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CARBON CREDIT RIGHTS UNDER THE PARIS AGREEMENT

HOW ARTICLE 6 AND THE IMPLEMENTATION OF NDCS MAY SHAPE GOVERNMENT APPROACHES TO THE CARBON MARKET, AND WHAT THIS MEAN FOR RIGHTS RELATED TO CARBON CREDITS





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1.0 EXECUTIVE SUMMARY

The adoption of guidance for Article 6 of the Paris Agreement ("Article 6"), combined with the beginning of implementation of the first Nationally Determined Contributions ("NDCs"), provides a new international context in which the voluntary carbon market is operating. This new context may have implications for entities intending to generate, own and use carbon credits in certain countries, as is already being seen in some jurisdictions. This paper examines this new context, the steps that governments are taking or may take in response, and what this means for market actors.

While largely unregulated, the voluntary carbon market has always existed in the context of different national legal and regulatory frameworks. The rights of ownership over carbon assets, and their treatment when traded as carbon credits, are derived from laws, regulations and customs in the applicable jurisdiction and as such are subject to the evolution of these laws, regulations and customs over time.

Over the past two years, there have been two major changes at the international level that are likely to shift the way that governments engage with and manage carbon market activities within their jurisdiction. The first of these changes is the beginning of the implementation period for countries' first Nationally Determined Contributions (NDCs) under the Paris Agreement. Governments now have a greater interest in tracking – and in some cases incentivising and managing – carbon market activities that are generating emission reductions or removals that can be counted towards the targets set in that country's NDC. The second change is the adoption of new guidance underpinning Article 6 of the Paris Agreement. This provides a framework for governments to 'authorise' the use of emission reductions and/or removals achieved within their jurisdiction by other entities, giving government an inherent right to control the use of carbon credits.

Governments of countries that host carbon market activities may choose to take a number of different steps in this new context, as some are already doing. Some may step up their tracking of carbon market activities, for instance requiring registration and monitoring on a national registry. Some may introduce approvals procedures, requiring government approval or a 'statement of no-objection' before activities can proceed. Some may establish procedures and a legal basis to implement the Article 6

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mechanisms, and authorise the use of emission reductions and/or removals by other entities. Meanwhile others may take new and novel steps to incentivise the development of carbon market activities within their jurisdiction, for instance through the tax system, by sponsoring the establishment of local market architecture or by clarifying the legal classification of carbon credits.

These steps may interact in different ways and to varying extents on three distinct sets of 'rights' identified in this paper. The first of these is the right to generate carbon credits, the second is the right of ownership and legal title to carbon credits, and the third is rights related to the use of carbon credits. Based on experience to date as well as market expectations, it seems possible that rights related to the use of carbon credits are likely to be affected over time by the new context under the Paris Agreement; rights related to the generation of carbon credits may be somewhat affected in certain jurisdictions; and rights related to the ownership of carbon credits may not be significantly affected as a direct result of the two changes described above.

In addition to uncertainty about what the future may hold, market actors have also responded with concern regarding a number of steps that governments have taken in the first year after the adoption of Article 6 guidance at COP26. However, it is important to remember that there are substantial shared interests between governments and market actors, when the carbon market is working effectively. The emission reductions and removals, sustainable development benefits and inward investment delivered by carbon market activities provide benefits for local communities, economies and environments, and can therefore support national objectives. Notwithstanding the current uncertainty in the market in the wake of the adoption of the Article 6 guidance, it is hoped that increased engagement by governments can be applied to support, enable, and incentivise the role of socially and environmentally impactful carbon market activities in achieving the goals of the Paris Agreement, rather than hindering them.

2.0 INTRODUCTION

For an asset like a carbon credit, legal rights matter. Carbon credits exist not as tangible, visible assets but instead as digital assets created by a crediting programme to represent a verified emission reduction or removal, in line with their specific rules and methodologies. At the same time, the rights that underpin these assets are derived from the laws or regulations of relevant national or local authorities (and in some cases, the customs of indigenous communities), which vary between jurisdictions¹. It is not a surprise, given the importance of this issue, that one of the three areas focused on by the Taskforce on Scaling the Voluntary Carbon Markets in 2021 was legal principles to clarify the treatment of carbon credits across jurisdictions. The International Swaps and Derivatives Association has also deemed this issue to be sufficiently material to merit a detailed legal analysis².

The implementation of Article 6 of the Paris Agreement introduces new considerations for rights related to carbon credits. Under Article 6.2, a host government has the right to authorise emission reductions or removals (or 'mitigation outcomes'³, in the parlance of Article 6) for use towards an NDC or by public or private entities for other international mitigation purposes. Implicit in this is an understanding that national governments have certain rights related to emission reductions or removals which take place within their jurisdiction. Aside from Article 6, there are already examples of governments beginning to exert new powers over carbon market activities taking place within their jurisdiction, including those intended for the voluntary carbon market.

The purpose of this paper is to examine how the new context under the Paris Agreement, and the decisions that host governments make in this new context, may affect market actors in relation to the generation, ownership, and use of carbon credits. This paper considers jurisdiction-specific examples of government

¹ https://www.iif.com/Portals/1/Files/TSVCM_Phase_2_Report.pdf

² https://www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf

³ In this paper, the authors use the term 'mitigation outcome' to refer to an emission reduction or removal that has been achieved, and will typically use the term in the context of Article 6; the term 'carbon credit' will be used to refer to the asset issued to a project developer for a verified emission reduction or removal. The two terms are therefore distinct but closely linked.

requirements, laws or regulations currently affecting market participants; the Article 6 framework created through the adoption of a rulebook at COP26; and the changes that we may now see as a result of this framework and the new context under the Paris Agreement.

