Operationalizing Article 6 of the Paris Agreement

Perspectives of Australian Business

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Carbon Market Institute

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About the Carbon Market Institute

The Carbon Market Institute is at the centre of climate change policy and business in Australia. We're dedicated to helping business seize opportunities in rapidly evolving carbon markets. Independent and non-partisan, we're the peak industry body for climate change and business. We believe that market based solutions are the most efficient policy mechanism to address the challenge of climate change.

We share knowledge and facilitate connections between business, policy makers and thought leaders to drive the evolution of carbon markets towards a significant and positive impact on climate change. Engaging leaders, shaping policy and driving action, we're connecting insights and catalysing opportunities in the transition to a low carbon economy.

CMI membership represents a broad range of professionals, organisations and industry. Our members include: Australia's heavy emitting, trade exposed companies; leading professional service providers; carbon market participants; offset providers; academia and international organisations. Individuals within the CMI membership base are some of the most respected Australian carbon market innovators and leaders. CMI's Working Groups have played a key role in connecting government, bureaucrats and regulators with industry to facilitate the constructive input of member views into policy implementation. Drawing on the expertise of the CMI membership, the Working Groups have provided a vital forum for the exchange of information between market participants, policy makers and government agencies.

CMI has undertaken extensive consultation in preparing this Paper, including through:

- A dedicated Working Group on International Climate Policy and Markets which has been established to share knowledge and stimulate discussion among the CMI membership about optimising engagement in international carbon markets;
- A series of national workshops and discussions held at CMI's 2nd Asia Pacific Carbon Market Workshop and 4th Australasian Emissions Reduction Summit from April – May 2017; and
- Extensive consultations with international experts, as part of a Scoping Study it carried out, supported with a funding agreement by the Department of Foreign Affairs and Trade, on 'Public-private collaboration on carbon markets in the Indo-Pacific' in 2017 which engaged over 200 stakeholders.

<u>Corporate Membership of the Carbon Market Institute</u>

Executive Summary

Australia is well positioned to engage in existing and future carbon markets. This document details CMI's position on Article 6 of the Paris Agreement, recognising that it offers the opportunity to build a global carbon market to achieve the ambition of the Agreement. It also outlines initiatives that could lead to increased economic activity for Australian business; innovative ways to capitalise on opportunities to reduce emissions; and opportunities to align the national climate change agenda with Australia's aid, trade and diplomatic agendas. The recommendations in this paper build on the following key principles:

- **Australia's national emissions reduction target should be in line with the global response** to the threat of climate change to keep temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5 degrees Celsius.
- **A market-based approach to emissions reduction** provides an effective, efficient framework to meet emissions reduction goals and challenges at lowest cost.
- Australia's **policy suite should be comprehensive and enduring** to create a stable and predictable policy landscape for business; climate policies should be reviewed at predetermined intervals again in line with United Nations Framework Convention on Climate Change (UNFCCC) commitments and evolving market conditions.
- Policies designed **to reduce emissions from large emitters should be aligned with the trajectory required** to meet current and future targets which are likely to be set at more ambitious levels.
- To meet emissions reduction targets at lowest cost to the economy, **Australia should open opportunities to link and trade with international markets.**

While Article 6 of the Paris Agreement offers the opportunity to build a global carbon market to deliver net zero emissions at lowest cost, it is critical that the rules, principles and technical details to operationalise its market provisions are developed in a way that have environmental integrity, transparency and avoid double counting. With this in mind, CMI's position on Article 6 can be summarised as follows:

- **Countries should be able to develop their own (bilateral, regional) linking arrangements** subject to their own rules and governance arrangements. Bilateral and regional secondary carbon markets should be designed in a way that they can be scalable and have liquidity and depth.

- **Internationally transferred mitigation outcomes should be 'unitised'.** 'Unitising' mitigation outcomes creates conditions under which the private sector is more likely to engage in markets, therefore facilitating greater business engagement, finance flows and investment in low-carbon activities. This could be achieved by establishing a process to quantify NDCs and translate them (or a portion of them) into units available for transfer. Under Article 6.2, the unit 'type' and denomination should be determined bilaterally/plurilaterally between the participating countries.

- **Australia's Emissions Reduction Fund methods should be recognised as eligible under Article 6.4**'s Sustainable Development Mechanism (SDM), and eligible in the bilateral and regional carbon markets that Australia participates in. Sharing methods could help to advance the development of robust, comparable and potentially fungible mitigation actions globally.

