Private sector engagement in Article 6

A post-COP27 analysis

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Lev Gantly
Philip Lee LLP

Lev Gantly, *Partner and Head of Energy*

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Contents

01 INTRODUCTION

02 BACKGROUND

03 PRIVATE SECTOR ENGAGEMENT PATHWAYS

07 CONCLUSION

Introduction

COP27 saw limited progress being made with respect to the operationalisation of the Article 6 market mechanisms, with discussion of key issues being pushed into next year's meetings of the Supervisory Body and to COP28 in Dubai. These issues include:

- administrative procedures for connecting national and centralised Article 6.4 mechanism registries to the international Article 6.2 registry;
- rules governing greenhouse gas removals;
- the ability to revoke or somehow "change" the status of authorisations;
- the grievance mechanism to resolve disputes relating to communities negatively affected by projects giving rise to credits under the Article 6.4 mechanism; and
- the fraught issue of whether emission avoidance and conservation enhancement activities qualify under either or both of the Article 6 mechanisms (leaving many nature-based project in a state of uncertainty).

There were also some positive developments. These include:

- the EU launching a capacity building project for developing countries for readiness for Article 6 referred to as the Integrated Assessment for Article 6 (IAAS);
- the commencement of a work programme for Article 6 capacity building activities by the Supervisory Body with a view to (amongst other things) increasing dialogue with the private sector on its involvement with the Article 6 market mechanisms;
- Japan launching its international knowledge sharing and capacity building for its Article 6 platform initiative; and
- the provision of guidance on the transition process for projects and CERs from the Clean Development Mechanism ("CDM") to the Article 6.4 mechanism adopted by the Conference of the Parties serving as the meeting of the Parties to the Paris Agreement ("CMA").

In addition to Article 6 (and funding arrangements for loss and damage (which is outside the scope of this article)), one of the other key topics dominating the discourse at the conference was that of climate finance. The outcomes were somewhat mixed with interesting (if light on detail) announcements being made by (amongst others):

- John Kerry on the new Energy Transition Accelerator, the purpose of which will be to finance the energy transition in Africa;
- the World Bank with respect to the Climate Investment Fund, the purpose of which will be to finance nature-based solutions on the African continent;
- the newly launched Africa Carbon Markets Initiative, the purpose of which is to unlock the true potential of African countries to help grow and scale the voluntary carbon market ("VCM") with high quality and high integrity projects that will provide much needed revenue streams and climate finance to developing communities; and
- the G7 group of countries announced the development of the 'Global Shield against Climate Risks' initiative for V20 countries with the aim of supporting vulnerable communities to prepare and address climate change risks through activities from measures such as climate-related insurance.

Whether or not the measures that were announced will result in the provision of the US$100bn annual climate finance promised by developed countries to developing countries since 2009 remains to be seen.

The question of whether private finance channelled through the developing and much discussed Article 6 market-based mechanisms can make material contributions to this goal was left unanswered. The degree to which private project developers and investors/financiers can engage in developing and funding activities that will yield mitigation outcomes under Articles 6.2 and 6.4 is yet to be discussed in an official forum. This is particularly surprising because it is private actors and, to a large degree, private capital, that is driving the seemingly irreversible growth trajectory of the VCM.

The purpose of this article is to consider the degree to which private actors will be able to participate in the Article 6 market-based mechanisms with the support of the host countries in which their projects are being developed. Given that there are currently more questions than there are answers, it is not the authors' intention to provide conclusive analyses on these issues – our aim is simply to ask questions with a view to encouraging ongoing conversation and dialogue.

Background

In order to assess the degree to which a pathway for private sector engagement exists within the Article 6 framework, it is worthwhile to briefly revisit some of the fundamental principles behind the two market-based mechanisms:

i. Article 6.2 mechanism: this relates cooperative approaches between parties that involves the generation and use of internationally transferred mitigation outcomes ("ITMOs"). In simple terms, cooperative approaches are bilateral or multilateral agreements between countries to cooperate on the achievement of mitigation outcomes in the country that hosts the project activity. Effectively, it is one country financing a climate change mitigation project in another country in exchange for ITMOs that the financing country can then apply towards the targets set out in its own Nationally Determined Contributions ("NDCs") or, depending on the nature of the authorisation provided by the host country, for "other international mitigation purposes" or for "other purpose" (see below for more on this); and

ii. Article 6.4 mechanism: this is a new mechanism which establishes the framework for the creation, transfer and use of unitised mitigation outcomes referred to as "A6.4ERs". An A6.4ER can be traded on what is essentially a new carbon market through a registry that is currently in its design phase with the recently established Supervisory Body.