2.1 Drivers of a changing context

This paper examines two linked but distinct drivers that may lead certain 'host governments' (governments in whose jurisdiction carbon market activities are taking place) to exert new powers with respect to carbon market activities and the carbon credits that they generate:

- 1. Adoption of the Article 6 rulebook. At COP26, governments adopted a rulebook to underpin the use of Article 6 of the Paris Agreement, including rules related to the authorisation, reporting and accounting of internationally transferred mitigation outcomes ("ITMOs"). With the adoption of this rulebook, governments essentially hold the right to determine (through a process referred to in the rulebook as "authorisation") which mitigation outcomes achieved within their geographical boundaries (including emission reductions or removals represented by carbon credits) may be transferred for unique use by other countries or entities, and which mitigation outcomes will or at least may be counted towards the host country's NDC.
- 2. Implementation of first NDCs. From 2021, governments have begun to implement measures to achieve the targets set out in their first NDCs under the Paris Agreement. Each Party is required by the Paris Agreement to pursue domestic mitigation measures with the aim of achieving the targets in its NDC, and to report every two years from 2024 on progress towards meeting these targets as part of its Biennial Transparency Report. This represents a shift from the Kyoto Protocol era, in which developing countries held no international responsibility to set and maintain a national climate mitigation target. In this new context, governments have a far greater inherent interest in understanding and tracking and potentially managing, administering and incentivising activities that are achieving emission reductions and/or removals within their jurisdiction, including

those in the carbon market, all with a view to achieving the targets set out in that country's NDC.

At the level of an individual country, either or both of these two drivers may apply. Even in a country that has no stated interests or plans to authorise the transfer of mitigation outcomes under Article 6, the second of these drivers may lead the government to establish a greater role with respect to carbon market activities within its jurisdiction. As will be explored later in this paper, governments may for instance require the registration of activities on a national registry or may introduce incentives or frameworks to foster a domestic carbon market, to support achievement of the targets set out in that country's NDC and broader climate-related plans and ambitions.

2.2 Categories of rights

This paper also considers three distinct categories of rights related to carbon credits, to more accurately identify how the two drivers referred to above may have a bearing on them in the future. These categories are:

RIGHT TO GENERATE

This is the right of a project developer to implement an activity that will ultimately generate (or cause the applicable carbon registry to issue) carbon credits. This could, for instance, be affected by any activity approvals processes implemented by governments. Governments will already be required to approve all activities within their jurisdiction that intend to be registered with the new crediting mechanism established by Article 6.4 of the Paris Agreement. Governments are not obliged to issue similar approvals for activities registered with other programmes, such as those traditionally associated with the voluntary carbon market, though some may choose to do so.

RIGHT TO OWN

This is the right of a project developer to hold and assert legal ownership over carbon assets (in the form of credits) that are referrable to emission reductions or removals resulting from a particular activity. This right is typically subject to arrangements between parties involved in the applicable activity and the legal, regulatory and/or customary framework of the country in which the activity takes place, including laws and customs related to use of and title to natural resources as well as land and property rights.

RIGHT TO USE

This is the right of an entity to use carbon credits for a specific purpose, whether that is a corporate claim, an NDC target or a compliance obligation. It is this right that is most directly affected by the adoption of the Article 6 rules. Under Article 6, a host government has the right to decide whether mitigation outcomes achieved within its jurisdiction are authorised for use towards (i) an NDC of another country, and/or (ii) 'international mitigation purposes', which is generally understood to include use by an airline operator to comply with CORSIA⁴, the international aviation sector's offsetting regime. Host governments also have the ability to authorise the use of mitigation outcomes for 'other purposes', which may include the voluntary market, and an implicit ability to impose more tailored terms and conditions as part of their authorisation, such as restricting use by certain types of entity.

This right should be understood to include two related concepts: the 'right to claim' (whether an entity can claim unique ownership over an emission reduction and therefore make certain claims against it) and the 'right to sell' (for instance, whether an entity can sell credits to buyers based in a jurisdiction other than that in which the emission reduction or removal occurred). While

⁴ Carbon Offsetting and Reduction Scheme for International Aviation

there may be slight differences between these concepts, the implications are broadly similar.

It is important to keep these categories in mind, as they are likely to be affected to varying extents by the adoption of Article 6 guidance and the implementation of NDCs. Broadly, and as explored further in this paper, the authors assess that rights and abilities related to the use of carbon credits are likely to be considerably affected over time; rights related to the generation of carbon credits may be somewhat affected in certain jurisdictions; and rights related to the ownership of carbon credits are unlikely to be significantly affected as a direct result of the two drivers described above, though may of course be affected by other factors.

The following section considers some existing mechanisms that governments have in place to regulate or otherwise manage carbon credits, before turning to the new context under the Paris Agreement.

3.0 HOST PARTIES CONTROL MECHANISMS

This section explores some of the mechanisms and powers that certain governments already hold and which affect the categories of rights described in the previous section. While the focus of this paper is on the implications of the transition to a new context under the Paris Agreement, it is important to remember that projects generating carbon credits have always existed within a legal and regulatory context, which has a bearing on rights relating to those carbon credits. Just as there are some similarities as to the treatment and categorisation of carbon-related rights between different jurisdictions, there are also significant variations. This section does not intend to provide an exhaustive overview, but instead provides some illustrative examples of the treatment of carbon rights in a number of jurisdictions.

3.1 Right to generate

National governments have, over the past two decades, had the responsibility of approving activities intending to generate carbon credits under the Clean Development Mechanism ('CDM').⁵ This approval, given to project participants by the designated national authority of a government, is a pre-condition for any project intending to qualify for the issuance of certified emissions reductions under the CDM.

A similar standardised approval mechanism (analogous to the approval process under the CDM) has not historically formed part of other crediting programmes that oversee and administer projects in the voluntary carbon market. Under the Gold Standard's crediting programme, for instance, projects are required to notify national government officials or focal points as part of their stakeholder consultation prior to the project's registration, but any requirements and steps beyond this are considered to be the responsibility of the relevant national government.⁶

There are certain countries that impose requirements on activities within their jurisdiction, as a condition of them operating. In Colombia for instance, activities are required to register on RENARE, the National Registry of Reduction of Greenhouse Gas Emissions.⁷ The act of registration, in which a project needs to report its existence to a government, is however quite distinct from an act of approval, in which a government has the right to make an election as to whether or not the project may exist. There are currently few, if any, examples of jurisdictions in which the government consistently asserts a right of approval for projects registered with crediting programmes serving the voluntary carbon market.

