CLEAN DEVELOPMENT MECHANISM

**CDM-EB93-AA-A01**

# Concept note

# Share of proceeds to cover administrative expenses

Version 01.0

United Nations
Framework Convention on
Climate Change

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# 1. Procedural background

1. At its ninety-second meeting, the Executive Board of the clean development mechanism (CDM) (hereinafter referred to as the Board) considered a concept note on the implementation of the rules relating to the share of proceeds (SOP) for administration due at issuance.[1] The Board took note of the information from the secretariat about the level of pending SOP[2] and a related recommendation from the United Nations Board of Auditors on disclosing pending SOP in the United Nations Framework Convention on Climate Change (UNFCCC) financial statements for 2015.[3]

2. More specifically, the Board took note of the regulatory provisions on SOP and the established practice of requiring payment of the SOP prior to the forwarding of certified emission reductions (CERs) rather than prior to the issuance of CERs. The Board also considered the various implications of amending the practice so that the SOP is collected prior to commencing the assessment of requests for issuance.

3. In view of the growing trend of accumulating pending SOP, as well as the impact of changes to the current practice on different stakeholders, the Board decided to consider a more comprehensive review of the SOP, including other options besides bringing forward SOP collection to be part of the request for issuance process.

4. This work relates to the activity “Finance” under the cross-cutting activities as referred to in table 6 in the appendix of the CDM two-year business plan 2016–2017 and management plan 2016 (CDM-MAP 2016) (EB 87 report, annex 1).

# 2. Purpose

5. This concept note builds on the note on the same topic presented to the Board at EB 92[4] and takes into account guidance received by the Board. It identifies and discusses several options for changes to the current practice that address a broader set of objectives, namely improving the collection of SOP and the prudent management of resources, while protecting the interests of CDM practitioners and other stakeholders. The secretariat then makes a recommendation on the options it considers to have the most positive implications for various stakeholders and to be appropriate in different market conditions.

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[1] SOP in this note should be understood to be SOP at issuance. The registration fee, which is a one-time advance payment to the SOP at registration, is not in the scope of this note. The registration fee is calculated on the basis of the estimated annual emission reductions or removals to be achieved by the CDM activity. The registration fee is deducted from the SOP for subsequent requests for issuance until it is fully absorbed.

[2] SOP that is due but not paid by project participants.

[3] For reference see Chapter II, recommendation (d), of the external audit report on the UNFCCC financial statements for 2015. The report can be found at the following link: <http://unfccc.int/resource/docs/2016/sbi/eng/inf12.pdf>.

[4] CDM-EB92-AA-A01 Share of proceeds to cover administrative expenses: <https://cdm.unfccc.int/filestorage/L/A/K/LAKQ6UIHS3JM1PZOF5R48TBCGYVXW7/eb92_propan01.pdf?t=bVB8b2tlN3VvfDB4dEm1NSrRs_tFFePNbZWY>.

# 3. Analysis of key issues

## 3.1. Background information

6. The key issues discussed by the Board at EB 92 are briefly reviewed in this section in order to establish the scope and context for the subsequent analysis.

### 3.1.1. Regulatory basis for the share of proceeds

7. The SOP to cover administrative expenses was established in paragraph 8, Article 12 of the Kyoto Protocol. Later, with its decision 3/CMP.1, paragraph 66 and appendix D, paragraph 6(b), the Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol (CMP) determined that the SOP for administrative expenses should be a proportion of the issued CERs. Subsequently, decision 7/CMP.1, paragraph 37, established monetary terms[5] for the SOP for administrative expenses rather than using a proportion of issued CERs.[6]

8. The approach taken to implement these provisions requires project participants (PPs) to pay the SOP upon issuance but prior to being granted access to their CERs (such that forwarding or voluntary cancellation may occur).[7] This practice ensures that the SOP is calculated and billed on the basis of the actual number of issued CERs (i.e. the issued CERs become known only upon approval of a request for issuance by the Board due to possible adjustments following the request for review process) and has been consistently applied since the beginning of CDM operations [8].

9. As mentioned above, at EB 92, the Board decided to comprehensively review the SOP practice, including the rates and timing of SOP collection. In this connection, it should be noted that the SOP rates were established through a CMP decision and thus may only be revised by a CMP decision and not by the Board. The timing of the collection of the administrative fee was specified in decision 7/CMP.1, paragraph 37, as being before issuance. However, the implementation was done as explained in paragraph 8 above for practical reasons and the long-standing practice was never overturned by the CMP. As such, the Board appears, through uninterrupted practice, to be able to determine the timing of collection. Notwithstanding this, any changes to the current practice should be reported to the CMP in the annual report of the Board.

### 3.1.2. Audit recommendation and accounting treatment

10. With respect to the United Nations Board of Auditors' recommendation relating to SOP, it should be noted that the recommendation relates to the disclosure of pending SOP in the UNFCCC financial statements and not to the established practice for its collection. The United Nations Board of Auditors expressed a concern that a significant aspect

[5] Decision 7/CMP.1, paragraph 37, established a two-tier structure for the SOP for administrative expenses with two rates for issued CERs: USD 0.10 and USD 0.20 per issued CERs. The higher rate is paid for CERs in excess of 15,000 tonnes of $CO_2$ equivalent in a given calendar year.

[6] The full text of the cited paragraphs is provided in appendix 1 of the present document.

[7] PPs are not allowed to submit a request for forwarding or voluntary cancellation of CERs without a security code, which they receive upon payment of their SOP.

[8] It should be noted that various exceptions to the payment of SOP have been implemented as a result of CMP decisions. A summary of these exceptions is included as appendix 3.

influencing the secretariat's financial results, such as the amount of pending SOP, was not reflected in the financial statements. Therefore, the external auditors recommended that the UNFCCC secretariat make a suitable disclosure in the notes[9] to the financial statements.

11. The United Nations Board of Auditors' recommendation is worth noting as one of the reasons for bringing the matter of pending SOP to the Board's attention. The recommendation does not imply a need to change the accounting treatment of pending SOP[10] or a need to change the policy and regulations related to SOP.

