ENERGY STUDIES INSTITUTE

Policy Brief 50

29 November 2021

COP26 Article 6 Outcomes: Untangling the Spaghetti

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SYNOPSIS
At the recent Glasgow COP26, countries finally concluded the outstanding rules on Article 6, which outlines the ways in which countries can cooperate through cross-border carbon markets to achieve the objective of the Paris Agreement. This policy brief examines the Article 6 carbon market outcomes and discuss how they might impact both mandatory and voluntary carbon markets, as well as Singapore's role as a carbon services hub.

KEY POINTS

- COP26 has laid a firm foundation for future progress, and is a positive step forward for raising global climate ambition. The Glasgow Climate Pact provides greater clarity on how to apply Article 6 rules when engaging in cross-border emissions transfers.
- All governments need to work hard in order to ensure that corresponding adjustments, which help avoid double-counting of carbon credits, will be strictly monitored and applied appropriately. The approved Clean Development Mechanism (CDM) credits must also be used wisely, bearing in mind the accumulated green investments in developing countries and embodied achieved emissions reductions.
- The conclusion of Article 6 presents a significant opportunity for Singapore in its ambition to become a carbon services hub since greater clarity on cross-border carbon markets will help generate demand for associated services at a global scale.

INTRODUCTION

The 26th Conference of the Parties to the UN Framework Convention on Climate Change (COP26) took place in Glasgow, United Kingdom from 31 October to 13 November 2021. Amongst other things, countries were finally able to conclude negotiations on Article 6, which sets out rules on an international carbon market. For an overview of COP26 outcomes, see *ESI Policy Brief no. 49*. The Paris Rulebook, which informs countries how the various articles in the Paris Agreement is to be put in practice, is complete. This was a result of six years of detailed negotiation and compromises, resulting in a bumpy, but reasonably safe landing zone. COP26 has now laid a firm foundation for future progress, and is a positive step forward for raising global climate ambition. At a round-up media interview in Glasgow, Singapore's Minister for Sustainability and the Environment Grace Fu described Article 6 as "a bowl of spaghetti", referring to the interlinkages with other issues such as ambition, finance, transparency and more. It was imperative to agree on rules for Article 6 as it is the "spaghetti" that brings together and unlocks other goals of the Paris Agreement, including climate ambition, finance, transparency, and provisioning for climate adaptation. Co-facilitators Hugh Sealy (Barbados), Mandy Rambharos (South Africa), Peer Stiansen (Norway), and Kim Solberg (Netherlands), as well as COP26 ministerial co-facilitators, Singapore's Minister Grace Fu and Norway's Climate and Environment Minister Espen Barth Eide, should be given credit for accomplishing such a difficult task.

This policy brief will focus on the market mechanisms under Article 6, since Article 6.8 negotiations resulted in a Glasgow Committee on Non-Market Approaches. The committee's first focus areas will be on adaptation, resilience and sustainability; climate mitigation and sustainable development; and the development of clean energy sources.

ANALYSIS

Use of Article 6 in Climate Pledges

Most countries have said that they plan to or intend to use at least one type of voluntary cooperation under Article 6 in at least one of its scopes in implementing their NDCs. This is according to the latest Nationally Determined Contribution (NDC) Synthesis Report released on 25 October, covering 116 updated or new NDCs submitted by 143 countries out of all the 192 Parties to the Paris Agreement as of 12 October 2021. This figure has nearly doubled compared to the first round of NDCs submitted in 2015-16, from 46 to 85 per cent. However, the World Bank's State and Trends of Carbon Pricing 2021 report warned of other factors influencing future demand for cross-border carbon markets. One of the key challenges ahead will be to ensure environmental integrity in the carbon markets, while not setting up high barriers of entry for developing countries, or imposing punitive rules for countries with significant exposure to existing carbon credit projects.

Corresponding Adjustments

Corresponding Adjustments (CAs) was possibly the most controversial part of the negotiations, yet it was also this issue which delivered the most robust outcomes. Developing countries, especially those which have been hosts of projects under the CDM, wanted to retain the benefits of the greenhouse gas (GHG) emission reductions under Article 6. On the other hand, developed countries were generally of the position that having paid for the development and operationalisation of these projects, they should be able to claim the GHG emission reductions for themselves. If both host countries and funding countries claimed the emission reductions, there would be a double-counting of these reductions, which would mean that the global GHG inventory would be reflect a lower figure than in reality. The outcome of the negotiations was clearly and neatly encapsulated in paragraphs 42-44 and 71-72 of the annex to the decision on Article 6.4. Host countries will need to authorise the application of the emission reductions generated within their territory towards NDCs, or other international mitigation purposes, for example the International Civil Aviation Organisation's (ICAO) Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA). Further, they will have to apply CAs for Article 6.4 emission reductions (A6.4ERs) transferred to other countries, whether they are used towards that other country's NDCs, or other international mitigation purposes. Similarly, paragraphs 7-15 in the Article 6.2 rules also require host countries to make similar CAs.

