FNI Climate Policy Perspectives 2 November 2011

Dangers of the Endgame: Engaging Russia and Ukraine during the Gap

Anna Korppoo and Olga Gassan-zade

FRIDTJOF NANSENS INSTITUTT
FRIDTJOF NANSEN INSTITUTE

perspectives climate change

Dangers of the Endgame: Engaging Russia and Ukraine during the Gap

Anna Korppoo
Senior Research Fellow
Fridtjof Nansen Institute
anna.korppoo@fni.no

Olga Gassan-zade
Associate Director
Thomson Reuters Point Carbon
olga.gassan-zade@thomsonreuters.com

- In the absence of functional carbon market opportunities, the approaching gap in the international climate regime beyond 2012 is likely to alienate the major transition economy emitters Russia and Ukraine from the potential future climate regime.
- The new carbon market mechanisms currently under negotiation remain too underdeveloped and uncertain to provide incentives for Russia and Ukraine to remain actively engaged. Further, experiences with carbon market mechanisms thus far illustrate many weaknesses in the administrative and political systems of these countries which discourage their involvement in complex future mechanisms.
- In the absence of post-2012 carbon market options it seems likely that Ukraine will attempt to preserve its carbon market capacity by establishing a domestic ETS – however, without external involvement and prospects of demand, this may not be successful. Given Moscow's negative attitude towards further Kyoto commitments, it would be easy for Russia to interpret a gap as a broken promise: the surplus of AAUs and the Kyoto mechanisms are considered as a right that Russia was promised in Kyoto in 1997.
- Given the functionality of Joint Implementation (JI), its extension seems the most feasible option for engaging Russia and Ukraine in the international climate regime immediately post-2012. However, various politically difficult questions remain as to the JISC recommendation to base ERU issuance on the first commitment period AAUs.
- Regardless of the problems and frustrations experienced with JI and GIS during the first commitment period, engaging Russia and Ukraine in the climate regime through the continuation of JI would probably provide the least-effort option for the future. Allowing domestic carbon-market capacities to disintegrate during the gap years would probably lead to serious problems when the support of these countries is sought for the future climate regime, due not least to Russia's confrontational approach to international climate diplomacy.

*The **Fridtjof Nansen Institute (FNI)** is an independent, non-profit institution engaged in research on international environmental, energy and resource management politics. **Perspectives** is an independent service enterprise that works in consultation with the private sector as well as governments and NGOs in realizing and enhancing instruments in the international greenhouse gas market. **FNI** exercises quality control and editing of the papers, but the views expressed are the sole responsibility of the authors.*

Dangers of the Endgame: Engaging Russia and Ukraine during the Gap

The future direction of the global climate regime is highly uncertain beyond 2012 due to the widely diverging viewpoints between developed and developing countries on the allocation of mitigation responsibilities. In recent years, negotiators and analysts have focused on the need and opportunities for upscaling mitigation efforts in the developing countries. Less attention has been paid to the evolution of climate policy in Russia and Ukraine. If anything, the two countries have caused concern due to their formidable AAU surpluses and potential to supply large volumes of ERUs to European markets. Nonetheless, Russia and Ukraine were, as of 2008, the world's 4th and 20th largest greenhouse gas emitters respectively, jointly responsible for close to 7% of total global emissions.[1]

How to keep Russia and Ukraine engaged in the global climate regime during the approaching gap period between the Kyoto Protocol (KP) and the follow-up regime? This paper argues that the new market mechanisms under consideration remain too distant in time to provide sufficient stimuli for these countries to continue active participation in international climate policy. The continuation of Joint Implementation (JI) could preserve domestic capacities and provide incentives for participating in the future regime after the gap.

Market mechanisms and climate diplomacy intertwined

Russia and Ukraine share common concerns as regards climate policy. Replacing obsolete Soviet technology improves economic competitiveness and energy security – issues high on the domestic political agendas – while, as a side benefit, it also reduces the carbon intensity of these economies. Their loose targets under the KP have further detached the domestic mitigation agenda from international climate diplomacy. Nonetheless, their vastly different resource bases and political traditions place Russia and Ukraine in different circumstances in terms of climate diplomacy and views on the Kyoto mechanisms.

Russia's climate diplomacy is guided by a foreign policy that emphasizes the country's prestige and independence, compounded with the domestic imperative of economic growth and international competitiveness. The Russian leadership has repeatedly expressed dissatisfaction with the lack of a wider, more inclusive climate agreement. In the Russian view, advanced developing economies like the BASIC bloc, which do not face climate obligations similar to those of Russia, enjoy an unfair competitive advantage. Therefore, in Cancun in 2010, Russia declared its intention to opt out of a second commitment period of the Kyoto Protocol (KP2). Past experience has also shown that Russia is prepared to bargain not only to gain direct benefits but also to demonstrate its position as an important foreign-policy player.

