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LEGAL GAP ANALYSIS FOR TRANSACTIONS

IN PREPARATION FOR ARTICLE 6

Prologue

Background and context

Last year, the COVID-related postponement of COP 26 delayed completion of the rulebook for Article 6 of the Paris Climate Agreement for another year. But the climate imperative has meant that action agendas and cooperation plans could not wait. National climate leaders intensified work on the next round of "Nationally Determined Contributions" due before COP 26 – and on how they will trend towards "net zero" targets. In February 2021, the UNFCCC published an NDC Synthesis Report that looked at information from 48 new or updated NDCs, representing 75 Parties, submitted as of 31 December 2020. This showed that the share of Parties stating that they plan to or will possibly use voluntary cooperation through Article 6 more than doubled since the previous NDCs. At the same time, corporate CEOs advanced their own commitments to "net zero" climate emissions, reflecting rising pressure from investors, customers and policy leaders that the goal was an essential part of good corporate governance.

Background and context

The "net" of "net zero" should not be taken lightly. The word "net" is essential for getting to zero. It signals the imperative for cooperation, where sectors, countries and regions meet the goal together. Without the "net," the zero becomes infeasible for most – or worse yet, a sign of blind ambition.

The "net zero" level of climate protection will eventually require an international system that brings emissions into balance with compensating removals from both natural and engineered solutions. An international market could be the most important tool for engaging businesses in the broader cooperative system. Those business systems will likely draw on familiar legal and contractual structures, although Article 6 will undoubtedly spark innovations to meet its evolving requirements.

In 2020, Switzerland entered into framework agreements with Peru and Ghana to enable the first pilot trades pursuant to Article 6.2. These agreements were made based on draft Article 6.2 guidance with the intention to conform to final guidance in the future. Importantly, these activities not only positioned the Parties for greater cooperation in the future, but they also inform the negotiations with real world experience.

The pilots highlighted a growing appreciation that Article 6.2 allows countries the freedom to engage in market cooperation "consistent with guidance" that may (or may not) be agreed. In the absence of that guidance, Parties retain the sovereign rights to cooperate with each other, respecting the Paris Agreement's principles of integrity as demonstrated in quality performance and transparent accounting.

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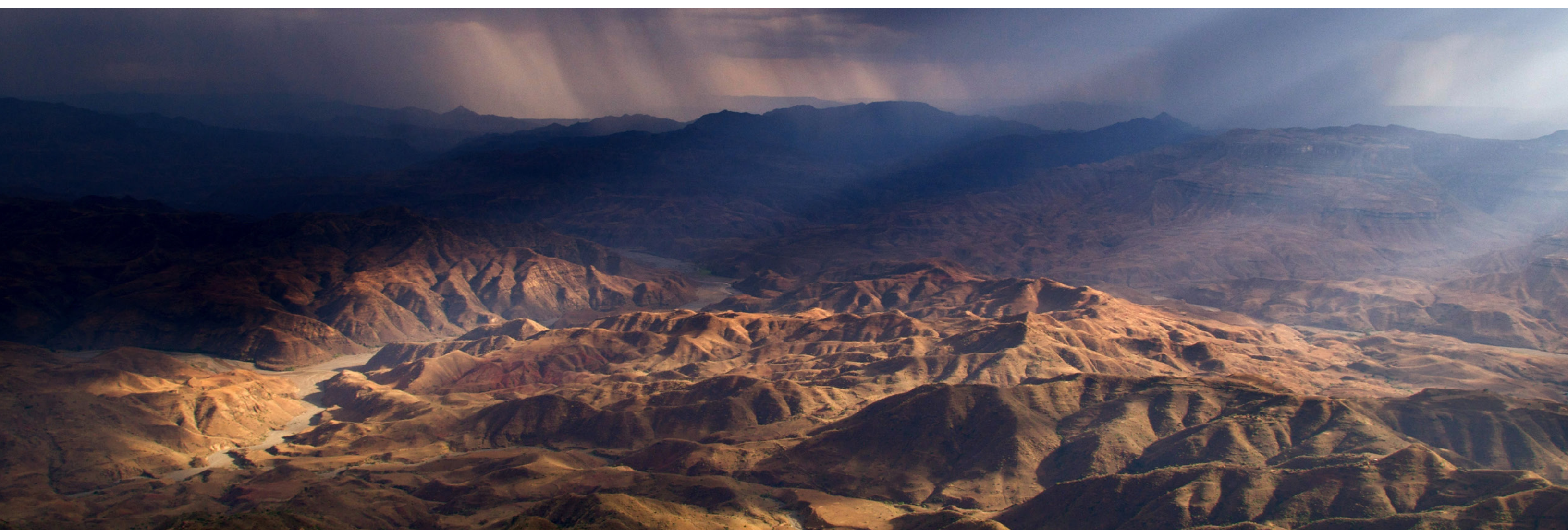

Legal gaps and risk mitigation measures

The private sector must overcome a number of stumbling blocks to scale up market cooperation within Article 6.2 in order to scale down to net zero emissions levels. One of the chief concerns is the legal uncertainty around Article 6.2, and how it will work both practically and commercially.

Thanks to funding from the Children's Investment Fund Foundation and the Markets for NCS Initiative, IETA commissioned Pollination to perform this Legal Gap Analysis for Article 6.2 transactions. It aims to identify the current legal risks for those transacting early using draft guidance for Article 6.2 as it currently exists. Since Article 6.2 guidance is not agreed, market participants should understand the risk that the final guidance could change from the current drafts. Like the countries in pilot transactions, private companies will be wise to plan for conformity with the Article 6.2 guidance, as it evolves.