While these rules are as robust as could be hoped for, there is still uncertainty as to whether voluntary credit standards will also need to seek host country approval for the export of the emission reductions generated by projects registered on their marketplaces, in order to meet countries' NDCs. Today, compliance and voluntary carbon markets operate largely independently. Gold Standard, which appraises and certifies non-governmental emissions reduction projects under the CDM, has indicated in recent public statements that they will move towards a bifurcation of their marketplace by 2025. Credits which host countries have adjusted for will be sold as "Article 6 adjusted units" and can be used as carbon offsets outside the host country, including for CORSIA offsetting by airlines. Other credits which have not been adjusted for by host countries will be sold as "support units" and can only be used as offsets within the host country. At the same time, foreign buyers are, in principle, not allowed to claim the benefit of the emission reductions embodied. On the other hand, Verra, another standard for certifying carbon emissions reductions, have expressed that their VCMs will certify credits as either "adjusted units" or "non-adjusted units", and market actors, as well as corporate investors will have to exercise due diligence in terms of making and assessing carbon neutrality claims accordingly. In the long run, however, the expectation is that Gold Standard's model might prevail, as it better contributes to a robust regime of responsibility to maintain the environmental integrity of their standard.

Baselines, Additionality, Crediting Periods

The first paragraph of Chapter V.B of the annex (Methodologies), states that methodologies adopted under the new Article 6.4 mechanism (A6.4M) are required to, amongst other things, "encourage ambition over time; encourage broad participation; be real, transparent, conservative, credible, below "business as usual"; avoid leakage, where applicable; [and] recognize suppressed demand". On the other hand, paragraph 1(a) of the Article 6.2 decision annex only require that Internationally Transferred Mitigation Outcomes (ITMOs) are "real, verified, and additional". In practice, however, considering the close relationship between Articles 6.2 and 6.4, it is expected that methodologies recognised for A6.4M purposes will also be applied in ITMO contexts, though the open wording in the latter does allow states to adopt more flexibility in crafting approaches and methodologies than under the A6.4M. State parties can also adopt shorter crediting periods unilaterally, though it is unlikely that states will do so unless there is significant international consensus.

Overall Mitigation in Global Emissions (OMGE) and Share of Proceeds for Adaptation and Administrative Expenses (SOP)

The SOP element was, in principle, not particularly controversial. Under the CDM, 2 per cent of all credits generated had been set aside at first transaction, and transferred to the UNFCCC Adaptation Fund. A further USD0.20 was levied on each unit for administrative expenses. The SOP proposal simply proposed that a similar scheme be adopted in Article 6. OMGE, however, was more controversial, as it proposed the cancellation of another percentage of credits at first transaction as well. The concept behind OMGE was to increase the amount of carbon credits needed to be purchased for each unit of GHG emissions. To some, however, this implied that the carbon credits themselves lacked integrity, and that one carbon credit represented less than one tonne of CO2-equivalent (tCO2e) in practice. The Article 6.4 rules set aside 5 per cent SOP for adaptation at first transfer, to be transferred to the Adaptation Fund, plus an administrative fee, to be determined by the Article 6.4 supervisory body in the future. Another 2 per cent will be cancelled at first transaction for OMGE. Taken together, when a buyer of A6.4ERs buys these credits from the project developer, 7 per cent of the A6.4ERs will be withheld from this first transaction for SOP and OMGE, plus an additional administration fee to be paid by the buyer. If the buyer purchased 100 units of A6.4ERs, at USD1 per credit, they would pay USD100, plus the A6.4ER administrative fee, and receive 93 units from this transaction. Five units would be transferred to the Adaptation Fund, and two units would be cancelled for the purpose of OMGE. After this, the buyer can either claim the benefit of 93tCO2e of carbon offsets by cancelling the credits, thus removing them from the market, or they can sell the A6.4ERs to other parties, without having to withhold, set aside, or cancel further A6.4ERs. On the other hand, OMGE and SOP are not required for ITMOs, though state parties are "strongly encouraged" to contribute to OMGE and to the Adaptation Fund as well. Further, the purchase of existing CDM credits are not subject to OMGE, and the SOP rules to be applied are expected to be that of the CDM, and not the higher figures prescribed by the A6.4M.

