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MAKING NET ZERO POSSIBLE

IETA Article 6 Discussion Paper

How Governments Can Implement NDCs Cooperatively and Encourage Private Sector Investment

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INGREDIENTS FOR SUCCESS – A POLICY CHECKLIST FOR COUNTRIES

Intention:

- Announce whether the country intends to directly make use of Article 6 and/or authorise entities in their jurisdictions to participate in Article 6 transactions.
- Determine whether the country intends to participate or allow participation in Article 6 either as a seller, a buyer, or both.

Ambition:

- Articulate how Article 6 will help achieve the goals of the Paris Agreement and contribute to sustainable development.
- Put forward clear and quantifiable objectives for the magnitude of the targeted reductions to be achieved through Article 6.
- Articulate how Article 6 will support higher ambition and the achievement of long-term climate targets beyond the existing NDC period.

Authorisation:

- Provide a clear strategy and guidelines on which sectors, projects, and vintages of emission reductions and removals will be eligible for Article 6 as well as how they relate to the national inventory and nationally determined contribution (NDC).
- Specify whether activities are (i) authorised for use towards an NDC, (ii) authorised for use for "other international mitigation purposes", or (iii) both.
- Elaborate what policy framework a host country will adopt and how it will interact with the receiving country.

Integrity:

- Articulate how the country will ensure the quality and integrity of carbon credits traded under Article 6.
- Provide guidance on how existing quality initiatives and services will inform approaches to Article 6.

Transparency and Accountability:

- Ensure that the country has a suitable digital registry for ITMO tracking, GHG accounting, and reporting under the UNFCCC.
- Establish a national policy framework for Article 6 and NDC compliance and determine how it will interact with other countries.
- Acknowledge key risks in the transaction lifecycle and support mechanisms to reduce them.
- Clarify the legal nature of carbon credits within each jurisdiction and regulatory framework.

Interoperability:

- Elaborate a comprehensive carbon market strategy considering the possible interactions between domestic compliance carbon pricing instruments, voluntary market activity in the country, and Article 6.
- Support the emergence of a widely accessible traded market for carbon credits.

Capacity building:

- Emphasise the areas where capacity building is required and the role of international organisations.

Introduction

The potential benefits of cooperation in achieving Nationally Determined Contributions (NDCs) using Article 6 are significant for all Parties to the Paris Agreement. The potential cost reductions that may be achieved through Article 6 cooperation are estimated to exceed $300 billion per year in 2030 when compared with the independent implementation of NDCs by countries.[1] If the savings from the cooperative implementation of NDCs using Article 6 were reinvested in increased ambition, emissions mitigation could be more than doubled.[2] International carbon market transactions under Article 6 could surpass a value of $100 billion per year by 2030 if all Parties choose to implement their NDCs cooperatively.[3] There is also the opportunity to build efficiencies from the lessons learned from the Clean Development Mechanism.

Since the adoption of key decisions on Article 6 at COP26 in Glasgow, there has been increasing interest in the implementation of Article 6 to support cooperative approaches to help countries and sectors decarbonise. Almost 80% of all countries have signalled that they will use or consider using international markets or broader international support to meet the targets of their NDCs. However, there has been limited attention to what role governments and the UNFCCC envisage for business entities in the implementation of Article 6.

A first discussion paper, whose objective was to highlight important elements for the business sector to help maximise the impact and use of Article 6, was prepared by IETA in 2022. This updated version aims to build upon the previous one, incorporating developments observed over the past year.

While carbon markets are evolving rapidly across the world, progress on carbon pricing and cooperation under Article 6 is not happening at the necessary speed and scale to address the urgency of the climate crisis. In discussions with our members and other business organisations, IETA identified the following elements that governments need to consider and address to mobilise private sector resources and investment towards Article 6 mechanisms. We have broadly organised them into seven categories: (I) Intention, (II) Ambition, (III) Authorisation, (IV Integrity), (V) Transparency, (VI) Interoperability, and (VII) Capacity Building, and we have provided specific recommendations under each of them. By articulating these elements, the objective of this paper is to help advance the implementation of Article 6 and international cooperation on carbon markets.