⁵ https://unfccc.int/resource/docs/cop7/13a02.pdf#page=20

⁶ https://globalgoals.goldstandard.org/standards/102_V2.1_PAR_Stakeholder-Consultation-Requirements.pdf

⁷ Law 1753 2015. Article 175, Resolution 1447 2018

3.2 Right to own

Project developers seeking certification under established standards are currently required to demonstrate their legal entitlement to carbon assets before credits representing those assets are issued by those standards. Under Gold Standard, for instance, projects are required to demonstrate "full and uncontested legal ownership of any Products that are generated under Gold Standard Certification". Where this ownership is transferred from project beneficiaries, this must be demonstrated "transparently and with full, prior and informed consent." Similar arrangements are in place under the Verified Carbon Standard overseen by Verra and other established standards.

The question of the right to extract or harvest natural resources as well as rights to use of land can often be fundamental to any analysis of entitlements to rights to carbon assets (which can be defined as a benefit from reduced GHG emissions and/or sequestered carbon with this benefit ultimately being represented by a digital credit). Any such analysis is highly context-specific, with significant variations between jurisdictions. It is nevertheless helpful to compare examples and consider general trends.

It is first important to assess and categorize different systems of land tenure, which directly affect the carbon right arising from the sequestration of CO2 by a forest. This is of particular importance for REDD+ activities as, dependent on the land ownership status, not all credits could be assigned to the government.

In some developing countries, the government owns or has authority to deny the rights of others to forest resources. As such, the government becomes a default owner of the carbon rights from all the forest resources in the country. The Democratic Republic of Congo made such a move in 2018 by passing a Homologation Decree, under which private project developers can only have a secondary right to carbon, which is transferred to them through a certification of homologation. A similar standard is applied in Mozambique, where all land and natural resources are a

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⁸ https://globalgoals.goldstandard.org/standards/101_V1.2_PAR_Principles-Requirements.pdf 9 https://verra.org/wp-content/uploads/2022/06/VCS-Standard_v4.3.pdf (Section 3.6)

property of the state and as such the project developers have only a secondary right to carbon. Projects can, in this context, receive a license to generate carbon credits.

A legal framework which assigns all the carbon rights to the government runs into some challenges, given the mixed system of ownership, strong communal or statutory land titles, and a non-negligible role of the government. Local communities and tribes which steward the land may need to be compensated. In countries such as Ecuador, where all ecosystem services belong to the state, private projects are not permitted, and it remains unclear whether and to what extent indigenous peoples should be compensated. Another challenge is the extent to which land in the country remains within informal arrangements. Potential compensation is complicated by unresolved land tenure issues.

Where there are well-established laws on title to private land (including forested land), landowners can benefit from carbon rights as a part of ecosystem services arising from their ownership of the land. As such, owners can generate carbon credits and trade them on compliance or voluntary markets. In Guatemala and Chile for instance, carbon rights belong to the entity with the title to land and private entities are free to participate in carbon markets. Similarly, in Kenya, rights to emissions reductions or removals stem from legal regimes for the ownership of land, thereby providing a landowner with the right to assign the benefit of the carbon asset to a third party or to transfer this right by expressly referring to it as part of a leasing or licensing agreement for the use of the relevant land by such third party.

There are also examples where carbon rights are not necessarily connected directly to the land title, but rather to stewardship over the land by a multiplicity, individuals, legal entities, and communities. Carbon rights of project developers in this case are

the land title, but rather to stewardship over the land by a multiplicity, individuals, legal entities, and communities. Carbon rights of project developers in this case are often claimed as secondary, resulting from project financing and monetization. This is the case in Peru, where carbon rights can be claimed by communities, land managers or local governments which steward over the land and sequester the carbon through reforestation. However, these entities can choose to transfer their carbon rights to project developers.

In addition to forest rights, there are cases where legal title associated with CO2 sequestration also needs to take into account the ownership of resources below ground. In Iceland, the ownership of ground resources is attached to the ownership of private grounds. As such, the carbon right associated with carbon capture and storage

lies with the project developer. In jurisdictions where resources below ground are owned by the government, and with no regulation of carbon capture and storage, it becomes more ambiguous whether the capture of carbon and its storage in the ground is associated with a transfer of carbon rights to the government.

Furthermore, some jurisdictions (Uganda being one example) passed national laws to implement certain aspects of the CDM including with respect to appropriation and transfer of rights to carbon assets. It is important therefore to check whether the host country for a proposed project has a history with project development under the CDM and whether a legal or customary precedent has been set in that jurisdiction for the ownership, appropriation and transfer of carbon rights.

In order to avoid potential disputes, it is key that parties agree who has the primary carbon right and which party converts it to a carbon credit. In order to achieve this, carrying out legal due diligence on carbon-related laws, regulations and customs in the host country for the proposed project is essential. Without understanding the source of what gives rise to the right to carbon assets and benefits under local laws, regulations and customs in a given jurisdiction, a project developer, investor or financier would be ill-advised to commit to providing equity or debt in a carbon activity in that jurisdiction. Once these matters are understood by contracting parties, the risk allocation on issues such as the passage of risk and title to carbon assets as well as the creation of liens, encumbrances or other forms of security can be documented in a contract. This contract should also specify the rights, responsibilities and financial benefits arising from the commercialization of the carbon right.

3.3 Right to use

The classification of a carbon credit for legal purposes is vital for project developers and buyers of carbon credits, as it determines its tax treatment and the way it is recognized in financial reporting. Whether an entity decides to acquire carbon credits may depend in part on the legal certainty that the entity can have about the type of instrument that a carbon credit represents. For example, whether the relevant authority considers and treats a carbon credit as a commodity, financial instrument,

tangible or intangible asset or simply as a set of contractual rights to benefit from the verification process performed by the project developer¹⁰.

So far, a uniform international definition of carbon credits has not been adopted. By the nature of a carbon credit, it can be seen to have more characteristics of an intangible asset than a tangible asset. Certain jurisdictions, including Colombia¹¹, consider carbon credits as intangible property and therefore regard them as a supply of services. Furthermore, carbon emission allowances are generally treated as intangible assets for accounting purposes. Only some countries, including Australia define carbon credits as financial instruments¹².

According to the legal definition of voluntary carbon credits ("VCCs") in Colombia, VCCs are verified, quantified, tradable GHG emission reductions or removals that are registered in a public registry, are certified and have been assigned a unique serial number. VCCs are required to be registered on a public registry, and certain eligible carbon credits may also be used for compliance purposes under Colombia's National Carbon Tax. At the same time, the regulations impose restrictions on project developers, who are only permitted to develop projects within a defined scope approved by the government. Only domestic carbon credits with vintages not older than five years are eligible. In addition, priority is granted to the forestry sector. The projects must be validated and their removal results verified by the bodies independent of the standards and projects, duly accredited under the requirements of ISO 14065. The eligible emission verification bodies are either the National Accreditation Body of Colombia (ONAC) or, following the modification made by Decree 446[2] of 2020, organisations that are members of the International Accreditation Forum (IAF) until a Mutual Recognition Agreement is in place¹³.