Historically, the carbon market mechanisms have been closely linked with climate diplomacy for Russia, whereas mitigation policies have tended to come about as side benefits of economically motivated policies. Russia's participation in international climate politics has been underpinned by the potential benefits retrievable from the Kyoto mechanisms (KM) ever since they were introduced, even though monetizing these benefits has remained rhetoric until recently. Hence Russia considers surplus AAUs and the KM as its rights under the international regime in recognition for fulfilling its Kyoto obligations. This, however, has been more of a diplomatic issue than a pragmatic one, as Russian leaders have never had sufficient interest in the KM to take full advantage of them. Still, the rhetoric is likely to remain an important element in the country's climate discourse

[1] United Nations Statistics Division, Millennium Development Goal Indicators. Available at http://mdgs.un.org/unsd/mdg/SeriesDetail.aspx?srid=749&crid=.

and diplomatic agenda, due to feelings of entitlement and negotiating tactics. Additionally, the very public failures of the Russian administration with JI, the lessened demand for AAUs and the availability of other lucrative sources of income, such as energy exports, contribute to the low priority that Russia has given to the pragmatic implementation of JI and GIS. In contrast, the rationale for mitigation policies is the opposite: they are being introduced apparently independent of climate diplomacy. Through the 'national project' of modernization promoted by President Medvedev, energy efficiency in particular has gained importance on the domestic policy agenda.

In ***Ukraine***, a combination of private and national interests unrelated to climate concerns appears to drive mitigation measures, the country's ambitious renewable energy policies in particular. Intrinsic drivers, such as energy security and modernization of industry to improve competitiveness, are also relevant, although not promoted on the national level as in Russia. The approach to the KM is rather pragmatic than political. The financing available through the KM has been seen as a major opportunity in Ukraine, especially in comparison to its energy-rich neighbour Russia. Despite an initially slow start, KM have been keenly and successfully developed in Ukraine, becoming a major factor in climate policy.

In terms of climate diplomacy, Ukraine has mostly been a 'policytaker' and not a 'policymaker'. Kiev has seldom pressed independently for its viewpoints. It tends to work behind the scenes when necessary, mostly on securing the KM and the carry-over of the AAU surplus, as well as headroom for growth due to the country's disadvantaged economic status. In order to facilitate KM continuation, Ukraine supports KP2.

Experiences from the first commitment period

Russia and Ukraine have differed in their experiences and practical approaches to implementing carbon market mechanisms. Ukraine has been ranked by PointCarbon as the best JI host country in the world, while Russia launched its first functional JI approval process only as recently as in 2009. Ukraine has also experimented with GIS, while such scheme has remained rhetorical in Russia. Table 1 shows various indicators, with potentials of Russia and Ukraine to host mechanisms, and actual activities reported at the time of writing. Several lessons can be drawn from the experiences of JI and GIS in these countries, many of them applicable to the future mechanisms currently under negotiation.

The ***start-up of the mechanisms was slow*** in both countries. In Ukraine it took 8 years – until 2007 – to gain the political will to establish the National Environment Investment Agency, which eventually led to the formulation of JI and GIS procedures. In Russia, the process did not start until the mid-2000s, after Russia's ratification of the KP, which led to the first functional administrative system for JI in 2009. The system has been revised since, but it still remains opaque and challenging for investors. The time and effort required for launch can become a major problem for post-2012 mechanisms should they require new types of administrative systems or their re-launch.

Table 1. *Main indicators of emissions and activities under the Kyoto mechanisms (November 2011)*

	Russia	Ukraine
KP commitment of 1990 level	0%	0%
GHG emissions 2009	-35.5% / 2,159 Mt	-60% / 370 Mt
Estimated surplus 2008-2012	5,500 Mt	2,500-2,800 Mt
JI projects approved	89 Mt	133 Mt
ERUs transferred	26.5 Mt	62 Mt
AAUs allocated for JI	300 Mt	N/A
AAUs sold (including early JI crediting)	0 Mt	47 Mt (GIS) + 30 Mt (early JI crediting)

Sources: UNFCCC database, Ukrainian registry, Thomson Reuters Point Carbon.

The ***choice of domestic actor involvement*** in project implementation is crucial. Activities in the public sector are dependent on the successful implementation of government policies; under GIS, both practical problems and credibility issues have been experienced with the absorption of the revenues. The involvement of the politically strong private sector has supported JI in Ukraine. By contrast, in Russia even powerful interest groups have less direct access to policymakers and thus have shown less interest. As a result, the political support to carbon market mechanisms is considerably lower in Russia than in Ukraine.

