ERCST

Roundtable on
Climate Change and
Sustainable Transition

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Article 6 rule book

A POST COP26 ASSESSMENT

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Table of Contents

A warm welcome to the Article 6 rule book

After too many years and too many discussions the rule book for Article 6 under the Paris Agreement has been completed. This also marks the completion of the Paris Agreement rule book which allows everyone to now move forward with the implementation in all areas.

Article 6 is important for international cooperation and for the framework that it provides for an international carbon market under the Paris Agreement, as well as the symbolism that it projects. There is also widespread (but not universal) belief in the efficiency that markets can provide, despite their imperfection. Studies show Article 6 trading rules could save up to $250 billion/year for climate action by 2030.[1]

However, its importance is yet to be demonstrated through action, but there is hope that it will unleash the same type of entrepreneurial spirit that the CDM and JI have unleashed under the Kyoto Protocol. While some complain about the lack of demand, it remains to be seen if Art 6 will allow for the kind of carbon market that will be liquid, with significant supply of ITMOs coming to the market, beyond the level of what is required for piloting and political statements, but a real market supply.

This short paper is not intended as a deep technical analysis of known aspects of the CMA decision on the Art 6 rule book, but rather as an overall view of where it landed, and some of the implications.

While ERCST has worked as hard as any in ensuring that there was a positive outcome at COP 26 on this topic, and welcomes, salutes and applauds the fact that we now have a rule book, this paper will also examine critically the outcome.

"The subject who is truly loyal to the Chief Magistrate will neither advise nor submit to arbitrary measures." (Junius)

Key outcomes

The outcome of the Article 6 negotiations could not have been a total surprise, as every issue had been debated and every option considered. There was nothing more to say, just the

[1] Effective Article 6 trading rules could save up to $250 billion/yr for climate action by 2030, study finds- https://www.ieta.org/page-18192/7895908 .

political will to make choices, and for some, to accept them. The texts that are referred in this paper are the texts gavelled in Glasgow,[2] unless otherwise specified.

Article 6.2

Article 6.2 was intended as a framework on how transfers of mitigation outcomes between Parties can be accounted for, including conditions such as promoting sustainable development and protecting environmental integrity.

The resulting internationally transferred mitigation outcomes (ITMOs) can be produced from any mitigation approach agreed by cooperating Parties through bilateral or multilateral agreements.

The very essence of Art 6.2 lies in the flexibility presented to the parties to design the architecture and rules for functionality which has resulted in divergence of views and interests..

The current text moves Art 6.2 into the direction of Art 6.4, which in our view was not the intention in Paris. That convergence was going to take place in the long-term, but its speed is increased through political decisions.

Significant progress has been achieved to provide a guidance framework in order to shape up the cooperative approaches among countries. However, human rights and (some) ambiguity in texts remain outstanding issues.

i. ITMO definition

The ITMO definition, which for a long time was not seen as desirable component of the decision, includes reductions and removals. The inclusion of avoidance in the future work programme has raised a few eyebrows, and many questions. The exact definition of avoidance is not clear, and this may have led some observers to conclude that avoided deforestation, REDD+ is not part of Art 6, and is only included in Art 5.

[2] Guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement can be found at https://unfccc.int/sites/default/files/resource/cma3_auv_12a_PA_6.2.pdf ;

Rules, modalities and procedures for the mechanism established by Article 6, paragraph 4, of the Paris Agreement can be found at https://unfccc.int/sites/default/files/resource/cma3_auv_12b_PA_6.4.pdf ;

Work programme under the framework for non-market approaches referred to in Article 6, paragraph 8, of the Paris Agreement can be found at https://unfccc.int/sites/default/files/resource/cma3_auv_12c_PA_6.8.pdf .

As part of the ITMO Definition debate at COP 26, text had been introduced that would have specifically included REDD+ under Art 6.2.[3]

"Emission reductions and removals resulting from decision 14/CP.19 from 2015 onwards."

This would have led to the acceptance for REDD+ of a specific standard, albeit an UNFCCC developed one, under Art 6.2, as well as the acceptance of REDD+ units from 2015 to 2021. This was rejected on both accounts. First one was due to the lack of information on the amount of the pre-2020 REDD+ that would be transferred.