Under Colombia's tax regime (through tax ruling 13505 from 2017), VCCs are defined for tax purposes as intangible assets representing a right for 1 tonne of CO2 removal or reduction which is transferable for exchange of a price. The rationale behind this

¹⁰ The potential categorisation of a carbon credit as a set of contractual rights to benefit from the verification process is considered and suggested by ISDA in its paper on the legal implications of voluntary carbon credits (https://www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf)

¹¹ Estatuto.co - Estatuto Tributario Nacional Tax Law (Estatuto Tributario). Article 420

¹² Corporations Act 2001

¹³ Resolution 1447 2018, Resolution 831 of 2020, Decree 926 of 2017, Decree 446 2020

accounting definition is the association of the carbon credits with projects where carbon capture or reduction is achieved in the activity, duly certified and represented by a measure in tons of carbon. Once the project is approved and carbon credits are issued, they can be traded and purchased by those who wish to offset or reduce their carbon footprint voluntarily. Hence for tax purposes, these credits are considered an intangible asset under a form of a right to offset or reduce the purchaser's carbon footprint for exchange of a price.

Looking at another example, the United Kingdom is taking proactive efforts to ensure that the voluntary carbon credit market develops significantly. One of the ongoing actions is the development of the London Stock Exchange's Voluntary Carbon Market. A proposal for a definition of carbon credit has been submitted by the London Stock Exchange, public consultations were conducted, and according to the statement from the Exchange, the final rules should have been published by the end of September 2022¹⁴.

In the statement, the Exchange proposed to define a credit as a tradable permit or certificate which represents an independently certified removal or avoidance of one ton of carbon dioxide or the global warming equivalent of another greenhouse gas.

As English law is commonly used to govern the contractual arrangements between transacting parties in the voluntary carbon market, the legal categorisation of carbon credits under English law is important. In its paper on the legal implications of voluntary carbon credits, ISDA asserts that European emissions allowances (under the EU's Emissions Trading System) have been recognised as a form of intangible property under English law¹⁵ and that therefore the categorisation of voluntary carbon credits could, if tested in court, follow this precedent. The aforementioned paper also provides considerable insight on the possible categorisation of carbon credits in the US and Germany and considers the question of what law would be the most appropriate to determine the categorisation of rights to voluntary carbon credits on the insolvency

¹⁴ London Stock Exchange, Market Notice, N12/22 - Consultation on the creation of London Stock Exchange's Voluntary Carbon Market and amendments to the Admission and Disclosure Standards, 2022, p. 6.

¹⁵ Armstrong v Winnington [2012] EWHC 10, [2013] Ch 156

of the project proponent (on the basis that the governing law of the underlying contract would, at that point, be less relevant)16.

¹⁶ The options put forward by ISDA in this context are (i) the jurisdiction of the register on which the carbon credit is recorded, (ii) the jurisdiction of incorporation of the registrar, (iii) the governing law of the carbon standard rules and/or registry rules, and (iv) the law of the location of the project from which the carbon credits are generated. This is a highly complicated question that merits further detailed consideration by the international legal community and is, for current purposes, outside the scope of this paper.

4.0 ARTICLE 6 FRAMEWORK FOR HOST PARTIES CONTROL

4.1 An overview of Article 6

Under the Paris Agreement, all Parties are required to adopt and implement Nationally Determined Contributions (NDCs), representing the contributions that they will make towards achievement of the collective goals set under the Paris Agreement. The NDC of a country typically sets out the economy-wide and/or sector-specific emission reduction targets that a country has set for itself as well as, in some cases, the means by which that country intends to meet those targets.

Article 6 of the Paris Agreement recognises that some Parties may choose to voluntarily cooperate in the implementation of their NDCs, working together to allow for higher ambition in both climate mitigation and adaptation. Following the adoption of the Paris Agreement in 2015, Parties took several years to negotiate more detailed Decisions to underpin key parts of Article 6. This culminated in the adoption of three further decisions at COP26 in 2021, covering the following areas:

1. ARTICLE 6.2

Guidance for Parties intending to cooperate through the transfer of mitigation outcomes, with mitigation outcomes achieved in the host jurisdiction available for use by another Party towards its NDC, or other entities towards other targets or obligations, provided that the host jurisdiction has 'authorised' the use of that mitigation outcome for the intended use-purpose.

2. ARTICLE 6.4

Rules, modalities and procedures for a new carbon crediting mechanism that has been established within the UNFCCC system and that will effectively replace the Kyoto Protocol era's Clean Development Mechanism.

3. ARTICLE 6.8

Establishment of a work programme to support implementation of a framework for non-market cooperative approaches, through which Parties may cooperate in the implementation of their NDCs but without transfer of rights to mitigation outcomes.

4.2 Authorisation of mitigation outcomes

At the heart of the Article 6.2 Decision is a framework and guidance for Parties to account for transfers of mitigation outcomes. A 'mitigation outcome' may be a verified tonne of CO_2 -equivalent reduced or removed, as is represented by carbon credits, but may also represent a flow of allowances within a linked emissions trading system or – where this aligns with the NDC of participating Parties - other climate-related impacts measured in metrics other than CO_2 -equivalent, such as renewable energy capacity.

When a mitigation outcome is authorised by a host Party (i.e., the country in which the mitigation outcome has occurred) for use towards an NDC or for other international mitigation purposes, the host Party is required to make an upward corresponding adjustment to its national emissions ledger on the first transfer of that mitigation outcome. Parties must report an emissions balance in their 'Biennial Transparency Reports' submitted every two years to the UNFCCC, which represents their national inventory plus any adjustments to reflect the net transfer of mitigation outcomes¹⁷. For example, if a host Party authorises the use of 30,000 tonnes of CO2e (represented by 30,000 ITMOs) removed by a certain activity for use under Article 6 and these ITMOs are subsequently sold to another government, a company or an airline, the host Party would need to adjust its emissions balance for that year upward

¹⁷ If another Party is using transferred mitigation outcomes towards its NDC, it reports its national inventory minus an adjustment to reflect the net flow of mitigation outcomes – thus the term 'corresponding adjustment'.

by 30,000 tonnes so as not to count the mitigation outcomes towards its NDC^{18} (thereby ensuring that double counting is avoided). These adjustments are known as 'corresponding adjustments'.