Mechanisms which require trust between the buyer and seller suffer from the unpredictability of the ***state level regulatory environment***. For instance, failures to honour contracts and the lack of stability of JI regulations have alienated buyers in Russia, whereas Ukraine has experienced similar issues with the GIS. Inter-agency conflicts and changes in domestic politics (like new governments or presidential elections) can trigger such changes, through new priorities in the domestic policy agenda and changes of personnel in key agencies. Also the overall *perception* of corruption within the civil service and general problems with the rule of law can have a similar effect. The problems with eligibility to trade under the KP provide a wider lesson for transition economies; Ukraine has been one of those affected.[2]

Prospects for new mechanisms

The Cancun Agreements formally opened up the establishment of 'one or more market-based' mechanisms beyond 2012. The key suggestions from the submissions by the Parties can be roughly categorized into three options. The ***crediting mechanisms*** entail the issuance of credits after verification of performance resembling the CDM. Sectoral crediting is typically used to describe absolute or intensity-based sector targets, whereas credited NAMAs refer to implementation of regulatory mitigation measures. The ***trading mechanisms*** foresee the establishment of an absolute emission target, on the sector level or the domestic level. In the case of the crediting mechanisms, any targets set are likely to be 'no-lose'; by contrast, under trading mechanisms, the host countries will face a compliance bill should they overshoot the agreed target. **The *custom-made instruments*** such as bilateral mechanisms would allow countries to design, establish and implement their own market mechanisms, under the direction of the COP/CMP on the basic principles of MRV. Domestic offsets could receive international recognition through formal accreditation under the UNFCCC.

Even in the most optimistic scenario it seems unlikely that the new mechanisms could be ready for implementation before the late 2010s or early 2020s. It will take two or three years to agree on the implementation details and modalities on international level, and another three to five years to build domestic institutions and policy frameworks. Based on the experiences from JI and GIS, in Russia and Ukraine this process might take even longer. The weakness of administrative and institutional systems, demonstrated by JI project approval in Russia and GIS programmatic schemes in Ukraine, and policy implementation in general are likely to hinder participation in mechanisms which require strong public sector involvement. Further, the uncertainties of state-level regulatory practices, for instance stability of contracts and rules would further reduce the chances of success for these mechanisms.

The approaching gap: Still-life without carbon market

The void in carbon-market activities while the struggle on the future climate regime continues is of great concern for the continuity of climate policies in economies in transition. Demand is declining for both CDM and JI, and, the sole remaining buyer – the EU – is unwelling to accept credits from projects registered after 2012, because of the absence of a global climate regime, and low demand under the current cap. Thus, without the continuation of the KP and its AAUs, under the current rules JI projects will be unable to issue credits from new projects beyond 2012. That will leave the hard-won capacity of the climate administrations redundant in Ukraine and Russia during the gap.

In the absence of post-2012 carbon market options, some activities in Ukraine might continue. Ukraine is in the process of establishing a domestic ETS, inspired by the success of JI and GIS and supported by the domestic carbon-market lobby. While an indication of potential demand from the EU would provide a

[2] Bulgaria, Romania, Ukraine, Lithuania and Greece have appeared before the enforcement branch of the Kyoto Protocol Compliance Committee due to issues with national inventory systems. Enforcement Branch of the Compliance Committee,12 October 2011, CC-2011-2-9/Ukraine/EB.

strong incentive to develop the mechanism, the scheme currently appears to be driven by considerations of purely domestic business opportunities. These plans, however, can be disrupted by the ongoing reshuffle in Ukraine's climate administration as a result of Ukraine's non-compliance. The upheaval in the climate administration combined with the lack of external market drivers might direct the focus of the crucial domestic interest group – the oligarchs – away from the carbon market. Without their backing, Ukraine's climate institutions will face the risk of expiry together with the mechanisms they were designed to support.

Russia would face even bleaker prospects. JI investments have only recently benefited from the attention of President Medvedev, who has linked them to the presidential modernization goals. At the time of writing, a third presidential term for Vladimir Putin seems assured. His return to power may shift away the focus Medvedev put on the mechanisms, as Putin doubts the support achievable for the primary goal, modernization, through the mechanisms. [3] Considering the lack of interest from the future political leadership, Russia's negotiating position and the rather modest success of Russia's JI administration, it seems unlikely that Russia would actively seek out carbon-market options beyond the international regime.