Transitional Rules for the CDM

The transitional rules for CDM credits and projects, to be applied until 2030, were the product of substantial compromises. Large developing countries such as the BRICS have significant exposure to the CDM market, and feared that the introduction of the A6.4M would result in the zeroing out of the credits and projects generated. Developed countries also were concerned that their investments in the CDM would be wiped out. The rules agreed are that CDM projects registered from 2013 onwards are eligible to transfer credits already issued as CERS to the A6.4M, but those have to be labelled as "pre-2021 emission reductions". They may be used towards first NDCs until 2030; and CDM projects registered from 2013 onwards may also apply to transition to the A6.4M, and issue A6.4ERs, using their existing CDM methodology until end-2025, or the end of the project's current crediting period, after which it must use new A6.4M methodologies. Together, these rules have been estimated by the NewClimate Institute, a German-based non-profit research company, to potentially add up to 3,200 MtCO2e of credits into the market, resulting in a significant ballast effect on the market; though it is also estimated that only 30 per cent of this will actually materialise – but this 962 MtCO2e is still about the equivalent Germany's annual GHG emissions.

Impact on Singapore

For Singapore, agreement on the terms and application of Article 6 helps to provide the country with a foundation to build on as it seeks to achieve its ambition of establishing itself as a carbon services hub. Singapore is actively building expertise in carbon project development, carbon financing and trading, legal services, low carbon advisory, proper verification of carbon credits, carbon credit training and risk management. The trajectory and level of Singapore's carbon tax, currently set at SGD5/tCO2e from 2019 to 2023, is being reviewed. Following Glasgow COP26, Singapore announced that it will be reviewing its NDC. The overall trend of the Article 6 market rules means that it will be easier for Singapore, and countries with similar circumstances, necessitating access to, or with the intention of accessing, carbon markets, to effectively set and achieve more ambitious targets through broader access to carbon credits through to 2030. This is an opportunity for countries to provide greater international climate financial transfers to developing countries by making the fullest use of the carbon markets and accelerating the adoption of new rules and methodologies.

CONCLUSION

COP26 has delivered the Article 6 market rules, providing relief and certainty to the carbon market. The methodological and technical rules are robust and address most of the issues which parties had raised over the past six years. These rules are likely to affect the voluntary market as well, as it has historically taken the lead from the CDM in various issues due to the CDM's dominance in its early years. The next decade should see stabilisation of carbon credit markets with converging approaches, including shorter five-year crediting periods for GHG reduction projects, and 15-year periods for carbon removal projects, CAs becoming mandatory, and the phaseout of old methodologies and projects. Until then, however, state parties which intend to rely on carbon credits to achieve their NDCs, as well as those with significant exposure to the CDM, will appreciate the gentle transition. The relatively low OMGE and SOP percentages will also be of concern to climate vulnerable countries which were hoping for double digit figures. While this may have been possible for SOP as the credits were visibly going "somewhere", i.e. to the Adaptation Fund, OMGE simply cancels credits out of existence, as opposed to placing them in a buffer account, or transferring them to another fund such as the Green Climate Fund. This concept required buy-in from developed countries, and the fact that OMGE has been agreed is a significant concession on their part. In a related vein, a group of state parties have reportedly agreed to abstain from using these old credits, and preserve the environmental integrity of their NDCs. While this seems to be a good idea, the ex-CDM credits also represents some level of GHG reduction in developing countries. The abrupt rejection of ex-CDM credits by developed countries will send troubling signals to project developers, as the CDM and A6.4M will be seen as unable to deliver stable returns on investments, damaging the prospects for green investments in developing countries. It would be better for these states to commit to purchase and cancel significantly more ex-CDM credits than they need for their first, with the aim of accelerating the phase-out of these old credits well ahead of 2030. Overall, the Article 6 market rules are balanced, as most observers expected them to be. No party got everything they wanted, but no party left Glasgow empty-handed either – which is the best outcome parties could have hoped for.

WHAT TO LOOK OUT FOR

- Further technical and procedural work under the Subsidiary Body for Scientific and Technological Advice (SBSTA) in June 2022 for conclusion by the next CMA held in Egypt in November 2022.

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Key words: COP26, Article 6, Carbon Market, Climate Change, Emissions Trading