### 3.1.3. Amount and trends in the accumulation of pending shares of proceeds

12. Until 2012, the SOP collection rate (proportion of all SOP collected by the secretariat) was nearly 100 per cent. However, with the decline of the CDM market post-2012, the secretariat is maintaining an increasing record of pending SOP (amounts due, but not yet paid, by PPs). As at 31 December 2016, the pending SOP stood at USD 43.13 million.[11]

13. The concept note presented at EB 92 discussed the main trends in the accumulation of pending SOP, with their respective implications. To recapitulate, the following trends and implications are significant:

(a) Under current market conditions, pending SOP is expected to continue to accumulate. The absolute amount of pending SOP represents the revenue the secretariat may forego if PPs never request forwarding or cancellation of their CERs (and consequently never pay the required SOP);

(b) The trend in the cost recovery of assessment services provided by the secretariat can be seen in the proportion of requests for issuance for which SOP is due.[12] This trend is not increasing proportionally[13] to the absolute amount of pending SOP, suggesting that SOP is accumulating primarily through requests for issuance with a higher SOP value;

(c) The newly accumulated SOP would be exclusively for issuances for the second commitment period (CP2).[14]

14. Pending SOP will be recovered when/if PPs can find buyers willing to pay a price that covers the cost of SOP due.[15] Such a likelihood is difficult to estimate as it would require making assumptions on the future state of the CDM market.

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[9] A disclosure in the notes to the financial statement is a short explanatory text.

[10] The SOP is not treated as a receivable and is accounted on a cash basis, i.e. revenue is recorded when the cash proceeds are received.

[11] All analyses in this concept note are based on a cut-off date of 31 December 2016.

[12] The secretariat's effort for processing requests for issuance is relatively constant per request.

[13] The proportion of requests for issuance for which SOP is due is growing more slowly than growth in the proportion of pending SOP.

[14] Issuance for commitment period 1 is occurring at a rapidly decreasing rate (rate refers to the proportion of all issuances) and is typically carried out in conjunction with issuances for CP2, e.g. the issuance requests cover monitoring periods that straddle the commitment periods.

[15] Currently, there is no rule to enforce payment of SOP other than not allowing PPs access to (i.e. forwarding or cancellation of) the CERs until SOP is paid.

15. There are several measures that can be employed in order to minimize the accumulation of pending SOP, with different implications for relevant stakeholders (i.e. PPs, secretariat, designated operational entities (DOEs)). These measures are assessed below in the context of the background described above in order to determine which measures are most appropriate for further consideration.

## 3.2. Possible measures for affecting the trend in pending share of proceeds

16. As the Board noted during the discussion at EB 92, the trend in accumulating SOP could be impacted by three groups of measures:

    (a) Incentives or disincentives for SOP payments;

    (b) Changes in the rates of SOP;

    (c) Changes in the timing of SOP collection.

17. Each of these options is analyzed separately below. However, different measures could be combined; for example, changes in the timing of SOP collection could be combined with incentives for SOP payment.

### 3.2.1. Incentives or disincentives for share of proceeds payments

18. Incentives for SOP payments could include early payment discounts or the prioritization of scheduling assessments if early payment is made. Disincentives for not paying SOP could include making the subsequent issuance conditional upon the payment of SOP for the previous issuance. Other disincentives, such as publishing a list of bad debtors, would first require the introduction of rules according to which the non-payment of SOP constitutes wrongdoing (see footnote 16).

19. Offering early payment discounts, even if made proportionate to the issuance amount, could have a different impact on different projects (e.g. the incentive may be negligible for smaller projects). Determining the size and conditions in which discounts would apply would require an appropriate marketing study. It should also be noted that offering early discounts in effect alters the SOP rates as established by the CMP, and any such measures would therefore require CMP consideration.

20. Introducing disincentives without considering legitimate challenges PPs may be facing in meeting the SOP cost (e.g. loss of buyers, low market prices, lack of demand) could result in such PPs ceasing to participate in the CDM altogether.

21. Disincentives may be perceived as, and would likely be, too harsh in depressed market conditions that already pose significant financial challenges for many PPs in implementing their CDM activities. PPs may feel that the Board is toughening regulations and increasing CDM regulatory uncertainty without considering the market reality.

22. This brief analysis suggests that introducing incentives for SOP payment or disincentives for non-payment could lead to either challenges or undesirable consequences. In the absence of a marketing study, it is not possible to reasonably determine how to establish discounts nor it is possible to compare negative consequences to expected improvement in the SOP collection. To pursue this option further, the secretariat would need guidance from the Board.

23. The secretariat considers the option of prioritizing assessment scheduling for PPs who make early payment to be viable in the context of the option 2 below (see section 3.3.). The secretariat does not recommend pursuing disincentives in the context of the current market conditions.

### 3.2.2. Changes in the rates of share of proceeds

24. As already mentioned, the rates of SOP were established through a CMP decision, and any revision would require referring the matter back to CMP, which would involve substantiating the rationale for proposed changes in the rates.

25. In the context of this approach, it is relevant to recall that at EB 74, the Board discussed the potential impact of a reduction or waiver of the registration fee, which is part of the SOP for administration.[16] It was noted that such adjustments to the registration fees, in terms of reducing costs for CDM project developers, would be relatively minor, meaning the benefits for project developers would not be significant in relation to other costs. In contrast, the impact on CDM revenue would be more substantial. Therefore, the Board agreed to continue with the current arrangements.

26. Measures that would lower[17] the cost of SOP in the current market conditions would likely have a multitude of interrelated implications, including on (i) absolute revenue for CDM activities; (ii) revenue for other stakeholders such as consultants and market intermediaries,[18] both of which are essential for a well-functioning market that is highly-specialized and multi-national; as well as (iii) resources for the continued operation of the CDM.

27. The CERs market is currently very low and substantially oversupplied. Therefore, further depressing the prices may to bring about many benefits other than making it progressively easier for agents with emission reduction obligations or voluntary intent to meet their targets.[19]

28. Other implications or challenges associated with the potential lowering of SOP rates include:

    (a) Unsuitability for changing market conditions – if the market conditions and prices improve, the rationale for lowering the SOP rates would weaken. It is worth recalling that in the stronger pre-2012 market, SOP collection was nearly 100 per cent;

    (b) Determining the adequate level for SOP rates – the economic rationale for establishing the original rates is not well known. What can reasonably be assumed is that the rationale reflected various considerations, including reflecting the cost of services provided and ensuring the ongoing availability of resources for the continuous support and development of the CDM;

[16] CDM-EB74-AA-A11.

[17] There are no known arguments for increasing the SOP rates. Increasing the SOP rates in the context of the prevailing market conditions is not justifiable and is therefore not considered in this paper.

[18] With the decline of the Kyoto market, many intermediaries (brokers and, more importantly, traders) discontinued their operations, which left many CDM projects stranded to this day (either through non-terminating emission reduction purchase agreements or not handing over forwarding rights).

[19] The arguments in this paragraph are based on a general economic and commodity markets rationale.