The goals of the legal analysis are to identify the likely procedural requirements for Article 6.2 transactions, identify legal risks and contractual mitigation measures and discuss at a conceptual level structural measures that can be taken to mitigate, manage or transfer the risks identified.

Delivering “net zero” with integrity

Market integrity is an overarching requirement for Article 6.2. It is a governance requirement for negotiators, and it is deeply shared by business leaders and environmental observers. In this legal analysis, Pollination finds that the Paris Agreement and the draft Article 6.2 guidance offer a number of structural protections for market integrity. These include core requirements of –

- the definition of what constitutes an "internationally transferred mitigation outcome" (ITMO);
- tracking of ITMO transfers in registries; and
- consistent reporting of ITMO authorization, first transfer, use and other information.

The analysis goes on to show that more steps will be required for Article 6.2. Countries can begin to advance preparations for these new steps, understanding that with each step, confidence in market integrity will grow stronger – and the price may well reflect stronger business confidence. Based on the draft Article 6.2 guidance, the steps for an Article 6.2 transaction include the following:

- the host government authorization for first transfer of a credit, which provides a base level of assurance that the unit is not being used for the host’s NDC;
- the host government’s commitment to make a corresponding adjustment;
- the clear recording of the transfer in the host country’s UN FCCC reporting;
- ultimately, the actual “corresponding adjustment” shown by the host country in its UN FCCC reporting; and
- the full process will be complete upon use of the units (e.g., the importing country reports its corresponding adjustment in UN FCCC reporting).

After reviewing the risks and mitigation measures that exist with each major step, the analysis goes on to highlight a set of potentially valuable “structural risk mitigation measures” that cut across multiple risks. These structural measures could further enhance market confidence. They include:

- Meta registries;
- Self insurance pools;
- Political risk insurance;
- Buyer’s club criteria and rules; and
- Positive lists of pre-authorized activities by sovereigns

IETA plans to continue exploration of these mechanisms with interested Parties and businesses.

Taken as a whole, we think you will find that this Legal Gap Analysis helps contribute to a common understanding of the steps to be taken for Article 6.2 transactions. We hope that this common understanding will benefit commercial preparation and be valuable to market participants in advance of final guidelines on Article 6.2 – as well as assisting with market formation after the guidance is completed.

Confidence in market integrity will grow stronger – and the price may well reflect stronger business confidence.

Acknowledgements

On 10 February 2021, IETA convened a forum to review the Legal Gap Analysis and gain insights from experts and practitioners in the market. We would like to acknowledge the valuable insights from the participants, who represented a wide range of perspectives: Enric Arderiu (BP), Lisa DeMarco (Resilient), Amy Merrill Steen (UN FCCC), Kelley Kizzier (Environmental Defense Fund), Chandra Shekhar Sinha (World Bank), Misha Classen (KliK Foundation), Mary Grady (Winrock International / American Carbon Registry), Angela Foster Rice (Everland), Federico Di Credico (ACT Commodities) and Peter Zaman (HFW).

The review confirmed that the core transactional steps, potential risks and available risk management techniques were captured well by the analysis. However, the reviewers were not asked to endorse the analysis, so the legal views presented are solely attributable to Pollination. Three key topics emerged that are worthy of continued attention:

1. The reviewers stressed the importance of understanding that Article 6.2 is still a work in progress, so some elements may evolve differently than the view presented, which was based on the draft Article 6.2 guidance.
2. The reviewers debated whether the legal nature of the ITMO itself is clear at this stage, and how past practice can inform future market development. They noted that ITMOs under Article 6.2 may derive their legal status not from the Paris Agreement itself, but rather from national laws and/or mutual recognition agreements between countries. For practitioners, it will be vital to know the formal legal nature of the units and the ownership rights of the seller in order to specify what is being traded and how delivery is to be accomplished.
3. Some participants questioned whether individual unit transfers will be denominated at the time of transfer as ITMOs, or whether the markets in the future may trade in nationally authorized and issued units that will eventually be summed up as ITMOs when corresponding adjustments are made. The discussion did not resolve this question, so we urge market practitioners to keep it under review.
4. The national “authorization” process for a mitigation outcome to become an ITMO was seen as a critical legal matter.
5. Some discussants saw the Paris Agreement and Article 6.2 structures as having legal parallels to the Joint Implementation provisions of the Kyoto Protocol.
6. Some discussants believed that structural risk mitigation measures (meta registries, buffer reserves, etc) could be useful in addressing risks, and would perhaps be most feasible when applied by a group of countries in a “club” structure.

We would like to express appreciation to the IETA membership who support our work, particularly those who joined the February workshop. We hope this analysis supports your increased engagement in international climate action. The analysis highlights that for many of the steps to an Article 6.2 transaction, a deal may be structured now with strong integrity that will stand the test of time. But this analysis also highlights the novel areas where more risk exists – and where techniques for addressing those risks is beginning to take shape.

Finally, we appreciate the diligent work by the team at Pollination – Rick Saines, Marisa Martin, Martijn Wilder and James Cameron. This is a cornerstone document we hope will inform policymakers, businesses and stakeholders in their joint efforts to build a strong, credible and enduring Article 6 market – one that enables us to achieve the Paris climate goals faster and better together.

Dirk Forrister
President and CEO, IETA
May 2021

Legal Gap Analysis for Transactions

IN PREPARATION FOR ARTICLE 6

1. INTRODUCTION AND SCOPE OF WORK

The International Emissions Trading Association (**IETA**) is collaborating with Pollination[1] to conduct a legal gap analysis of the current arrangements for transactions under Article 6.2 of the Paris Agreement. This effort is urgently needed to help attract broad participation in the trading of "internationally transferred mitigation outcomes" (**ITMOs**) under Article 6.2, which is key to unlocking ambition in the Paris Agreement. In this memorandum, we lay out the steps of an exemplar Article 6.2 transaction (based the available guidance to date) and identify the areas of potential legal risk that sovereign and private market participants may face and offer potential means by which to address them.