Private sector engagement pathways

To date, most (if not all) of the capacity building around Article 6.2 has been through bilateral or multilateral agreements between countries that are party to the Paris Agreement with the objective being that the purchasing / funding country applies the ITMOs generated and sold to it by the host country towards its nationally determined contribution ("**NDC**"). This is, after all, enshrined within the text of Article 6.2 which expressly refers to *"Parties … engaging on a voluntary basis in cooperative approaches that involve the use of internationally transferred mitigation outcomes towards nationally determined contributions…".*

However, when considering decision 2/CMA 3 *(Guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement)* (the "**Article 6.2 Rules**") adopted at COP26 in Glasgow, it becomes apparent that an authorisation of an ITMO for use towards an NDC is just one of several "use-cases" of ITMOs. The other key "use-cases" or "authorisation types" of ITMOs are generally considered to be as follows:

- authorisation by a participating party for use of mitigation outcomes for "international mitigation purposes" other than achievement of an NDC (this is broadly understood to mean international schemes such as the Carbon Offsetting and Reduction Scheme for International Aviation ("**CORSIA**"));
- authorisation by a participating party for use of mitigation outcomes for "other purposes" (this is broadly understood to mean the VCM); and
- authorisation for use of A6.4ERs towards achievement of "international mitigation purposes" and "other purposes" (collectively referred to as "other international mitigation purposes" or "**OIMPs**").

For ease of terminology, each of (i) – (iii) above is hereinafter referred to as a "private sector engagement pathway" or "**PSEP**" (with (i) being the "**First PSEP**", (ii) being the "**Second PSEP**", and (iii) being the "**Third PSEP**").

It is, in the authors' view, implicit in each PSEP that private sector engagement will be critical to its mobilisation and success.

First PSEP

One interpretation is that where a host country authorises mitigation outcomes for "international mitigation purposes", it is signalling to the market that it is designing its Article 6.2 participation strategy with a focus on transferring mitigation outcomes to private entities that are or may become subject to international emission reduction compliance schemes. In the context of CORSIA, this would mean airlines and, in the context of any equivalent regime that may ultimately be mandated by the International Maritime Organization, it would mean vessel owners, operators or charterers.

An authorisation of this type by a host country would necessarily require airlines and vessel operators to be the ultimate purchasers of these ITMOs. Our expectation (based on current CORSIA rules set by the International Civil Aviation Organisation) is that once purchased, such ITMOs would need to be retired in compliance with the scheme's rules and, in addition, the host country would need to proceed to make a corresponding adjustment.

The First PSEP, if utilised strategically, could be used to enable a host country to develop an economy around the technologies that are needed to decarbonise the sectors subject to the types of schemes that would constitute "international mitigation purposes". For instance, could the mass-production of green hydrogen, sustainable aviation fuel or biofuels be financed by industry end-users through the purchase of ITMOs under the First PSEP? These technologies are critical to decarbonising the aviation and shipping sectors in the medium and long-term. Could a case therefore be made for these industries to utilise the avenue provided by the First PSEP to help the funding and scaling of these technologies in collaboration with host countries that are willing to engage with these processes?

Second PSEP

An authorisation by a host country of the use of mitigation outcomes for other purposes would, in the authors' view, necessarily require private party engagement in collaboration with existing international standards in the VCM. As most market participants are aware, the current make-up of the VCM broadly consists of private (normally not-for-profit) standard setters and governance bodies, private project developers and private investors/purchasers/offtakers (which can be sub-categorised into carbon credit brokers and other intermediaries, funds, more traditional financiers and corporate investors/offtakers).

One interpretation of engagement by a host country in this type of ITMO "use-case" is that it would reflect a signalling by that host country that it supports the growth and scaling of the VCM within its jurisdiction. This may require collaboration between the designated national authority (the "DNA") responsible for Article 6 implementation in the relevant host country and existing VCM standards such as Verra and Gold Standard, including in relation to matters such as (i) the conversion or labelling of existing or new VCM projects overseen by such standards as "ITMO-issuing" projects, and (ii) the transparent processing of corresponding adjustments by the DNA (or one of its affiliate authorities) which will ensure the integrity and validity of issued ITMOs. Such "ITMO-issuing" projects have the potential to yield a higher price and value for the associated ITMOs, resulting in enhanced financial benefit to project developers, local communities as well as increased returns to project investors.

This type of Article 6 engagement strategy by a host country would, in our view, have the potential to provide confidence to investors and financiers of private GHG reducing or removing projects in that country, stimulating the growth of climate change mitigation activities resulting in the generation of revenue from such activities. Perhaps this is an avenue that ought to be considered by the Africa Carbon Markets Initiative launched at COP27.

