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COP 26:
ARTICLE 6 AND ITS IMPACT ON VOLUNTARY MARKETS

After 5 years of trying, COP26 delivered the final piece of the jigsaw for the operationalisation of the Paris Agreement. The final verdict requires for corresponding adjustments to be applied regardless of whether an abatement activity falls inside a country's national determined contribution (NDC) or outside of its NDC, for both Article 6.2 and Article 6.4 transactions. However, the Paris Agreement does not mandate for voluntary carbon units issued by voluntary standards to be subject to a corresponding adjustment.

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At a glance

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From a country’s perspective, this allows a host country to be able to tap into Article 6.2, Article 6.4 or to tap into voluntary markets to generate financing for its abatement opportunities, with the option of whether it will apply a corresponding adjustment or not. What ensues is therefore a price differential between the types of credits available to a market participant based on whether a corresponding adjustment will or will not be necessary.

Further, an approval and authorisation framework for each Paris Agreement host country will be needed for the purposes of Article 6 markets and will probably extend to the voluntary markets as well. By issuing a Letter of Approval, Letter of Authorisation and Use Authorisation, the host country will be able to determine whether it would like a particular abatement opportunity to raise carbon revenue from the Article 6 markets, or from the voluntary markets. This allows the host country to retain control over its carbon abatement opportunity and ensures that they can sell their mitigation outcomes for a price that justifies the cost of the corresponding adjustment to the host country.

Introduction

The outcome of the 26th conference of parties to the Paris Agreement, held in Glasgow (COP26), in terms of its success or failure, has left different impressions on people. The spectrum of views tend to depend on the degree of expectation by which COP26 is measured. If measured from a narrow spectrum based on the operationalisation of the Paris Agreement architecture, including the Article 6 (Market Mechanisms) and Article 13 (Transparency Framework), after five years of trying, then COP26 would be declared a success. Of course, we appreciate this is not the main measure for determining success at COP26 and we address that in a separate client note. This client note considers what impact Article 6 may have now that its obstacles for operation have been removed and, in particular, what does that mean for the voluntary markets and initiatives like the Integrity Council for the Voluntary Carbon Markets (ICVCM).

Corresponding Adjustment

We start by dealing with the proverbial elephant that has been in the room for the past five years of COP discussions. The issue of what a corresponding adjustment is and when it should apply for transactions that may arise under either (i) cooperative approaches under Articles 6.2-6.3 (**Cooperative Approaches**) or (ii) the sustainable development mechanism under Articles 6.4-6.7 (the **Mechanism**), has been one of the main sticking points preventing progress. So how was it resolved at COP26 and what are the results of that outcome?

Going into COP26, there were a number of fundamental ideological issues at play here. Although the exercise of when you should add a +1 or subtract a -1 from a country’s NDC should be a question of accounting and therefore an exercise of logic, the politics of NDCs always got in the way of reason. It was no different in Glasgow, except that logic became a sacrifice at the altar of compromise. One of the outcomes of the compromise deal reached in Glasgow on corresponding adjustments was to determine that corresponding adjustment applies, even when the action in question that leads to a greenhouse gas (**GHG**) emission abatement or removal has nothing to do with a host country’s NDC. The rationale given to justify this illogical outcome is that it avoids any perceived perverse incentives that host countries might have to expand their NDCs and therefore, limit ambitions.

Whether or not that is sufficient justification to mess with the logic of accounting, it has the effect of taking away the freedom that a host country might have to manage its cost of abatement by relying on Article 6 markets to finance its more costly abatement sectors without being penalised with a corresponding adjustment in a sector that is not covered by its NDC. This is also a way in which to slowly kill off the ‘common but differentiated responsibilities’ (**CBDR**) principle enshrined in the Paris Agreement because, now a host country has to apply a corresponding adjustment for an internationally transferred mitigation outcome (**ITMO**) under a Cooperative Approach

or an internationally transferred Article 6.4 emission reduction (**Art6.4ER**), regardless of whether that activity sits within the country's NDC. Applying a corresponding adjustment, irrespective of whether the ITMO or Art6.4ER arises inside or outside an NDC, means that a host country has little reason now to keep costly abatement sectors outside its NDC.