In both Russia and Ukraine, the slow death of the mechanisms domestically can have a devastating effect on the prospects of any future climate policies. The biggest danger will be the impeding international gap period, when the existing mechanisms expire and the new mechanisms remain uncertain. In Ukraine, which has staked significant political will on the mechanisms, failure of the planned ETS would be a major flop for the government. In Russia, the discontinuation of the KM would readily be seen as a broken promise; together with the AAUs, the mechanisms are considered as a privilege Russia was promised in Kyoto in 1997. This will also resonate with the original Russian expectations of direct bulk trading with the US, instead of complicated piecemeal deals through the project-based mechanisms.

Post-2012 JI as a solution?

Without other carbon-market mechanisms, continuation of JI after 2012 could provide the vital link needed to sustain climate action in Russia and Ukraine and legitimize mitigation activities beyond accidentally favourable energy policies and involvement in international climate regime. For there to be prospects for JI post-2012, however, will require solving at least two problems: the lack of applicable procedures for JI, and the lack of demand for credits.

The JISC has recommended a CMP decision that either 1) existing and new JI projects could be credited based on converting first commitment period AAUs into ERUs under Track 2 until the end of the 'true up' period or the establishment of KP2 Assigned Amount for the host party; or 2) using Track 2 procedures to issue offset credits and deduct them from the future emission reduction and limitation targets adopted by host parties. [4] The first option sounds more feasible, as it could exist independently of further carbon commitments. However, it will require consensus amongst the negotiating parties on the treatment of the AAUs beyond 2012. Also, both Russia and Ukraine would be apprehensive about retaining control of the issuance and their AAUs under such solution. Further, Russia's rejection of the KP2 would constitute a legal obstacle to these solutions.

Crediting JI based on first commitment period AAUs could provide politically acceptable use for the surplus. First, under these suggestions the conversion of AAUs into ERUs would only take place under Track 2 i.e. supervision by the JISC. Second, only a limited volume of AAUs can be utilized through the project-based JI in practice: for instance during the first commitment period, the total volume of ERUs from Ukraine and Russia is likely to remain below 0.5 Gt[5]. Third, the availability of more ERUs during the true-up period may reduce the volume of direct AAU trading when fulfilling first commitment period compliance requirements due to a corresponding reduction in demand. However, Russia and Ukraine are unlikely to accept post-2012 JI as the only way of using AAUs beyond 2012.

[3] В.Путин: "Мы должны думать о модернизации, об инновациях, о внедрении новых технологий на новую перспективу и на этом развиваться". New story by Автономная некоммерческая организация Центр экологических инноваций, available at http://ngo-cei.ru/news/72.html.

[4] Joint Implementation Supervisory Committee (2011). Twenty-sixth meeting report, Annex 4: Recommendations on options for building on the approach embodied in joint implementation.

[5] Below 0.2 Gt in November 2011 taking into account that Russia's third tender was cancelled.

Table 2 outlines some options (including those suggested by the JISC) for continuing JI beyond 2012. Ukraine could participate in most opportunities of continuing JI, subject to eligibility to trade under the Kyoto Protocol – partly due to the endorsement of KP2, partly as a result of the positive experiences with JI. For Russia, problems arise from its opt-out of KP2 – the EU is unlikely to accept ERUs from Russia, and the G77 have opposed allowing the KM to be used without KP2.

As to the mechanisms, the Russian stance on KP2 appears to be a losing strategy, but is probably hard to change. Russia's compliance with its Copenhagen pledge seems secured by current domestic policies and emission trends, and would be unlikely to put the country into any worse position economically than the non-Annex I major emitters without commitments. Even though there is a well-founded and logical basis for this national position, the practical outcome in rejecting KP2 is likely to fall short of the benefits potentially available for Russia. First, the current havoc of the climate regime provides Russia with an opportunity to act as a constructive partner in foreign policy, as sought after by the leadership. Second, participation in post-2012 KM would be legally more straightforward under KP2. Third, with Russia under KP2 it may be easier for the EU to support the continuation of JI and even consider the access of ERUs into EU ETS Phase III in the absence of a global regime. On the other hand, these opportunities would have to attract the attention of the top leadership, as well as backing from a clearly stated principle of wider participation – and both these seem unlikely developments.

Another difficult problem is the dwindling demand for credits. The ineligibility of ERUs under EU ETS Phase III in the absence of 'an international agreement on climate change' is a major obstacle, as the EU is potentially a major buyer. Yet, allowing access of post-2012 ERUs into EU ETS could prove difficult, given the already low demand in the system and concerns that an influx of ERUs could further depress the EUA prices. Japan barely needs further credits at all. The reluctance of the buyer countries to prop up international markets artificially is understandable, especially in hard economic times. But when the other side of the coin is the risk of seriously derailing international climate policy, it might well be worth searching for a compromise.