(c) Creating differential treatment for CDM activities or issuances within CDM activities – considering the non-retroactivity principle for changing regulations, lowering the SOP rates would disadvantage PPs that have a pending SOP. While requests for issuance already in the pipeline could be allowed to benefit from the possible lowering of the rates, it would be very difficult to justify to PPs with pending SOP the different treatment of their issuances;

(d) Adding to regulatory uncertainty – lowering the SOP rates may well prompt the upward revision of the SOP rates if the market conditions improve. Lowering the SOP rates temporarily until certain conditions are met may be a possible alternative approach.

29. Similar to the previous chapter, a conclusion on the economic effects from lowering the SOP rates on different stakeholders would benefit from a marketing research, including suitable economic modeling. Taking a decision in the absence of an appropriate analysis is an available alternative. However, it would be difficult to determine the extent to which, if at all, the lowering of SOP rates would meet the objectives of improving the collection rate for SOP while protecting the interests of various stakeholders.

30. Overall, this analysis, as well as the relatively low proportion SOP taken up in the total costs that PPs incur in implementing their CDM activities,[20] do not suggest that there is a clear basis for lowering SOP rates at this stage.

### 3.2.3. Changes in the timing of share of proceeds collection

31. At EB 92, the Board considered the possible implications of bringing forward the SOP payment in the issuance assessment process and making it a condition for commencing assessment. This option mainly addresses administrative concerns, such as reducing the accumulation of pending SOP, the prudent management of resources, and the impact on the disclosure of pending SOP in the notes to the UNFCCC financial statements.

32. The Board requested the secretariat to analyze further options for addressing the growing trend in pending SOP, including splitting the amount due and allowing SOP to be paid, for example, in two instalments, one of which would be paid prior to commencing assessment in order to secure compensation for the secretariat's assessment services.

33. The Board stressed that it is necessary to keep the principle of the prudent management of resources in sight. However, the Board also recognized that the level of funding for secretariat operations is currently adequate, and therefore any proposed changes need to carefully take into account the implications for other stakeholders, particularly for the PPs, but also for DOEs, with a view to preserving the institutional arrangements for CDM.

34. Based on the analysis presented in this note, the secretariat considers that the most significant potential for benefits to most stakeholders lies within this group of measures. The next section elaborates on four options with a corresponding assessment of the implications of each option. These options are:

(a) **Option 1:** Full SOP payment prior to commencement of the issuance assessment (EB 92);

[20] Study by Ecofys published in 2013: <http://www.ecofys.com/files/files/kfw-ecofys-2013-cdm-market-support-study.pdf>; and concept note CDM-EB74-AA-A11.

(b) **Option 2:** SOP payment in instalments, with a proportion payable prior to commencement of the issuance assessment;

(c) **Option 3:** SOP payment in instalments for issuances that straddle the Kyoto commitment periods;

(d) **Option 4:** Status quo (payment only required prior to forwarding/voluntary cancellation).

35. The only possible combination of options, as seen in the analysis, is a combination of options 2 and 3, or 3 and 4.

## 3.3. Options for changes in the timing of share of proceeds collection

### 3.3.1. Full share of proceeds payment prior to commencement of assessment (option 1)

36. This option foresees bringing forward the SOP payment in the issuance assessment process and making it a condition for commencing an assessment. The option was extensively discussed in the concept note on the same topic presented at EB 92.

37. The option can be expected to mainly benefit the CDM Trust Fund by:

(a) Reducing the financial risk by ensuring that the secretariat and the Board provide assessment services only if the SOP is paid. If all conditions remain the same, the secretariat will be assessing 150 issuances fewer per year, saving approximately 10 staff months annually;

(b) Better aligning the processing of requests for issuance with requests for registration (the registration fee is payable prior to commencing the assessment of requests for registration)[21];

(c) Making the financial reporting on SOP more straightforward and transparent, and better aligning the practice with decision 7/CMP.1, paragraph 37, in that the issuance will be effected only after the SOP has been received.

38. Negative implications include:

(a) PPs may see it as disadvantageous for them, arguing that it is easier to market issued, or approved for issuance, CERs. From the high amount of CERs currently in the pending account of the CDM registry, it appears that PPs are often only willing to incur the verification costs in order to have the CERs issued, possibly hoping to attract buyers and/or better prices in the absence of "issuance risk";[22]

(b) Postponing some submissions of requests for issuance (until PPs are ready to incur the SOP costs) or completely deterring other submissions would reduce

[21] A registration fee payment is part of a submission of a request for registration. The processing of a request for registration cannot commence prior to receipt of the registration fee. The registration fee is an advance payment to the SOP and is calculated on the basis of the estimated annual emission reductions or removals to be achieved by the CDM activity. The registration fee is deducted from the SOP for subsequent requests for issuance until it is fully absorbed.

[22] The risk of part or all emission reductions or removals requested not being approved.

the supply of CERs. The secretariat may forego some[23] SOP that PPs would have paid if allowed the possibility to issue and market CERs before having to pay SOP;

(c) The above deterrents to requesting issuance may have a negative impact on DOE certification work, thus further lowering the economic rationale for DOEs to stay in business;

(d) There would be a negative financial impact for market practitioners, especially regarding liquidity: PPs would likely need a certain level of reserves to cover the time between requests for issuance and payment by the final buyers. This will negatively affect primarily the smaller CDM activities;

(e) The change will create different treatment for PPs with approved issuances but pending SOP payments and those who are yet to issue, disadvantaging PPs with future issuances. The impact on issuances in the pipeline could be alleviated through a grace period;

(f) The change will have no effect on already accumulated pending SOP;

(g) This is the most restrictive of the identified options in this section, and it is therefore likely to be perceived as adding to regulatory unpredictability;

(h) Administrative costs would be incurred by the secretariat and PPs for accounting for changes to SOP as a result of the request for review process.[24] Such costs would be material only for the secretariat but it would likely be negatively perceived by PPs in times of low CER prices.

39. In conclusion, this option is in line with the principle of prudent management of resources. However, toughening the requirements for SOP payment seems contrary to the notion of enabling continued participation in CDM despite current market conditions.

### 3.3.2. Share of proceeds payment in instalments, with a proportion payable prior to commencement of issuance assessment (option 2)

40. This option was proposed by the Board as an alternative to option 1 to alleviate some of the pressure on PPs. It involves splitting the amount of SOP due in order to allow payments at different points in time. The upfront part of the payment would be a condition for scheduling the assessment, while the remaining part of the SOP would be billed after the request for issuance is approved, as currently administered, and be paid by PPs when they need to access their CERs.

41. As a variant to this option, the balance of SOP due upon issuance (the balance after the upfront payment) could be subject to further partial payments in several instalments as a means of offering greater flexibility to PPs in meeting the cost of SOP. It could be envisioned that if PPs are allowed to pay SOP in several instalments, the payment of one instalment and the revenue received from the corresponding CERs may be used to fund

[23] A market study on the effects of this option is required to establish the possible amount of SOP forgone by the secretariat.