This memorandum is divided into three sections. The first section describes the steps of an indicative transfer of ITMOs under Article 6.2 and addresses the practical and structural timing of each step, including the timing between when an ITMO is first transferred and when a corresponding adjustment is applied in connection with such transfer. The second section identifies the legal risks presented by the process and timing outlined in the first section. The third section offers suggestions to mitigate such legal risks, including via contractual provisions and the creation of broader market risk mitigation tools.

IETA and Pollination recognize this memorandum is limited by the ongoing state of the Article 6 negotiations. As such, this memorandum necessarily includes the following assumptions:

- This memorandum is based on the current state of the Article 6 negotiating text as represented by the draft Article 6.2 guidance from COP 25[2] as well as relevant decisions adopted at COP24 in Katowice.
- This memorandum focuses on the legal risks specific to ITMO transfers under Article 6.2 for NDC use. This memorandum does not address additional legal risks which may apply to transfers of mitigation outcomes for other international uses, such as CORSIA or for the voluntary carbon market.
- This memorandum does not address the separate (but equally critical) developments under Article 5 related to REDD+, such as, project-based versus national level accounting; finalization of Forest Reference Emission Levels and other national-level REDD+ preparedness concerns.
- This memorandum does not cover transfers under Article 6.4 because Article 6.4 requires centralized infrastructure that is not yet developed.
- This memorandum focuses on transactions of ITMOs in tCO_2 equivalent.

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[1] Pollination Capital Partners received legal advice from Pollination Law in the preparation of this memorandum.

[2] UNFCCC Conference of the Parties serving as the meeting of the Parties to the Paris Agreement, Draft Text on Matters relating to Article 6 of the Paris Agreement: Guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement, DT.CMA2.i11a.v3 (15 December 00:50 hrs) (referred to herein as the Draft Guidance).

2. ITMO TRANSFERS UNDER ARTICLE 6.2 OF THE PARIS AGREEMENT

a. ITMO Transfers

ITMOs are emission reductions and removals generated from 2021 onwards and internationally transferred for use toward NDCs or other international mitigation purposes.[3] ITMOs must be real, verified, and additional[4], and are typically measured in tCO2e in accordance with the methodologies and metrics assessed by the IPCC and adopted by the CMA. We outline the steps of an ITMO transaction at a high level below in accordance with the Draft Guidance.

– **Authorization**

According to Article 6.3, the use of ITMOs for achievement of NDCs needs to be authorized by a participating Party. This would be most important on the sell-side to ensure the country selling ITMOs applies a corresponding adjustment. ITMOs can be transferred to another country for mitigation purposes or for other international mitigation purposes (e.g., CORSIA). The Draft Guidance does not specify how this authorization should be expressed or documented, so various manners of authorization could be developed and utilized. Authorization of the ITMOs could extend to approval of the mitigation activity generating the ITMOs, depending on the governance process set up by a host country.

– **National Tracking**

The Draft Guidance requires Parties to have (or have access to) a registry that is capable of tracking ITMOs. The registry must be capable of tracking the following: authorization, first transfer, transfer, acquisition, cancellation, use towards NDCs, authorizations for use towards other international mitigation purposes, voluntary cancellation, and must have accounts as necessary. For Parties without a registry, an international registry will be established but this is not expected to occur until after the Article 6 operational rules are agreed upon and finalized.

– **UNFCCC Article 6 Database**

Parties must submit annual information on ITMOs to a centralized Article 6 database managed by the UNFCCC (**Article 6 Database**). Submitted information must include annual information on ITMO authorization, first transfer, transfer, acquisition, holdings, cancellation, use towards NDCs, authorization of ITMOs for use towards other international mitigation purposes, voluntary cancellation, and must specify the cooperative approach, other international mitigation purposes, first transferring participating Party, using participating Party and year in which the mitigation occurred, sector and activity type, as applicable.

The Article 6 Database will allow for "recording of corresponding adjustments and emissions balances for and information on ITMOs first transferred, transferred, acquired, held, cancelled and/or used by participating Parties through unique identifiers that identify at the minimum, the originating participating Party, vintage of underlying mitigation, activity type and sector."[5]

– **Biennial Transparency Report**

Every two years, Parties must submit a Biennial Transparency Report (**BTR**) that includes information on ITMO transfers. In their BTR, Parties must submit both general information on Article 6 cooperation and specific information on each cooperative approach. Submitted information must include how the country's approach contributes to the implementation of its NDC, including the quantity of ITMOs first transferred, quantity of mitigation outcomes authorized for use toward its NDC and for other international mitigation purposes, and whether it has achieved its NDC targets at the conclusion of its implementation period.[6] It must also show how corresponding adjustments undertaken in the latest reporting period are representative of progress towards implementation and achievement of its NDC and ensure participation will not lead to a net increase in emissions within and between NDC implementation periods. BTRs

[3] xCMA.2, Draft CMA decision on guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement, para. 1 (December 2019). For the purposes of this memo, we focus on mitigation outcomes generated from sectors covered by the country's NDC.

[4] x/CMA.2, Draft CMA decision on guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement, para. 1 (December 2019).

[5] x/CMA.2, Draft CMA decision on guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement, para. 32 (December 2019).