Article 6.2 guidance states that Parties must apply a corresponding adjustment for all 'Internationally Transferred Mitigation Outcomes' that the Party authorises. However not all emission reductions or removals achieved within a jurisdiction are automatically treated as ITMOs. A Party that hosts activities that generate emission reductions or removals has the sole right to decide in which cases, under which conditions, and towards which use-purposes, it is willing to authorise these emissions impacts as ITMOs under Article 6.2, and therefore to take on an obligation to apply a corresponding adjustment. At the time of writing in Autumn 2022, very few Parties have publicly shown a readiness to provide authorisations under Article 6. In some cases, Parties may choose not to use Article 6 at all; in others, they may do so but take more time to introduce the legal basis, policies and institutional arrangements required to do so.

4.3 Distinguishing between 'authorisation' and 'approval'

It is important to distinguish between, on the one hand, authorisation of ITMOs under Article 6.2 and, on the other hand, a more general approval or non-objection to the implementation of an activity. The former is specifically tied to and has a specific purpose under Article 6, essentially committing the host country to apply a corresponding adjustment. The latter may be applicable for projects that are either subject to or not subject to Article 6. Further, for projects not registered under the UN's Article 6.4 mechanism, an approval or explicit statement of no objection may not be required by the host country at all.

¹⁸ There are several different possible 'triggers' for this adjustment. If authorised mitigation outcomes are for use by another Party towards its NDC, the trigger is the 'first international transfer' of the mitigation outcomes. If the mitigation outcomes are for use for other purposes, such as CORSIA or the voluntary carbon market, the trigger can be any of the following: the initial authorisation of the mitigation outcomes; their issuance; or their use. The host Party must specify which of these triggers will apply. Depending on the nature of the entity that purchased these ITMOs, it may be required to make a downward rather than upward adjustment to its emissions balance.

In practice, a project developer may be free to carry out an activity within a jurisdiction and may have legal title to carbon credits issued with respect to that activity, even without an authorisation of those carbon credits as ITMOs. Indeed, this could be the most common situation for carbon market activities in the future, with emission reductions or removals represented by carbon credits potentially being counted by the host country towards its NDC (without such reductions or removals being categorised as ITMOs following some form of authorisation)¹⁹. This is made explicit in the rules, modalities and procedures adopted at COP26 for the new crediting mechanism established by Article 6.4. In the section entitled 'Approval and Authorization', Parties must make two separate statements to the mechanism's Supervisory Body: first, whether the Party approves the activity proceeding, and secondly whether it authorizes A6.4ERs issued for the activity for use towards achievement of an NDC and/or for other international mitigation purposes. Any such authorisation of an A6.4ER has the effect of converting it into an ITMO, thereby obliging the host country Party to apply a corresponding adjustment on the first transfer of that ITMO.

For crediting programmes other than the mechanism established by Article 6.4, for instance Gold Standard and Verra, such an explicit approval may not always be required in the future. Instead, approaches may vary between jurisdictions and possibly between crediting programmes, as is described in further detail in the following section. It is nonetheless possible that project developers may actively seek letters of approval or no-objection (as distinct from letters of authorisation²⁰), even where this is not actively required by the host Party. This may be the case, for instance, if such letters provide greater investment certainty and/or are required by partners or funders. In other cases, governments may continue to take a more laissez-faire approach to carbon market activities, at least in the short- to medium-term as capacity is built. This may be more likely in countries where the emissions impact of the carbon market is small relative to overall emissions.

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¹⁹ There is, at the time of writing, differing views amongst market actors as to how carbon credits should be treated in the voluntary carbon market when they are not authorised for use under Article 6, and in particular whether non-authorised credits can be used towards offsetting claims. Gold Standard provided guidance on this issue in a June 2022 update to its Claims Guidelines.

²⁰ Letters of authorisation are increasingly likely to be the instrument that host country governments will use to signal that a particular project or type of activity is or will in the future be authorised by it for a particular use or purpose under Article 6. The form

4.4 Article 6 and use-purposes

A host government that is using Article 6 has the ability and the responsibility not only to decide when to authorise mitigation outcomes generated by a particular activity; it must also decide which purposes the mitigation outcomes may be used towards. Under Article 6.2 guidance, ITMOs may be used towards:

1. An NDC other than that of the host country

For example, if the government of Peru were to permit mitigation outcomes achieved within its national borders for use by other countries, such as Switzerland, with which it has a bilateral agreement.

2. International mitigation purposes other than achievement of an NDC

For example, the use of mitigation outcomes by aircraft operators to comply with obligations under CORSIA, the offsetting scheme adopted by the International Civil Aviation Organization. International aviation (and shipping) emissions are typically treated and accounted for separately from Parties' NDCs, which is why this is generally understood as a distinct 'international mitigation purpose'.

3. Other purposes, as determined by the host government

The ability of a host government to authorise mitigation outcomes for use towards 'other purposes' allows governments to choose to allow mitigation outcomes to be used by companies for voluntary purposes, with the government granting the company a unique claim by applying a corresponding adjustment. While there has been extensive debate amongst carbon market actors about whether Article 6-authorised mitigation outcomes are required for offsetting claims in the voluntary carbon market, the wording of Article 6.2 guidance –

referring to other purposes 'as determined by the host government' – seems to make clear that governments have the right to choose to authorise mitigation outcomes for this purpose if they wish.

It is not yet clear how governments will practically apply Article 6.2 guidance, when it comes to authorising use towards specific purposes. For market actors interested in the development of a liquid global market, there would be advantages to governments deciding to authorise mitigation outcomes for all possible purposes, rather than placing limitations on this by only permitting certain use-purposes. Governments may, however, have their reasons for placing limitations on use-purposes, for instance if they wish to exclusively hold bilateral relationships under Article 6 with certain other Parties.

