommended baseline methods or multi-project baselines for priority project categories or sectors. These methods would be subject to the final approval of the main EB baseline panel and the EB.

- Under the bottom-up process, project participants could develop new baseline methods or multi-project baselines that would be documented in their project design documents and submitted to a designated OE for validation. If the OE recommended approval of the baseline methods or multi-project baselines, then they would be submitted to the EB baseline panel for review and approval prior to project registration.

Therefore, baseline methods developed by both the top-down and bottom-up processes would be submitted first to an EB baseline panel and then to the EB for approval. Some Parties have also suggested that public comments should be solicited prior to EB approval of new baseline methods and multi-project baselines (see paragraph 92(b)). As new baseline methods and multi-project baselines were approved by the EB, they would be compiled into a CDM reference manual for use as precedents by future project developers and by OEs. Even once the EB had approved baseline methods for use as precedents by future projects, the EB should retain the authority to revise the recommended baseline methods over time.

If during project validation, an OE determined that a project was using an appropriate baseline method for which a precedent had been set by the EB, then the EB would not be required to review the baseline for those projects. However, OE decisions on project validation would be open for public review before they became final. If the OE determined that a project involved a new baseline methodology or a multi-project baseline, then the OE would prepare a recommendation for the acceptance or rejection of that baseline methodology or multi-project baseline, and it would be submitted to the EB for review as part of project registration.

Some Parties have proposed that similar procedures could be used for EB review of new monitoring methods as well as new methods for assessing permanence of benefits in the land-use, land-use change and forestry (LULUCF) sector. Because these project elements are also critical to ensuring the environmental integrity of the CDM and involve both policy and technical components, we recommend that the same governance processes be applied to new methods for baselines, monitoring, and permanence assessment.

Conclusion

The recommended terms of reference for the EB are summarized as follows:

- *Issue policy recommendations to the COP/MOP.*
- *Maintain a permanent supporting staff.*
- *Have the authority to create panels and draw upon outside experts as needed to fulfill the EB's responsibilities.*
- *Approve "first of their kind" baseline methods and multi-project baselines after OE validation and public comment period (bottom-up).*
- *Approve "first of their kind" monitoring and permanence methods after OE validation and public comment period (bottom-up).*
- *Develop recommended methods for baselines, monitoring, and permanence (top- down).*
- *Develop validation and verification protocols for use by OEs.*
- *Develop OE accreditation standards.*
- *Oversee the accreditation of OEs by the accreditation body (this is addressed in a separate section below).*
- *Develop and maintain the CDM reference manual.*
- *Register projects after OE validation and a public comment period.*
- *Issue CERs based on an OE verification report.*
- *Publish non-confidential project information.*
- *Manage the share of proceeds for adaptation and administration.*
- *Resolve appeals/disputes.*
- *Facilitate project financing and capacity building in non-Annex I countries.*
- *Propose measures for promoting equitable distribution of CDM projects.*
- *Be accountable to the COP/MOP, including issuing an annual report to the COP/MOP.*

C. Operational Entities

The Role of Operational Entities in Project Approval

In the Chairmen's text, the primary role of designated OEs is to conduct project validation (project evaluation and the preparation of a recommendation for project registration by the EB), verification (the evaluation of project implementation), and certification (the preparation of a recommendation for issuance of CERs by the EB). Both validation and verification would require in-depth review of the project elements, including the sources of financing, the project crediting period, the baseline, the monitoring plan, measures for addressing leakage and permanence, and the contribution to sustainable development. The OE decisions would be guided by standards, methods, and decision-making protocols developed and/or approved by the EB.

As discussed above, OE validation is one of four layers of review required for initial project approval under the Chairmen's text. The other three layers of review consist of project approval by the host Party, project approval by the investor Party, and registration by the EB. Imposing

four layers of independent review on the project approval process would raise transaction costs and slow the process of project implementation. As discussed above under the terms of reference for the Executive Board, some Parties have suggested that the stages of validation and registration should essentially be based on one in-depth project review by an OE that is informed by public comment and subject to possible appeals by the EB. To further streamline the process of project approval, we suggest that the OE validation report could also serve as the basis for approval by the host and investor Parties. In this way, the host and investor Parties would benefit from the in-depth review undertaken by OEs when making their decision to approve projects. Once the EB received the validation report from the OE as well as letters of approval from the host and investor Parties, the EB could then proceed to register the project.