- Governments should establish processes and criteria to recognise 'early action' under the SDM and on a bilateral and regional basis. Presently, the lack of domestic policy allowing the use of international units and the uncertainty about international climate policy is deterring Australian business from investing in international emission reduction activities. Recognizing a certain quantity of early action credits would give business the confidence to start engaging in international markets to purchase international units.

- Offsets from the land sector should be recognized in the SDM and in bilateral and regional carbon markets. It is important for the Australia to engage early in UNFCCC negotiations to ensure that emission reductions from the land sector are recognized. In its bilateral and regional discussions, it will be important for Australia (and Australian business) to engage early with key potential export markets to ensure that emission reductions from the land sector are recognized.

- The private sector should have a designated role in the establishment of the rules, modalities and procedures and governance arrangements for the SDM and bilateral and regional linking arrangements.

The position that is detailed in the remainder of this paper represent a synthesis of CMI's research and consultations, and does not represent any particular individual or CMI member company position.

The Paris Agreement and its provisions for Carbon Markets

The Paris Agreement, reached in December 2015, aims to limit the global temperature increase to 1.5 - 2 degrees Celsius. It is based on voluntary emission reduction commitments made by each country – in the form of Nationally Determined Contributions (NDCs) – and requires countries to revise NDCs at least every five years, starting from 2023. While the emission reduction targets themselves are not legally binding, the process of regular review and submission of NDCs is binding.

The international community is now considering how the global response to the Paris Agreement, will be operationalized to achieve the 1.5 to 2-degree reduction target. A key component of this will be the preparation of a Paris Agreement Rule Book that is to be finalized in 2018 and is expected to cover:

- How countries will communicate their efforts on adaptation, climate finance, technology transfer, capacity building, and how they will be held accountable for their commitments;
- How collective efforts will be reviewed, with scaled-up actions and support every 5 years; and
- How to create a process to facilitate implementation and promote compliance.

Article 6 of the Paris Agreement

Article 6 of the Paris Agreement recognizes that countries may establish market-based mechanisms to address climate change, enabling their emission reduction commitments to be achieved at lowest cost. Article 6 of the Paris Agreement allows for a future global carbon market to build on a growing network of bilateral and plurilateral carbon markets, using different forms of linking coupled with an overarching international architecture. Its key aspects are as follows:

- Paragraph 6.1: Recognises that Parties may cooperate voluntarily in the implementation of their NDCs and this may allow higher ambition and the promotion of sustainable development and environmental integrity.

- Paragraphs 6.2 to 6.3: Specifies that Parties may use internationally transferred mitigation outcomes (ITMOs) in meeting their NDCs. The paragraphs also state that the use of ITMOs will be take place under robust governance and accounting.

- Paragraph 6.4: Outlines a new mechanism to 'contribute to the mitigation of greenhouse gas emissions and support sustainable development'. This new mechanism has become unofficially known in many networks as the Sustainable Development Mechanism (SDM). This paragraph also states that the mechanism will be supervised by a body designated by the Conference of the Parties, that will aim to (among other aims) incentivise and facilitate participation by public and private entities.

- Paragraphs 6.5 to 6.7: Focuses on avoiding double-counting of emissions reductions in meeting NDCs and the use of proceeds for administration and in the support of developing nations.

- Paragraphs 6.8 to 6.9: The final section of Article 6 refers to non-market mechanisms for Parties to meet their NDCs through mitigation, adaptation, finance, technology transfer and capacity-building activities as appropriate.

Purchasing international units, through either one or both Article 6 mechanisms, could benefit Australia and Australian business in a number of ways. For example, the purchasing of international units could:

- Help to achieve our national emission reduction commitments at lower cost, as cheaper abatement opportunities may exist overseas. This is because reducing one tonne of emissions in one jurisdiction has the same environmental value as reducing one tonne of emissions anywhere else. It has been estimated by the World Bank that international cooperation through carbon markets can reduce the global costs of NDC implementation by 30% by 2030 and by 50% by 2050;

- Offer an effective 'hedge' against the risk that current national and/or sub-national policies do not deliver the emissions reductions needed to meet our international commitments;

- Enable companies covered under national emission reduction policies such as the safeguard mechanism, meet compliance obligations for emissions exceedance of baselines at lowest cost.

- Open up new markets and new business lines for Australian businesses, as the transfer of international units could occur in both directions and correspond to a transfer of finance and investments across jurisdictions.

Importantly, there are likely to be financial implications of delaying decisions to purchase international units. The future availability and price of international units is uncertain, and there is unlikely to be an endless supply of cheap international units in a post-2020 environment, as Australia would increasingly compete with demand from other countries hoping to access international units (in addition to soaking up their own domestic supply) to meet their NDC targets. Presently, the international carbon price is at a historic low (less than $1 t/CO2e).