It is also not yet clear how governments will respond to their ability to authorise mitigation outcomes under Article 6 for use in the voluntary carbon market. After COP26, a small number of governments including Costa Rica, Colombia, Peru and Switzerland signed on to a statement that included a vow to 'apply corresponding adjustments to support voluntary corporate climate commitments', as well as to support 'transparent and credible corporate claims'²¹. The ability to authorise mitigation outcomes for purposes other than NDCs is also incorporated into the bilateral agreements that Switzerland has now signed with a number of countries, including Peru and Senegal.

As important as whether governments will authorise mitigation outcomes under Article 6 for use under Article 6 will be whether governments introduce legal or guidance-based restrictions on the claims that can be made by companies with respect to mitigation outcomes generated within their jurisdiction. It is possible, for instance, that certain governments may choose to clarify that mitigation outcomes, represented by carbon credits, cannot be claimed to offset the emissions of a company or other

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²¹ https://cambioclimatico.go.cr/following-cop26-climate-talks-the-san-jose-principles-coalition-recommits-to-principles-for-high-integrity-carbon-markets-pledges-to-act-on-them-together/

entity if they are counted towards the NDC of the host government. It is of course also possible that governments choose not to do this.

5.0 IMPLICATIONS OF ARTICLE 6 FOR MARKET ACTORS

Section 3 considered some of the existing ways in which government regulation informs and influences rights related to carbon credits. The adoption of Article 6 and its rulebook introduce a new layer of considerations, which affects in particular rights related to the use of credits.

As described in Section 4, the Article 6.2 guidance adopted at COP26 gives national governments the right to 'authorise' the use of ITMOs generated within their jurisdiction by entities other than themselves. Once authorised, ITMOs can be used by other Parties to the Paris Agreement, public or private entities for 'other international mitigation purposes', which may include use by aircraft operators towards obligations under ICAO's Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) or by companies towards voluntary climate targets or claims.²² Implicit in Article 6.2 guidance is that host governments also have the right to choose not to authorise the use of mitigation outcomes by other entities, instead retaining the right to use these mitigation outcomes towards their own NDC²³.

The host government, under the Paris Agreement, has an implicit right - and indeed a responsibility - to count mitigation outcomes achieved within its jurisdiction towards its NDC (assuming the mitigation outcomes are generated inside the boundary of the country's NDC), and in addition the government has the right to decide whether and under what conditions to surrender this first right and allow another entity to count the mitigation outcome towards a separate NDC, obligation, target or claim. Governments also seem to have the right to amend or withdraw authorisations at a later date, with Article 6.2 guidance requiring governments to report every two years on "any changes to earlier authorisations"²⁴.

From the perspective of a government, the decision to provide an authorisation under Article 6 – to permit an entity other than the government itself – to make claim to mitigation outcomes achieved in its jurisdiction is one that should not be taken lightly. This is as any mitigation that is authorised for use under Article 6 cannot be used

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²² https://unfccc.int/documents/460950

²³ Furthermore, governments also seem to have the right to amend or withdraw

²⁴ https://unfccc.int/sites/default/files/resource/cma2021 10a01E.pdf (paragraph 21c)

towards the country's NDC. If a country were to 'over-sell' mitigation outcomes (i.e., agree to transfer and surrender rights to too many) or 'mis-sell' mitigation outcomes (i.e., agree to transfer and surrender rights to mitigation outcomes from relatively low-cost activities that the government could have achieved itself), then it risks failing to achieve its NDC. While there are no punitive measures for this under the Paris Agreement, it would likely draw reputational harm both for the government itself, but also potentially for the concept of market-based cooperation under Article 6.

At the same time, Article 6 provides a significant opportunity for governments if used wisely. It offers a route for inward investment that could be directed to mitigation activities that go beyond the capabilities of the government and are not economically viable without carbon finance, and that can both help the government to achieve its long-term climate strategy as well as creating jobs and other benefits for sustainable development²⁵. It is therefore likely to be in the interest of many governments to use Article 6, and to authorise projects and mitigation outcomes to be used towards another country's NDC, towards CORSIA obligations and/or towards a unique voluntary offsetting claim by a company. Governments may also seek to generate direct income through their carbon market policy, for instance through fees related to registration or authorisation.

There are advantages and disadvantages of this new context following the adoption of Article 6 guidance, from the perspective of a market participant, and in particular a project developer.

Taking the advantages first, project developers may ultimately have more certainty about the legal and accounting treatment of their carbon credits by the host government, which could provide assurance for end-buyers and enable clearer claims. It is also broadly expected that any carbon credits authorised for use under Article 6 will attract a higher price than non-authorised credits in the future, reflecting factors including their broader eligibility, the unique claim that the end-user will have, and potentially the higher cost of implementing the activity²⁶.

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²⁵ Good examples are direct air capture and green hydyrogen-producing technologies and project

²⁶ securing a letter of authorisation from the host country and any obligations that the project developer is required to take on as a result of this, such as reporting. Second, mitigation

Looking at the disadvantages, project developers may experience a period of uncertainty following the adoption of Article 6 guidance, while national governments establish policy and processes for managing carbon market activities and the mitigation outcomes that these activities generate. Project developers may also be subject to greater administrative requirements, costs (including any new taxes or fees), and delays in the future, if host governments require projects to register with or be approved by the national government. For this reason, project developers may choose to take care in protecting themselves through carefully considered contractual provisions in the agreements that they enter into with their investors and financiers.

Project developers may also be subject to greater sovereign risk, considering that governments will have the ability to change or withdraw authorisations or approvals. For this reason, developers, investors and financiers may choose to undertake 'forum shopping' for the jurisdiction of incorporation of their project or investment vehicles, with a view to accessing the benefits of investment protection treaties. It is though still to be seen how frequent or rare such changes will be, and what arrangements (such as insurance products) are available to manage such sovereign risk.

These factors and their impact will inevitably vary across jurisdictions, as governments take different approaches and move at different speeds to implement national frameworks for use of Article 6. This could shape flows of investment through the carbon market, with jurisdictions with clearer and more stable policies and better enabling environments considered more attractive for project development.

This is important to bear in mind when considering the potential disadvantages listed above. Many national governments are likely to see the carbon market as an opportunity for inward investment, climate mitigation and to generate broader social, economic, and environmental benefits. Where this is the case, it is therefore in the government's interest to incentivise and enable carbon market activity within its jurisdiction rather than to deter it.