However, at least for a host country, that is not the end of the story thanks to a solution raised by the Japanese at the eleventh hour and accepted by others to break a negotiation stalemate. We discuss the impact of this 'Japanese solution' below.

Once the dust settles and countries consider how they wish to approach using the carbon markets to fund their GHG abatement needs, a host country will ask itself, does it wish to seek climate financing through the sale of an ITMO, an Article 6.4ER or voluntary carbon unit issued by one of the voluntary market standards, such as Verra or the Gold Standard? The answer to this will be determined by which market pays more and whether the cost of country's corresponding adjustment, that might follow, is worth it.

Article 6.2

Long before COP26, a number of bilateral and multilateral initiatives were underway to create Cooperative Approaches that were consistent with the idea enshrined in Article 6.2-6.3 of the Paris Agreement. However, such initiatives were always subject to the uncertainty of the outcome of the guidelines needed under Article 6.2 (the **Art 6.2 Guidelines**) and therefore, could not plough ahead with full steam. The decision in Glasgow removes that obstacle and the final Article 6.2 Guidelines now establish the international legal and accounting principles within which those Cooperative Approaches must now operate. The infrastructure to facilitate the operation of a Cooperative Approach, namely national registries or if none, the International Registry, the Article 6 Database and the Centralised Accounting and Reporting Platform must now be established.

As between the Cooperative Approach under Article 6.2 and the Mechanism under Article 6.4, the key differences are that under the former, government to government level arrangements have to be agreed before a Cooperative Approach can come into force. Furthermore, to participate in a Cooperative Approach, each party must meet common participation requirements (**Art 6.2 Participation Requirements**). The most relevant of these Art 6.2 Participation Requirements are that the country must be a party to the Paris Agreement (i.e. you cannot withdraw from the Paris Agreement but still utilise its market mechanism) and that it must have a framework in place that authorises the use of ITMOs for NDC purposes. The absence of the framework will mean that a transferring country is not in compliance with the Art 6.2 Participation Requirements but, unlike the Kyoto Protocol, there isn't much of a penalty for non-compliance.

The authorisation framework is important in the case of both ITMOs and Art6.4ERs. How a unit should be used can, for the most part, be determined by the parties participating in the Cooperative Approach using this framework. There are three uses for which an ITMO can be authorised: (i) for use towards an NDC (**NDC Use**), (ii) for use towards other international purposes (**International Use**) (e.g. CORSIA) and, (iii) for use for other purposes (**Other Use**) (e.g. voluntary corporate use).

Consistent with the bottom up approach of the Paris Agreement, the mechanics by which such authorisation framework should operate is not prescribed and the participating parties to the Cooperative Approach should determine this for themselves. However, it would make sense for such an authorisation framework to address two other issues at a minimum. These are (i) whether private sector participation should be authorised for the purpose of the Cooperative Approach (**Letter of Authorisation**) and (ii) the timing of when the participating parties should apply their corresponding adjustment. For ITMOs that are authorised for NDC Use, the Article 6.2 Guidelines require a corresponding adjustment to be applied to them when they are first transferred internationally. On the other hand, in respect of ITMOs that are authorised for International Use or Other Use, participating parties are given a number of choices as to when the corresponding adjustment should be applied (e.g. at issuance or at the time of authorisation etc.). It is worth noting that an Art6.4 ER is considered an ITMO when it has been authorised for NDC Use, International Use or Other Use and therefore, is subject to a corresponding adjustment by the host country when it is transferred internationally (as opposed to used domestically).

Additionally, the banking of ITMOs between NDC periods is not permitted. Other safeguards, beyond those required by paragraph III, D of the Annex to the Article 6.2 Guidelines (e.g. that may limit the transfer and use of ITMOs) should be proposed by SBSTA[1] after 2028 and may be adopted by the COP for implementation, probably not before 2030.