***Table 2:** Options for continuing JI beyond 2012*

Mechanism option	Details	Unresolved issues	Russia (RF) and Ukraine (UA)
AAU-based crediting of JI (JISC proposal 25a)	Converting AAUs into ERUs under Track 2 until end of true-up period / beginning of KP2	Host country issuance. Prejudges the treatment of AAUs beyond 2012. Allows JI to continue without KP2. Eligibility under EU ETS Phase III.	Unclear whether this would apply to RF, which has opted out of KP2 beyond true-up period. Joining KP2 facilitates UA's participation.
Future commitments based crediting of JI (JISC proposal 25b)	Crediting offsets under Track 2 and deducting from future commitments	Difficulty of ex-post agreement on commitments: how to ensure that offsets are not counted in by pledging Parties? Allows JI to continue without KP2. Eligibility under EU ETS Phase III.	No mention of commitments being under KP, so would allow RF to participate despite its opt-out of KP2.
JI under the UNFCCC	Crediting similar to the CDM	G77 opposes continuation of CDM and JI without KP2; opposition to JI likely to be even stronger than to the CDM. Eligibility under EU ETS Phase III.	Would facilitate RF even outside KP2.
Bilateral arrangements	Any option from above or other without international oversight	How to avoid crediting non-additional projects if both parties have vested interest in them?	RF's negative experiences with regulatory stability and transparency reduce chances of demand. UA is in somewhat better position, but negative experiences with GIS scheme may discourage buyers.

Conclusion

The new carbon market mechanisms currently under discussion remain uncertain and too distant in time to offer incentives for Russia and Ukraine in the international climate regime. Further, experience has indicated that many of the proposed mechanisms may prove overly complicated, especially for Russian stakeholders with less experience of JI and GIS. Also the credibility of both Russia and Ukraine as providers of credits has suffered from the shortcomings of the administrative arrangements during the first commitment period. Given their existing JI administrations, continuation of JI beyond 2012 would offer the most feasible – and tested – solution to facilitate their engagement, from the perspective of the regime as well as that of the host country.

The main problems with the post-2012 solutions for JI relate to the use of the first commitment period AAUs. First, allowing their use through JI would require consensus on the issue of carry-over, on which the parties are severely divided. Second, Russia's rejection of KP2 calls into question the legal basis to carry over AAUs, or even participation in the KM post-2012. Ukraine thus seems more likely to benefit from the approach suggested by the JISC; however, given the political will among other parties, it could also be possible to facilitate Russian participation.

Many other parties may not even consider Russia and Ukraine's engagement beyond-2012 relevant at this point. International attention has focused on the major developing economies as the main source of the rise in global emissions. Moreover, problems with buying ERUs from Russia and AAUs from Ukraine have reduced their attractiveness for buyers thus far. However, for Russia and Ukraine, termination of JI without any replacement will pose a serious threat to the continuity of their climate policies and institutions. These two countries are both major emitters and sources of cost-effective emission reductions, so their support for a future climate regime is likely to be essential some years down the line. Russia's foreign policy-focused approach to the climate regime, and especially Putin's expected return to power, suggests that if ignored at this point, it would be difficult and time-consuming to bring Moscow back to the regime after a gap. The most drastic outcome would be if whatever institutions that have been built will disintegrate in the absence of the need for them as the negativity that this would generate might prove an insurmountable barrier to re-engaging these countries in any future climate regime. All in all, keeping Russia and Ukraine focused on post-2012 JI stands out as the least-effort option.

Acknowledgements

The authors would like to thank Thomas Spencer, Michael Yulkin, Andreas Tuerk and Dorian Frieden for their comments. The work was funded by the post-doctoral research project 252853 of the Academy of Finland and the NORKLIMA project 207810 of the Norwegian Research Council.

About the authors

Dr Anna Korppoo *works as a Senior Research Fellow at the Fridtjof Nansen Institute. Her work focuses on the climate and energy policies of Russia and other transition economies.*

Olga Gassan-zade *is an Associate Director at Thomson Reuters Point Carbon, focusing on international climate change negotiations and post-2012 mechanisms. She has worked extensively in Eastern Europe and the Former Soviet Union countries and has in-depth knowledge of climate politics in the region.*

ISSN 1893-1510 / ISBN 978-82-7613-633-3
Series Editor: Anna Korppoo (anna.korppoo@fni.no) / Cover photo: Jan Dalsgaard Sørensen