

Agenda item: 4 PMR Technical Brief

VOLUNTARY CANCELLATION OF CERs FOR DOMESTIC OFFSET SCHEMES

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1. Background

1. The World Bank Partnership for Market Readiness offsets working group is elaborating a manual on the use of voluntary cancellation of certified emission reductions (CERs) for the purposes of supporting domestic/national offset programmes in Non-Annex I Parties (NAIP).
2. The UNFCCC secretariat (secretariat) is able to support this work, including through providing technical input. This paper sets out (in section 3) the current functionality of the Clean Development Mechanism (CDM) registry and its voluntary cancellation process and elaborates on how these could be used for domestic compliance purposes. It also discusses possible use of voluntary cancellation in Annex I Parties (AIP) national registries. The paper further sets out (in section 4) the intended development of an online tool that will allow online purchasing of voluntary cancellation of CERs by any interested entity, including governments and companies with compliance obligations under domestic offsetting programmes.
3. Definitions used are set out in the Annex to this paper.

2. Voluntary cancellation in the Kyoto registry system

4. CERs can only be tracked in the registry system established pursuant to the Kyoto Protocol. The system comprises of AIP national registries and the CDM registry which are all connected through the International Transaction Log (ITL). Most AIPs operate separate registries for the purposes of their domestic emissions trading schemes (ETS). These registries are not part of the Kyoto system but if integrated with the Kyoto registries of the respective AIPs they would also be able to track CERs. For example, CERs are currently tracked in the EU ETS registry, as well as in the EU member states Kyoto registries.
5. NAIPs that develop national registries cannot currently connect to the ITL. The Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol (CMP) would need to adopt corresponding decisions in order to extend this right to NAIPs. The NAIPs would also need to comply with ITL technical criteria.

6. Voluntary cancellation (VC) is possible in AIP registries and in the CDM registry. VC is a transaction type that involves a transferring account (typically a holding account of any type) and a receiving voluntary cancellation account (VCA). This transaction type is irreversible and once CERs are received into a VCA they cannot be transferred or moved further in any way. The ITL ensures the accuracy and consistency of all transactions.

3. Use of voluntary cancellation for domestic compliance purposes

7. In considering possible use of VC and Kyoto registries services for domestic purposes, NAIPs should consider the specifics of the voluntary cancellation processes and registry account services as implemented by individual AIP registries and the CDM registry. Broadly, three possible options for use of VC in the CDM registry and in AIP registries are discussed:
 - (a) Regular VC process;
 - (b) Centralized control over VC through a Party holding account(s);
 - (c) VC with reissuance of units in a domestic registry as an extension of (a) and/or (b).
8. NAIPs designing domestic offset schemes may choose to rely on one of the options in a particular registry type (the CDM registry or AIP registries). They may also consider relying on more than one option within a registry type or even rely on options in any combination as they see fit for their specific purposes. Caution should be applied to avoid complexity of hybrid options.

3.1. CDM registry services

9. In considering the use of VC in the CDM registry, one may benefit from first understanding the CDM registry operations. While the CDM registry transactions and holding account services are limited in comparison to those of AIP registries, the CDM registry offers a publicly transparent VC process.
10. The CDM registry was established with the primary purpose of issuing CERs and forwarding them to accounts of Project Participants (PPs). It is not configured as an emissions trading registry and does not support many of the functionalities that AIP registries support. Essential elements of the business model of the CDM registry are:
 - (a) NAIPs or their authorized PPs may have one or more holding accounts. NAIPs may have holding accounts in the name of funds or other institutions they authorize. PPs have their holding accounts associated with the authorizing NAIP. Private individuals cannot hold project participant status in the CDM nor can they open holding accounts;
 - (b) PPs may only receive CERs into their holding accounts that have been generated from activities in which they participate. NAIP holding accounts may acquire CERs from all CDM activities in which that NAIP is a Party involved;
 - (c) NAIPs or PPs may only forward CERs from their holding accounts to:
 - (i) Other CDM registry or AIP registry holding accounts of PPs or Parties involved in the CDM activity that has generated the CERs (an important limitation to be considered by NAIPs that may wish to monetize CERs);
 - (ii) CDM registry voluntary cancellation accounts;

