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De-risking Article 6 for Business: Challenges and Proposed Solutions

Hosted by IETA
Welcome Remarks & Introduction

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De-risking Article 6: Challenges and Proposed Solutions

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Legal Gap Analysis for Article 6 Transactions
MAY 2021
Assumptions and Scope

This analysis focused on the risks related to ITMO transactions authorized pursuant to Article 6.2.

We recognize there are other important and related issues being debated more broadly but are not addressed in this analysis.

OUR ANALYSIS IS LIMITED BY THE FOLLOWING:

- The current state of the Article 6.2 negotiating text is represented by the draft Article 6.2 guidance from COP 25.*
  The guidance is not final and could change.
- This analysis addresses Article 6.2 only and not Article 6.4 transfers
- This analysis relates to first transfer of ITMOs; not secondary market transactions.
- Generic commercial risks or additional legal risks which may apply to transfers for other international uses, such as CORSIA or for the voluntary carbon market, are not covered.
- REDD+ developments under Article 5 are not addressed.
- Transactions of ITMOs occur in tCO₂ equivalent and countries have quantifiable NDC targets.

*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)
High-level Overview of an Article 6.2 Transaction
Relevant Events in an Article 6.2 Transaction

**AUTHORIZATION**
- Seller obtains authorization from host country for mitigation outcome
- **TIMING:** Likely a condition precedent to a transaction

**ARTICLE 6 REPORT**
- Parties report ITMO transfers, corresponding adjustments/indicative corresponding adjustments in UNFCCC Article 6 database
- **TIMING:** Annual

**REGISTRY TRACKING**
- Seller transfers ITMOs to buyer in registry (national / 3rd party)
- **TIMING:** Upon delivery date set forth in contract

**BIENNIAL TRANSPARENCY REPORT**
- Parties report to UNFCCC on NDC progress, including corresponding adjustments/indicative corresponding adjustments, ITMO transfers
- **TIMING:** Every other year beginning in 2024

**END OF NDC IMPLEMENTATION PERIOD**
- Parties report against NDC target
- **TIMING:** 2030

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Risks Associated with Article 6.2 Transactions
Risk

Failure of seller to maintain Authorization of mitigation outcome activity by host country

- Authorization demonstrates host country approval of the mitigation outcome activity to generate ITMOs.
- Without an Authorization, mitigation outcomes are not ITMOs.
- Critical for transactions involving private sellers as the primary link with the host country

LETTER OF AUTHORIZATION

The letter of authorization could set forth relevant details of the mitigation activity, including:

- Names of project proponents;
- Date of mitigation activity commencement;
- Vintages of ITMOs;
- Sector of mitigation activity and location;
- Crediting framework;
- Anticipated volumes of mitigation outcomes; and
- Use of ITMOs.
RISK

Failure of host country to apply corresponding adjustment (or submit Article 6 report)

• Timing lag exists between delivery of ITMOs and application of corresponding adjustment
• Corresponding adjustments can only be taken by a host country, not private sellers
• Failure to adjust or submit report may not unwind ITMO transaction but could cause reputational risk to buyer and affect value of ITMO
RISK

Failure of host country to submit Biennial Transparency Report or show progress toward NDC in BTR

- Timing lag exists between delivery of ITMOs and submission of the BTR
- BTR includes information demonstrating progress toward NDC goals
- Potential risk to buyer that continues subsequent deliveries after progress not demonstrated
RISK

Failure of host country to demonstrate achievement of NDC

- Risk of host country overselling ITMOs and not meeting NDC target
- Would likely not affect ITMOs already sold
- Reputational risk for buyers of ITMOs from countries that oversell
- Risk to Article 6 as a tool for enhanced ambition if ITMO-selling countries fail to meet NDC goals
Mitigation outcome does not have environmental integrity

- ITMOs must have environmental integrity to maintain market credibility
- Environmental integrity may be defined by host country or informed by buyer
- May be included by requirements for authorization (e.g., crediting frameworks, conservative baselines)
- Failure for ITMOs to have environmental integrity represents risk for buyers and may affect value and use of ITMOs

OTHER RISKS
- Enforcement risk with sovereign counterparties
- Change in law
Mitigation Options for Article 6.2 Transaction Risks
Approach to Mitigating Risks

- ITMO transactions are uniquely sovereign in nature, even where undertaken by authorized private parties.

- Private actors are not able to complete certain of the actions necessary for a full cycle of ITMO transfer (through to CA), thus should not assume performance risk of sovereigns.

- Where possible, attempt to align interests and incentives versus focus on traditional contractual remedies for default.
Mitigating Risk Through Contract

• Good Due Diligence

• Clarity on Eligibility Requirements
  (pre closing or condition precedent)

• Staggered Milestone Payment Schedules

• Ability for Buyer to Suspend Obligation to Accept Deliveries
  (and make payments)

• NDC Implementation Plan

• Traditional remedies as last resort (default, termination, damages)
Mitigating Risk Through Structural Mechanisms

• Meta Registry (greater transparency, reduce time lag between transfer and CA)

• Self Insurance Pool
  — Buffer approach
  — Aggregated purchases for “reserve ITMOs”

• Political Risk Insurance (MIGA)

• Buyers Club
  — Establish common “club rules”
  — Create scaled and durable demand with inclusive participation
  — Set high standards to join “the club”

• Establish positive list of mitigation activity types that would be pre-authorized by sovereigns
Delivering Net Zero
De-risking Article 6: Challenges and Proposed Solutions

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