Another significant aspect of the Article 6.2 Guidelines was the acceptance that countries can issue ITMOs in other metrics, not just metric tonnes of carbon dioxide equivalent (**tCO2e**), that are consistent with the NDCs of the participating parties. Whether there will be demand for ITMOs in non-GHG metrics is unclear but it allows for mitigation co-benefits from adaptation actions or economic diversification plans to be converted into ITMOs as a means of generating climate financing.

There is also a significant emphasis in the Article 6.2 Guidelines on reporting. Participating parties to a Cooperative Approach will have to submit at least three sets of reports: an initial report, an annual report and a regular report annexed as part of its biennial transparency report. Since each of these reports are per the Cooperative Approach, where a country (e.g. Switzerland) has signed a series of bilateral Cooperative Arrangements it will have to file one for each such arrangement.

1 Subsidiary Body for Scientific and Technological Advice.

This administrative burden on participating countries may encourage the use of the adoption of club approaches in respect of Cooperative Approaches.

Finally, although there is no express reference, Article 6.2 does not prohibit Cooperative Approaches to be agreed in respect of REDD+ activities. The same is true of the Mechanism but there, the Supervisory Body would have to approve the REDD+[2] methodology.

The Article 6.4 Mechanism

Surprisingly, the negotiators at COP26 could not come up with a name for the Article 6.4 mechanism, and therefore, it is simply called the Mechanism (for now).

Much like the Clean Development Mechanism (**CDM**), there will be a centralised body (the **Supervisory Body**) whose role is to run the Mechanism, establish a registry for the Mechanism (the **Mechanism Registry**), accredit designated operational entities (DOEs), register activities under the Mechanism (**Mechanism Activities**) and develop and approve methodologies and standardised baselines for the Mechanism Activities. The Supervisory Body will be supported by a secretariat. Many readers will recognise the similarities to the organisational structure and approach of the CDM and, with a few differences, the Mechanism looks very similar to the CDM. The mandate for this is set out in the guidelines annexed to the decision on Article 6.4 (the **Article 6.4 Guidelines**).

Similar to Cooperative Approaches, a host country wishing to issue Art6.4ERs under the Mechanism, must also satisfy a similar, but not identical, set of Article 6.4 mechanism participation requirements (the **Art 6.4 Participation Requirements**). These include the need to establish a designated national authority (**DNA**) and the host country has to publicly state the types of Mechanism Activities that it would consider approving for the issuance of Art6.4ERs. The idea is that once such Mechanism Activities are identified by the host country, public or private entities can design such activities and propose them for registration under the Mechanism. Such activities may involve reducing emissions, increasing removals and mitigation of co-benefits of adaptation actions and/or economic diversification plans. Therefore, the type of activity should not force a country to choose between approving the activity under the Mechanism or a Cooperative Approach (where it is a participant in one), since the mitigation outcome can be reflected either in the form of an Art6.4ER or an ITMO.

Before a Mechanism Activity can be registered with the Supervisory Body it will need to obtain from the host country, approval of the Activity, probably in the form of a letter (a **Letter of Approval**). The Mechanism also requires the host country to issue a Letter of Authorisation to the public or private entities that will participate in the Mechanism Activities. Such a Letter of Authorisation requirement also applies to the private entities of the other country that is participating in the Mechanism Activity (eg. is financing the Mechanism Activity), but there is currently no obligation for that other country to issue a Letter of Approval. Such authorised entities will become 'Activity Participants' (akin to project participants under the CDM). Just like the CDM, the Mechanism therefore distinguishes between the approval of the activity and the authorisation of the private entities' participation. In the CDM, these two letters were usually issued as a single document but for the purposes of the Mechanism, it seems sensible to keep them distinct as the buying country does not need to approve the activity in order to authorise the private entity participation. It remains to be seen whether the host countries combine the Letter of Approval and the Letter of Authorisation into a single document.