The second one was rejected as the general view is that Art 6.2 was not intended to bless specific standards but allow Parties to cooperate under whatever standard they wish. It is likely that requesting recognition and blessing for a specific protocol for REDD+ under Art 6.4 as a methodology would have been more successful.

This rejection, coupled with the language of avoidance in the work programme, has led some to conclude that REDD+ was not in Art 6.2.

We believe that this is a flawed interpretation from some who do not wish to see REDD+ in Art 6.2, as there is nothing in the decision that would point to an exclusion of REDD+.

Politically, this would also be unacceptable to a very large number of countries. In addition, the provision that was rejected about REDD+ (quoted above) referred to reductions and removals, not avoidance.

The reference to "avoidance" is more likely addressing the issue of not crediting decisions not to extract fossil fuels, but that is an issue that does not belong in 2021.

Another part of the ITMO definition, under 2 (b), is a convoluted construct that refers to special circumstances for other uses (likely ICAO related), and results in a temporal clause when first transfer, and therefore a corresponding adjustment, takes place.

ii. Corresponding adjustments

Corresponding adjustments (CA) are nothing more than double-booking entry practiced in relation to transfers of ITMOs, to ensure that there is no double counting, and that an ITMO

[3] UNFCCC 2021. Draft text on SBSTA 52–55 agenda sub-item 15(a) Matters relating to Article 6 of the Paris Agreement Guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement (version 4) Annex 1(h) https://unfccc.int/sites/default/files/resource/Art.%206.2%20draft%20decision_2.pdf

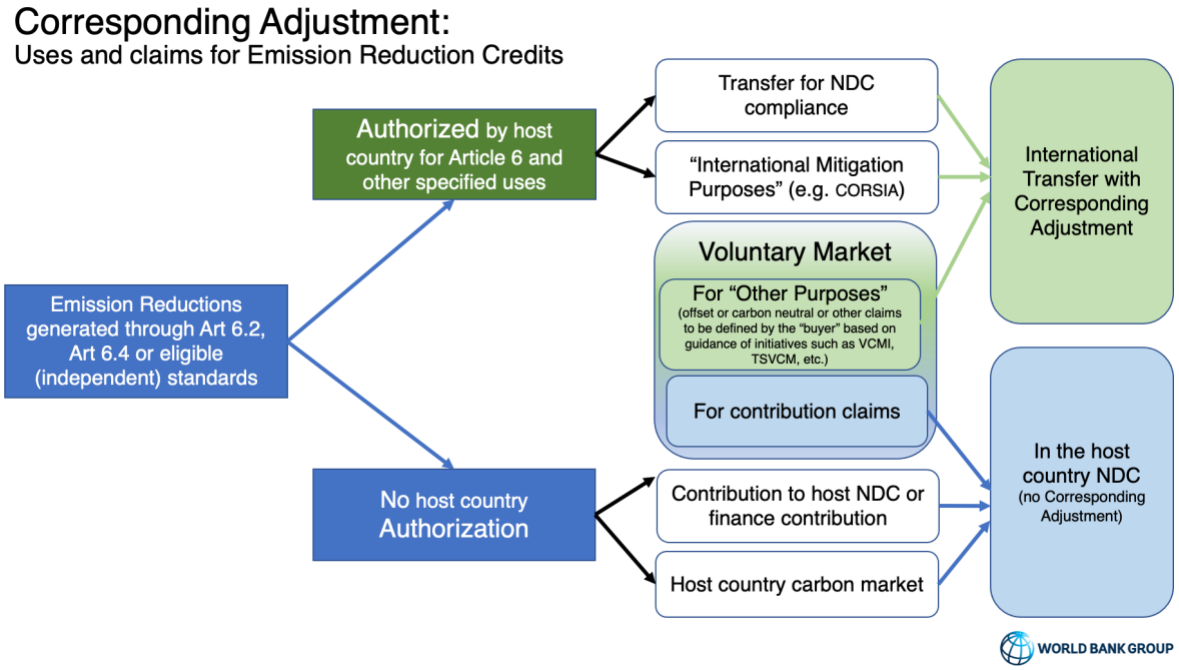
is only used once, towards an NDC and other (somewhat) defined purposes. As we will see, and as the figure below shows, the purposes that require a CA are not easy to explain.