[6] x/CMA.2, Draft CMA decision on guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement, paras. 21–23 (December 2019).

must also show how environmental integrity has been ensured, including that there is no net increase in global emissions, through robust, transparent governance and the quality of mitigation outcomes.

- Corresponding Adjustments

To avoid double counting and claiming, Parties must apply corresponding adjustments for ITMOs. The corresponding adjustments must be applied in a manner that ensures: transparency, accuracy, completeness, comparability and consistency; that participation in cooperative approaches does not lead to a net increase in emissions within and between NDC implementation periods; that corresponding adjustments are representative and consistent with the participating Party's NDC implementation and achievement.[7]

Corresponding adjustment timing differs depending on whether a party has a multi-year or single-year NDC target. For NDCs based on a single-year target, the timing of the corresponding adjustment depends on the type of method used (i.e., averaging or trajectory method).

1. Multi-year NDC target

In the event a Party maintains a multi-year NDC target, it would apply a corresponding adjustment on an annual basis equivalent to the ITMOs "first transferred" in the case of a seller country, and "used" in the case of the buyer country and report such corresponding adjustments in its annual report submitted to the Article 6 Database. It would then further elaborate on such reported transfers and corresponding adjustments in its BTR.

2. Single-year NDC target

Parties may choose between two approaches when reporting their Article 6 transfers under an NDC that reflects its target as a single year target: the Trajectory Approach or the Averaging Approach. The Trajectory Approach largely converts a single-year target into a multi-year target by establishing a trajectory against which transfers are recorded and corresponding adjustments applied on an annual basis. The Averaging Approach is different in that rather than applying corresponding adjustments on an annual basis, the corresponding adjustment would be applied only in the target year of the NDC, and it would be an amount of ITMOs representing the average annual amount over the entire NDC period. Prior to that, annual indicative corresponding adjustments based on the average would be applied, but not count as corresponding adjustments.

a. Trajectory approach

If a Party uses a trajectory approach, the application of corresponding adjustments replicates that of the multi-year NDC target described above. A corresponding adjustment for ITMOs first transferred and used would be required to be made on an annual basis in the Article 6 Database.

b. Averaging approach

If a Party uses an averaging approach, it will apply an indicative corresponding adjustment on an annual basis in the Article 6 Database in the years prior to the NDC target year. In the NDC target year, the party would apply a corresponding adjustment in an amount of the average annual ITMOs transferred over the entire period. For example, if a selling Party sold 3000 ITMOs in 2021 and had a 2030 single year NDC target, to accommodate the 3000 ITMOs first transferred, it would need to correspondingly adjust 300 (3000 / 10 = 300). On the other hand, if a Party with a 2030 single year NDC was short 300 tons, it would need to purchase 3000 ITMOs to make up the 2030 shortfall (300 x 10 = 3000).

[7] x/CMA.2, Draft CMA decision on guidance on cooperative approaches referred to in Article 6, paragraph 2, of the Paris Agreement, paras. 8–9 (December 2019).

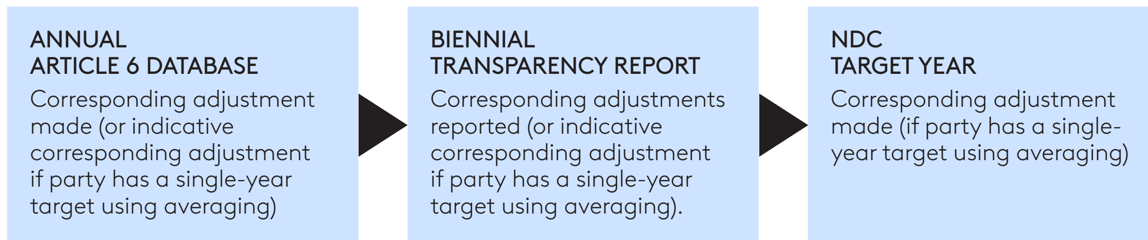

Figure 1: ITMO Transfer and Corresponding Adjustments

3. LEGAL RISKS IN ITMO TRANSACTIONS

Transfers of ITMOs involve consideration of unique risks due to the need for a corresponding adjustment, the fact that the trades could happen between sovereigns, between private parties or between sovereign and private parties and the application of domestic law as well as international requirements under Article 6.2.[8]

As described above, the corresponding adjustment in annual reports to the Article 6 Database would generally be applied after the transfer of the ITMOs to the buyer. For countries with NDC targets that are multi-year (or single year based on a trajectory approach), corresponding adjustments could be applied up to twelve months after transfer (i.e., the time information is submitted in the Article 6 Database). For sellers with a single year target using averaging, indicative corresponding adjustments are applied annually but corresponding adjustments are only applied at the NDC target year, which could be many years after transfer. This lag in timing presents risk that the corresponding adjustment will not happen, which may affect the nature, utility and value of the ITMO.[9] It is also possible that multiple trades of the ITMOs would have happened before the corresponding adjustment is applied.[10]

When a sovereign is a seller, Paris Agreement obligations like applying the requisite corresponding adjustment (and other reporting actions) can be contractual obligations because they are within the control of the sovereign seller. This provides greater contractual control over requirements that are sovereign led (e.g., application of corresponding adjustment and submission of BTR) and consideration of remedies in the event these obligations are not met.

In transactions involving a private seller, whether to a sovereign or private buyer, the application of sell-side corresponding adjustments (and other reporting requirements) would not be in the control of the parties to the transaction. If the relevant corresponding adjustment does not occur, the private seller could not remedy the failure because applying a corresponding adjustment is a government action outside the remit of private parties. In these transactions, greater emphasis may be put on the authorization of the mitigation outcomes generated by seller as qualifying as ITMOs. This authorization would likely be a process outside of the ITMO transaction and could involve the host sovereign agreeing with the private seller to apply the requisite corresponding adjustment.