1. Intention

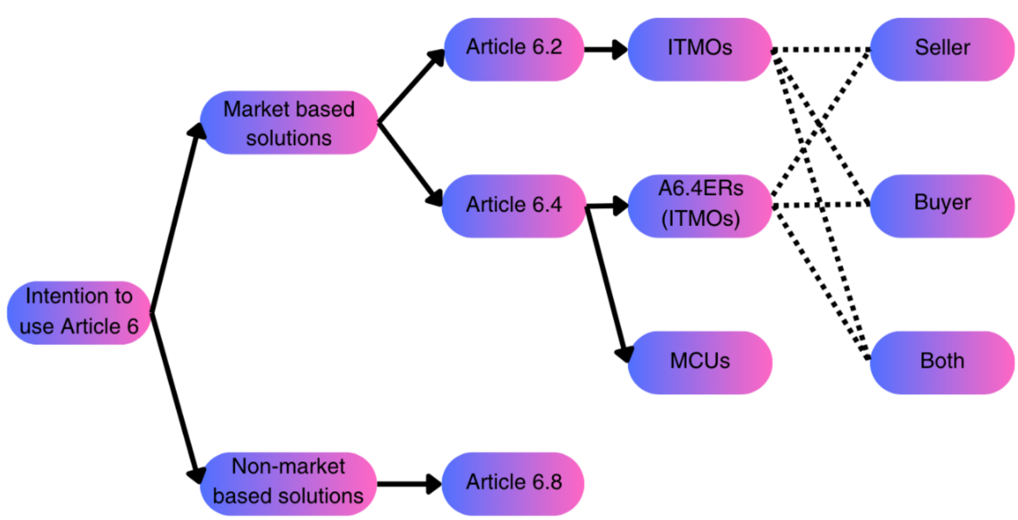
Announce whether and how they plan to engage with Article 6 to achieve their NDCs and increase their climate ambition. Countries that intend to meet their decarbonisation ambitions solely or predominantly through

[1] Edmonds, J., Yu, S., Mcjeon, H., Forrister, D., Aldy, J., Hultman, N. et al. (2021). How Much Could Article 6 Enhance Nationally Determined Contribution Ambition Toward Paris Agreement Goals Through Economic Efficiency? Climate Change Economics, 12(02), 2150007.
[2] Edmonds, J., George, M., Yu, S., Forrister, D., and Bonzanni, A. (2023), Modelling the Economics of Article 6, International Emissions Trading Association and Center for Global Sustainability (CBS) at the University of Maryland
[3] ibid

domestic efforts will adopt different strategies from countries that intend to meet their ambitions through international cooperation. For market participants, it is important to know how the country will authorise carbon credits as Internationally Transferred Mitigation Outcomes (ITMOs) under Article 6 and under which conditions. Similarly, it is crucial to know whether a country intends to procure ITMOs for the achievement of its NDC and/or whether it will approve projects under its jurisdiction to register under the Article 6.4 mechanism. Moreover, knowing whether the country intends to promote the issuance and use of units without corresponding adjustment (Mitigation Contribution Units) and how they intend to do so are also key aspects for attracting private capital to where it is needed. Clarity over these elements is urgent as prolonged ambiguity and postponed decisions discourage investment and private finance flows.

In addition to clarifying which activities could be authorised for transactions under Article 6 in the short and medium-term, it is crucial to have a strategy of engagement to provide developers, investors and buyers with a clear long-term understanding of the country's decarbonisation approach for fostering international private investments and decrease the cost of achieving NDCs.

Figure 1: Government's intention to use Article 6.[4]



2. Ambition

Articulate how the use of Article 6 will help achieve the goals of the Paris Agreement. How Article 6 contributes to increasing a host country's ambition in its mitigation and adaptation actions will be key. This requirement

[4] Article 6.8 is not included in this figure as this paper focuses on market-based mechanisms, whereas the latter concentrates on non-market approaches for international cooperation on climate change mitigation and adaptation.

