

# QUESTIONS AND ANSWERS

## Green Investment Schemes

### 1. What are Assigned Amount Units (AAUs)?

Assigned Amount is the quantity of greenhouse gases (GHGs) that an Annex B country<sup>1</sup> can emit in accordance with the Kyoto Protocol, during the first commitment period (2008-2012). For most economies in transition (EITs), such as Russia and Ukraine, the projected growth in emissions by 2012 still leaves their total greenhouse gas emissions significantly below their Assigned Amount. The positive difference between their Assigned Amount and projected GHG emissions is often called "headroom" (the term preferred by the host countries) or "hot air", which can be sold under certain conditions as excess Assigned Amount Units to sovereign buyers and/or authorized private buyers of other Annex B countries in need of GHG emissions reductions under Article 17 of the Kyoto Protocol.

**Different perspectives:** There are different views on surplus AAUs between OECD countries and EITs. Most OECD countries are of the opinion that surplus AAUs in EITs are "windfalls" that have been given to EITs as their "headroom" have occurred from a decline of their economic activity and not from concerted efforts to reduce GHG emissions. These OECD countries are concerned that purchasing "headroom" would damage the environmental integrity of their actions to mitigate climate change. On the other hand, some EITs argue that they have paid a price for achieving GHGs emissions reduction through economical decline, impoverishment of the people and social disruptions after the collapse of communism. They further note that this "headroom" was largely a known reality at the time the Kyoto Protocol and its targets were agreed in 1997, and that it was therefore taken into account in the overall reduction commitment of OECD countries and, consequently, poses no threat to the environmental integrity of the Kyoto Protocol.

**Political challenge of surplus AAUs:** Considering the different and at times conflicting perspectives, the issue of the surplus of AAUs presents a political challenge in both host and buyer countries, that could possibly lead to a considerably diminished scope or render inaccessible a compliance mechanism that is otherwise straightforward under Article 17 of the Kyoto Protocol.

### 2. What is a Green Investment Scheme (GIS)?

A Green Investment Scheme is now widely perceived as a financing mechanism in which the proceeds from the sale of surplus AAUs are reinvested in projects and/or programs in the EITs for the local, regional and/or global environment benefits, including further

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<sup>1</sup> Annex B countries are the 38 industrialized countries and economies in transition (EITs) listed in Annex B to the Kyoto Protocol.

reducing GHG emissions. However, there is no official definition or consensus nor requirement under the Kyoto Protocol to implement a Green Investment Scheme.

### **3. Who is active in GIS currently and why?**

On the sellers' side, Bulgaria, Latvia, Czech Republic and Ukraine have already indicated their interest in GIS, while Russia, Romania and potentially others will also likely seek GIS opportunities. These countries express interest because they see a potential in GIS as a form of revenue and/or as a way to address local/regional environmental issues.

On the potential buyer's side, so far Japan, the Netherlands, and lately Finland have been most actively engaging in discussions with host countries. Others considering GIS in the near term could include Spain, Austria, Italy and Canada. The main drive to make these countries seek for GIS opportunities seems to be the notion that AAUs through GIS would be more efficient and economical way to meet their Kyoto targets than purchase of credits through CDM/JI.

Regarding multilateral and non-governmental organizations (in addition to the World Bank working with Latvia, Ukraine and Bulgaria), EBRD and Resources for the Future in Ukraine, and UNEP and Resources for the Future in Poland have indicated their interest in contributing to the GIS.

### **4. Why is the World Bank involved in GIS and what is the scope of its involvement?**

The AAU trade would be an additional and necessary avenue for the success of Kyoto Protocol, considering that CDM and JI as well as domestic policies and measures of some countries may not meet the demand for Kyoto compliance. However, there are several bottlenecks for the development of AAU transactions. They include (i) lack of clear definition and rules of "greening" that mitigate "reputational risk", (ii) inadequate capacity of the host country to establish and implement an accountable, credible and transparent GIS, (iii) weak political willingness to engage in AAU transactions in the host country, and (iv) no established market and pricing mechanisms for AAUs.

Under these circumstances, the involvement of the World Bank in the GIS is required for the following reasons. *First*, the success of the Kyoto Protocol is indispensable for the world's sustainable development as well as mitigating global warming. As one of the multilateral development institution, the World Bank contributes to the fulfillment of Kyoto Protocol through various means, and cooperation with EITs in setting up GIS is considered by the World Bank a very promising opportunity for addressing climate change and channeling additional financing to clean technologies and projects. *Second*, to address the bottlenecks mentioned above, the World Bank expertise in carbon finance and environmentally sustainable development as well as its strong and good relationship with the governments of EITs mean it is uniquely positioned to address the bottleneck mentioned above in cooperation with the governments and businesses of the EITs as well as with the potential buyers of GIS assets and other stakeholder groups.

Countries that have requested Bank's assistance include Latvia, Ukraine, Bulgaria and Russia. In addition as per request from some host countries, the Bank organized an informal buyer's roundtable for the World Bank carbon funds participants from the public sector in Paris, on March 31, 2006. Key messages received were flexibility in definition of greening and scope of GIS (could include local pollution abatement) and need for an accountable and transparent fund management structure. Bank's potentially conflicting role in GIS (seller's representative, "honest broker" or "buyer" as a trustee) was also pointed out.

#### **5. What impact would AAUs (even greened ones) have on the CDM market?**

There is an expected compliance gap of one to two billion tons of carbon dioxide equivalent in OECD countries after their domestic policies and measures and purchase of credits through CDM and JI. The potential supply of AAUs is six to eight billion tons.