After three years of discussions, what can be called the "progressive club" which rallied around the San Jose principles, largely carried the day. Most aspects dear to them are included in the agreed text, while what was included to provide comfort to others that had militated for, and held on to alternative views of principle, is, in our view, largely inconsequential.

An ITMOs was defined as an authorized transfer of a mitigation outcome for use: a) towards an NDC; b) for other international purposes (undefined, but largely understood as ICAO and IMO); for other purposes as determined by the first transferring Party (largely understood for voluntary carbon markets (VM)) if the Party so wishes to do, or the standard requires it.

In the case when an international transfer is authorized for these uses, it then requires that a corresponding adjustment be undertaken.

An Art 6.4 mechanism unit is also treated as an ITMO.



Transfers that are not authorized could potentially be used for domestic purposes, results-based finance, or voluntary corporate targets. This does not represent a departure from the current situation, as mitigation outcomes can currently be transferred for VM that do not require a CA (e.g., VERRA). The Gold Standard requires a CA, and may get one, if the Party agrees to it.

One can argue that while technically correct, this outcome is at a minimum questionable when it comes to ensuring that not more than one claim towards neutrality can be made on the back of the same mitigation outcome and makes the enormous noise made around ensuring environmental integrity in Art 6.2 sound a bit hollow.

A post COP 26 declaration from four countries signatories of the San Jose Principle stated that they will not transfer or use mitigation outcomes without a CA (authorization). Other countries will be watched with interest if they join this "club", but it is likely that they will come under increasing pressure to do so, as will the corporate buyers.

The CA debate started under Art 6.4 and then moved in Art 6.2 under the label inside/outside NDC. This was "faded-away" and was replaced with the "Japanese solution": a CA will be done if the transfer is an ITMO (it has authorization), otherwise double usage is not double counting.

On another angle, the logic of adjusting an NDC even if the mitigation action takes place in sectors not covered by NDC was papered over, and this provided a political solution that allowed for the issue to be dealt with.

Finally, a few words on an incomprehensible provision under 2(b) which ensures that a potential loophole is closed in some cases, potentially if the ITMOs are used towards CORSIA obligations.

In the end, good that we could move forward, that is what was needed, even if the outcome does not seem to be always logical.

iii. Use of non-CO2 metrics in ITMOs

This concept, initially rejected, if not derided, was included in the final text. As a matter of principle, it had to be included, as it is fundamental to the concept of nationally determined in the NDC approach, which is the foundation of the Paris Agreement. If NDCs can be expressed in different metrics, it followed, at least in our view, logically that ITMOs can also be expressed in the metric of the NDC.

A few things need to be highlighted. The definition includes reference to "metrics that are consistent with the NDC of the participating Parties" which is likely to be a limiting factor for transfers and transactions conducted in non-CO2 metrics.

What is it meant by it exactly, one cannot be sure. However, it could be read as: an ITMO expressed in non-CO2 cannot be transferred between Parties unless their NDC and that of the ITMO is expressed in the same metric.

In our view this is unjustifiable, has no basis in the Paris Agreement, and its importance was either not understood, noticed, or considered important enough by those that will be affected or supported multi-metrics to object to.

A second observation is that para 9 of the text as gaveled, which explains how a CA is done in for ITMOs in non-CO2 metrics, seems to have inversed additions and substructions, when compared to the para 8 which refers to ITMOs denominated in CO2.

Another observation refers to how to convert between metrics, a simple exercise which had been a roadblock for three years. In the gaveled text, para 22(d) which refers to Regular Information addresses this issue.

While in earlier texts there was a work programme to figure out how to do metrics conversions, some of the suggestions that ERCST made earlier were adopted (e.g. to represent emissions reductions in the geographical boundaries and time frame where and when it was produced) and the issue was finally put to bed.