However, beyond the Letter of Approval and the Letter of Authorisation, the Mechanism introduces a third level of authorisation that is discretionary in the hands of the host country. This third authorisation relates to the use to which the Art6.4ERs, arising from the registered Mechanism Activity, should be allocated – namely; NDC Use, International Use or Other Use. Once the choice has made by host country (its **Use Authorisation**), it must share that with the Supervisory Body. Where the allocation is for anything other than NDC Use, the host country must then provide additional information including conditions or limits it places on such use and its preference in terms of timing of when it will carry out the corresponding adjustment (see discussion above under Article 6.2).

Since this is something a host country is unlikely to do on a activity-by-activity basis (i.e. it will not be project specific), the host country is most likely going to set out this preference via the same domestic legislative framework by which it establishes its DNA, and decides the Mechanism Activity types that it will approve for the purposes of the Mechanism etc. In our client alert published just before the start of COP26[3], we refer to the passing by a host country of its legislative framework to establish control over their emission abatement opportunities and to comply with the Art 6 requirements as 'nationalisation' of its emissions abatement opportunity. We anticipate that each host country will seek to establish such a legislative framework to comply with the Letter of Approval, Letter of Authorisation and Use Authorisation requirements of the Article 6.4 Guidelines.

In addition to the corresponding adjustment, a share of proceeds for administration (**SoP Admin**), at a percentage to be determined by the Supervisory Body and a 5% share of proceeds for adaptation (**SoP Adaptation**) will also apply to issued Art6.4ERs issued in respect of the Mechanism Activity with a Use Authorisation. On top of that, an additional 2% shall be deducted from issued Art6.4ERs and cancelled for the purposes of delivering overall mitigation in global emissions (**OMGE**). OMGE is an attempt to ensure that Mechanism Activities achieve overall net mitigation in global emissions and don't simply allow for leakage in emissions via activities.

The 'Japanese solution' comes into play at this stage, because where the Use Authorisation is applied to an Art6.4ER, the host country is agreeing to apply a corresponding adjustment for that Art6.4ER but an Art6.4ER can also be issued without a Use Authorisation in which case the host country may report that mitigation outcome as part of its inventory reporting under Article 4 of the Paris Agreement but not apply a corresponding adjustment.

The Article 6.4 Guidelines does not make the Use Authorisation obligatory on the host country. This leaves the host country with discretion as to whether it wishes to benefit from the Mechanism but have the Art6.4ER used for either domestic purposes (e.g. towards a national emission trading scheme or tax regime) or whether it wishes to sell Article 6.4ERs into the voluntary markets but without having to make a corresponding adjustment. As such, it allows host countries to tap into financing opportunities in the voluntary markets or the Article 6 markets but recognising that for the latter, it will come with the additional cost of the corresponding adjustment.

Therefore, for practical reasons, a price differential should emerge between an Art6.4ER that has a Use Authorisation (and therefore a corresponding adjustment), an Art6.4ER without a Use Authorisation and a voluntary carbon unit. Similarly, the market price for an Art6.4ER without a Use Authorisation and a voluntary carbon unit may be determined by how the market perceives the robustness of the methodologies, processes and integrity of the Mechanism relative to the voluntary standard (e.g. VCS or Gold Standard). Therefore, the respective qualitative standards of the Supervisory Body and the ICVCM could become a point of distinction in the market. A competition for quality and perceptions around the acceptability that, the GHG abatement used by a corporate for making an offsetting claim may also be being used by the host country towards achieving its NDC (i.e. a double claim, especially if the GHG abatement arises from an activity covered by its NDC and does not go beyond its NDC), may be resolved by choices made by the Standards themselves or by the ICVCM.

The timing of when that competition will start, may be sooner than originally anticipated. Unlike the early stages of the CDM when lack of funding slowed the implementation, the Mechanism can kick start with the benefit of a $40m loan from the Trust Fund for the CDM to the Supervisory Body, of which $10m is earmarked for capacity building and the transition of the CDM into the Mechanism (on which see below).