[24] Changes to requested CERs as a result of the review occurs in about 5 per cent of all issuance cases.

the payment of the next instalment and so on. This would be particularly valid for large issuances.[25]

42. This added flexibility is considered to hold significant potential for increasing the proportion of collected SOP. It is particularly so, because the option could potentially benefit both future issuances as well as past issuances for which SOP is pending. The secretariat has assessed the potential for collecting SOP for past issuances with pending SOP. This analysis is included in appendix 2 (see figures 1 and 2) and is supported by over 60 inquiries from PPs in the last two years asking about the possibility of partial SOP payment in order to access only the CERs for which they have buyers.

43. Having established the increased potential for collecting SOP for approved issuances, there are several other considerations that need to be made in determining the parameters of this options, namely:

(a) How much could/should the upfront payment be?

(b) In how many instalments could/should the SOP be paid?

(c) How would CERs be "released"[26] in accordance with the SOP payment schedule?

44. The secretariat considers an upfront payment for a fixed-amount[27] of USD 1,500 to be appropriate, with the balance of SOP due upon issuance reduced accordingly. This is based on an analysis of the median size of issuance requests and the corresponding amount of CERs that would be released in response to this fixed-amount payment. USD 1,500 would be equivalent to any amount of CERs between 7,500 and 15,000, depending on the applicable SOP rate(s) (USD 0.10 and/or USD 0.20 cents).

45. With respect to the maximum allowable number of SOP instalments per issuance, introducing a split of two instalments would offer little flexibility to PPs for the price of having to start making upfront payments. It may also hinder the potential for collecting SOP on past issuances, particularly in the case of medium and large issuances for which PPs could only sell smaller proportions of CERs at a time.

46. Without creating undue administrative complexity, allowing for up to four instalments is considered to be more appropriate. A greater number of instalments may not be necessary because, historically, for 80 per cent of issuances, the first forwarding involves between 75 and 100 per cent of the issued CERs[28] (see figure 3, appendix 2). This high proportion is most likely because PPs have always had to pay the total SOP due.

[25] Nine per cent of all issuances are for over 500,000 CERs. As at 31 December 2016, over 60 per cent of the SOP due relates to these large issuances.

[26] "Release" of CERs should be understood to be the act of allowing PPs to access the CERs and request forwarding or voluntary cancellation.

[27] It is worth nothing that the Board has already discussed and approved in principle a payment schedule for programmes of activities that involves a fixed amount of registration fees and variable SOP payments for subsequent issuances.

[28] The total issuance is adjusted with the 2 per cent levy for meeting the cost of adaptation, where applicable.

47. To limit the need for managing small payments, instalments (other than the initial instalment and the balance due) could be subject to a minimum amount (e.g. USD 2,000). This would also limit the maximum instalments for smaller issuances to a maximum of two instalments.[29] PPs should also be allowed to pay the full SOP upfront.[30] The details of how to manage the SOP billing depending on the choice made by the PP, including the handling of bank charges,[31] could be elaborated as part of the proposed procedural revision for SOP.

48. Finally, each payment of SOP, upfront or post-issuance, would be associated with the release of a corresponding amount of CERs. Determining the amount of CERs to be released is straightforward because of the fixed rate of SOP per CER (e.g. USD 0.10 or USD 0.20 cents). In the case of the upfront payment, the corresponding amount of CERs will be made available to PPs immediately upon issuance (by releasing them for forwarding/voluntary cancellation).

49. Following its adoption, this option would be applicable to CDM activities that have already issued CERs but have not yet paid the SOP. PPs would be required to pay the minimum of USD 1,500 for their first instalment in order to comply with the concept of an upfront SOP payment.[32] As such, the proposed rule of “partial payment for partial release of CERs” would be available to these PPs but the part of the rule of mandatory partial prepayment prior to issuance assessment would not be applicable to them, as the CERs would already have been issued.

50. A potential negative but not yet quantifiable implication of this option could be the risk of creating an incentive for PPs to prolong their monitoring periods in order to reduce their verification costs after having been allowed to benefit from partial SOP payments. This may have the effect of decreasing the workload for DOEs. However, the possibility exists that this trend could be partially mitigated if the flexibility offered to PPs by this option incentivizes CDM activities to issue CERs.

51. The implementation of this option would require the development of a tool for tracking SOP payments for CDM activities. The SOP tracking tool would be a prerequisite for enforcing the option as manual tracking would not be possible due to the high potential for errors and significant effort needed to manage records and rectify errors. The secretariat would also incur an estimated two staff-months of effort per year to administer this option at the current level of issuance.

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[29] For example, an upfront payment of USD 1,500 and a second payment of USD 2,000 for a first issuance in the calendar year would correspond to 25,000 CERs (15,000 tonnes at USD 0.10 cents and 10,000 tonnes at USD 0.20).

[30] Some PPs are interested in this option as a means of reducing the issuance processing timelines. The secretariat’s practice suggests that the full advance payment of SOP would be desirable by PPs for five per cent of the total CERs issued in a year.

[31] Multiple payment instalments per issuance will increase the total bank charges for the issuance. The secretariat would have to establish a clear policy for handling bank charges, e.g. if bank charges are applied upon receipt of payment, a corresponding adjustment to the CERs for release may be appropriate.

[32] If a registration fee balance is available for an issuance with pending SOP and this balance covers the minimum payment of USD 1,500, the registration fee balance can be applied. This and similar rules can be described in detail in the procedure proposed for development on changes to the SOP.

52. Finally, a grace period would have to be offered for issuances in the pipeline and those submitted within a stipulated period of time following adoption. The grace period could match the time period necessary for implementation of the information system changes.

53. In summary, this option holds the highest potential for positively affecting the collection of SOP without unnecessarily burdening PPs in the context of the prevailing market conditions. It also offers an opportunity for some PPs to access some of their CERs. Its implementation is administratively feasible but it requires a detailed procedure for the SOP payment process to be developed. Finally, the information system development costs are the highest this option.

### 3.3.3. Partial payment of share of proceeds for issuances that straddle the Kyoto commitment periods (option 3)

54. As mentioned in option 2, the secretariat has received over 60 inquiries from PPs in the last two years asking about the possibility of partial SOP payment. About half of those inquiries relate to issuances with monitoring periods that straddle the Kyoto commitment periods and, as a result, include both CP1 and CP2 CERs. At the end of 2016, there were 179 issuances with pending SOP that straddle the commitment periods (see appendix 2, table 2).