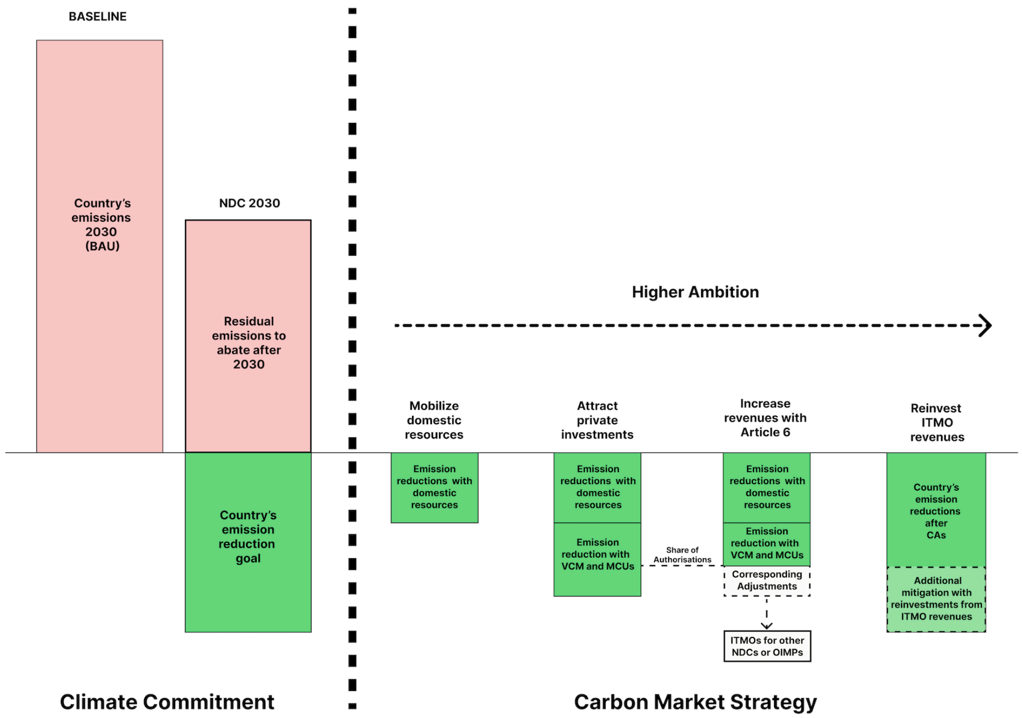
should be applied in a pragmatic manner, allowing countries to use Article 6 to help finance their NDCs rather than engaging in cooperative mechanisms only for activities above and beyond their NDCs. Likewise, a country that intends to acquire ITMOs faces a similar task in identifying how Article 6 transactions are consistent with its long-term decarbonisation ambition and the goals of the Paris Agreement. Such steps are necessary to strengthen the credibility of cooperative approaches and minimise the risk of perverse incentives that may lead to overselling and lower ambition. The principles around participation, baselines, and other methodological requirements (including additionality) outlined in the existing Article 6.4 guidance are good starting points that need to be rapidly specified and operationalised. Understanding these elements will help the private sector focus resources and capital on opportunities that are amenable to both selling and buying countries.

Put forward clear and quantifiable objectives concerning emissions reduction through Article 6. This involves specifying the magnitude of the targeted reductions through international market mechanisms and establishing a timeline. Clarity on these matters is paramount for effective planning and international collaboration, fostering a shared understanding of the collective effort required. Having an NDC and/or a carbon market framework with quantitative GHG emission reduction targets per sector and a clear indication of the role of Article 6 to achieve such commitments in time is key to help the private sector understand market opportunities and channel resources efficiently to where they are most needed.[5]

Figure 2 shows a hypothetical example of how a country could build its strategy aligned with its NDC, considering mitigation activities that could be authorised to become ITMOs and transferred internationally with corresponding adjustments. Given the long lead times that usually characterise carbon projects, such signals are critical for promoting market confidence and increasing private sector engagement in mitigation activities. However, it is crucial to emphasise that, as detailed in the section below, host countries have sovereignty in determining the activities, entities and credits that would be eligible for Article 6 according to their national prerogatives. This autonomy is unquestioned but should be exercised through a decision-making process with clear parameters.