In respect of the host country authorization, the legal means by which the host country undertakes the authorization can vary depending on the host country. In most cases, we anticipate host country authorizations to follow an activity-specific process. A host country will want to have the ability to selectively choose which mitigation activities and which mitigation outcomes from such activities it authorizes to be ITMOs. That granularity would give the host country the most visibility on mitigation outcomes to be transferred out of its country obligating it to make a corresponding adjustment. One could envision

[8] Purchase agreements for the transfers of carbon units have other legal risks (e.g., related to delivery and price) that should be considered but are not unique to Article 6 transactions and are not within the scope of this memorandum.

[9] It does not appear that there is a mechanism in the Paris Agreement to "unwind" or cancel a transfer of an ITMO if a corresponding adjustment is not applied.

[10] As registry infrastructure develops, a scenario under which ITMOs are automatically adjusted by linking to the Article 6 database may be possible (see discussion of meta-registries in Section 4 of this memorandum).

a more "blanket" type advanced authorization for various mitigation activities, up to a certain amount of ITMOs each year (or over an NDC period). In that scenario, the individual private seller (and any likely buyer) would still want specific recognition that mitigation activities and ITMOs that would be the subject of a trade are authorized under the "blanket" authorization.

Article 6 cooperative approaches are intended to raise ambition under the Paris Agreement.[11] However, it is possible that countries may "oversell" ITMOs, which could result in the country failing to meet its NDC target. Alternatively, any country that participates in ITMO sales and subsequently fails to meet its NDC will be scrutinized as if it "oversold" ITMOs, irrespective of whether the reason for failing to meet its NDC bears any relation to the transfer of ITMOs. While failing to meet NDC targets could be viewed as a separate matter beyond the scope of Article 6 transfers (provided corresponding adjustments are properly applied), the future of Article 6 as a tool for enhanced ambition will be negatively impacted by failures to achieve NDC targets among ITMO-selling countries. This risk will concern both sovereigns and authorized private parties transacting in ITMOs.

Because Article 6.2 is a voluntary cooperation mechanism whereby the participating parties can agree on the basis and definition of the ITMOs to be transferred, there is a risk that the environmental integrity of certain ITMO transactions may not be easily verified or understood. Environmental integrity is a principle embedded within the Article 6 text and guidance. While flexibility and self-determination is an inherent part of the Paris Agreement, including Article 6, maintaining some degree of standards and consistency for what should be eligible to constitute an ITMO will be important to demonstrate the propriety of Article 6 as a tool to drive ambition.

Present in all of these transactions is the risk related to sovereign immunity whereby a sovereign is immune from legal action. Navigating sovereign immunity concerns is not specific to ITMO transactions but is generally an issue with any sovereign contract.

While immunity can be affirmatively waived or deemed waived by the nature of the transaction in some jurisdictions, the scope of protection afforded relies heavily on local law considerations. Even if initially waived, immunity issues may arise in enforcement or when attempting to collect a judgement or an arbitral award. While contracts between sovereigns could rely on diplomatic measures, sovereign immunity concerns may be more apparent in transactions involving private parties and a sovereign.

[11] The fact that all countries now have NDCs under which they have established their respective contributions makes Article 6 fundamentally different from theClean Development Mechanism under the Kyoto Protocol. Article 6 of the Paris Agreement is more analogous to Joint Implementation under the Kyoto Protocol where Annex B countries could trade emission reduction units with other Annex B countries, while each still needed to meet its respective Kyoto emission target. However, JI was still largely a top down process while the Paris Agreement is bottom up.

4. SPECIFIC RISKS, MITIGATION MEASURES AND CONTRACTUAL REMEDIES

Below we outline legal risks, contractual measures to mitigate such risks and contractual remedies relevant to the following types of ITMO transactions: (i) sovereign to sovereign; (ii) sovereign buyer to private seller; (iii) private buyer to sovereign seller; and (iv) private buyer to private seller.[12] The mitigation measures and contractual remedies can be thought of as a menu of options where the specific contractual choices may differ depending on the nature of the parties and transaction and the negotiating leverage of the parties. To be clear, the table below is not intended to recommend any particular remedy over another, and it is not suggesting that all of the remedies identified are appropriate to be included in a contract. In particular, event of default and termination of the contract may be a standard remedy, but the nature of the relationship of the contracting parties and the underlying goals of Article 6 suggest that measures to encourage corrective action may be a more suitable remedy, at least in the first instance. Of course, recalcitrance, certain bad acts or repeated failures may leave a contracting party no other reasonable option but to invoke an event of default termination remedy. A key mitigation measure that overlays all Article 6 transactions is the degree to which seller countries make Article 6 decisions based on their marginal abatement costs for various activities and utilize Article 6 as part of an informed strategy to strengthen and implement their NDCs.

a. Sovereign buyer and Sovereign seller

SOVEREIGN BUYER AND SOVEREIGN SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Seller fails to apply indicative corresponding adjustment/ corresponding adjustment amount in the Article 6 Database	**Risk Mitigation Measures** • Require Seller to undergo enhanced reporting and monitoring (e.g., showing recordation in national registry upon transfer) • Specific due diligence by Buyer on host country Article 6 readiness **Buyer Contractual Remedies** • Hold back portion of purchase payment contingent on submission of appropriate indicative corresponding adjustment/corresponding adjustment in Article 6 database • Suspension event, including suspending future ITMO deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require Seller to purchase replacement ITMOs (with consideration for value of non-adjusted ITMOs already transferred) (in the event Buyer is making a corresponding adjustment) • Require compensation for difference between value of adjusted and non-adjusted ITMOs (if Buyer is not making a corresponding adjustment) • Customary Event of Default remedies (including termination right)

[12] For purposes of this analysis, we are assuming transactions of ITMOs are structured as a payment upon delivery of ITMOs (i.e., not a pre-payment of ITMOs). If an Article 6 transaction were structured as a pre-pay to provide investment into the underlying mitigation activities generating the emission reductions, a number of additional risks related to financing would be introduced that are not addressed here.