The large potential to close the compliance gap of OECD countries through AAUs purchases could ease pressure and the current tendency of overheating in the carbon market or pose a destabilizing factor if released to the market in large quantities and in an uncontrolled manner.

It should be noted that the relevance of EU ETS with respect to international emissions trading is diminished by the fact that the two markets are quite strictly separated from each other. Unlike carbon credits from the project-based emissions reductions (ERUs and CERs), AAUs can not be converted to EU Allowances nor used by the EU ETS participants for compliance. Accordingly, the impact of influx of AAUs through the GIS on the CDM market might be partly mitigated. However, the "hard-greened"<sup>2</sup> portion of AAUs during the Kyoto commitment period could be converted to ERUs under flexible 1st track of JI that increases the ERU supply to the market.

#### **6. What are the specific challenges of greening AAUs?**

There are several bottlenecks for the development of AAU transactions. They include (i) lack of clear definition and rules of "greening" that mitigate "reputational risk", (ii) inadequate capacity of the host country to establish and implement an accountable, credible and transparent GIS, (iii) weak political willingness to engage in AAU transactions in the host country, and (iv) no established market and pricing mechanisms for AAUs. There are a number of other challenges as well.

**Majority of AAU's in just two countries:** About 75% of the surplus AAUs could come from Russia and Ukraine. The supply of AAUs may be constrained if one of the two big potential sellers fails to meet eligibility criteria defined under the Kyoto Protocol, or meet them late. The deadline to submit a report on eligibility is January 1, 2007, and UNFCCC secretariat will review within 16 months whether the eligibility criterion is met, i.e.

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<sup>2</sup> Hard-greening investments are those where investments create reductions of GHGs emissions equal to the AAUs purchased

whether AAUs transfers are possible. Internal disputes or low capacity to trade may restrict the participation of Russia and Ukraine in AAU trading. Finally, it is not yet clear if there is enough technical capacity in Russia and Ukraine to establish and implement the GIS in a transparent, credible and accountable manner.

**Greening: What is green? And how green is green (soft vs. hard-greening)?**

What makes greening a very complicated issue is the lack of definition, consensus among the international community and regulatory framework. One universal issue among buyers appears to be the *transparency, accountability and credibility* in the use of funds deriving from AAU purchase. Under the GIS, the host country would need to assure buyers that the proceeds from the sales of AAUs would be used to finance agreed projects and programs. Suitable monitoring and verification measures would need to be adopted. In return the buying country would provide financing for the GIS under the terms of a negotiated contract.

Buyers' preferences are most clear with respect to so-called "*hard-greening*" where investments create reductions of GHGs emissions equal to the AAUs purchased. However, a number of "*soft-greening*" measures can also be considered by some of them as a justified use of AAU revenues. For example, they may include reduction of health damaging air pollutants (e.g. SO<sub>2</sub>, NO<sub>X</sub>, VOCs, PM); other environmental measures, such as adaptation or biodiversity; and capacity building and public awareness raising activities that would contribute to further emission reductions in host countries.

**Pricing:** Complicating the transactions of AAUs is the uncertainty over price and over host country strategy. However, basic rules of demand and supply apply to GIS. If an excess supply of AAUs were to be put to the market by Russia and Ukraine, the AAU prices would tend to fall. On the other hand, if there are expectations that Russia and Ukraine would not meet Kyoto eligibility criteria in the foreseeable future; or EU countries, Japan and Canada will have more difficulties in achieving their Kyoto targets, the expected AAU prices would move upwards.

Regardless of the modalities of transaction, pricing mechanism should be accountable, efficient and practical to secure the credibility and benefits of participation in international emissions trading. A number of questions will need to be addressed before making a decision about price formation mechanism for AAU trade. Depending on answers to these questions, the most preferable price formation mechanism should be chosen. The key questions to ask include:

**Timing:** The decision by a seller country as to when and how to float its AAUs will be driven by an analysis of the development of the carbon market, AAU price forecasts, economic conditions and political readiness, emission projections, lead time for preparing projects and programs under the GIS, and reserve needs. Host countries' economies are growing rapidly. Early implementation of GIS could therefore lead to less GHG intensive and more sustainable economy. On the other hand, some buyers might not be interested in acquiring AAUs for domestic political reasons but might later realize that they need them to fulfill their Kyoto targets. This could towards the end of the Kyoto period lead to purchase of even non-greened AAUs.

## **7. Is there a role for the private sector in GIS?**

It would be safe to assume that an AAU sales transaction, in principle, involves sovereign governments as buyers and the governments of host countries as the sellers, especially at the pilot transaction stage. This is because the right to trade AAUs under the terms of the Kyoto Protocol resides with the “Parties”, i.e. the sovereign governments, while private entities can only participate in trade if they are authorized by sovereign governments (e.g. Japan).

Not only as buyer and temporary holder of AAUs, private sector could participate in the GIS as financier, guarantor, fund manager and also could provide several services such as monitoring and supervision of the projects and programs under the GIS as well as their know-how and technology about energy-saving and environmental protection. Some governments may allow their private entities to use AAUs as compliance tool.

## **8. What has been the response from NGOs to GIS?**

Since GIS preparation is at a very early stage, NGO community has so far been mostly quiet. More discussion is expected. However, many of them have been against simply buying AAUs without any collateral benefits.

The factors preventing some OECD countries from being active in the GIS may be the limited capacity of the ministries concerned and potential reputation risk that means the buying government may be criticized domestically or internationally if it buys poorly "greened" AAUs, for example.