In order to support the effective mobilisation of the Second PSEP, UN-level policy guidance would be welcome, particularly in relation to any requirement to make corresponding adjustments on the buy-side of Second PSEP transactions and on the interoperability of VCM standard registries and national/international registries under the Article 6 market-based mechanisms. Current sentiment from standard setters such as Verra is that corresponding adjustments are not required on the buy-side where the ultimate purchaser is a private entity / corporate – Verra's detailed rationale can be found here. Furthermore, CMA guidance on how contracting parties envisage the interface between Articles 6.2 and 6.4 (on the one hand) and the VCM (on the other) to function in practice would be very welcome, although perhaps this is something that individual participating countries may need to work through independently as part of their national Article 6 implementation processes.

The Article 6.4 Mechanism and the Third PSEP

One of the stated aims of Article 6.4 is (per paragraph (b)) *"to incentivize and facilitate participation in the mitigation of greenhouse gas emissions by public and private entities authorized by a Party".*

However, to examine the potential opportunities presented by the Third PSEP in any meaningful way, decision 3/CMA 3 (Rules, modalities and procedures for the mechanism established by Article 6, paragraph 4, of the Paris Agreement) (the "**Article 6.4 Rules**") should be considered in some more detail.

The Article 6.4 Rules provide that, unlike Article 6.2, the Article 6.4 mechanism is to be governed by the Supervisory Body whose role and function includes:

- to develop and approve methodologies and standardised baselines;
- register activities as Article 6.4 activities, renew crediting periods and issue A6.4ERs;
- administer and maintain the registry for the mechanism; and
- promote the consideration of human rights, apply robust social and environmental safeguards and develop tools and approaches for sustainable development.

In terms of the types of methodologies that will be approved by the Supervisory Body, this is presently somewhat unclear but the expectation is that the Supervisory Body will consider methodologies that currently exist within and have been approved by the many registries in the VCM as well as the Kyoto Protocol era's Clean Development Mechanism. In other words, the range of activities that may be designated by a host country for participation in its Article 6.4 implementation strategy is, if not unlimited, then very broad indeed provided that certain requirements are met. The Article 6.4 Rules require methodologies to encourage ambition over time; encourage broad participation; be real, transparent, conservative, credible and below business as usual; avoid leakage, where applicable; recognise suppressed demand; align to the long-term temperature goal of the Paris Agreement; and contribute to reducing emissions in the host country, and align with its NDC and long-term low GHG emission development strategy. Crucially, methodologies must also specify an approach to demonstrating additionality.

It is expected that private sector participation in the Article 6.4 mechanism, together with progressive and necessary implementation of the mechanism by host countries, will be key to driving and scaling the market for A6.4ERs.
As the de facto replacement of the Clean Development Mechanism, the successful implementation of the Article 6.4 mechanism will be significantly predicated on the robustness and clarity in the design of the mechanism's registry by the Supervisory Body. The not-for-profit body, Carbon Market Watch, has issued some helpful notes on ideal features of the registry's design – these can be found here and may be summarised as follows:

- the registry should set an example for transparency and completeness and should learn from existing strengths and weaknesses of the current VCM registries as well as from the CDM;
- the registry should include detailed information about each registered project including project name, methodology used, host country as well as specific data that allows more in-depth analysis of the full range of registered projects such as annual baseline emissions used to calculate total reductions/removals, annual project emissions used to calculate total reductions/removals, GPS coordinates of the project, name of the project developer(s), name of the validation and verification bodies, total quantities of credits retired etc.; and
- the registry should include information on unit transactions, in order to better identify the paths taken by specific units between their issuance and their retirement or cancellation including a public record of all transactions involving the credits, identifying the change in their legal ownership.

It is the authors' view that the features of the Article 6.4 Rules as well as some of the market discourse around registry design are intended to provide confidence by ensuring the development of a market-based mechanism and registry that are both transparent and coherent. This should encourage private project development expertise and private equity/debt capital to invest their human and financial resources into developing and funding eligible projects and project activities in jurisdictions that proactively engage in implementing the Article 6.4 mechanism, as part of a national policy to create an investable environment for climate finance activities.

Crucially, the interface between the Article 6.4 mechanism and the Third PSEP is set out in Section C (Approval and authorisation) of the Article 6.4 Rules – specifically:

- paragraph 41 of the Article 6.4 Rules requires the host country to provide to the Supervisory Body *"authorization of public or private entities to participate in the activity as activity participants under the mechanism"*;
- paragraph 42 of the Article 6.4 Rules goes on to require the host country to provide a statement to the Supervisory Body specifying whether it *"authorize A6.4ERs issues for the activity for use towards achievement of NDCs and/ or for other international mitigation purposes ….",* the effect of which will result in a conversion of such A6.4ERs into ITMOs; and
- paragraph 43 of the Article 6.4 Rules confirms that A6.4ERs may only be used towards NDCs or towards OIMPs if they are authorised in accordance with paragraph 42. It goes on to clarify that the host country will be required to apply corresponding adjustments for such A6.4ERs.