[5] Ghana's NDC represents a concrete example of ambition quantification from a seller's perspective, as its framework on international carbon markets mentions a *"goal of making approximately 24 million tonnes of emission of its conditional absolute emission reductions available for transactions under Article 6.2 cooperative approaches"* (Ghana's framework on international carbon markets and non-market approaches, 2022, p.17). On the other hand, Japan provides a concrete example from the buyer's perspective: *"Japan aims to contribute to international emission reductions and removals at the level of a cumulative total of approximately 100 million t- CO2 by fiscal year 2030 through public-private collaborations. Japan will appropriately count the acquired credits to achieve its NDC"* (Japan's Nationally Determined Contribution, 2021, p.1).

Figure 2: Importance of a Carbon Market Strategy Aligned with the NDC to Increase Climate Ambition



Overall, Article 6 should not be interpreted as a mechanism in which only countries that have already achieved their NDCs could be sellers, but as a dynamic process—where trade occurs during the pursuit of goals to help all countries achieve their NDCs faster and at a lower cost. Well-crafted strategies and institutional frameworks can ensure the effectiveness of the mechanism. Countries that can reduce or remove emissions domestically more cost-effectively, can sell a portion under Article 6 at a premium, generating revenues for increasing their climate ambition. On the other hand, authorising emission reductions or removals in hard-to-abate sectors can promote technology transfers and other co-benefits in sectors that would not reduce emissions otherwise.

3. Authorisation

Provide a clear strategy and stable guidelines on which sectors, activities, and vintages will be eligible for Article 6 credits. Each country will have a different set of circumstances and priorities for achieving its NDC. In developing a country's Article 6 strategy, clear guidance on which sectors, activities and vintages will be eligible to generate credits under Article 6 in the host country will support the private sector in identifying opportunities and cooperative approaches between countries. The elaboration of positive lists of sectors and/or activity types where the private sector is encouraged to engage (as exemplified in figure 3) would allow rapid identification of these opportunities and avoid lengthy and complex NDC and policy alignment processes.[6] Moreover, specifying the sectors and activities that can be authorised for international transfer provides a clearer overview of the cost abatement. Clarity on the share of mitigation outcomes from projects that will be authorised for international transfer, if not 100%, is also crucial. Whether authorisations will be granted for use towards an NDC, other international mitigation purposes (OIMP) or both should be made unequivocally clear. Frequent regulatory changes and pending regulations regarding the eligibility of carbon projects are extremely damaging and may lead to forgone mitigation opportunities. Similarly, countries that acquire ITMOs should provide clear guidance regarding what sectors and activity types they expect to be eligible.

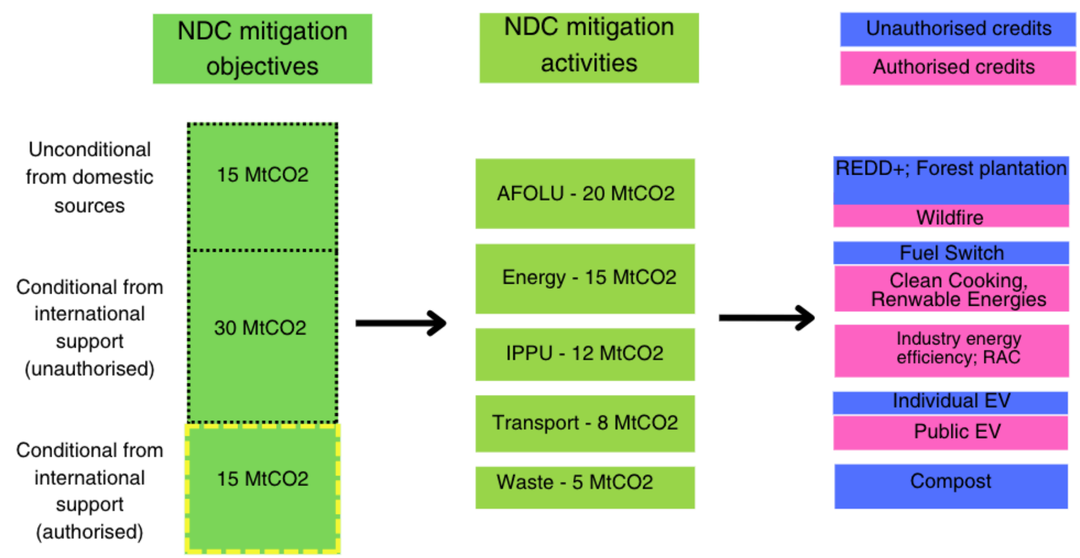
Elaborate on what policy framework a host country will adopt and how it will interact with the receiving country. Illustrating the policy and procedural framework a country will follow when engaging in Article 6 mechanisms will be integral for the private sector. This will help reduce uncertainties, provide credibility to the process, and encourage investment. The framework may also specify how a country will manage future improvements. This could include, for example:

- framework agreements establishing specific cooperative approaches with other countries;
- volume, types, and origin of credits that a country intends to support for sale and/or purchase;
- accepted standards and methodologies;
- how the host country will implement authorisations for transfer and/or use;
- whether and under what conditions authorisation statements may be amended or revoked;
- how the host country will implement corresponding adjustments;
- how compliance, voluntary markets, and standalone projects will interact;
- applicable taxes and any other levy or mechanisms that may impact the project's economics;
- credit and/or revenue sharing arrangements between project developers, the host country, and local communities;
- any other requirements for investors and project proponents.

A model letter of authorisation (LOA) should also be published to streamline and standardise the process, reducing risk and uncertainty for all parties involved.

[6] Ghana's framework on international carbon markets and non-market approaches provides a whitelist of sectors for eligible mitigation activities (including for instance distributed solar PV systems or landfill gas management) (Ghana's framework on international carbon markets and non-market approaches, 2022, p.17).

Figure 3: Hypothetical scheme of sectors and activities eligible for authorisation



4. Integrity

Articulate how the country will ensure the quality and integrity of carbon credits traded under Article 6. It is also essential to identify quality thresholds for the carbon projects developed under Article 6. The quality and integrity of units issued by the Article 6.4 mechanism will be addressed by the Article 6.4 Supervisory Body as it will assess and approve eligible methodologies. For cooperative approaches under Article 6.2, it is up to the discretion of participating countries to determine eligible activities based on existing UNFCCC guidance. Transfer of low-quality credits risk undermining the integrity of Article 6 transactions. Quality criteria could be elaborated by both host countries and acquiring countries willing to sell or buy high-quality credits. This would also incentivise private sector investment in high quality initiatives.

Provide guidance on how existing quality initiatives and services will inform approaches to Article 6. The concepts of quality and integrity are shaping most conversations in the voluntary carbon market, and this has produced several industry-led initiatives. New initiatives such as the Integrity Council for Voluntary Carbon Markets (IC-VCM) and the Voluntary Carbon Market Integrity Initiative (VCMI) have emerged recently, while existing ones such as the International Carbon Reduction and Offsetting Alliance (ICROA) continue to remain relevant for quality assessments at the programme and methodology levels. The Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) also plays a key guidance role by approving eligible standards. At the project level, ratings agencies have emerged to provide granular assessment of individual projects. Host countries and acquiring countries could provide direction on how existing quality initiatives and thresholds will influence or inspire their cooperative approaches under Article 6. This would ensure uniformity in quality and collective action towards high integrity.

5. Transparency and Accountability

Ensure a suitable digital registry infrastructure for GHG accounting and reporting is in place. The effectiveness and credibility of Article 6 mechanisms must be underpinned by an infrastructure enabling the comprehensive accounting and tracking of GHG emissions by source and removals by sink. The requirement to apply a corresponding adjustment to account for all transfers points to the need to properly quantify activities, policies, and measures, both inside and outside the NDC of a country. A country's registry can either directly issue and hold credits or track credits issued in other registries – each approach has pros and cons that need to be carefully considered in light of national circumstances. Recording, tracking, and reporting provisions set out in the UNFCCC Article 6 guidelines should be interpreted as minimum requirements. Annual Information, Biennial Transparency Reports, and NDC commitment period reports should be fully published. A list of all pending and completed corresponding adjustments should also be made publicly available. Greater data availability and transparency are necessary to enhance the environmental integrity of cooperative approaches, avoid double-counting and protect private sector actors committing significant resources to carbon projects.