- (iii) CDM registry other cancellation accounts;
 - (d) CERs already forwarded externally to AIP registries cannot be returned to the CDM registry;
 - (e) The CDM registry cannot forward CERs to AIP registries that have been issued for a particular commitment period after the carry over period for that commitment period has started¹ (CERs issued for the second commitment period can be forwarded to AIP registries until sometime in 2023);
 - (f) CERs in the CDM registry are not subject to carry-over rules that apply to AIP registries. There are currently no rules that determine for how long CERs issued for a particular commitment period may remain in the CDM registry. The secretariat's understanding of the rules is that CP1 CERs can subsist and continue to move within the CDM registry after the end of the CP1 true-up processes;
 - (g) Currently, no fees apply to services offered by the CDM registry.
11. Voluntary cancellation transactions in the CDM registry can be initiated by project/POA focal points for cancellations from the pending account and by holding account representatives for cancellations from holding accounts. A voluntary cancellation request may carry information on the purpose and/or beneficiary of the cancellation and an attestation of cancellation is issued for each transaction. Detailed information on VC transactions is publicly available on the CDM registry website. The CDM registry can produce reporting on VC transactions associated with a given NAIP.
12. The attestation of VC may offer a useful simplification for a buyer who wants to purchase and cancel CERs but who does not wish to take title over the units. In such a case it would be sufficient for the seller to cancel the CERs on behalf of the buyer and provide the buyer's name for the attestation of cancellation.
13. In summary, the following opportunities and limitations would apply irrespective of which specific design option a NAIP may wish to consider for their purposes.
14. *Opportunities:*
- (a) Publicly transparent VC process;
 - (b) CERs for a particular commitment period can subsist and continue to move within the CDM registry after the end of that commitment period true-up processes (but note, no external forwarding allowed after the beginning of the carry over period for that commitment period);
 - (c) No charges for services to NAIPs and PPs.
15. *Limitations:*
- (a) Transaction limitations – only forwarding to NAIPs and PPs involved in the activities generation CERs (no trading);
 - (b) Holding account services only to NAIPs and PPs;

¹ The secretariat is supporting the preparation of Kyoto registries for CP1 true-up activities. As of February 2015, it is expected that external forwarding may continue after the end of the 100 day additional period for fulfilling commitments for CP1 (commonly referred to as the true-up period) but not later than the beginning of the carry over period for CP1

- (c) Limited user interface – currently no user interface for holding accounts and forwarding from holding accounts. These are supported via manual processes.

16. The next sections discuss the possible options for use of VC in the CDM registry and the specific opportunities and limitations as applicable in each context.

3.1.1. Use of regular VC process

- 17. This scenario assumes that a NAIP would rely on CDM registry voluntary cancellation functionalities and reporting capabilities. The NAIP would instruct PPs to obtain CDM registry attestations of cancellation (directly or indirectly for cancellations made on their behalf) and report to the NAIP. In this scenario a NAIP domestic regulator would accept proof of cancellation from the CDM registry administrator when assessing a regulated entity's compliance statement. The CDM registry may establish a secure communication line with the NAIP authority responsible for domestic compliance to confirm VC transactions directly as a mean of reducing the risk of errors and fraud.
- 18. The implementing NAIP would determine the eligibility conditions for both entities and CERs and would communicate this at a national level. For example, the NAIP would have to determine if it would accept only CERs generated by CDM activities in which that Party is involved or any CERs or CERs subject to particular conditions.
- 19. Applicability:
 - (a) Suitable for policy instruments not supported by domestic registry systems;
 - (b) Entities have compliance obligations that could be met by CERs. The entities with obligations may either become CDM PPs that acquire and cancel CERs, or by purchasing CERs from other PPs who cancel on behalf of the entities with domestic obligations.
- 20. *Opportunities:*
 - (a) Easy to track information on cancellations (public on the CDM registry website);
 - (b) Flexibility on who cancels the CERs - no need for obligated entities to become PPs as other PPs that hold eligible CERs may cancel on behalf of the obligated entities;
 - (c) Flexibility to determine which CERs would be eligible for compliance – the NAIP may accept attestations only for certain CERs (e.g. originated by hosted CDM activities or by other Party hosted activities).
- 21. *Limitations:*
 - (a) Reliance on transactions' descriptive information (transaction details) when PPs cancel CERs on behalf of other entities with compliance obligations. Inconsistencies in descriptions may hinder transparency;
 - (b) A recoding system for reported transactions may be required at the NAIP level.