Finally, a rather obvious statement: it is unlikely that a significant number of transactions which would result in transfers will be carried out in non-CO2 denominated ITMOs, but due to the Paris Agreement and the need to be inclusive, this language has made its way in the final text.

iv. OMGE & SOP

These two issues were part of the three "crunch" issues identified before the COP. How to deal with adaptation finance in Art 6.2 (the inclusion of an Art 6.4-like provision on Share of Proceeds (SOP)) and how to include overall net mitigation in global emissions in Art 6.2 were some of the most hard-fought battles. To be blunt they were a replay of the negotiations at COP 21 in Paris where they were rejected – right or wrong. In the end, they were again rejected in Glasgow in favor of soft wording referring to encouragement to do the right thing, and increased transparency.

It may be true that a SOP in Art 6.2 would not address the issue of adaptation finance, but the encouragement to make adaptation finance available commensurate with what is collected under Art 6.4, coupled with strong transparency provisions, may lead to larger and more predictable adaptation finance being made available.

v. Safeguards and limits

These provisions are meant to ensure that a) no Party oversells and have difficulty reaching its own NDC, and b) that most of the effort to reach ones NDC is domestic in nature, and that reaching ones NDC is not largely based on purchases and the use of ITMOs towards an NDC.

Similar provisions were in place in the KP, expressed as "supplementarily" and "commitment period reserve". Under the KP these provisions where more easily expressed as the KP was based on budgets. Under the Paris Agreement, this provision (paragraph 17) is to be operationalized through future work that was pushed to 2028.

vi. Impact on voluntary markets

While the discussion under this issue can be deduced from some of the discussion above, it is an issue that deserves more clarity.

There were two views that were being put forward before Glasgow: the use of a mitigation outcome transferred internationally and use for voluntary commitments a) requires a CA by the issuing Party or b) does not require a CA.

The situation has now been clarified (to some degree), in that the UN system will not impose additional constraints. Any additional regulation may need to be imposed at the national level, or at the standard and voluntary user level.

Transfers can take place internationally for use in VM, without Party authorization, if the Party so decides, and they will not require a CA. The user must also accept that the mitigation outcome that it uses does not have a CA, which is likely to cause increasing reputational risks for many users.

On the other hand, standards such as the Gold Standard which view a CA as a real necessity to preserve environmental integrity, will ask to have a CA undertaken, and Parties may agree to that.

This may seem to point in the direction that many see prices in the voluntary markets being a lot more significant than in the past, including in relation to those in the compliance markets.

Article 6.4

Article 6.4 is a new crediting mechanism that many have tried to label the Sustainable Development Mechanism since it was created in Paris six years ago. The name has some bearing on the orientation and focus of this new mechanism, and there was pushback from those that see this as a mechanism for CO2 mitigation. It has therefore remained nameless, and it is referred to as the A6.4M.

There has been disenchantment with the CDM from some quarters during its heyday, which led to a lot of bad press which has then become the politically correct line. As such, it must not be a big surprise that there has been a sustained effort over the last few years to make

the A6.4M as different as possible from the CDM. This has succeeded in some respects, but the fundamentals are still there.

As in the case of Article 6.2, there were some aspects in previous text iterations that were controversial and led to failure in Katowice and Madrid. This time the outcome led to a "balanced" approach, which turned out to be close to the wish list of those that promoted the San Jose Principles.

So, what makes the A6.4M different from the CDM, and where is it the same?

i. Differences

The project cycle is essentially the same, so those that are still around and have memories of the CDM will be on familiar ground. Surprisingly, there is reference made in the definition of emissions reductions in Art 6.4 of the possibility of having different metrics. However, that is unlikely to be anywhere near a significant part of the market, probably more of a political statement for those that advocated multi-metrics.

Appeals process. Given the turbulent, politicized and sometimes inconsistent record of the CDM EB decisions, an appeals process was agreed to, but with the operational details to be agreed in the work programme.

The appeals process will be to an independent grievance process, to be defined. In the CDM, there was never an agreement to have an appeals process, as issues similar to those that are likely to re-emerge in the discussion defining the appeals process under the A6.4M, blocked an agreement in the CDM: who can appeal, what can be appealed (e.g. human rights), whom can they appeal to. This is a provision that exists in any regulatory process and a welcome development, but we would like to see the process details agreed on before we can celebrate.

OMGE. Another aspect that differentiates the A6.4M from the CDM is the OMGE (overall mitigation in global emissions) which shall be operationalized through a 2% of A6.4ER being cancelled at issuance. This is seen as a novelty and great progress by many Parties, which had the opportunity to do this voluntarily in the CDM, but never did.