Although the Chairmen's text identifies verification and certification as separate stages,[4] it appears that very similar tasks are allocated to OEs in both sections. The verification activity consists of OE review of monitored emission reductions, the determination of project conformity with the registered project design document, and the issuance of a verification report that is then published by the EB. The certification activity consists of the submission by an OE of a written assurance that the project has achieved the verified emission reductions. These sound like very similar reports, unless separate OEs are to be tasked with verification and certification. It would be possible to eliminate this redundancy by merging the sections on verification and certification into a single section. Under this option, issuance of CERs by the EB could be contingent upon receipt of an OE verification report recommending issuance.

The Identity and Oversight of Operational Entities

Because the interests of project developers, the host Parties, and the investor Parties are likely to be aligned with regard to facilitating project approval and awarding the maximum possible number of CERs to projects, OEs must be able to function as independent third parties that conduct objective project evaluations and guard against the approval of non-additional projects. The Chairmen's text does not address what types of entities the OEs could be or how many there could be. Some Parties have suggested that OEs will be private-sector entities, whereas others envision OEs as being public entities or public/private hybrids. Some Parties assume that developing countries will have their own OEs that will be accredited to evaluate projects within their country, whereas others would prefer for OEs to be independent of the project's host country. Some Parties have identified the need for capacity building in developing countries to prepare domestic entities for designation as OEs. It also is not clear who will have the authority to select or assign OEs. Options include the project participants in the host country, the host country government, the project investors, and the EB.

As discussed above, in order to enable an expeditious flow of new projects, it will not be possible for the EB to review every validation and verification decision issued by designated OEs. An oversight mechanism will need to be developed to ensure that OEs are qualified to conduct project reviews, avoid conflicts of interest, and perform their functions with competence. Various Parties have proposed the following mechanisms for ensuring good performance by OEs:

[4] The potential to merge the functions of verification and certification is acknowledged in italicized language in Section K of the Chairmen's text.

- *Developing stringent accreditation standards for OEs, and requiring periodic re-accreditation of OEs.* Appendix A to the annex to the decision on the CDM provides a preliminary list of standards and procedures for the accreditation of OEs. These relate to the demonstration of expertise, operational requirements (e.g., financial stability, adequate management procedures, measures for protection of confidential business information), and avoidance of conflict of interest. The text provides for periodic OE review by the accreditation body and spot-checking at any stage. The issue of which entity should serve as the accreditation body is addressed in the next section.

- *Designating a different OE to conduct validation and verification for each project.* This measure is included in the Chairmen's text (paragraph 31(f)). The benefit of this approach is that each project would pass through two levels of review by independent OEs before CERs were issued. The OE conducting verification would have to review the validation decision, and presumably would have the opportunity to object to the decision. The drawback of this approach is that the project participants would need to select two OEs to evaluate their projects, and both would need to invest time in reviewing all of the project documentation. This would increase the transaction costs considerably. It would be much more cost effective for the OE that has already analyzed the project for the purpose of validation to be the OE that verifies the project. This issue requires further consideration.

- *Random and/or periodic auditing of OEs.* Either random or periodic auditing could be conducted to ensure that OEs were operating within designated parameters and to "spot check" validation and verification/certification decisions. This potentially could be conducted through a peer-review process among OEs or by professional auditors that were independent of the EB or OEs.