However, the emergence of new net-buyers in the Indo-Pacific (and globally), and the transition to the new market mechanisms post-2020 means that the opportunity to purchase high-quality, low-cost abatement is likely to be a short-term one.

Factors to consider based on CMI's research and consultations

CMI supports the Australian Government engaging business on discussions around Article 6 of the Paris Agreement, to ensure that it has a window into the dialogue about the mechanics and design of future global carbon markets, and that Australia is well placed to benefit from the cost/efficiency benefits that linked markets can potentially bring.

In its Submissions to the UNFCCC on Article 6 and the design of the Paris Agreement Rule Book, the Australian Government has already confirmed that issues such as avoidance of double counting of mitigation outcomes, ensuring environmental integrity, and transparent governance arrangements are critical in design the new approaches; and that guidance should be sufficiently broad and flexible to account for both existing cooperative approaches and those that are still to be developed (both within and outside of the UNFCCC).

CMI supports this position and have highlighted below a number of considerations with respect to Article 6.2 and 6.4 that should also be considered, within Australia and abroad.

Article 6.2: Voluntary Cooperative Approaches

- **Countries should be able to develop their own (bilateral, regional) linking arrangements subject to their own rules and governance arrangements**. Any international units that are sourced and transferred under Article 6.2 should need only the approval of the countries involved, and shall observe guidance from the UNFCCC (not governance) related to sustainable development, environmental integrity, transparency and accounting.

- **Internationally transferred mitigation outcomes should be 'unitised'.** 'Unitising' mitigation outcomes creates conditions under which the private sector is more likely to engage in markets, therefore facilitating greater business engagement, finance flows and investment in low-carbon activities. This could be achieved by establishing a process to quantify NDCs and translate them (or a portion of them) into units available for transfer. Under Article 6.2, the unit 'type' and denomination should be determined bilaterally/plurilaterally between the participating countries.

- **Bilateral and regional secondary carbon markets should be designed to be scalable and have liquidity and depth**. Larger and more diversified markets provide a stronger and less volatile carbon price signal to incentivise climate-smart investment, and also reduce the potential for market manipulation.

- **Australia's Emissions Reduction Fund methods should align with, and be shared across jurisdictions on a bilateral and regional basis**. Sharing methods could help to advance the development of robust, comparable and potentially fungible mitigation actions bilaterally and in our region.

- **Offsets from the land sector should be recognized in bilateral and regional carbon markets, as this is the likely source of Australia's supply**. It should be noted that contributions of afforestation and reforestation activities under the Kyoto Protocol's CDM were almost negligible, both in terms of project numbers and emission reduction value. In its bilateral and regional discussions, it will be important for Australia and Australian business to engage early with key potential export markets to ensure that emission reductions from the land sector are recognized.

- **Governments should be able to establish processes and criteria to recognise 'early action' on a bilateral and regional basis.** Presently, the combination of a lack of domestic policy allowing the use of international units, and the extended period of uncertainty about international climate policy is deterring Australian business from investing in international emission reduction activities. Early actions to invest in activities that reduce emissions, should be rewarded and not penalized. Recognizing a certain quantity of early action credits would give business the confidence to start engaging in international markets to purchase international units.

  This would also help to mobilise business to start building important links and open up economic opportunities to export professional capabilities across the full suite of project development, financing, technology transfer, monitoring, reporting and verification.

Article 6.4: Sustainable Development Mechanism (SDM)

- **The composition of the SDM governing body is key to its efficient functioning and impartiality.** It is important that the SDM governing body strive to make the mechanism as efficient and a-political as possible, thereby allowing a global carbon market to emerge at scale. The governing body of the Clean Development Mechanism (CDM) was comprised of members that functioned in their individual capacity but drawn primarily from country delegations. This can hinder the partiality of the governing body and, therefore, its full efficient functioning.

- **Offsets from the land sector should be recognised in the SDM, as this is the likely source of Australia's supply**. Given that contributions of afforestation and reforestation activities under the Kyoto Protocol's CDM were almost negligible, it is important for Australia to engage early in UNFCCC negotiations to ensure that emission reductions from the land sector are recognized.

- **Australia's Emissions Reduction Fund methods should be recognised as eligible methods under the SDM**. Recognizing these methods could help to advance the development of robust, comparable and potentially fungible mitigation actions globally.

- **The SDM rules should ensure the emergence of an international carbon market that has liquidity and depth**. Larger and more diversified markets provide a strong and less volatile carbon price signal to incentivise climate-smart investment, and also reduce the potential for market manipulation.

