CLIFFORD CHANCE

COP26: ARTICLE 6 RULEBOOK FOR THE NEW GLOBAL CARBON MARKET MECHANISM AGREED

— THOUGHT LEADERSHIP

NOVEMBER 2021

COP26: ARTICLE 6 RULEBOOK FOR THE NEW GLOBAL CARBON MARKET MECHANISM AGREED

Some 6 years after the Paris Agreement, COP26 has resulted in agreement on a global carbon market mechanism (GCMM) largely completing the so-called 'Paris Agreement Article 6 Rulebook'.

Key decisions (the Rules) have been made on the eligibility of projects and activities to be included in the GCMM, the approval process and issuance of credits, the making of corresponding adjustments to host state's emission accounts, and how to deal with legacy projects and credits under the Kyoto Protocol's Clean Development Mechanism (CDM). We discuss the key elements below along with the likely impacts on the compliance markets and voluntary carbon markets.

Requirements for eligible projects / activities to be included in the GCMM

Host states will approve and authorise the types of carbon emissions reduction or removal activities and projects (Projects) to be included in the GCMM, and identify how these will help the host state to achieve its Nationally Determined Contribution ('NDC') under the Paris Agreement. Host states will also have to approve whether resulting credits from the GCMM (known as Article 6.4 emission reductions or 'A6.4ERs') can be used for the purposes of satisfying its own NDC or for international transfer. The Rules explicitly recognise the ability for private entities to participate in Projects (as activity participants) and to receive resulting A6.4ERs.

Projects will have to comply with a methodology agreed by a new international Supervisory Body. They will also have to satisfy a number of key criteria to be eligible for the GCMM:

- The mitigation of GHG emissions must be 'additional', i.e. taking into account national policies and legislation, the Project wouldn't have happened on a *business as usual* basis without funding from the GCMM, and are not required by law or regulation; they should also be ambitious, and not lock in levels of emissions, technologies or carbon-intensive practices.
- Projects must deliver real, measurable and long-term benefits over multiple NDC implementation periods, including remedying any reversals and leakage and minimising adverse environmental and social impacts.
- Ambitious benchmarks must be used to establish a baseline for the activity (against which reductions will be measured) set at the average actual or historical emission level of best performing comparable activities in similar circumstances, using best available techniques.
- Projects must have a crediting period of a maximum of 5 years, renewable twice (i.e. up to 15 years), or a single unrenewable period of 10 years. Crediting periods cannot start before 2021.
- Projects must ensure accurate monitoring and calculation of emission reductions.
- Projects must be subject to suitable stakeholder consultation.

Projects will have to be validated by accredited independent national 'designated operational entities' to verify that the Projects comply with the requirements. These entities will also monitor the implementation of Projects to ensure emissions reductions are achieved, and make an application for certification and issuance of A6.4ERs to the Supervisory Body. The Supervisory

Body will then issue A6.4ERs into a mechanism registry in which activity participants will have holding accounts.

Use of credits and corresponding adjustments

A key sticking point of the Article 6 discussions was the proportion of credits that would need to be given over to support developing countries' adaptation efforts. Ultimately it was decided that the proceeds from 5% of all A6.4ERs, in addition to a monetary payment (of a level to be set by the Supervisory Body based on the scale of the Project, will need to be given to the Adaptation Fund for these purposes. A further minimum of 2% of all A6.4ERs must be cancelled as a contribution towards global emissions reductions. Finally, a payment must also be made to cover administrative expenses of the GCMM. Remaining A6.4ERs can be internationally transferred and used for trading purposes.

Once A6.4ERs are issued, a host state may use them towards its NDC. Where, alternatively, the state has decided to permit the A6.4ERs to be transferred internationally, it will need to make corresponding adjustments to its emissions accounting (both for emissions within its NDC and outside it) to reflect that state's notionally increased emissions inventory; this is to ensure no double counting of emissions reductions between states, a key point of contention in the negotiations. Similar corresponding adjustments will need to be made in respect of shares of A6.4ERs devoted to adaptation purposes and administrative expenses.

Legacy CDM projects / credits

A key controversy hanging over the Paris Agreement was the extent to which legacy credits (CERs) under the CDM could be used going forward to achieve host states NDC's. The ultimate compromise reached in the Rules is that CERs can be used towards satisfying NDCs, subject to compliance with a number of conditions, including:

- Only CDM activities registered on or after 1 January 2013 would be eligible;
- The CERs can only be used for the first NDC only (i.e. a maximum of 5 years); and
- Temporary and long-term CERs could not be used.

The Rules also provide that, contrary to the position with Art 6.4ERs, no corresponding adjustments would be required to be made to NDCs by the host Party for sale of CERs, nor would a share of the proceeds of CERs have to be provided for developing country adaptation.

It was also agreed that ongoing CDM projects can transition into the GCMM provided they comply with GCMM rules (and methodologies following a phase in period), apply for approval from the host CDM state by 31 December 2023 and receive the approval of the host CDM state by 31 December 2025.

Co-operative approaches

The Rules also set out a separate mechanism for 'co-operative approaches' which may be agreed between individual states to help one another to achieve their NDCs (under Article 6.2 of the Paris Agreement). This framework is separate from the GCMM but will similarly allow for the creation of credits (called 'Internationally Transferred Mitigation Outcomes', or 'ITMOs') from projects or activities which can be traded between states. It is possible that private entities will be able to get involved in projects and activities linked to ITMOs, or trade in ITMOs, although the framework for inclusion of private entities is not set out in the Rules and would be dependent on the national laws and regulations of the relevant countries. It is thought that some host states may prefer to make individual co-operative approach arrangements with other states rather than allowing the creation of A6.4ERs. This would be to enable the host states to exercise greater control over the extent to which emissions reductions can be sold internationally (see further below in relation to voluntary markets).