SOVEREIGN BUYER AND SOVEREIGN SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Seller fails to submit BTR	**Risk Mitigation Measure** • Require Seller to undergo enhanced reporting and monitoring (e.g. access to underlying country data that is intended to inform BTR) **Buyer Contractual Remedies** • Hold back portion of payment contingent on reporting of appropriate indicative corresponding adjustment/corresponding adjustment in BTR • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Audit rights to country data • Customary event of default remedies (including termination right)
Seller's NDC progress is not demonstrated in its BTR	**Risk Mitigation Measure** • Due diligence by Buyer on mitigation activities underpinning the ITMOs relative to overall NDC **Buyer Contractual Remedy** • Require NDC Implementation Plan or other assurances whereby Buyer and Seller agree on certain actions to assist in getting Seller back on track to achieving NDC target • Hold back portion of payment contingent on reporting of appropriate indicative corresponding adjustment/corresponding adjustment in BTR • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Audit rights to country data • Customary Event of Default remedies (including termination right)
Seller misses its NDC target (e.g., oversells ITMOs)	**Risk Mitigation Measure** • Require Seller to undergo enhanced monitoring and reporting (e.g., demonstrate progress toward NDC target in BTR) **Buyer Contractual Remedy** • Hold back portion of payment contingent on meeting NDC target • Option of first right to compensatory ITMOs in subsequent NDC period • Require NDC Implementation Plan or other assurances whereby Buyer and Seller agree on certain actions to assist in getting Seller back on track to achieving future NDC target • Seller agrees to undertake root cause analysis and report findings to Buyer

SOVEREIGN BUYER AND SOVEREIGN SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Seller fails to ensure environmental integrity (as defined in the agreement)	**Risk Mitigation Measures** • Require mitigation activity to use a third-party standard or a bilaterally agreed methodological standard that includes conservative baselines/reference levels, accredited verifiers and other measures that ensure environmental integrity • Transfer only partial amount of GHG reductions generated by mitigation activity to Buyer and require retirement of remaining amount • Ensure clear requirements on avoiding double-counting (e.g., use of registry, application of corresponding adjustments) **Contractual Remedies** • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require compensatory ITMOs to be retired • Require root cause analysis and corrective action plan • Customary event of default remedies (e.g., suspend performance, damages, termination right)
Party asserts sovereign immunity in defense to enforcement	**Risk Mitigation Measure** • Obtain explicit waiver of sovereign immunity as a condition precedent and require demonstration of any required legal consents necessary to demonstrate waiver of immunity • Establish robust dispute resolution provisions • Include diplomatic measures in case of disputes

b. Sovereign buyer and private seller

In a sovereign buyer and private seller transaction, the main legal risk relates to the authorization of the private seller's mitigation outcomes as ITMOs and the host country applying the appropriate corresponding adjustment related to the ITMO transaction. Many of the risks noted in the table above are uniquely the responsibility of the sovereign seller and not an authorized private seller. Market participants will need to determine how to address the gap in ultimate performance inherent in this scenario.

SOVEREIGN BUYER AND PRIVATE SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Seller's emission reductions are not authorized by host country and are not ITMOs	**Risk Mitigation Measure** • Review evidence of authorization by host country government as part of Buyer's due diligence (e.g., authorization agreement or authorization letter between Seller and host country) **Buyer Contractual Remedies** • Require Seller to provide an authorization letter as a condition precedent that would include a commitment by host country to authorize Seller's mitigation outcomes once generated and verified
Seller fails to maintain its authorization during the term of the agreement	**Buyer Contractual Remedies** • Include change of circumstance clause or change of law provision, which could trigger renegotiating the agreement in good faith • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require Seller representation of valid authorization to be repeated on each delivery, and invoke remedy for breach of representation • Require Seller to use reasonable/best efforts to cause the host country to re-instate the authorization • Customary event of default remedies (e.g., suspend performance, damages, termination right)

SOVEREIGN BUYER AND PRIVATE SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Host country fails to apply indicative corresponding adjustment/ corresponding adjustment amount in the Article 6 database for private seller's ITMOs	**Risk Mitigation Measures** • Require Seller to provide an authorization letter as a condition precedent that would include a commitment by host country to apply the corresponding adjustment to Seller's ITMOs • Require Seller to provide evidence of Article 6 reporting by host country (e.g., Article 6 database submission, BTR) • Require evidence of framework agreement between host country and buyer that commits host county to apply corresponding adjustment to authorized mitigation outcomes **Buyer Contractual Remedies** • Seek remedies under framework agreement, if applicable • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require Seller to provide replacement ITMOs to account for shortfall with consideration of value of ITMOs already transferred • Require Seller to compensate buyer for difference in value between adjusted ITMOs and non-adjusted ITMOs • Customary event of default remedies (e.g., suspend performance, damages, termination right)
Host country misses its NDC target (e.g., oversells ITMOs)	**Risk Mitigation Measure** • Require Seller to undergo enhanced monitoring and reporting (e.g., demonstrate annual progress toward NDC target) **Contractual Remedy** • None • Non event of default termination right