- **The rules should establish a process and criteria to recognise 'early action' under the SDM**. Recognizing a certain quantity of early action credits would give business the confidence to start engaging in international markets to purchase international units.

- **The private sector should have a designated role in the establishment of the rules, modalities and procedures and governance arrangements for the SDM.**

Options to Optimise Australia's position in International carbon markets

Australia is well positioned to engage in existing and future carbon markets. Outlined below are a number of opportunities that could lead to increased economic activity for Australian business, and innovative ways to capitalise on opportunities to reduce emissions throughout the evolution of international carbon markets. These opportunities include:

- **An Australian 'Bilateral Offset Crediting Mechanism':** Australia has the technology, finance and market capability to export Australian methods, technologies and expertise into partner countries, with agreement to transfer the abatement that is achieved (or part of it). Japan has a similar model - the Japanese Joint Crediting Mechanism – and has bilateral partnerships with 16 countries under this approach. Other countries are now initiating bilateral carbon market connections, and it is opportune for Australia to do likewise. New bilateral carbon market partnerships should be 'multi-purpose' and allow for the transfer of Australian methods, technologies and expertise into Partner jurisdictions, as well as the transfer of emission reductions.

- **New models for sharing of methods**: Based on initial conversations CMI has conducted, there is interest among experts in Australia, California, New Zealand, Korea, South Africa, India, China and Thailand in sharing emissions reduction methodologies. This interest is based on a recognition that jointly developing emissions reduction methodologies can help to build important links with other jurisdictions and could open up economic opportunities to export professional capabilities across the full suite of project development, financing, monitoring, reporting and verification.

- **Export of ACCUs:** Australia has a well-designed and well-governed domestic offset scheme that to date has issued over 40 million Australian Carbon Credit Units (ACCUs). As markets and policies evolve, there will be a domestic demand for these ACCUs as well as potential international demand. Engaging with the many countries that have outlined the use of international markets in their NDCs is an effective way to create an export market for ACCUs credited under the ERF. To ensure that the option of exporting ACCUs is available, it is important that the Government promote Australia's land sector abatement methodologies as a source of high quality, robust mitigation outcomes in appropriate fora.

- **Stapling ACCUs to exports:** As Australia's major trading partners implement policies to reduce emissions, it will be important to consider how key trade exposed industries in Australia can remain competitive in a carbon-constrained world. One option is to 'staple' Mitigation Outcomes (ACCUs or other units) to energy intensive exports that are fungible into their customers' domestic markets. This could give exporters of emissions intensive commodities a competitive advantage, and could finance a major expansion of private investment in carbon abatement activity in Australia.

- **Establishing a strategic reserve (purchase units pre-2020):** A strategic reserve should be established to procure a sufficient quantity of eligible international units to meet Australia's national emissions reduction target, and to provide a reserve of credits for use by domestic entities. Australia could draw on models used by other countries and private sector institutions when designing its strategic reserve, and develop a mandate that suits our specific policy requirements and emissions reduction goals.

- **Leveraging climate finance:** Australia has a very sophisticated finance and investment sector. There is an opportunity to connect Australian business and investors to global climate finance developments that also deliver carbon market outcomes. The Australian Government is already supporting a number of climate finance platforms in the Indo-Pacific Region which could be leveraged, as this region represents close trading relationships for Australian business.

- **Alignment of aid, trade and diplomacy:** As countries (particularly in our region) embark on the challenges to implement their NDCs, Australia's business, finance and market capability can help support those efforts. There is an economic opportunity for the Government to work in collaboration with business to align aid, trade and diplomatic efforts to open up and create economic opportunities for Australian professional services, technology and financial expertise in our region.

Considerations when engaging in existing and future carbon markets

A joint CMI/International Emissions Trading Association (IETA) Report on Optimising Australia's Position in International Markets (Oct 2016) highlighted that international units should satisfy the following principles:

- **Integrity**: Imported international units should represent real, permanent and additional reductions, and be subject to robust monitoring, reporting and verification (MRV).
- **Regulatory stability:** The extent to which international units should be allowed (volume and type) should be defined as clearly and as early as possible. This offers market participants greater visibility, and it helps to avoid a sudden inflows or outflows of units when rules are modified.
- **Compliance with the UNFCCC framework**: International units should comply with the evolving framework established by Article 6 of the Paris Agreement.