The CDM was, and is, a mechanism to deliver CERs according to a UNFCCC defined protocol. How the CERs were then used by developed countries was at their discretion – could have been used to offset 100%, or only partially (e.g., 80%). This was totally at the latitude of developed countries throughout the KP period.

Decentralization. There is also some level of decentralization in the governance of the A6.4M, when compared to the CDM which was all top down and centralized. Parties will be able to specify certain elements such as baseline approaches and methodologies to be applied

consistent with guidelines by the Supervisory Board, and under the supervision of the Supervisory Board. This would seem to indicate that the Supervisory Board will have the ability to override decision by Parties if they are deemed not be aligned with the guidelines approved by the CMA.

Transborder projects. Another aspect that needs to be highlighted is the provision in para 31 (c) under Activity Design which states "Shall be designed to achieve emission reductions in the host Party". It would seem that this puts an end to power pool type projects which involved the transfer of clean energy.

Under the CDM, a methodology was developed and approved for such projects, and several projects was also approved, including the India- Bhutan project. That project gave credit for reductions on the Indian power system as a result of imports of hydro power from Bhutan.

That was not unique, and several such examples have emerged like Felue Hydropower Project, West Africa Power Pool project and Central American Electrical Interconnection System (SIEPAC)[4]. Under this provision, these projects will no longer receive approval under the A6.4M.

It is in our view regrettable that such aspects which are primarily South-South cooperation have been denied additional incentives.

ii. Novelty

The "big one" was the provision in Art 6.4 for the avoidance of use of emission reductions by more than one Party. Essentially a group of countries, which included Brazil, India, China, KSA, and others read Art 6.5 of the Paris Agreement as an indication that emission reductions achieved from activities and sectors outside the NDC should not trigger a corresponding adjustment. This was one of the main reasons for the failure to reach agreement in Katowice and Madrid.

As in Art 6.2, this started as a somewhat unclear discussion, which evolved at some point into a debate whether there needed to be a corresponding adjustment for A6.4ER issued from "outside the NDC." The initial "ask" was actually not to do a corresponding adjustment for Art 6.4 This led to further discussion on the definition of an NDC – sectors and gases or also policies and measures.

The debate them metamorphosed into the "Japanese option" which dispensed with the inside/outside debate and brought in a facing saving solution of A6.4ER with or without

[4] ERCST. Renewable Energy Sales on Integrated Grids and Article 6- https://ercst.org/wp-content/uploads/2021/01/20201206-Integrated-Grids-Final.pdf

authorization. The two debates (and solutions) seem disconnected, but provided the way forward to clear the way from what seemed a dead end.

iii. CDM Transition

CDM transition was another one of the "three crunch" issues that had blocked agreement on the Art 6 rule book in two previous COPs. An incredible amount of time and resources were spent in trying to determine how many projects and CERs would be transferred for use towards NDCs under the Paris Agreement.

All this notwithstanding the fact that there was absolutely no reference in the Paris Agreement that such a transition should be considered. However, like in SOP under Art 6.2, political pressure justified in moral grounds made this a long debate.

The outcome was in some ways predictable and aligned with what seems logical if such transition was to be envisaged.

CDM activities (projects and POAs) would transition to the Art 6.4 under certain deadlines: the request for transition by project participants has to take place before 2023; the approval by the Supervisory Board has to take place by 2025 and methodologies could be used for a certain period.

The conditions for use of CERs towards NDC (only in the first NDC) were aligned with the start of the KP2 when it came to the date of registration of the project. No temporary and long-term CERs can be used towards NDC, showing some bias. No corresponding adjustment is required for pre-2020 CERs.

In the issue of CDM transition, the text needs to be considered jointly with the CMP decision on CDM. Accordingly, Parties can provisionally register new CDM projects, but for these projects to be eligible for transition to Art 6.4, they will need to meet the following conditions (Para 73 a-d of 6.4 text), including using current methodologies until the end of its current crediting period or end 2025, whichever is earlier.

iv. Concern

One issue of concern is that the combination of OMGE (2%), SOP (5%), the conservative baselines and the monetary contribution under para 67 (b) might create a high barrier to entry into the Art 6.4 mechanism.