3.1.2. Centralized control over VC through a Party holding account(s) (Diagram 1)

- 22. This scenario assumes that a NAIP would track CERs in the CDM registry through one or more holding accounts under their direct control. The NAIP would accumulate

CERs until it decides to voluntarily cancel the units or monetise the CERs by selling them in the international market (in practice to AIP buyers). CERs forwarded by entities with obligations² to designated NAIP accounts would qualify for meeting a domestic scheme obligation. In a similar manner the NAIP would have to determine the eligibility of CERs and communicate this at the national level.

23. It is possible to contemplate arrangements where a NAIP opens multiple holding accounts and designates representation rights to entities with obligations while it retains full responsibility over the accounts. There may still be the need for a “central” account where CERs are accumulated from other accounts.

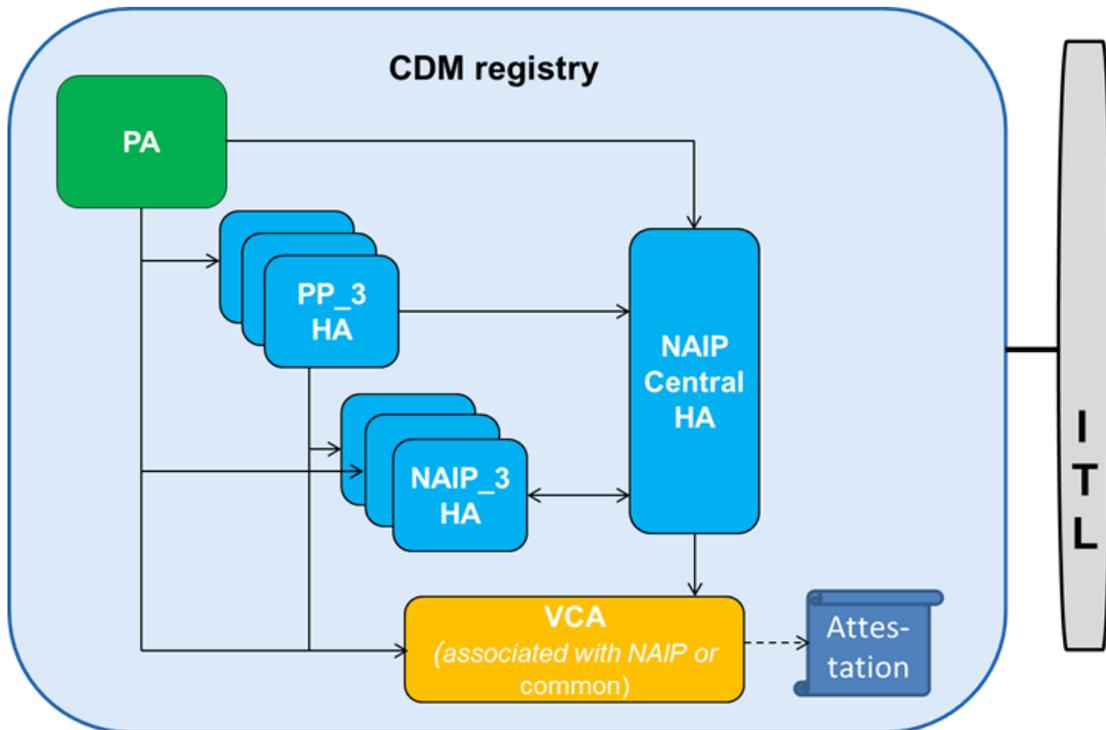


Diagram 1: Tracking of CERs through Party holding account(s)