- *Public comment on OE decisions.* The Chairmen's text provides for public comment on OE decisions prior to validation by OEs and both registration and certification by the EB.
  - According to paragraph 58, an OE shall provide for public comment on project elements relating to environmental additionality (i.e., baselines). It appears that this public comment period would happen once the OE was ready to validate the project, although this is not definitively established in the text.
  - A public comment period must also precede project registration by the EB following validation by the OE (paragraphs 91-92 and 93-94). It appears that objections would be restricted to provisions relating to the demonstration of environmental additionality (i.e., baselines and monitoring plans). However, it is not clear whether objections could be raised by Parties involved in the project activity, Parties on the EB, accredited observers to the UNFCCC, and/or legal entities.
  - The Chairmen's text provides for the EB to publish the OE verification report prior to project certification (paragraph 104(g)). The text does not place the publication of the verification report in the context of public review of the OE's verification decision. However, paragraph 112 suggests that Parties involved in the activity, accredited observers, and/or private/public entities could raise objections to the issuance of CERs by the EB.

- *Holding OEs financially liable for their decisions.* This is indirectly suggested in the Chairmen's text in Appendix A to the annex to the decision on the CDM. Para 120 states that OEs must "have sufficient arrangements to cover legal and financial liabilities arising from its activities." Stronger language could be inserted to create provisions for financial liability. For example, if auditing revealed that an OE had verified a project that did not meet the EB standards, then the OE could be required to compensate the project investors for the discrepancy between the CERs verified by the OE and the actual CERs approved by the EB. OEs could also be subject to additional financial penalties such as fines.

The number of opportunities in the Chairmen's text for public comment on OE decisions as well as potential appeals of OE decisions raises important questions regarding who should be able to submit comments and initiate appeals, and how the governance system should respond to comments and appeals. As mentioned above, "public comments" potentially could be submitted by Parties involved in the project activity, Parties on the EB, accredited observers to the UNFCCC, and/or legal entities. Given the potential volume of projects and the political nature of the issues involved, the public comment process may have to be able to accommodate a large number of submissions. This raises the question of how OEs should be instructed to respond to public comments, and to demonstrate that they gave full consideration to the comments before choosing to accept or reject them. Parties (or other entities) whose comments were not addressed to their satisfaction by an OE might resort to an appeals process under which the EB would evaluate OE responses to public comments. In order to manage the appeals process, the EB could appoint a Special Review Panel, as is suggested in the previous section.

Limiting the origination of comments and appeals to the Party level and limiting the scope of comments and appeals to issues of environmental additionality (i.e., baselines and monitoring) would help to reduce the volume of these transactions. However, the use of the general public as a watchdog to oversee OE activities appeals to some Parties as well as to observers and other legal entities that may not have the political influence to initiate comments and appeals at the Party level. Furthermore, some Parties and other entities would not want to relinquish the option to question OE judgments regarding the sustainable development and other impacts of projects that extend beyond baselines and monitoring. Further consideration is needed here.

Conclusion

The recommended terms of reference for OEs are summarized as follows:

- *Apply EB standards, decisions, precedents and decision-making protocols to:*
  - *Conduct baseline approval for project-specific baselines where baseline precedents have already been established by the EB*
  - *Issue recommendations to the EB for approval of new baseline methods and multi-project baselines*
  - *Validate projects (after a public comment period)*
  - *Verify projects and issue a recommendation to the EB to issue CERs*
  - *Respond to public inquiries.*
- *Be subject to accreditation and periodic re-accreditation by an accreditation body.*

- *Be subject to periodic and/or random auditing; this would be separate from the accreditation process, and would help to inform the accreditation process.*
- *Be accountable to the COP/MOP through the EB.*
- *Be held financially liable for their decisions.*

D. Accreditation Body

Section C of the Chairmen's text indicates that an "accreditation body" shall be tasked with accrediting OEs in accordance with standards and decisions by the EB and/or the COP/MOP. The text contradicts itself regarding the identity of this accreditation body. According to paragraph 20, "The executive board shall be the accreditation body for operational entities." However, paragraph 31 contains sequential statements that OEs shall be accredited through the accreditation body but supervised by the EB, implying that these are indeed separate entities.

These contradictions indicate that further thought needs to be applied to the OE accreditation process. Should accreditation be conducted by the EB itself, by a subsidiary body to the EB such as an accreditation panel, by an international accreditation authority that answers to the EB, or by multiple entities that are approved by the EB to conduct accreditation activities?