55. From these 179 issuances, 14.1 million are CP1 CERs and 17.1 million are CP2 CERs. The SOP for the CP1 CERs (which may no longer be forwarded outside the CDM registry[33]) appears to be holding back the payment of SOP for CP2 CERs from the same monitoring period, as PPs can only pay the total SOP in full. The figures suggest there is a need to find a solution for PPs who wish to access their CP2 CERs that are part of a monitoring period that straddles CP1 and CP2.

56. The simplest solution would be to allow PPs to pay only the part of the SOP associated with CP2 CERs.[34] It would also be possible to subsume this option into option 2; however, the PPs would lose some flexibility due to the requirement to pay the minimum of USD 1,500 as an initial payment. It would also be necessary to introduce an exception to allow PPs to choose which CERs they want to release first for such issuances. Subsuming this option into option 2 would reduce procedural complexity. This option could also be implemented in conjunction with retaining the status quo (option 4).

### 3.3.4. Status quo (option 4)

57. Retaining the status quo is a valid option and may become the preferable way forward if no other option is found to be more beneficial. There would be no immediate consequences for any of the stakeholders if the SOP practice continues as it is. With respect to cost recovery to the CDM Trust Fund, the proportion of requests for issuance for which SOP is not paid, at current levels of issuance, needs to increase substantially before a change in the SOP practice would be required to address any financial risks for the continuation of the secretariat's services.[35]

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[33] Transactions of, and the use of, CP1 CERs is no longer possible after the completion of the Kyoto accounting for CP1 in late 2016. The only possible use of CP1 CERs is through voluntary cancellation.

[34] Such calculation is feasible due to the fact that the SOP rate is per CER.

[35] As per the EB 92 concept note, over the period of the past three years, the assessment effort associated with requests for issuance for which SOP has not been paid is in the range of 10 staff months.

# 4. Impacts

58. The impacts on different stakeholders of the four options are detailed in table 1.

**Table 1. Impact analysis for the four options[36]**

| Option | Expected impact | | |
|---|---|---|---|
| | Project participants | Clean Development Mechanism Trust Fund | Other stakeholders |
| **<u>Option 1</u>**<br>**Full share of proceeds (SOP) payment prior to commencement of the issuance assessment** | - Deferring or deterring of some issuance requests due to added cost burden;<br>- Increased strain on liquidity;<br>- Less easy to market non-issued certified emission reductions (CERs);<br>- Negative impact on new submissions; | - No effect on the collection of SOP for CERs already issued;<br>- Reduction in staff effort (10 staff months per year at current levels of issuance);<br>- Better alignment with registration process;<br>- Simplified financial reporting; | - Possibly reduced workload for designated operational entities (DOEs); |
| **Option 1 overall impact** | - | + | - |
| **<u>Option 2</u>**<br>**SOP payment in instalments, with a proportion payable prior to commencement of issuance assessment** | - Increased flexibility, in particular for medium and large issuances;<br>- Applicable to CERs already issued;<br>- Ability to be combined with option 3 and serve as an incentive for the prioritization of assessment for early payment; | - Partial SOP payment is guaranteed;<br>- Increased proportion of collected SOP;<br>- SOP collection for CERs already issued (expected recovery of some SOP on 30 to 60 million CP2 CERs);<br>- Cost of implementation to be compensated by better SOP collection; | - Some projects may prolong their monitoring periods, hence possibility for reducing DOE workload (subject to uncertainty and possibility for compensation if the flexibility incentivizes non-issuing projects to issue); |
| **Option 2 overall impact** | + | ++ | - |
| **<u>Option 3</u>**<br>**Partial payment of SOP for issuances that straddle the Kyoto commitment periods** | - Reduced SOP cost or eased liquidity;<br>- Applies to project participants with already issued CERs;<br>- Ability to be combined with options 2 and 4; | - Potential for SOP collection for CP2 CERs already issued (17.1 million CERs);<br>- No impact on new submissions; | - Not foreseen; |
| **Option 3 overall impact** | + | + | 0 |
| **<u>Option 4</u>**<br>**Status quo** | - N/A (baseline scenario); | - Does not address the prudent management of resources; | - N/A (baseline scenario); |
| **Option 4 overall impact** | 0 | - | 0 |

36 The overall expected impact for each option is expressed as follows: “0” for no impact; “+” for positive impact; “++” for enhanced positive impact; “-” for negative impact.

59. There is no major risk from continuing the business-as-usual scenario. Option 4 would be more acceptable to PPs than option 1, particularly in combination with option 3. Option 3 addresses the known issues with issuances that straddle the Kyoto commitment periods, and it does not seem to present any drawbacks. However, option 2 offers the highest potential for balanced benefits between stakeholder groups. These benefits are expected to outweigh negative implications and costs associated with its implementation. The implementation of option 2 in combination with option 3 would enhance the positive impacts and is considered to be the superior choice.

60. It is difficult to quantify the expected improvement in SOP collection due to the multiple variables and factors associated with the timing and size of CER issuance. The secretariat expects that for the following two years, the implementation of option 2 in combination with option 3 would result in a 5 to 15 per cent increase in the SOP collection rate in comparison with the collection rate for the previous two years.

61. Finally, an implication from option 2 that is worth noting is with respect to approved issuances with pending SOP. In such cases, the partial payment part of the option would be available to PPs but the mandatory partial prepayment prior to the scheduling of issuance assessment would not be applicable to them, as the CERs would have been issued already.

## 5. Subsequent work and timelines

62. If the Board selects an option resulting in a change to the current procedure, the secretariat would develop a procedure for making changes to SOP payment for presentation to the Board at the next meeting. The secretariat also estimates that it will take six to nine months to implement the proposed procedural changes and develop its systems to cope with the tracking of SOP payments according to the amended schedule.

## 6. Budget and costs

63. If the Board selects an option resulting in a change to the current procedure, the cost of implementing the change would be one-time effort of two to four staff months for developing the procedure and modifying the secretariat's information system, and an ongoing administrative effort of two staff-months per year at the current submission rate. It is expected that this effort can be absorbed by CDM-MAP 2017.

64. In addition, the secretariat would require between USD 60,000 and USD 180,000 to develop an appropriate SOP tracking tool and implement related modifications to its information system. It is not possible to make a more precise estimation prior to determining the high-level requirements and related impact on the existing system.

## 7. Recommendations to the Board

65. The secretariat recommends that the Board approve the implementation of option 2 "SOP payment in instalments, with a proportion payable prior to commencement of issuance assessment" in combination with option 3 "Partial payment of SOP for issuances that straddle the commitment periods".