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outcomes authorised for use under Article 6 should in theory represent 'higher-hanging fruit', from activities that the host country is not able to undertake themselves to achieve their NDC, whether due to cost, availability of technology or 'know-how' or other reasons.

6.0. INITIAL AND POTENTIAL STEPS IN THE NEW CONTEXT

6.1 Categories of action

The previous two sections focused on the adoption of Article 6 guidance, and the implications for market actors. This section looks more broadly at how governments may act in the new context under the Paris Agreement, as they begin to implement the measures needed to meet the targets in their NDCs. There are several distinct forms of legislative and/or regulatory action that governments may choose to take in relation to carbon finance within the new international context. Some of these measures include:

TRACKING

Governments may establish national registries or other mechanisms to keep track of carbon market activities and the generation of carbon credits within their jurisdiction. As mentioned earlier, this has for instance already been done by the government of Colombia, which hosts a National Registry of Reduction of Greenhouse Gas Emissions. It is also part of plans by the government of Indonesia which drew significant carbon market attention in 2022²⁷. Implemented in isolation, such tracking measures would not be expected to affect rights related to carbon credits.

APPROVAL

Governments may introduce procedures and designated bodies to approve new carbon market activities within their jurisdiction, or to otherwise manage the generation of carbon credits. All governments intending to host activities registered under the new crediting mechanism established by Article 6.4 will be required to take this step, in order to provide approvals. However, it is possible that governments extend approvals to projects registered with other crediting programmes, through individual assessments or more general 'positive lists' of approved activity types. This would have a bearing on the right of project proponents to generate carbon credits, if their ability to implement a project is subject to a decision by the host government.

²⁷ https://www.spglobal.com/commodityinsights/en/market-insights/latest-news/energy-transition/040722-carbon-credit-issuances-from-indonesia-on-hold-developers-await-clarity

It is not clear if this step will be common in the context of the Paris Agreement, or if governments – for capacity reasons or otherwise – will choose not to assert a right of approval. There are though already examples of governments prohibiting certain types of activities from generating carbon credits intended for the voluntary carbon market, notably for forestry-based projects. The governments of Papua New Guinea and Honduras for instance, both introduced moratoriums in 2022 on REDD+ projects serving the voluntary carbon market²⁸.

AUTHORISATIONS AND CORRESPONDING ADJUSTMENTS

Governments intending to host activities under Article 6 will be required to establish a legal basis, procedures, and institutional arrangements to authorise mitigation outcomes for use by other entities, and to apply corresponding adjustments. The ability for a government to authorise mitigation outcomes for use under Article 6 will have a bearing on rights related to the use of carbon credits. An authorisation by the host government will enable carbon credits with a vintage of 2021 or later to be used for purposes that were otherwise not available, such as use towards an NDC or CORSIA. Some governments are beginning to build readiness to provide authorisations under Article 6. The government of Uganda, for instance, established certain legal powers within its National Climate Change Act 2021²⁹, a step that a number of other governments have also taken or are preparing to take.

INCENTIVES

Governments may take a number of different steps that would incentivise the generation or use of carbon credits within their jurisdiction. This could include steps to improve the enabling environment for carbon market activity, such as tax incentives. It could include building or enabling market architecture, such as a local carbon credit exchange as planned in Malaysia³⁰. It could also include establishing policy frameworks that either directly lead to or enable the generation and use of carbon credits. For example, both Brazil and India have recently introduced legislation that

28 https://www.spglobal.com/commodityinsights/en/market-insights/blogs/energy-transition/071922-voluntary-carbon-markets-value-retention-host-countries 29 https://climate-laws.org/geographies/uganda/laws/national-climate-change-act-2021 30 https://carbon-pulse.com/169396/?utm_source=CP+Daily&utm_campaign=63dc8e2604-CPdaily15082022&utm medium=email&utm term=0 a9d8834f72-63dc8e2604-110323781

will underpin the creation of new domestic compliance markets³¹³². Meanwhile Singapore has announced that companies subject to its national carbon tax will be able to use carbon credits to meet a portion of their compliance requirements³³.

LEGAL CLASSIFICATION

Governments may take new steps to provide certainty on the legal categorisation of carbon credits within their jurisdiction, where this is currently ambiguous. This could be considered as a form of incentive, as it could serve to provide greater confidence for investors and other market participants, and to simplify private contracting between buyers, sellers and financiers.

As a related point, governments may also take steps to clarify and regulate the nature of the claim that entities can make when using carbon credits generated within their jurisdiction. As discussed above, for instance, some governments may consider taking steps to avoid explicit double-claiming between their NDC and an offsetting claim by a company.

These categories show the types of measures that governments may choose to take in relation to carbon market activity within their jurisdiction, whether to ensure improved tracking of mitigation outcomes that can be counted towards the country's own NDC, to incentivise and manage the type of activity that takes place within the jurisdiction, or to enable the authorisation of mitigation outcomes under Article 6 for use by other Parties or entities. It should be noted that only the third measure – authorisations and corresponding adjustments – is directly associated with Article 6. Governments may choose to implement the other measures even in cases where they have no intention to transfer mitigation outcomes internationally.

For project developers, changing legislation and any lack of clarity about future policy direction will inevitably lead to uncertainty. As such, the way in which change is managed by governments, and the timeliness with which they introduce changes,

³¹ https://www.gov.br/en/government-of-brazil/latest-news/2022/brazilian-government-publishes-decree-that-regulates-the-carbon-market

³² https://www.bloomberg.com/news/articles/2022-08-02/india-planning-carbon-credit-market-for-energy-steel-and-cement

³³ https://carbon-pulse.com/159011/?utm_source=CP+Daily&utm_campaign=dafd6fd6ed-CPdaily11052022&utm_medium=email&utm_term=0_a9d8834f72-dafd6fd6ed-110323781

may in some cases be just as material as the end-state they intend to move towards. However, as is the case for any sector, this end-state itself will not be static. Governments change, and the policies that they apply for the carbon market may therefore change over time as well. This is a reality that market actors are likely to need to prepare to manage in the period ahead, if and where governments decide to take on a greater role with respect to the carbon market.