Make clear how Article 6 transfers relate to their carbon pricing mechanisms and broader decarbonisation strategies. For example, they should be encouraged to state:

- how the registries of the two countries will interact securely to assure the integrity of the transfer, tracking, and reporting infrastructure;
- how the transfer will help assure that NDCs are achieved by participating countries;
- how the countries intend to integrate transfers into their carbon pricing systems.

This will help cooperating countries ensure that all transfers and corresponding adjustments are rooted in high integrity and transparency.

Address key risks in the activity cycle and identify mechanisms to reduce them. Project developers and private sector players engaging in Article 6 transactions are exposed to several risks throughout the lifecycle of the trade, which may extend for several years in the case of forward purchases, or even decades in the case of removal projects. While host government involvement is limited in Clean Development Mechanism and voluntary market transactions, the need for authorisation and application of a corresponding adjustment in Article 6 exposes both sellers and buyers to significant sovereign risk.

Examples of such risks are:

- host government delays or denies the issuance of letters of authorisation;
- host government revokes or declines to honour previously issued letters of authorisation;
- host government does not issue ITMOs for verified emissions reductions from authorised projects;
- host government changes the scope of sectors eligible for Article 6 credits;
- host government does not apply corresponding adjustments or does not do so correctly;
- host government favours 'ex post' authorisation of ITMOs.

It is crucial for the private sector and investors to know what recourse they would have in such instances and where liabilities lie. The involvement of international institutions and multilateral development banks may help create incentives and penalties that would encourage positive behaviour by host governments. Mechanisms to reconcile the need for environmental integrity with investor protection should be developed. The provision of political risk insurance may be necessary.

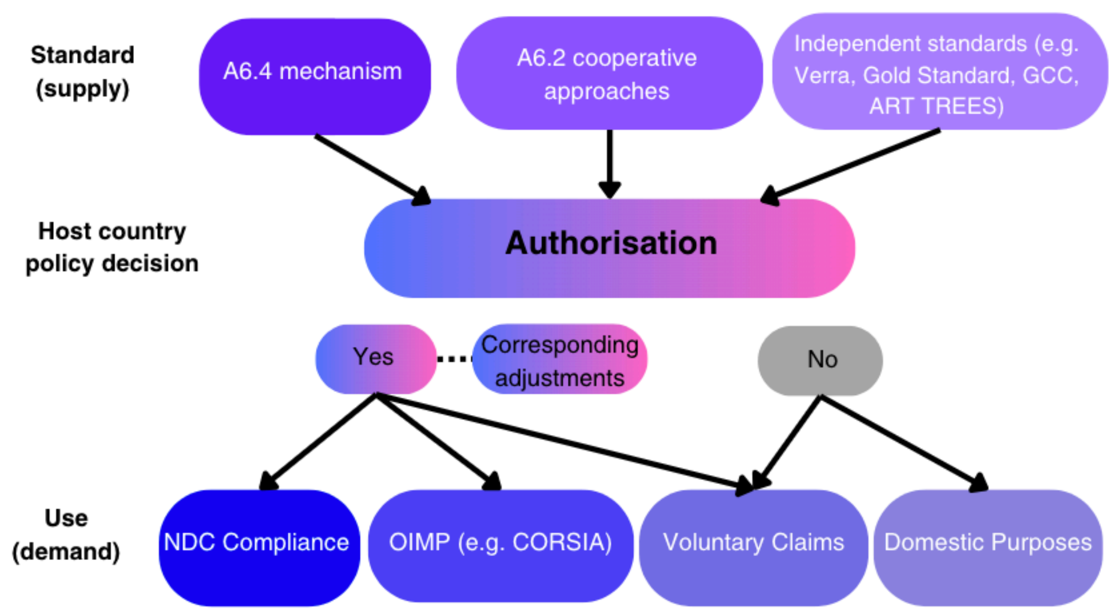
Define the legal nature and status of carbon credits within regulatory frameworks. Questions regarding whether carbon credits are deemed commodities, securities, services, or intangible assets need prompt answers in each jurisdiction. Understanding and clearly articulating the legal classification of carbon credits is vital for the effective functioning of carbon markets.