SOVEREIGN BUYER AND PRIVATE SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Seller fails to ensure environmental integrity of its mitigation activities	**Risk Mitigation Measures** • Require the mitigation activity to use a third-party standard that includes conservative baselines/reference levels and other measures that ensure environmental integrity • Transfer only partial amount of GHG reductions generated by mitigation activity to Buyer and require retirement of remaining amount • Ensure clear requirements on avoiding double-counting by Seller (e.g., use of registry) **Buyer Contractual Remedies (if failure caused by Seller or within Seller's control)** • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require compensatory ITMOs to be retired • Require root cause analysis and corrective action plan • Customary event of default remedies to the extent within the control of the private seller (e.g., suspend performance, damages, termination right)
Buyer asserts sovereign immunity in defense to enforcement of payment obligation	**Risk Mitigation Measures** • Obtain explicit waiver of sovereign immunity from Buyer • Require pre-payment/escrowed payment from Buyer **Seller Contractual Remedies** • Suspension event, allowing Seller to discontinue any deliveries and to find other buyers in the market • Customary event of default remedies (including termination right)

c. Private party buyer and private party seller

Risks would differ for transactions involving private parties. Because private parties do not have Paris Agreement responsibilities, the application of corresponding adjustments and other Paris-related obligations are not actions private parties can undertake. As such, they should not be contractual obligations they should assume. Instead, private party transactions would have greater emphasis on government authorization of the greenhouse gas reductions generated by the mitigation activity as ITMOs. For instance, a private seller project developer would need to demonstrate authorization from its host country to transact ITMOs. A private buyer may also want to have good faith commitments on behalf of the seller to work with its host country in connection with the host country's reporting of corresponding adjustments and to provide early notice to buyer if there are any changes at the host country level.

On the buyer side, whether a private buyer requires approval from a buyer country will depend on the circumstances of the transaction. There are many scenarios in which private buyers would not require approval of the buyer country to purchase ITMOs. For example, if an intermediary wanted to procure ITMOs on a merchant basis, it could do so without any buy-side government approval. Similarly, if a private buyer wanted to procure ITMOs to retire for its own voluntary climate target, government approval would not be required. On the other hand, a private buyer that is seeking to utilize ITMOs for domestic compliance purposes under domestic law may need governmental approval of the buyer's purchase of ITMOs to ensure the country is able to account for it in its own Paris reporting. As such, there are fewer unique contractual risks presented in a private buyer – private seller transaction. If the private parties expect to transact ITMOs that are correspondingly adjusted, they are exposing themselves to risks that neither can control and that are unlikely to be addressed contractually.

PRIVATE BUYER AND PRIVATE SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Seller's emission reductions are not authorized by Seller's host country and are not ITMOs	**Risk Mitigation Measures** • Review evidence of authorization by host country government as part of Buyer's due diligence (e.g., authorization agreement or authorization letter between Seller and host country) • Require Seller to provide an authorization letter as a condition precedent that would include a commitment by host country to authorize Seller's mitigation outcomes once generated and verified • Payment on delivery (requiring authorized ITMOs to be delivered) **Buyer Contractual Remedies** • Ability to reject delivery if Mitigation Outcomes are not authorized • Replacement ITMOs • Customary event of default remedies (including termination right)
Failure of Seller to maintain authorization of ITMOs from Seller's host country during term of agreement	**Buyer Contractual Remedies** • Include change of circumstance clause or change of law provision, which could trigger renegotiating the agreement in good faith • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require Seller representation of valid authorization to be repeated on each delivery, and invoke remedy for breach of representation • Require Seller to use reasonable/best efforts to cause the host country to re-instate the authorization • Customary event of default remedies (e.g., suspend performance, damages, termination right)

PRIVATE BUYER AND PRIVATE SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Failure of Buyer to maintain approval from Buyer's host country (for the scenario where Buyer using ITMOs for domestic compliance)	**Risk Mitigation Measures** • Review evidence of approval by host country government as part of Seller's due diligence • Require Buyer to demonstrate approval as a condition precedent • Consider whether this failure would be a force majeure event or affect Buyer's payment or acceptance obligations **Seller Contractual Remedies** • To the extent Buyer remains obligated under contract to pay and accept delivered ITMOs, treat any failure as a payment default.
Seller fails to ensure environmental integrity (as defined in the agreement)	**Risk Mitigation Measures** • Require Mitigation Activity to use a third-party standard or a bilaterally agreed methodological standard that includes conservative baselines/reference levels, accredited verifiers and other measures that ensure environmental integrity • Due diligence on seller and mitigation activity. **Buyer Contractual Remedies (if failure caused by Seller or within Seller's control)** • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require compensatory ITMOs to be retired • Require root cause analysis and corrective action plan • Customary event of default remedies to the extent within the control of the private seller (e.g., suspend performance, damages, termination right)

PRIVATE BUYER AND PRIVATE SELLER RISK	RISK MITIGATION MEASURES AND CONTRACTUAL REMEDIES
Host country fails to apply indicative corresponding adjustment/ corresponding adjustment amount in the Article 6 database for private seller's ITMOs	**Risk Mitigation Measures** • Require Seller to provide an authorization letter as a condition precedent that would include a commitment by host country to apply the corresponding adjustment to Seller's ITMOs • Require evidence of framework agreement between Seller's host country and Buyer's host country that commits Seller's host county to apply corresponding adjustment to authorized mitigation outcomes • Require Seller to provide evidence of Article 6 reporting by host country (e.g., Article 6 database submission, BTR) **Buyer Contractual Remedies** • Seek assistance from Buyer country to enforce framework agreement, if applicable • Require Seller to seek to enforce authorization letter • Suspension event, including suspending future deliveries/obligation to accept delivery (while not allowing ITMOs to be sold elsewhere) • Require Seller to provide replacement ITMOs to account for shortfall with consideration of value of ITMOs already transferred • Require Seller to compensate buyer for difference in value between adjusted ITMOs and non-adjusted ITMOs • Customary event of default remedies to the extent within the control of the private seller (e.g., suspend performance, damages, termination right)