The CDM

Although there was no legal obligation under the Paris Agreement to grandfather the CDM into the Mechanism, allowing that does give the Mechanism a jumpstart. As part of the transition, the Mechanism is allowed to adopt the Methodologies of the CDM until they are replaced by methodologies developed by the Mechanism. Further, there is a time limit for how long CDM methodologies may be allowed to be utilised under the Mechanism. This period is CDM project specific in that the time limit is the earlier of the end of the current crediting period for that project or 31 December 2025.

As alluded to above, the Mechanism is quite similar to the CDM. This means that too much alignment with the CDM could taint the Mechanism with all of the good of the CDM and, if not carefully managed, some of its bad. There was much talk in Glasgow about the detrimental impact of the grandfathering of existing CDM projects into the Mechanism. However, such grandfathering is not automatic and a number of conditions must first be met, including that a request to grandfather a project must be made by 31 December 2023 and the host country must agree to such grandfathering and reissue a Letter of Approval for the project by no later than 31 December 2025.

3 For more information on our previous client alert, it may be found at: https://www.hfw.com/COP26-Article-6-Nationalisation-Risk-and-what-it-means-for-voluntary-markets-Oct-2021.

Certified Emission Reductions (**CERs**) issued in respect of pre-2021 vintage from grandfathered CDM projects (registered after 1 January 2013) may be used toward a Paris Agreement party's first NDC only, will not be subject to a corresponding adjustment by a host country or be subject to SoP Admin or SoP Adaptation. Any emission reductions achieved from a grandfathered CDM project for vintage 2021 will be only issued as Art6.4ERs.

The impact of Art 6 on the voluntary markets

Practically speaking, not much changes in the voluntary markets as a result of Article 6. The rights and wrongs of the double counting versus double claiming debate remains very much alive. This is because the Paris Agreement countries felt that they did not have the jurisdiction to regulate corporate claims but, by insisting that a corresponding adjustment should apply, irrespective of whether the ITMO and Art6.4ER is authorised for NDC Use or Other Use, have put the marker down on what they feel should be appropriate positon even if they cannot regulate it. It ultimately falls on the buyers in the voluntary markets to determine whether they wish to accept and use voluntary market units that do or do not have a corresponding adjustment, in relation to their respective corporate claims. However, for ITMOs and Art6.4ERs with a Use Authorisation, that debate is clear and settled.

If anything, such voluntary buyers now have a plethora of choices of ITMOs, Art6.4ERs with Use Authorisation, Art.6.4ERs without Use Authorisation and, of course, the many different types of voluntary credits issued by different voluntary standards who can now, for themselves, insist on a corresponding adjustment or not. What is clear though is that the choice of corresponding adjustment vests in the host country and is not a matter for the relevant standard to unilaterally decide upon.

Conclusion

With the finalisation of the Article 6 at COP26, there is an opportunity for the host country to choose the carbon markets it wishes to raise climate financing from. The Article 6 markets, in particular the Mechanism, will need to compete with voluntary markets because a host country can look to voluntary markets and does not have to apply a corresponding adjustment.

While the Mechanism may become operational faster than Cooperative Approaches, the race will be determined by the level of willingness of the participating parties in a Cooperative Approach and their adoption of existing methodologies and infrastructure. The Mechanism is unlikely to 'reinvent the wheel' so may have the Mechanism Registry in place faster than the International Registry and the Article 6 Database. Counties will do well to fast-track their national legislation to implement the approval, authorisation and Use Authorisation frameworks to enable them to meet their Art 6.2 Participation Requirements and their Art 6.4 Participation Requirements as soon as possible.

ICAO will also now need to determine its eligibility criteria for vintage 2021 CORSIA units. It will be interesting to see what criteria they apply to qualifying credits given the corresponding adjustment debate on ITMOs and Art6.4ERs is now settled but not in respect of voluntary carbon units.

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