Moreover, criteria for the type of international units could include the following:

- **Net mitigation contribution**: The extent to which a project counts towards a host country's efforts to reducing their domestic emissions should be clearly established, to assure that there is no double-counting. Net mitigation could be set by project type and/or by country type.
- **Clear additionality**: Units should meet a clear additionality standard set by determining an appropriate sectoral benchmark for the country or region.
- **Sustainable development**: Units should, in addition to contributing to a net mitigation of GHG emissions, support sustainable development, as outlined by the Paris Agreement's Article 6.
- **Project neutrality**: Project size should not be a criterion for the eligibility of units, in order not to favour small projects over large projects and vice versa.
- **Credibility**: UN-issued units could be recognised, to ensure that qualitative criteria are guaranteed.

These criteria are also consistent with Australia's Climate Change Authority's international unit purchasing requirements and previous purchases of international units by the Australian Government under the Carbon Pricing Mechanism (CPM), in which 22 million tonnes of Certified Emission Reductions (CERs) were purchased. It should be noted that Australia has already established a precedence for the use and import of international units to use against it Kyoto 2020 commitments. The Waste Industry Protocol totalled $200 million from funds collected by landfill operators prior to the repeal of the CPM. These funds were then used to purchase international offset units. Units accounting for over 22 million tonnes were purchased.

Appendix: Article 6 of the Paris Agreement and Carbon Market Developments in the Indo-Pacific Region

- Article 6 of the Paris Agreement recognises that countries may cooperate through markets to reduce emissions and support sustainable development. Article 6 of the Paris Agreement sets up two new market mechanisms for international units: A framework for 'Voluntary Cooperative Approaches' (6.2) and a Mechanism for Sustainable Development and Mitigation Crediting (6.4). The Rules for sourcing and transferring international units under these Mechanism still need to be agreed.

- The transition towards a future global carbon market under Article 6 is likely to be built on a growing network of local carbon markets, using a range of different forms of linking coupled with an overarching international architecture.

- The process of operationalizing local carbon markets has also already started through bilateral and regional fora in the Indo-Pacific region, in what many now refer to as 'Carbon Clubs'. It is not clear when or how these Carbon Clubs will evolve, however, theoretically, any trading within these Clubs could precede the finalisation of the rules under the Paris Agreement provisions, since the rules and governance arrangements only need to be agreed by a handful of countries, and not all signatories to the Paris Agreement.

- Some of the developments in market linkage in our region include:
    - North East Asian Carbon Club: Stakeholders in China, Korea and Japan are convening in at least 2 different forums to explore prospects for a North East Asian Carbon Club, including:
        - A government-backed research program among academic institutes in China, Korea and Japan (announced Nov 2016).
        - Expert Forums supported by the Asia Society Policy Institute (announced May 2016).
    - Pacific Alliance Club: In June 2017, Chile, Colombia, Mexico and Peru signed the 'Cali Declaration' to strengthen their regional climate cooperation and to move towards a regional voluntary carbon market. Australia, Canada, New Zealand and Singapore are associate members of the Pacific Alliance.
    - Global Green Growth Institute (GGGI): 'Climate Finance and Carbon Markets Club'. Australia is a founding member of the GGGI which partners with 27 countries to deliver climate finance and carbon markets solutions.
    - Japanese Joint Crediting Mechanism: A bilateral offset crediting scheme between Japan and 16 partner countries, many of which are in the Indo-Pacific region. As of July 2016, 15 projects are registered and there were almost 100 financing programs and demonstration projects in the JCM pipeline.
    - China/Korea Joint ETS Committee: Korea and China held a Joint Committee on Climate Change Cooperation and Roundtable on Emissions Trading Scheme (ETS) in 2016 where views on climate policy and carbon markets were exchanged.
    - New Zealand/China joint climate action plan: Announced in March 20, this bilateral commitment was reached to cooperate closely on carbon markets, toward possible ETS linkage in the future.

- **New Zealand/Korea climate action plan:** Announced in April 2017, this bilateral commitment was reached to cooperate closely on carbon markets, toward possible ETS linkage in the future.
- **New Zealand-led Ministerial Declaration on Carbon Pricing:** Announced at COP21 in Paris, this initiative has been signed by 18 countries, including Australia. Signatories committed to work together on developing standards and guidelines for the environmental integrity of international market mechanisms used toward NDCs.

The carbon market partnerships that are emerging, are enabling some countries to build important links and open up economic opportunities to export professional capabilities across the full suite of project development, financing, technology transfer, monitoring, reporting and verification, and to share Mitigation Outcomes that are generated.

Australia, and Australian business can benefit from proactively participating in these regional platforms and it is timely to initiate connections, explore options and undertake research, as rules about eligible methodologies, credits and governance are discussed.

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