Another key difference between co-operative approaches and the GCMM is that co-operative approaches can allow *activities which do not result directly in emissions reductions* to be counted towards issuance of ITMOs. This might include, for example, renewable energy projects and adaptation programmes. ITMOs of this nature will be issued based on converting non-GHG metrics to GHG metrics to allow them to be used towards achievement of NDCs.

Impact on the compliance markets

In the past, under the Kyoto Protocol mechanisms of Joint Implementation and CDM, compliance markets such as the EU emissions trading system ('EU ETS') were linked with international credits such as CERs. However, from the beginning of the fourth trading period of the EU ETS in January 2021, the EU removed the ability to use CDM credits for satisfying EU ETS obligations due to a potential lack of transparency in the operation of the CDM mechanisms. Against this background, the Rules have the potential to overcome issues such as a lack of transparency and create a possibility for compliance systems like the EU ETS (and the new UK ETS) to be linked with international credits again. Governing bodies of emissions trading systems such as the EU ETS and the new UK ETS will now be considering the detail of the Rules to assess whether and to what extent to allow A6.4ERs to be used for compliance purposes under those ETSs without affecting the credibility of their NDCs or those trading systems. Their decisions on whether to restrict the ability for A6.4ERs to be used for compliance purposes will impact the behaviour of host states and the voluntary markets.

Impact on the voluntary carbon markets

Voluntary carbon markets are currently highly fragmented and face difficulties with the quality of certain carbon credits, e.g. with respect to issues such as double counting. Many market participants are currently hesitant to invest in voluntary carbon markets as a result. Such issues are currently being addressed by the Taskforce on Scaling Voluntary Carbon Markets (TSVCM) and we are supporting these efforts.

Although there is no clear guidance on the functioning of voluntary carbon markets in light of the Rules, it can be expected that, at the very least, the Rules have a potential to increase the integrity of voluntary carbon markets. Most importantly, the Rules suggest that governments might be able to authorise carbon credits for use in the voluntary carbon markets (as *mitigation outcomes* authorised to be transferred for "other purposes"). This would be similar to the way CERs from CDM projects have been used in the voluntary markets to date. However, the text has left this unclear and this issue remains controversial. A definite answer on this will hopefully emerge through the ongoing implementation process of the Rules. If voluntary carbon credits can indeed be authorised in this way, the requirement for corresponding adjustments to avoid credits being used in host and receiving state (as described above), would mean that double counting should be avoided. This would give voluntary carbon credits greater credibility and would potentially resolve one of the key concerns deterring many investors in the voluntary carbon market.

The broader picture is that the Rules provide for stringent requirements for A6.4ERs in the GCMM as described above. Unless voluntary standards (such as the VCS or Gold Standard) ensure that their credits meet equally high standards, they are likely to be regarded as low quality credits compared to A6.4ERs (again reducing demand). This may further encourage improvements in the standards for voluntary market credits leading to greater levels of investment. Ultimately this may lead to discussions over whether voluntary market credits should be allowed to be used in the compliance markets and the two markets might well begin to coalesce in the future. There is, however, a corresponding risk that host states will wish to exercise greater control over, and regulation of, projects in their territories in a way that favours the generation of A6.4ERs for the compliance market with voluntary market projects being more restricted. This would, however, depend on the compliance markets allowing the A6.4ERs to be brought into their markets.

However, as the implementation of the Rules will likely take some time, voluntary carbon markets are expected to continue to play a significant role in supporting the Paris Agreement's climate targets in providing for a means to offset unavoidable emissions.

Final comments

There are a number of continuing review processes in place to complete the Rules, but agreement of the key elements at COP26 will be welcomed as a crucial prerequisite for full implementation of the Paris Agreement and enabling private capital to be directed towards global carbon mitigation efforts. However host states and governing bodies of emissions trading systems around the world now need to consider the Rules and the positions they wish to take. The outcome of those considerations will play a significant role in determining the future of compliance and voluntary markets and the extent of investment into emission avoidance and reduction projects.

Note: This briefing is based upon published 'Advance unedited versions' of the relevant decisions, which may be subject to minor change.

CONTACTS

Nigel Howorth
Practice Area Leader
Real Estate
London
T: +44 207006 4076
E: nigel.howorth@
cliffordchance.com

Anneke Theelen
Senior Associate
London
T: +44 207006 3045
E: anneke.theelen@
cliffordchance.com

Mathias Elspass
Partner
Dusseldorf
T: +49 211 4355 5260
E: mathias.elspass@
cliffordchance.com

Frederic Maximilian Mainka
Associate
Dusseldorf
T: +49 211 4355 5355
E: frederic.mainka@
cliffordchance.com

Michael Coxall
Knowledge Director
London
T: +44 207006 4315
E: michael.coxall@
cliffordchance.com

Kirsty Souter
Senior Associate
London
T: +44 207006 4178
E: kirsty.souter@
cliffordchance.com

Nadia Kalic
Partner
Sydney
T: +61 2 8922 8095
E: nadia.kalic@
cliffordchance.com

Dale Straughen
Senior Associate
Sydney
T: +61 2 8922 8040
E: dale.straughen@
cliffordchance.com

Paget Dare Bryan
Partner
London
T: +44 207006 2461
E: paget.darebryan@
cliffordchance.com

Paul Landless
Partner
Singapore
T: +65 6410 2235
E: paul.landless@
cliffordchance.com

Kimi Liu
Counsel
Beijing
T: +86 10 6535 2263
E: kimi.liu@
cliffordchance.com

CLIFFORD

CHANCE

2111-002447