PA=Project Activity; PP_HA= Project Participant Holding Account; NAIP_HA= a Party account operated by an entity authorised by the NAIP; NAIP_Central HA= the Party account operated by the NAIP; VCA= the voluntary cancellation account in the CDM registry for administrative and other purposes

24. *Applicability:*
- (a) Suitable for policy instruments not supported by registry systems;
 - (b) Suitable for policy instruments that accept only CERs from CDM activities in which the NAIP is involved as a host or as a Party involved (NAIP could be non-host in a CDM activity) - this is required in order for the NAIP to be able to receive CERs in a central account;
 - (c) Entities with obligations can participate by either:
 - (i) Becoming a CDM PP that acquires CERs and forwards them to the NAIP account;
 - (ii) Becoming an operator of a NAIP holding account to acquire and forward CERs to the “central” NAIP holding account. The NAIP would give the operator the right to hold an account in its name in the CDM registry.

² Forwarding on behalf of (not directly by) entities with obligations are not considered

This would alleviate the operator from becoming a PP. Full rights and responsibilities over the account would remain with the NAIP.

25. *Opportunities:*

- (a) The NAIP hold control over the CERs by accumulating them in a designated central holding account;
- (b) The NAIP can reliably track who sends CERs to its central account;
- (c) Possibility for the NAIP to further sell CERs;
- (d) Flexibility for the NAIP on timing and volumes of cancellations/sales;
- (e) NAIP can set a criteria for acceptable CERs;
- (f) Possibilities for NAIP to involve entities that are not PPs but are subject to compliance obligations. Essentially, mimicking domestic³ emissions trading operations with CERs originated by CDM activities in which the implementing NAIP is involved;
- (g) The CDM registry could function as a ready-made registry, avoiding the need to develop a domestic national registry.

26. *Limitations:*

- (a) Administrative burden from opening and operating holding accounts;
- (b) Holding accounts associated with a given NAIP may only acquire CERs from CDM activities in which the NAIP is involved;
- (c) With regard to forwarding of CERs by NAIP to buyers, the limitations described in paragraph 10 (c, i) above should be noted. An alternative approach to transferring sold CERs is the voluntary cancellation on behalf of a buyer. This may eliminate the need for a buyer to become a PP in order to receive CERs from the CDM registry, however, it would not allow for further transactions with the same CERs;
- (d) Limitations may apply on when CERs could be forwarded outside the CDM registry, for example, the rules that prevent forwarding of first commitment period CERs to an AIP registry or related AIP ETS timeline on accepting CERs;
- (e) Legal concerns over the rights of non-PP entities operating NAIP holding accounts (the NAIP retains overall control).

3.1.3. VC with reissuance of units in a domestic registry (Diagram 2)

27. This scenario is an extension of the previous two options and it assumes that the domestic policy instrument would issue domestic-level compliance units into a domestic registry system that is not connected to the ITL. The implementing Party would need to determine a process for the issuance of domestic units which should include as a precondition the voluntary cancellation of CERs (see risk of double counting after limitations).

³ As long as the CERs forwarded between holding accounts of the NAIP originate from CDM activities in which that NAIP is involved, no international emissions trading would occur. The CDM registry rules do not prevent such forwarding between NAIP holding accounts.

28. The CDM registry may establish a secure communication line with the NAIP authority responsible for domestic compliance to confirm VC transactions directly as a means to reduce the risk of errors and fraud.