Where a host country elects to participate in the Article 6.4 mechanism in order to incentivise and stimulate private project development, it will need to carefully follow the procedures set out in the Article 6.4 Rules.

The question of whether a host country can engage in Article 6.4 activities without authorising them for any "use-case" was answered at COP27. The newly adopted CMA.4 (Guidance on the mechanism established by Article 6, paragraph 4, of the Paris Agreement) makes a case for unauthorised A6.4ERs at paragraph 29(b), which states:

> *"A6.4ERs not specified as authorized for use … may be used, inter alia, for results-based climate finance, domestic mitigation pricing schemes, or domestic price-based measures, for the purpose of contributing to the reduction of emission levels in the host Party."*

Initial market reaction at this point is indicative of such unauthorised "mitigation contribution A6.4ERs" or "**MCERs**" necessarily needing to be counted towards the host countries NDC and any claim to the contrary by project-investing or credit-purchasing corporates (such as claiming the carbon benefit achieved by the MCER for its own use) would amount to double-counting. Some market participants are suggesting that the market for MCERs is comparable to the market described by the Second PSEP but without the need for the host country to make a corresponding adjustment. Critically, this use-case for MCERs is qualified by the words "inter-alia" and as such, more clarity is needed to set some parameters around how MCERs will be issued, what methodologies and projects they might apply to and what kinds of claims the purchasers of MCERs are able to make.

Furthermore, the question of which types of entities (country or private) will form the buyer-base for "A6.4ER ITMOs" remains open. This is a material issue. If it is expected that private capital will be utilised to fund Article 6.4 projects and project activities, the funders will need clarity on their return – can they take title to authorised A6.4ERs and sell them in private contracts to other private entities or buying countries? Or, alternatively, is their return going to be limited to being financial in nature on the basis that authorised A6.4ERs can only be sold by the host country as ITMOs (with a pass through of the revenue generated to the project developer/funder)? Once more, clarity and guidance around these questions would be very welcome.

Finally, the issue of revocation of authorisations was tabled by the group of Like-Minded Developing Countries at COP27. It is the authors' view that an ability of a host country to revoke or cancel an authorisation of an A6.4ER would be counterproductive to, and endanger, investment flows to mitigation activities in that country. Investors and project developers need certainty – the possibility of the categorisation (and, consequently, the valuation) of a mitigation activity changing (from authorised to unauthorised) would likely deter confidence and delay investment as well as add to development costs by parties likely seeking to take out insurance cover to protect against this risk. This topic is set for further discussion at COP28 next year.

Conclusion

As is hopefully evident from the commentary above, the scope for private actor engagement in the Article 6 mechanisms is abundant. With the appropriate level of guidance and clarity from the UN, the Supervisory Body and proactive host countries, these mechanisms have the potential to provide significant volumes of climate finance by channelling private sector capital into climate change mitigation projects with high levels of co-benefits for local communities and economies. Much will also turn on the legal categorisation of an ITMO. It seems likely that the categorisation of A6.4ERs will be similar to the categorisation of carbon credits in the VCM. What this is likely to mean is that A6.4ERs may be viewed as an asset class that is tradable between public/private entities in the same way as other carbon assets.

Whether ITMOs will be subjected to a similar categorisation or whether they will be determined to be instruments limited to the realm of public international law and inter-governmental trading, remains to be seen. It would, in the authors' view, be beneficial to the engagement of private actors in these mechanisms if ITMOs were determined to simply be an extension of the carbon assets that exist and are traded within the private market today. There are some material downsides to this approach (the nature of which is outside of the scope of this article) but if one of the principal purposes of the Paris Agreement is to provide finance to developing countries at the level described in the introductory section to this article, then this will be much more difficult to achieve without the mobilisation of private capital. The key, therefore, is to ensure that private sector participants are fully equipped with an understanding of the scope of their engagement under both the Article 6.2 and 6.4 mechanisms.

About Philip Lee LLP

Philip Lee LLP is a leading corporate and commercial law firm headquartered in Dublin with offices in London and San Francisco.

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About the authors

Lev Gantly is a partner at Philip Lee LLP with many years of experience in renewable energy and carbon project development and finance.

Malwina Burzec is a senior associate and attorney-at-law with EY Law in Poland. She specialises in sustainability law and advises private and public entities on legal questions related to carbon markets. Anne-Laure Pilat is a junior associate with EY Law in Poland. Her topics of interest are climate, smart agriculture and current development of Article 6 carbon markets.

Philip Lee LLP

Dublin
Connaught House
One Burlington Road
Dublin 4, D04 C5Y6

London
Floor 30
The Leadenhall Building
London, EC3V 4AB

San Francisco
388 Market Street,
Suite 1300,
San Francisco,
CA 94111

www.philiplee.ie | T: + 353 1 237 3700

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