d. Private party buyer and sovereign seller

A transaction involving a private party buyer and sovereign seller would encounter similar sell-side risks described above in the sovereign buyer-sovereign seller chart because the risks primarily relate to actions under the control of the sovereign seller (e.g., making corresponding adjustments, reporting requirements). However, the risks for private buyers are heightened in many respects because private buyers may lack the diplomatic relations enjoyed by sovereign buyers and are removed from a more engaged diplomatic approach to correct seller deficiencies. Obtaining an enforceable waiver of sovereign immunity becomes more important as diplomatic measures are less available to private parties.

Additionally, as stated in the private seller-private buyer discussion above, private buyers may be required to hold governmental approval to purchase ITMOs, depending on the use of the ITMOs. Whether a private buyer requires approval from a buyer country will depend on the circumstances of the transaction.

e. Structural risk mitigation

In addition to the contractual-level mitigation measures described above, opportunities related to broader structural risk mitigation also exist.

i Self-insurance pool

Like has been utilized by certain well-established voluntary standards, Parties could create a collective pool of ITMO units that have been correspondingly adjusted that can mitigate against corresponding adjustment failures. In the event a seller fails to apply an appropriate corresponding adjustment, a buyer could draw replacement ITMOs from this pool. Parties could decide to contribute a percentage of credits to populate the pool. One of the key features of such self-insurance pools is the diversity of sourcing for the units that are populated into such pool. Bilateral transactions standing alone would diminish the utility of such pool. Which entity would administer such a collective unit pool is another important consideration. Such entity would have to engender the confidence of a diverse group of Parties as well as the broader private markets.

ii Meta registry

Given the diversity of units being created, both within Article 6 and outside of Article 6, there are a number of ongoing efforts to explore the creation of a “meta registry” which would be able to track and record transfers of all of the various units from different sources. Such a meta registry would address a number of the issues that have been raised regarding environmental integrity, double counting, the interplay between voluntary markets and Article 6 transfers, and means by which private actors can access ITMO transactions and contribute greater finance towards climate solutions utilizing the market mechanisms. If the infrastructure were developed, one could envision the scenario where the meta registry was also linked into the Article 6 Database administered by the UNFCCC. In such a case, the meta registry might be able to automatically record the corresponding adjustment upon transfer, which would reduce one of the primary risks presented currently under Article 6. A meta registry would not, however, assure ultimate NDC achievement.

iii Political risk insurance

At the heart of the unique Article 6 risk profile is that fact that it definitionally involves sovereign transacting parties. The nature of sovereign autonomy and immunity creates risks that governments could change course during the term of ITMO agreements and fail to abide by prior agreements of predecessor governments. This is fundamentally a political risk issue. The Multilateral Investment Guarantee Agency could create a specific product to address this issue. Private insurance markets could also engage to help offer risk mitigation solutions. The two risks that are prevalent are financial and environmental. While the financial risks are straight forward to administer, properly solving for the underlying environmental risk (i.e., NDC failure, overselling of ITMOs) is more complex. This would require the means to acquire a reserve pool of units that can be correspondingly adjusted, which is similar in nature to the self-insurance pool noted above.

iv Sovereign commitment to recognize ITMOs from "pre-authorized" activities

Similar to the framework agreement entered between Peru and Switzerland, having certain Article 6 countries commit to "pre-authorizing" or approving certain mitigation activities and agree to take actions necessary to convert private transactions into Article 6 eligible transactions, would create greater confidence among private parties transacting in such markets. Japan's approach to its offsetting mechanism could also provide a model—a single buyer engaging with multiple sellers subject to individual MOUs that are similar in substance. This type of arrangement could resolve some of the issues relating to sovereign seller's authorization of mitigation outcomes.

The details of how the respective sovereigns fulfill their commitments and how private actors would be protected from sovereign failures to act need to be addressed. This will require further contractual clarity, but the over-arching framework establishes a foundation upon which subsequent transactions can be undertaken.

v. Coalition of Article 6 actors

One approach to mitigating a number of risks would be to establish a plurilateral grouping of sovereigns representing buyers and sellers to establish a set of "club rules" to which all of the participating sovereigns would adhere. This would afford the opportunity to create consistent approaches to environmental integrity and risk mitigation. Such a group could also allow eligible private actors to participate. The other structural risk mitigation measures outlined in this section could work seamlessly within the "club rules".

5.CONCLUSION

Article 6 represents an unprecedented opportunity to leverage cooperation into increased ambition while drawing in the private sector. While Article 6 presents new and unique legal risks to contracting parties, the risks are manageable with a combination of well-understood approaches and with some new tailored solutions. Ultimately, the experience and lessons learned from the history of the carbon markets will prove invaluable in positioning Article 6 as a launch pad for scaled investment into climate solutions. The degree to which the structural risk mitigation measures can be employed will influence the nature (and complexity) of the trading contracts. The more risk that can be absorbed structurally, the simpler and more efficient the transactions will be. The measures outlined in this memorandum highlight the several means available to give effect to the cooperation principle embedded in Article 6 without undermining the integrity of this system. Finally, Article 6 transactions can be memorialized with robust contracts, both for sovereigns and for private parties, in ways that are consistent with established practices familiar to international and commercial lawyers around the world.

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