TAXATION

The relationship between carbon credits and taxation will also be important in the new context under the Paris Agreement. While this does not directly affect rights related to carbon credits, it is closely linked. Governments of course have and generally choose to assert rights to tax economic activities within their jurisdiction. If the scale and value of the carbon market grows, as is expected, in the years ahead, we may see new approaches to taxation of carbon credit or carbon market activities in the future.

There are broadly two categories of issue to consider:

- 1. Taxation policy related to carbon credits or mitigation outcomes, and activities generating these
- 2. The eligibility of carbon credits for use within carbon taxation frameworks

TAXATION POLICY

Governments may in certain cases use tax policy, and tax incentives, to stimulate the growth of domestic carbon market activity. This could result in lower purchase costs for carbon credits, which may make carbon credits from that jurisdiction more internationally competitive, therefore increasing demand and activity.

The main tax incentives that could be introduced by host governments are indirect tax incentives, especially VAT treatment for purchasing and trading carbon credits and direct tax incentives to boost supply. This is also connected with the specific tax treatment of carbon credits for accounting purposes, as discussed in Chapter 2. Through the indicated mechanisms, Host Parties can also influence the transactional costs associated with the purchase of carbon credits. Appropriate use of tax incentives can enable investment funds to be channelled towards project types that

are prioritised by the government or could attract investment from specific entities, such as locally based project developers.

With respect to indirect tax incentives, governments may also consider VAT exemptions. At present, countries take various approaches on VAT treatment of carbon credit trading.

In developing countries there is a trend to zero-rate international transactions so as to attract new investments from entities in developed countries. In this model, transactions between entities within a country may be taxed, but transactions with foreign entities (non-resident transactions) will be zero-rated. Countries that have implemented this type of incentive can attract new investors, while not entirely excluding budget revenues linked to the voluntary carbon market.

At the same time, governments may choose to introduce new taxes, fees or levies related to carbon market activities. Indonesia, for example, is reported to be adopting new regulations that would require a portion of carbon credits from local projects to be withheld, so these can if required be used towards the country's NDC³⁴. It should be expected that other governments will be exploring similar plans. The challenge for all governments intending to introduce new taxes or levies related to the use of Article 6 and to carbon credits will be balancing the potential revenue that could be generated with the potential impact on the attractiveness and competitiveness of the jurisdiction for carbon market investment.

ELIGIBILITY UNDER CARBON TAXES

There are already several examples of governments enabling companies to meet a portion of their obligations under a national carbon tax policy through the use of carbon credits. This is for instance possible under the carbon taxes of both Colombia, South Africa and South Korea, with varying criteria for the eligibility of carbon credits.

³⁴ https://carbon-pulse.com/177053/

It is likely that we will see further examples of such policy approaches in the future. The government of Singapore has already announced that it will permit the use of carbon credits to meet a portion of a company's obligations under its national carbon tax in the future. Such policies may lead to greater demand for carbon credits in the future, as well as clearer regulatory treatment. It is also an example of the ability of governments to determine and shape the use of carbon credits, and therefore their market value, as discussed elsewhere in this paper.

7.0 CONCLUSION AND FINAL MESSAGES

The carbon market now exists in a new context following both the adoption of an Article 6 rulebook at COP26, and the beginning of the implementation period for Parties' first NDCs. The extent and nature of change stemming from these two drivers is likely to vary between jurisdictions, depending on their legal and regulatory regimes, the choices made and approaches adopted by governments. In some cases, change – and any period of uncertainty in the build-up to change - may prove disruptive to private sector investment. In other cases, change is likely to prove supportive of private sector investment, for instance if governments introduce frameworks, policies and/or tax incentives to enable and incentivise carbon market activity. Like any market, private actors are likely to be drawn to jurisdictions that create positive and more certain enabling environments.

It is also clear, when considering the distinction between rights related to generation, ownership, and use of carbon credits, that the direct effect of the transition to the new context under the Paris Agreement is likely to be quite targeted. It is not obvious, for instance, that a project developer's rights related to ownership of carbon credits would need to be affected as a result of this new context. However, rights related to the use of carbon credits will inevitably be affected, with governments holding the authority to decide whether to authorise credits for additional uses, such as towards NDCs or CORSIA, and whether to introduce requirements or guidance on the use of carbon credits towards voluntary claims.

Finally, and as is often the case, the period of transition – and the uncertainty inherent to this period - from the past context to the new context may prove more

disruptive for the private sector than the new status quo itself. One only has to look at recent examples, such as reaction to comments (since clarified) by the Indian Power and Renewable Energy Minister in August 2022, to see the effect of policy uncertainty on market actors³⁵.

This paper concludes with four key messages and recommendations, to inform the transition to a new phase for the carbon market in the context of the Paris Agreement:

- Uncertainty itself can cause disruption. Examples in 2022 show that market actors do not respond well to instances where the intentions of governments with respect to the carbon market are either ill-defined or not clearly communicated. Governments can therefore support market confidence and investment through clear communication and well-considered long-term plans. Project developers, investors and financiers, in turn, can choose to mitigate the risks of this currently uncertain environment through structuring and contractual protections.
- Markets involve shared interests. When functioning effectively, carbon markets can bring considerable shared interest for project developers (who earn an income from the sale of carbon credits), local communities (who benefit from investment and co-benefits such as job creation) and national governments (whose climate targets and plans are supported by the mitigation outcomes achieved through market activities). Governments can take steps to maximise these benefits, for instance through incentivising private investment into certain sectors and creating a positive enabling environment.
- Local contexts matter. Each government will take a slightly different approach to
 carbon markets in the future: the regulatory treatment of carbon rights, the
 requirements on activities, and the willingness of the government to authorise
 mitigation outcomes under Article 6 may all vary. Project developers and other
 market actors should therefore understand the local context and requirements in
 the jurisdiction in which they are operating, through legal and market diligence.

³⁵ https://carbon-pulse.com/169050/

• Market action continues to matter. One of the drivers of change that is not directly discussed in this paper is the growth of the voluntary carbon market in recent years, and the broader recognition of the role that markets – both voluntary and compliance – can play in achieving the goals of the Paris Agreement. While some steps by governments in 2022 may have caused disruption in the carbon market, lying behind these steps is an understanding that the carbon market – and the emission reductions and removals achieved as a result of it – matter for national targets and for global climate efforts. What will be important over the next few years is that governments and the private sector find ways to work effectively together in partnership, to realise the full potential of market activities to drive climate security and sustainable development.