66. The secretariat recommends that the Board approve the procedure for making changes to SOP payment for consideration as soon as possible but not later than EB 95. The secretariat also recommends a call for public input on developing the revised procedure.

# Appendix 1. References

## 1. The following decision texts are provided for reference purposes

**Decision 3/CMP.1, paragraph 66:**

Upon being instructed by the Executive Board to issue CERs for a CDM project activity, the CDM registry administrator, working under the authority of the Executive Board, shall, promptly, issue the specified quantity of CERs into the pending account of the Executive Board in the CDM registry, in accordance with appendix D of this decision. Upon such issuance, the CDM registry administrator shall promptly:

(a) Forward the quantity of CERs corresponding to the share of proceeds to cover administrative expenses and to assist in meeting costs of adaptation, respectively, in accordance with Article 12, paragraph 8, to the appropriate accounts in the CDM registry for the management of the share of proceeds;

(b) Forward the remaining CERs to the registry accounts of Parties and project participants involved, in accordance with their request.

**Decision 7/CMP.1, paragraph 37:**

The Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol decides, with a view to accruing resources to cover administrative expenses for operational functions as of 2008, and with the understanding that the issuance of certified emissions reductions, in accordance with the distribution agreement, shall be effected only when the share of proceeds to cover administrative expenses has been received, that the share of proceeds to cover administrative expenses of the clean development mechanism as referred to in Article 12, paragraph 8, of the Kyoto Protocol shall be:

(a) USD 0.10 per certified emission reduction issued for the first 15,000 tonnes of $CO_2$ equivalent for which issuance is requested in a given calendar year;

(b) USD 0.20 per certified emission reduction issued for any amount in excess of 15,000 tonnes of $CO_2$ equivalent for which issuance is requested in a given calendar year.

# Appendix 2. Impact assessment – potential positive impact on collection of share of proceeds for already approved issuances in the context of option 2

1. The analysis of pending share of proceeds (SOP) and the potential for collecting some of it was conducted in accordance with the concept of dormancy.

2. CDM activities

3. [1] that have not been in contact with the secretariat for over three years are considered to be dormant. Therefore, pending SOP for such activities has a very low, if any, likelihood of being recovered. A shorter time period since the last contact with the secretariat and an active crediting period are conditions that increase the likelihood for SOP collection.

4. Figure 1 and figure 2 present the status of all CDM activities (projects and programmes of activities (PoAs) with respect to the concept of dormancy. The figures break down the activities into groups of those with an active crediting period and those with a non-active crediting period.

5. It is possible that activities that have been in contact with the secretariat less than three years ago have an expired crediting period. This reduces the likelihood that these activities will continue to operate under the clean development mechanism (CDM). A similar logic applies to CDM activities that have been registered for a long time without issuing.

6. The next level of breakdown relates to the existing issuances and availability, or lack thereof, of certified emission reductions (CERs) from these issuances in the CDM registry. Finally, the CERs in the CDM registry are presented according to status of SOP (paid/not paid). For the issuances with pending SOP, additional information on the size and length of pendency[2] is demarcated by dotted lines.

7. Considering the various factors impacting on the likelihood that SOP is to be paid (dormancy of the CDM activity, status of crediting period, existence of issuance, CERs commitment period, size of issuances and their pendency), the secretariat has assigned degrees of likelihood for SOP to be paid, represented through colour coding.[3] Red represents no likelihood for SOP payment, while green represents high likelihood, with the respective nuances portrayed as in-between in accordance with the colour legend.

8. Summing up the CERs in the bottom level of the chart for the degree of likelihood illustrates the potential CERs for which some, but not all, SOP could be expected to be paid if PPs are offered greater flexibility for managing their payments. Not all SOP could be collected, because the incentive from the proposed option 2 would not be sufficient to compensate for the lack of demand.

[1] CDM activities include projects and PoAs.

[2] Time since issuance was approved.

[3] The colour coding is assigned in a way that can be interpreted by a person with colour vision deficiency.

9. The secretariat estimates that according to different assumptions, there are between 30 and 60 million CP2 CERs from active CDM activities, with corresponding SOP due of between USD 5 and 10 million, which would not be realized unless the market conditions change. Without specifying how much, the secretariat considers that some of this SOP may be recovered if the Board offers flexibility in the payment of SOP as per option 2.

**Figure 1. Certified emission reductions in the CDM registry for which it is likely the share of proceeds could be paid (part 1)**