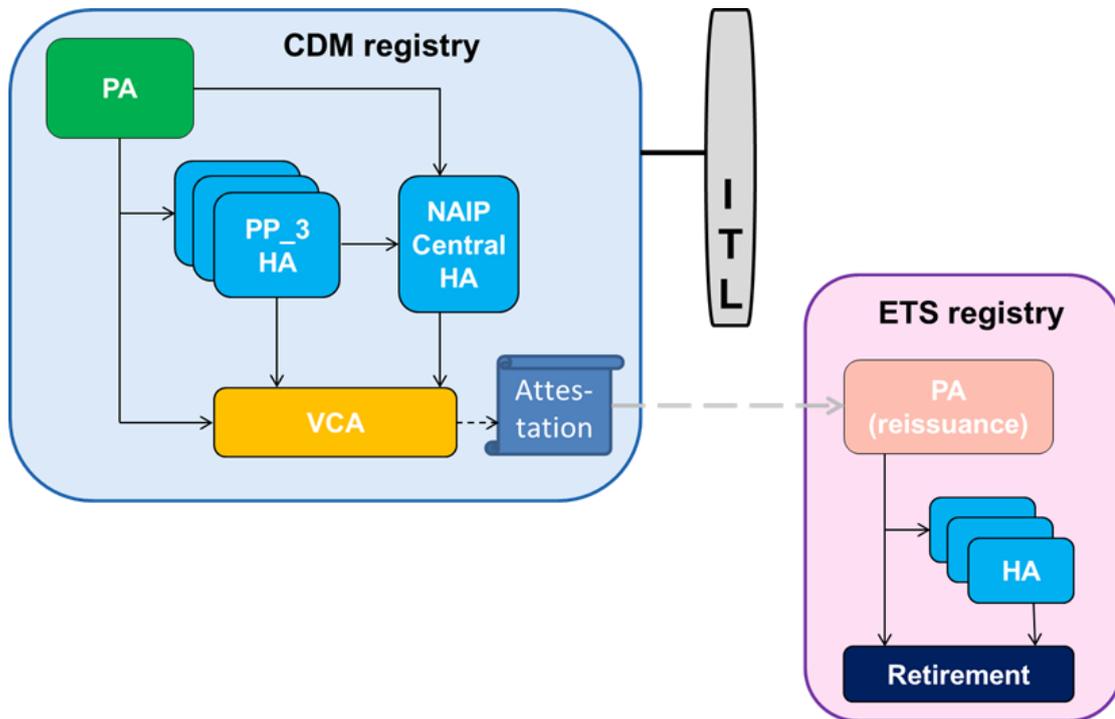


Diagram 2: Re-issuance of national level compliance units on the basis of VC

29. *Applicability:*
- (a) Suitable for policy instruments such as domestic emissions trading schemes which are supported by a registry system that is not connected to the ITL;
 - (b) Allows for the use of CDM where emissions trading is confined within the domestic scheme.
30. *Opportunities:*
- (a) Entities with obligations under the domestic ETS may benefit from CDM (as a flexibility option) without participating in CDM;
 - (b) NAIP could benefit from a reliable process as a precondition for the issuance of domestic units – this is particularly the case when using a Party central account which would allow full control and reliable reconciliation between cancelled and reissued units.
31. *Limitations:*
- (a) Converting CERs into domestic-level compliance units through a manual process (voluntary cancellation in the CDM registry/issuance in the domestic ETS registry) holds potential for errors;
 - (b) May require stringent reconciliation and a public reporting process – various stakeholders observe the established processes and have expectations for transparency. Responsible authorities should consider best practices for

transparency and regular reconciliation of cancelled CERs and reissued units in the domestic scheme to ensure no errors occur between the two systems;

- (c) Once cancelled and converted to national units, the units cannot be traded outside of the domestic market (one-way conversion).
32. *Risk of double counting:* Issuance of domestic units for emission reductions or removals achieved through CDM prior to the completion of voluntary cancellation would represent double issuance for the same activity. In other words, two units representing the same emission reductions or removals would exist, although in two seemingly unrelated systems. Such double issuance creates the conditions for double counting to occur at the international UNFCCC level.
33. In general, any domestic programme that issues units for emission reductions achieved under another programme (including purely voluntary schemes outside the Convention and its instruments) would need to ensure that the environmental integrity of each programme is upheld by validating and confirming that a new issuance for the same emission reductions or removals occurs only after the originally issued units had been cancelled.
34. Further risks of double counting may exist, e.g. in relation to acceptance of CERs generated by projects not hosted by the Party implementing the domestic scheme. This would be the case if the implementing Party claims the reductions and the host CDM Party reflects the reductions in their inventory.
35. The risk of double counting is not in scope for this paper and it is only highlighted as a relevant consideration.