Many developed and developing countries have existing national accreditation bodies – some established in accordance with national legislation – that have experience in overseeing accreditation of service providers in a wide range of technical, commercial, scientific and managerial disciplines. Some developing countries want their domestic entities to be eligible to accredit OEs as a means of building domestic capacity and creating new business opportunities tied to the implementation of the CDM. Furthermore, the use of domestic accreditation bodies to accredit OEs could potentially reduce the transaction costs involved, and could avoid the bottlenecks created by having a centralized accreditation body responsible for accrediting all OEs. For these reasons, several developing countries have argued that their national accreditation bodies should be given the authority to review and accredit OEs located within their borders using accreditation standards approved by the EB. Others have suggested that existing national accreditation bodies could serve as regional accreditation bodies on a rotating basis. However, the use of multiple accreditation bodies could potentially create the need for the EB to "accredit the accreditors." Furthermore, the use of national accreditation bodies to conduct the accreditation of OEs in the same country raises the potential for conflict of interest.

In the interest of maximizing the credibility of the accreditation processes, some policy makers have argued for the establishment of an international accreditation authority, as opposed to using already established national or regional accreditation bodies. This authority could either be a panel of the EB, or held accountable to the EB. The use of a single authority for conducting OE accreditation would help to ensure uniformity in decision making, and make it easier for the accreditation process to be overseen by the EB and/or the COP/MOP. Particularly at the beginning of the CDM, market demand for OEs may start off slowly and grow over time. Therefore, a single accreditation authority may be sufficient to manage the volume of accreditation requests at least during the early stages of the CDM. As more experience was gained with accreditation and re-accreditation activities over time and precedents were

established, then accreditation responsibilities potentially could be delegated to a broader number of entities. Alternatively, a single authority could be used for accreditation and re-accreditation, but a broad range of entities could be tasked with more frequent auditing of OE activities. These entities would then report to the accreditation authority.

A hybrid system involving both a central accreditation authority and national accreditation bodies could be designed in three ways.

- An international accreditation body under the EB could be tasked with accrediting OEs and reaccrediting them on a periodic basis, such as every five years. National or regional bodies could be tasked with more frequent auditing of OE activities, such as on an annual basis, and would report their findings to the international accreditation body.

- Under a second option, the roles would be reversed. National or regional accreditation bodies would be tasked with accrediting and re-accrediting OEs using standards approved by the EB. An international accreditation body under the EB would be tasked with overseeing the performance of the national or regional accreditation entities and periodically auditing OEs.

- Under the third option, a central accreditation panel established under the EB could be staffed by national accreditation bodies that served limited terms and rotated over time. To avoid the appearance of conflict of interest, the national bodies could be required to accredit OEs in countries other than their own.

In all of the hybrid cases, the central accreditation body under the EB would have to "accredit the accreditors," and could offer an appeals process for responding to Party (or other) complaints regarding the qualifications and performance of the national/regional accreditation bodies and OEs. Both the OEs and the national/regional accreditation bodies would therefore have to answer to the accreditation body under the EB.

The benefit of the second option is that the central accreditation body would be responsible for accrediting and overseeing only the national/regional accreditation entities, not all OEs. This decentralization of the process would avoid the creation of bottlenecks in the OE accreditation process. Complaints concerning the performance of OEs and national/regional accreditation bodies would be handled by a central authority, which would help to ensure consistency in judgment.

Further consideration needs to be given to this issue. However, if the negotiated text were to delegate accreditation authority broadly to the EB, then a later decision (perhaps by the COP/MOP based on EB recommendations) could be made to determine how the EB would delegate this role to a panel or subsidiary body, and whether there may be a supporting role for national/regional accreditation bodies.

Conclusion

The recommended terms of reference for the accreditation body are summarized as follows:

- *Be a subsidiary body (or panel) to the EB.*
- *Accredit OEs to conduct validation and/or verification activities, where such accreditation constitutes designation of OEs by the COP/MOP in accordance with Article 12.5.*
- *Conduct periodic re-accreditation and auditing of OEs.*
- *Report accreditation outcomes to the EB.*
- *Draw upon external accreditation bodies as needed to fulfill its responsibilities.*

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