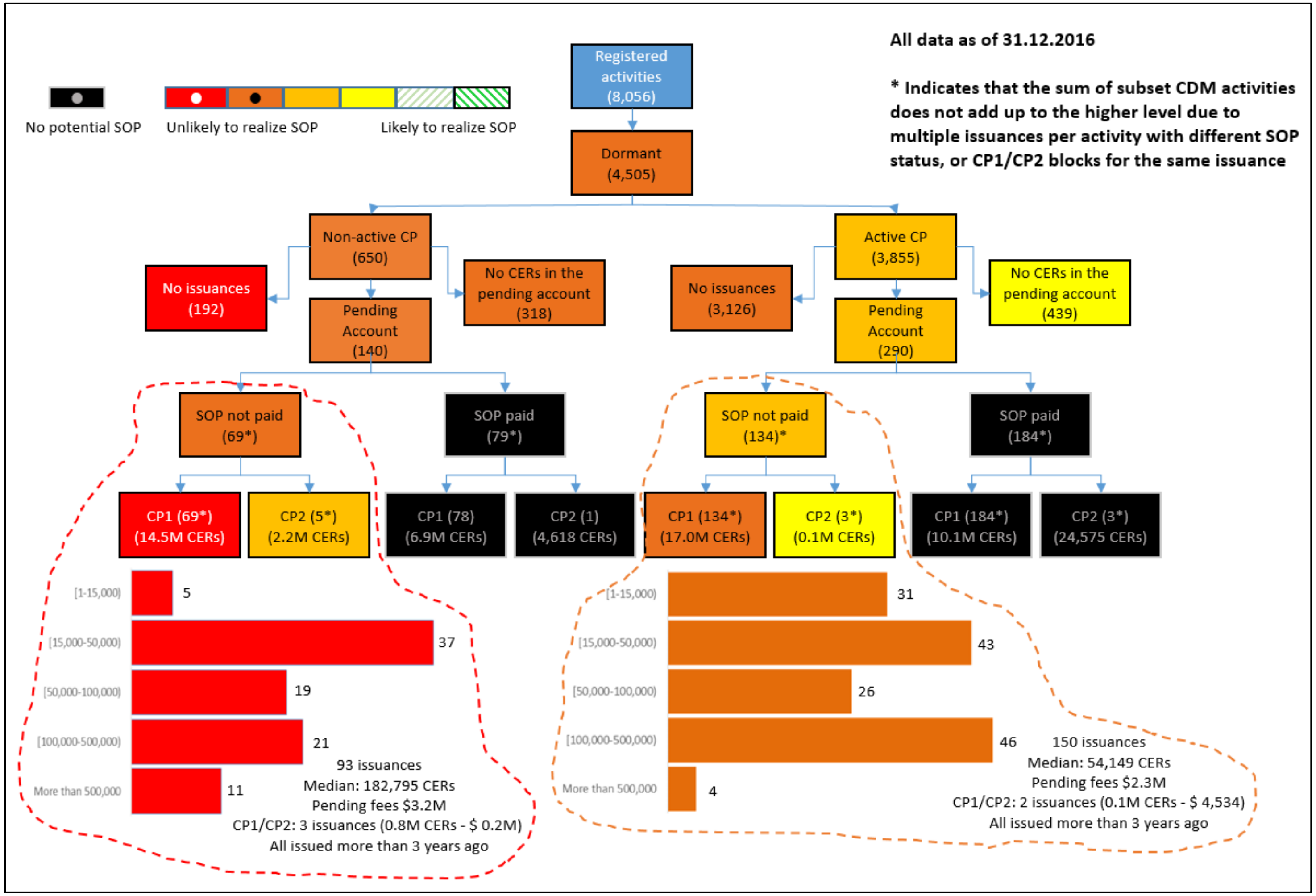


**Figure 2. Certified emission reductions in the CDM registry for which it is likely the share of proceeds could be paid (part 2)**