3.2. AIP registries services

36. AIP registries support emissions trading. Most AIP national registries are open to overseas clients. CERs are typically freely transacted between accounts within the AIP registry or externally to and from accounts in other AIP registries. It should be noted that AIP ETSs set eligibility limitations on certain types of CERs.
37. A NAIP that wishes to rely on VC of CERs held in an AIP registry would have to consider the voluntary cancellation process of that AIP registry. While the VC transactions are processed according to the same principles in all AIP registries, specific functionalities and transaction supporting documents could be different. Most AIP registries do not certify nor publish detailed information on VC.
38. The following are opportunities and limitations that would apply irrespective of which specific design option a NAIP may wish to consider for their purposes.
39. *Opportunities:*
- (a) Few limitations on who can open accounts;
 - (b) Trading with CERs is enabled subject to conditions that may apply in a particular AIP registry;
 - (c) Online user interfaces – AIP registries have well-functioning online user interfaces, including account holdings information, functionalities to process transactions online and user reports.
40. *Limitations:*

- (a) Operational AIP registries are subject to Party eligibility and connectivity to the ITL;
- (b) Limited means for reliable evidencing of VC - most AIP registries do not certify, nor make public, information on VC transactions and entities that cancel CERs may hold only a screen shot or an account transaction report as an evidence of the said transaction. AIPs registries may not even provide capabilities for including transaction descriptions. Without certification/confirmation by a registry administrator, it may be easy to manipulate VC evidence;
- (c) Carry over – the carry over is a process applicable to Kyoto units held in Kyoto AIP registries and it implies that AIPs can carry over units from one commitment period to the next, subject to quantitative limits (for CERs up to 2.5% of a AIP’s assigned amount). The number of units and who is eligible to have their units carried over is decided by the respective AIP;
- (d) Transaction limitations – while trading is fully enabled in AIP registries, Parties may apply eligibility criteria to CERs. This may refer only to acceptability for surrendering (meeting compliance obligations by entities) or to acceptability in the respective registry. AIP without targets for commitment period two can continue to receive CERs issued for commitment period two from the CDM Registry, however, the carry over right is not yet clarified;
- (e) Complexity from the need to consider the specific requirements and terms of use of AIP registries;
- (f) Charges apply to many AIP registry users.