6. Interoperability

Establish an effective interaction between compliance instruments and the voluntary carbon market (VCM). While Article 6 guidelines do not directly regulate the voluntary carbon market, addressing how Article 6 mechanisms and credits are expected to interact with the voluntary carbon market could encourage greater investment. Article 6 is designed to deal with carbon transfers between countries – obligations may be delegated down to private sector actors through mandatory schemes, but the reporting and accounting of emissions remain at the national level. Hence, the voluntary trade of carbon credits between private actors should have no bearing on country-level carbon accounting as long as those credits are not used for obligations related to the achievement of an NDC outside the host country or for other international mitigation purposes, such as CORSIA. International transfer of credits without host country authorisation and corresponding adjustment is permitted, and host countries should be able to count the mitigation associated with those credits towards their NDCs. In this process, voluntary carbon markets and A.6.4 mitigation contribution units (MCUs) catalyse private capital to deliver significant carbon projects without risk of double counting and other perverse incentives. This may also lay the groundwork for strategic thinking about involvement in Article 6, facilitating the enhancement of national ambitions through the utilisation of funds derived from carbon markets. However, if project developers or buyers would like the host country to authorise carbon credits issued by independent private standards and apply a corresponding adjustment when these credits are transferred internationally, they ought to have the option to make such a request to the host country.

Support the emergence of a widely accessible traded market for carbon credits. The private sector can mobilise capital towards mitigation projects by either investing in assets or committing to offtake agreements in return for the supply of carbon credits that can be used to discharge compliance obligations (such as an ETS or a carbon tax liability) or to compensate hard-to-abate emissions. Hence, clarity and transparency on the eligibility of various types of credits for compliance purposes and/or offsetting claims are necessary to incentivise sustained investment in mitigation.[7] Efforts to create standardised and fungible credits abiding to a minimum standard will allow the emergence of a liquid asset class and enable the deployment of streamlined trading and risk management that will reduce transaction costs, further mobilise capital, and increase investment flows.

Figure 4: Article 6 & VCM interaction – Difference types of credit supply and credit use cases



[7] Singapore's International Carbon Credit (ICC) Framework, introduced alongside a progressive increase in carbon tax rates, will allow from 2024 onwards carbon tax-liable companies to achieve an offset of up to five percent of their taxable emissions by using international carbon credits certified by independent standards that also meet the requirements of Article 6 of the Paris Agreement (Singapore National Environment Agency, 2023, "Singapore Sets Out Eligibility Criteria For International Carbon Credits Under The Carbon Tax Regime").

7. Capacity Building

Emphasise the areas where capacity building is required and the role of international organisations. All parties can benefit from the use of Article 6, but it is a complex mechanism that requires an integrated effort across governments, the private sector, and civil society initiatives. Areas identified by governments already include policy support for decarbonisation pathways, clarity on environmental integrity criteria, reporting and accounting, authorisation frameworks. The private sector will need a voice at the table to share areas where opportunities can be explored and where tensions exist, especially considering the need for private sector financing to achieve NDC goals. Mechanisms that allow for business to illustrate these points through a consultation process will allow all parties to progress forward on which areas need capacity building. Over time, these insights can be shared with the relevant communities to assist decarbonisation efforts.

Participate in and benefit from capacity building initiatives. Dialogues and initiatives such as the capacity building programme for implementing Article 6 run by the UNFCCC and its Regional Collaboration Centres (RCCs) are crucial. Private sector-led activities, such as IETA's Business Partnership for Market Implementation (B-PMI)[8], help private sector investors and other stakeholders understand the importance of Article 6 and emissions trading more broadly.

[8] More information about B-PMI can be found HERE.