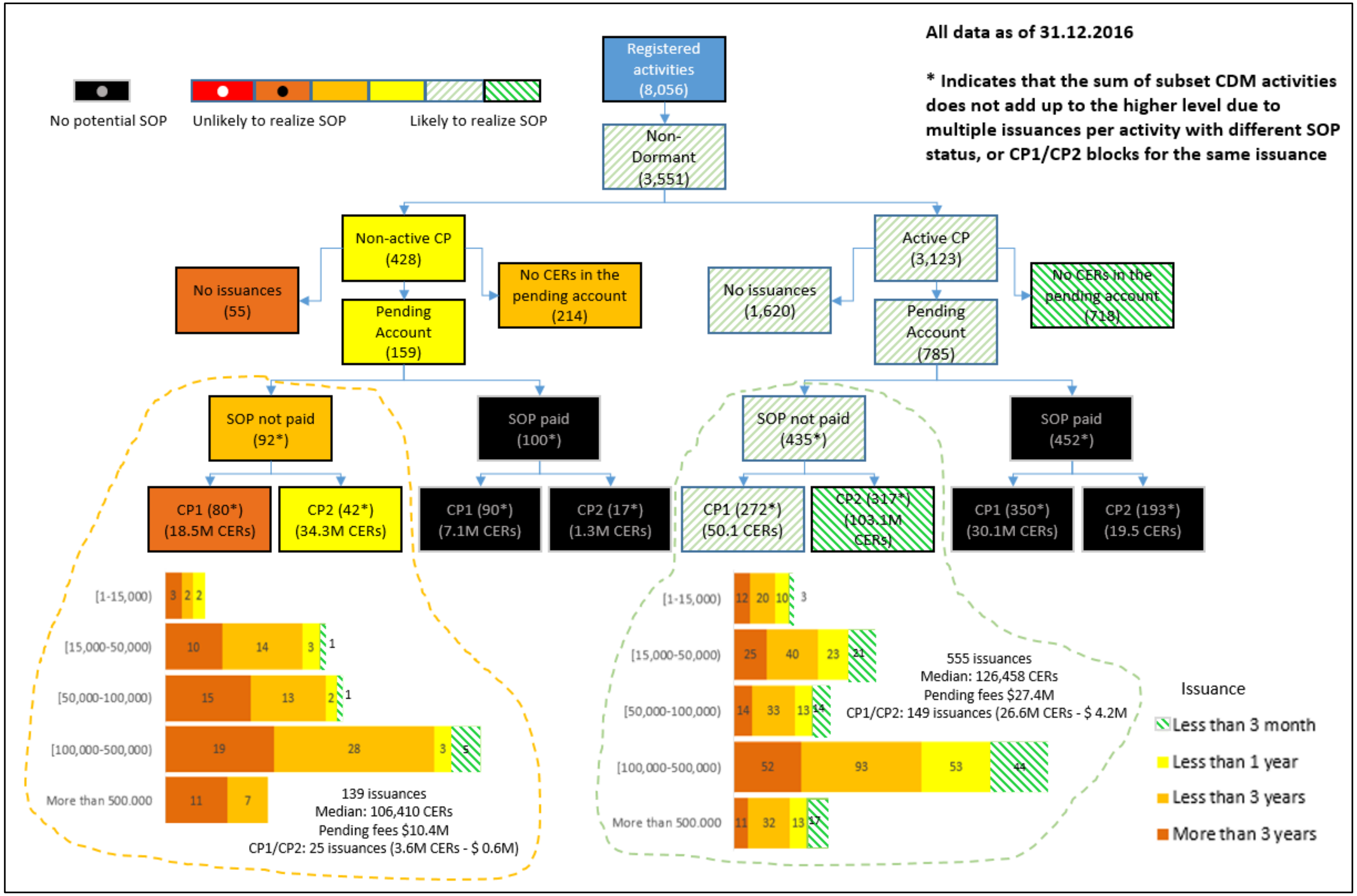


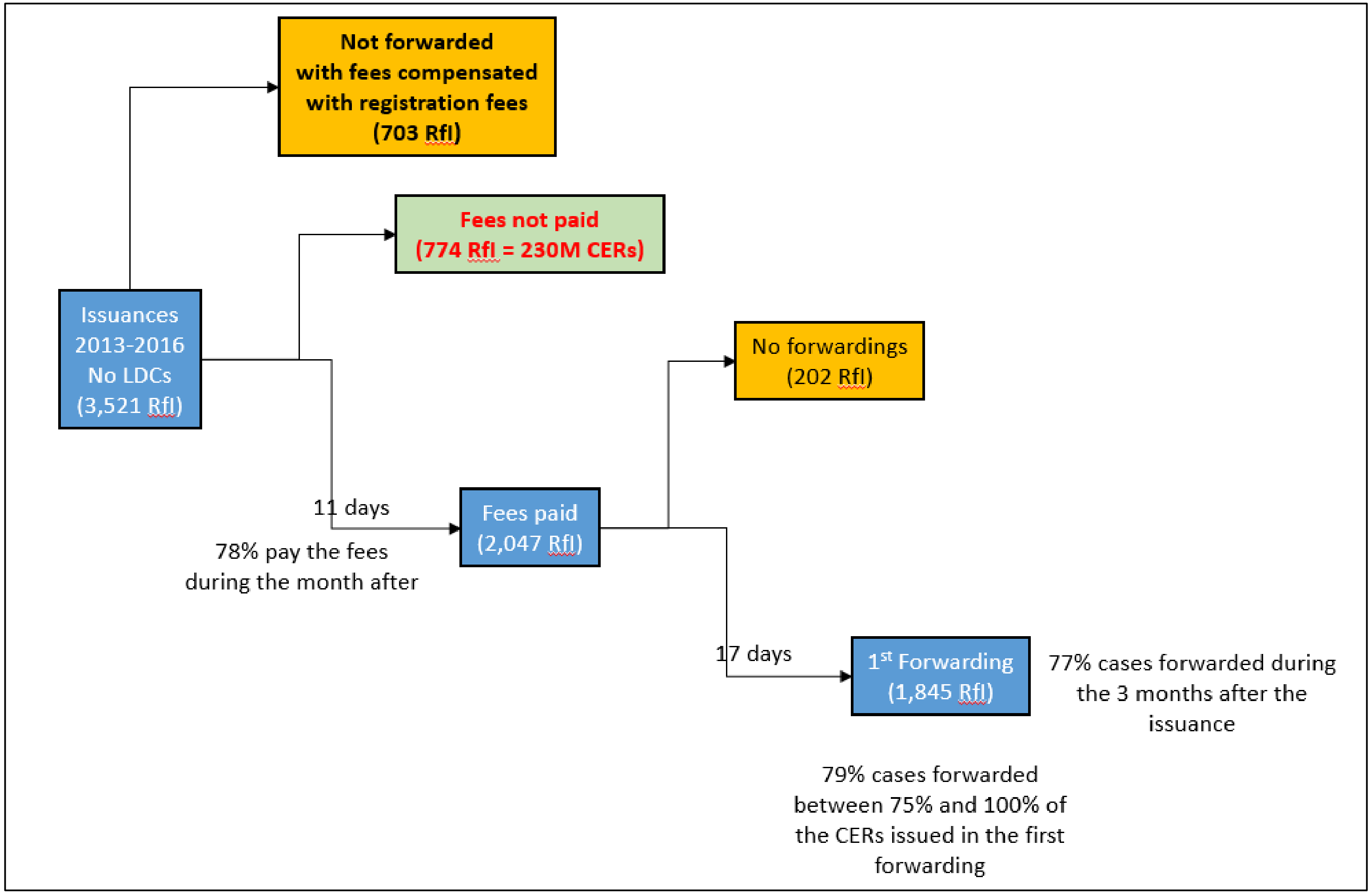
**Table 1. Issuances that straddle the Kyoto Protocol commitment periods**

| | | Kyoto CP2 | | | | | |
|---|---|---|---|---|---|---|---|
| | | [1-15,000) | [15,000-50,000) | [50,000-100,000) | [100,000-500,000) | More than 500,000 | Total |
| Kyoto CP1 | [1-15,000) | 30 | 23 | 6 | 6 | 0 | 65 |
| | [15,000-50,000) | 12 | 11 | 7 | 12 | 1 | 43 |
| | [50,000-100,000) | 6 | 3 | 11 | 14 | 0 | 34 |
| | [100,000-500,000) | 1 | 4 | 5 | 23 | 1 | 34 |
| | More than 500.000 | 0 | 0 | 0 | 3 | 0 | 3 |
| | Total | 49 | 41 | 29 | 58 | 2 | 179 |

The **179 issuances** with monitoring periods that straddle the Kyoto Protocol commitment periods equate to:

- 14.1 million CP1 CERs
- 17.1 million CP2 CERs

**Figure 3. Time elapsing between issuance approval and forwarding**



# Appendix 3. SOP rules, including exceptions

| | Case | Registration fee | Share of proceed (SOP) | Ref |
|---|---|---|---|---|
| **1** | Project activities (PAs) (regular) | Share of proceeds (SOP) applied to the expected average annual certified emission reductions (CERs) for the proposed PAs over their crediting period, as identified in the project design document with a maximum of USD 350,000. | USD 0.10 per CER for the first 15,000 tonnes for which issuance is requested in a given calendar year.<br>USD 0.20 per CER issued for any amount in excess of 15,000 tonnes for which issuance is requested in a given calendar year. | Project cycle procedure v0.9, Appendix 1, paragraph 3(a), 3(b) (SOP) and 4 (registration fee) |
| **2** | Project of Activities (regular) | SOP applied to the expected average annual CERs of the case-specific component project activities (CPAs) submitted with the request for registration, with a maximum of USD 350,000. The average annual emission reductions for each case-specific CPA are calculated over its crediting period. No registration fee is due for CPAs included subsequently. | USD 0.10 per CER issued for the first 15,000 tonnes for which issuance is requested in a given calendar year.<br>USD 0.20 per CER issued for any amount in excess of 15,000 tonnes for which issuance is requested in a given calendar year. | Project cycle procedure v0.9, Appendix 1, paragraph 3(a), 3(b) (SOP) and 5 (registration fee) |
| **3** | PAs and PoAs in least developed countries (LDCs) | None | None | Project cycle procedure v0.9, Appendix 1, paragraph 3(c) (SOP) and 9 (registration fee) |
| **4** | PoAs not hosted exclusively in LDCs | Due, calculated based on the sum of average annual emissions from the case-specific CPAs in non-LDCs. | Due, except for the emission reductions occurring in CPAs hosted in LDCs (*Application of the exemption is based on status of the country on the date of the publication of the request for issuance)* | Project cycle procedure v0.9, Appendix 1, paragraph 3(c) (SOP) and 9 (registration fee) |

| | Case | Registration fee | Share of proceed (SOP) | Ref |
|---|---|---|---|---|
| **5** | PAs and PoAs with case-specific CPAs with expected average annual CERs below 15,000 tonnes | None (deferred) | Due | Project cycle procedure v0.9, Appendix 1, paragraph 8 |
| **6** | PAs and PoAs in countries with fewer than 10 registered CDM projects and PoAs at the time of registration | None (deferred) | Due | Project cycle procedure v0.9, Appendix 1, paragraph 10 |

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## Document information

| *Version* | *Date* | *Description* |
|---|---|---|
| 01.0 | 6 February 2017 | Published as an annex to the annotated agenda of EB93. |

Decision Class: Operational, Regulatory
Document Type: Concept note
Business Function: Issuance
Keywords: data collection and analysis, payments, registries, share of proceeds