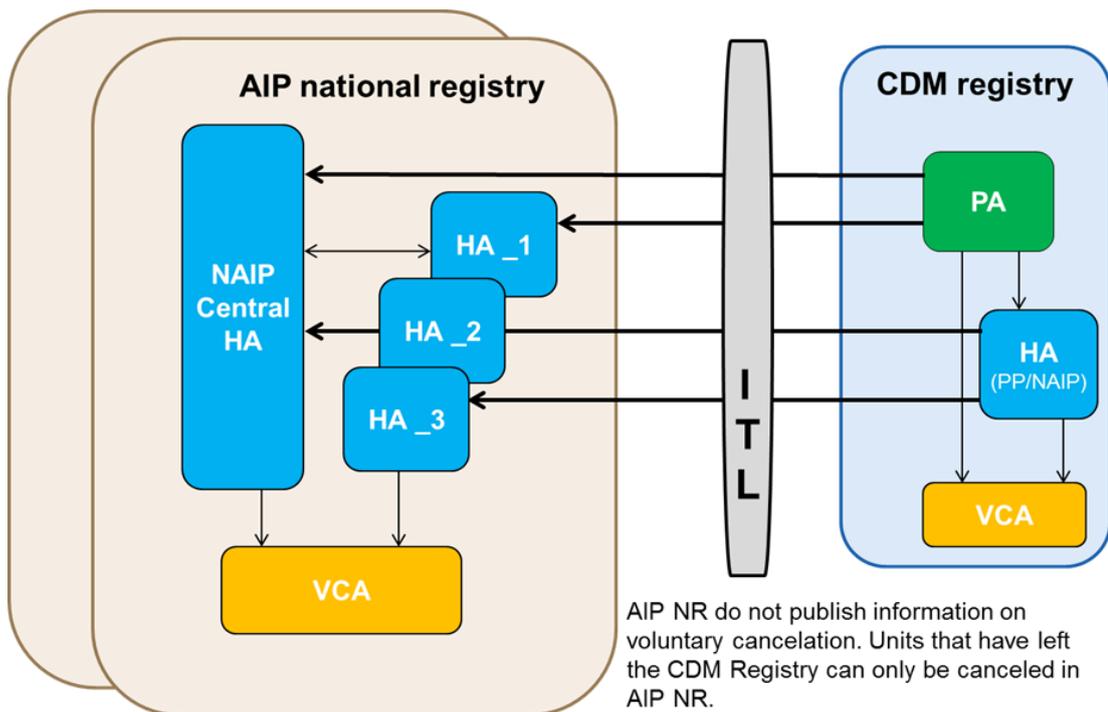


Diagram 3: Tracking and cancelling CERs through an AIP registry

41. The same three options for using VC and account services as provided by AIP registries are discussed below. In a similar way, the NAIP would have to determine eligibility requirements for entities and CERs and communicate those at the national level. The *applicability* of each option would also be similar to the applicability as indicated for the same option in the CDM registry section, without the corresponding limitations for the use of the registry (must be a PP or a NAIP to open an account).

3.2.1. Use of regular VC process

42. This scenario assumes that a NAIP would rely on the voluntary cancellation processes in AIP registries as implemented by the respective AIP national registry administrators. The NAIP would instruct entities with obligations to directly cancel CERs and report to the NAIP.

43. *Opportunities:*

- (a) Entities with obligations can acquire directly CERs and would have the choice to VC to meet their obligations or trade their CERs further.

44. *Limitations:*

- (a) AIP normally do not certify VC transactions and may not have transaction detail capabilities - the VC transaction evidence may be minimal and therefore the risk of validating VC transactions not certified by AIP registry administrators should be considered.

3.2.2. Centralized control over VC through a Party holding account(s)

45. A NAIP and entities with obligations may open accounts in selected AIP registries. CERs forwarded by entities with obligations⁴ to designated NAIP accounts would qualify for meeting a domestic scheme obligation. NAIP decides on the timing of VC and has the option of retaining CERs for further trading.

46. *Opportunities:*

- (a) This scenario could overcome the problem of the lack of transparency and/or verifiable evidence of VC in an AIP registry when the VC is managed by an entity with an obligation directly. The NAIP would typically be able to identify the sender from the related account transaction report or equivalent (TBC with the AIP registry authority) and on this basis establish if the compliance obligation was met;
- (b) Flexibility for the NAIP on timing and volumes of cancellations/sales;
- (c) Possibility for the NAIP to further sell CERs.

47. *Limitations:*

- (a) See general limitations for AIP registries in paragraph 40.

3.2.3. VC with reissuance of units in a domestic registry

48. This scenario is an extension of the previous two options and it assumes that the domestic authority would issue domestic-level compliance units into a domestic registry system that is not connected to the ITL. The implementing Party would need to determine a process for the issuance of domestic units (see also section 3.1.4).

⁴ Forwarding on behalf of (not directly by) entities with obligations are not considered

49. *Opportunities:*
- (a) Entities with obligations under the domestic ETS may benefit from CDM (as a flexibility option) without participating in CDM;
 - (b) If used in combination with a NAIP central account, the problem of transparent and/or verifiable evidence of VC could be overcome. The NAIP will have full control over the VC and could reliably reconcile cancelled with reissued units.
50. *Limitations:*
- (a) Converting CERs into domestic-level compliance units through a manual process holds potential for errors;
 - (b) May require stringent reconciliation and a public reporting process – various stakeholders observe the established processes and have expectations for transparency. Responsible authorities should consider best practices for transparency and regular reconciliation of cancelled CERs and reissued units in the domestic scheme to ensure no errors occur between the two systems;
 - (c) Once cancelled and converted to national units, the units cannot be traded outside of the domestic market (one-way conversion)

4. CDM registry online VC tool

51. The secretariat has started the process of developing and implementing an on-line platform for purchasing the voluntary cancellation of CERs held in the CDM registry. The platform will allow PPs to make price offers for CERs available to them in the CDM registry. Organizations and members of the public would be able to select CERs on the basis of different criteria, including host Party, project type, commitment period and price range. The buyers would be able to pay the requested price online which would trigger an automatic VC in the CDM registry. The buyers would receive, shortly afterwards, voluntary cancellation certificates that indicate the purpose of the cancellation, beneficiary or other reference. The cancellation certificates would be the same as those issued for regular voluntary cancellation transactions in the CDM registry and would be published on the UNFCCC website.
52. Another important aspect of the platform's implementation is that it would support online access to account holding information for all registry users. If a NAIP has a central account in the CDM registry, the NAIP would be able to view its holdings, including the movements in its holdings and it would be able to initiate online VC.
53. *Applicability:*
- (a) Entities that have compliance obligations under national or regional policy instruments would be able to meet their obligations by purchasing online CERs that were cancelled on their behalf. The VC tool would fast track the process from identifying to cancelling CERs;
 - (b) NAIPs may handle VC from central accounts online.
54. *Opportunities:*
- (a) See opportunities in section 3.1.2;
 - (b) The platform would provide a simple, fast and effective way to purchase CERs for voluntary cancellation;
 - (c) The platform would provide

55. *Limitations:*

- (a) See limitations in section 3.1.2;
- (b) Limitations on the total value per purchase would apply depending on the payment methods offered by the platform. For higher volumes, several purchases may have to be processed or buyers and sellers may agree zero price offers with settlement outside the system.

Annex I – Definitions

1. The following definitions apply in understanding the content of this paper:
 - (a) “Registry “account types” – Kyoto Protocol registry account types referred to in this paper include pending (issuance), holding, cancellation and retirement accounts. Other Kyoto registry system and AIP emission trading system registry account types exist including trading and operator holding accounts;
 - (b) “CDM registry permanent holding account (holding account)” – an account which can acquire and forward CERs. Holding accounts can be opened by a NAIP or by a related project participant. Party holding accounts may acquire CERs from all CDM activities in which the Party is involved. Accounts of project participants may receive CERs from CDM activities in which they participate;
 - (c) “Transactions” with units – movement of units involving issuance, forwarding, transfer, acquisition, retirement and/or cancellation. Other transaction types that involve replacement or reversal are not considered in this paper. Transactions may be external, between registries, or internal within a single registry;
 - (d) “Forwarding” – a transaction that involves the movement of CERs from the pending account or holding accounts in the CDM registry to holding accounts in the CDM registry or AIP national registries. Only CDM project participants (PPs) and Parties involved can receive units forwarded to their holding accounts;
 - (e) “Transfer” – an outgoing transaction from a holding account which is not a “forwarding”;
 - (f) “Acquisition” – an incoming transaction into a holding account;
 - (g) “Cancellation” – a transaction to a voluntary or a mandatory cancellation account;
 - (h) “Host Party” – a NAIP which hosts a CDM activity;
 - (i) “Other Party” – a NAIP or a AIP that participates in a CDM activity directly through a governmental institution(s) or indirectly through the authorization of a private entity(ies) and who can receive CERs from a CDM activity.