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Writing the Paris Rulebook

Principles and guardrails to keep
things in check



Guardrails for the Paris mechanisms

Operationalizing Article 6 and generating carbon market credibility

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The negotiation clock is ticking away at rapid speed. Only 14 months remain in which the rulebook for operationalizing the market mechanisms under Article 6 is to be developed and approved. Its foundations have been laid by the Paris Agreement and universally acclaimed UNFCCC principles. Nevertheless, old cleavages between countries have so far prevented any substantial progress in agreeing on the details. The negotiation meetings in May 2017 did not advance beyond “informal informal” lists of hundreds of topics to be covered in the future. Thus, it is crucial that COP 23 in Bonn delivers substantive progress on a number of critical issues. Otherwise, the hope that market mechanisms could become a cornerstone of the Paris regime may wither away. So what are the critical issues to be resolved in the negotiations on the Article 6 rulebook?

Many of the crucial elements for Article 6 are familiar to those who have worked on the Kyoto mechanisms in the past. They include defining roles for a governing body, host countries, auditors, and other stakeholders; ensuring additionality of mitigation action that generates emission credits, limiting transaction costs while ensuring transparency, and providing sustainable development (co-)benefits. But a number of them are new: How can we deal with crediting of policy instruments? How do we manage market mechanisms in a world in which the bifurcation of the Kyoto Protocol has been overcome, and all devel-

oping countries have defined their own Nationally Determined Contributions (NDC), even though these may have many different “shades”? How do we ensure that carbon markets (Article 6.2) with little or with no international oversight function well and ensure that these mechanisms enhance rather than undermine mitigation ambition? Given the history of NGO and media attacks against market mechanisms, the need to uphold high environmental integrity is paramount.

Preventing “hot air” from a hundred countries

A brief period in 2012 gave an impressive lesson on the danger of “hot air” for the credibility of market mechanisms. The Kyoto Mechanism Joint Implementation (JI) had previously been seen as inherently solid and credible due to the fact that both seller and buyer country have an emissions budget and emission reduction units (ERUs) would be deducted from the seller’s budget. Thus, the seller country would have to mobilize a volume of mitigation in its economy equal to the volume of units sold. Unfortunately, this reasoning does not hold if the seller has an emissions target that is not binding, i.e. where the business as usual emissions path is below the target. This means there is a surplus of emissions units – colloquially called “hot air” – that can be sold without the

need to mitigate elsewhere. Under the Kyoto Protocol, countries in economic transitions like Russia and Ukraine had generated huge amounts of hot air. When in late 2012 the Doha Conference of the Parties decided that such hot air could no longer be acquired under international emissions trading, Russia and Ukraine used JI “Track 1” that was devoid of international oversight to generate hundreds of millions of ERUs in just a few weeks. A large chunk of those ERUs was then sold to Western buyers. After heavy criticism from NGOs, JI was generally seen as a failed mechanism, despite the fact that “Track 2” issued no ERUs tainted by “hot air” suspicions thanks to the international oversight of the multilateral JI Supervisory Committee, which operates under the authority of the CMP.

Under the Paris Agreement, the situation is much more challenging than under the Kyoto Protocol (see also the discussion by Spalding-Fecher et al. 2017). Many NDCs have baselines that are way above any credible business-as-usual path. Some NDCs have no baseline at all. Under the Paris Agreement, there is no process in which an international body can scrutinize the methodological underpinnings and conservatism of the baselines used. It is thus highly likely that a significant number of NDCs would generate “hot air” if NDC baselines were to be used as a basis for crediting emission reductions or allocating emission allowances. The experience gained with JI leads to a clear recommendation for the Paris mechanisms – international oversight is crucial to prevent transfers of “hot air”.

One critical aspect of baseline setting is the question whether baselines should be “frozen” until the revision of the NDC or whether they should be dynamic, i.e. determined on the basis of a set of parameters such as economic growth, population development, share of different economic sectors or fuel prices. The actual values of these parameters should be used “ex post” to calculate baseline levels.

Coverage of NDCs: Sectors and conditionality

Some countries do not cover their entire economy in their NDCs. In principle, mitigation activities not covered by an NDC are akin to mitigation in countries without commitments under the Kyoto Protocol and should thus be subject to a Clean Development Mechanism (CDM)-type rulebook. Their additionality needs to be checked carefully.

Moreover, almost all developing countries have components of NDCs which they define as conditional on international financing, including through market mechanisms. As long as the additionality of such activities is ensured and the baseline of the conditional part of the NDC is derived in a conservative manner, conditionality should not be an issue in generating units under Article 6. When revenues from market mechanisms are blended with climate finance under a conditional part of an NDC, allocation of the mitigation to the different finance streams becomes an issue in order to prevent double claiming (Spalding-Fecher et al. 2017).

Ensuring additionality of policy instrument credits

Under the CDM, national policy instruments could not generate certified emission reductions (CERs). With the advent of upscaled crediting under the Paris mechanisms, it is important to understand when a policy instrument is additional.

Mitigation policies can generally be differentiated into regulation and carbon pricing instruments. The former includes efficiency standards for appliances or vehicles, the latter emissions trading schemes and carbon taxes. Generally, regulation addresses mitigation which in principle would be profitable but is not undertaken in the business-as-usual situation due to incentive problems – like the famous tenant-owner dilemma preventing efficiency improvements in buildings. Carbon pricing aims at mobilizing mitiga-



Source: Asian Development Bank / Flickr

Ensuring additionality: falling prices for low-carbon technologies have made wind and solar power plants increasingly attractive in many regions. Their additionality must thus be thoroughly assessed.

tion that has costs and thus would not be undertaken. As far as a country benefits from the removal of incentive-related barriers, such regulatory instruments should not be deemed additional unless real barriers are demonstrated, e.g. access to finance in a particular foreign currency. In cases of regulation that mandates a certain efficiency of a technology, a pragmatic approach would assess the payback period that would lead to investment into that technology. Academic literature and industry practice agree that 4 to 5 years would be a typical threshold.

But not all carbon pricing instruments should automatically qualify as additional. Given that a government theoretically should introduce a policy as soon as its benefits exceed its costs, a policy should principally only be seen as additional as long as its costs are higher than its benefits. The challenge here is

that often policymakers do not really believe in the accrual of the benefits, as can be seen in the context of many nationally appropriate mitigation actions (NAMAs) that are easily justified by their non-GHG benefits, but still not implemented. Moreover, specifying the discount rate to be applied to costs and benefits accruing at different dates is highly challenging. A simplified approach to additionality assessment of carbon pricing would be the definition of a carbon price threshold from which a policy would be seen as additional, which could in turn be differentiated according to the development level of a country. Furthermore, the political economy of an instrument should also be considered.

For project and programme-type activities, the erosion of environmental integrity through positive lists and automatic additionality seen with the CDM in

recent years should be scrutinized. Rapid increases in attractiveness of low-carbon technologies, as seen for photovoltaic and wind power plants, need to be captured by additionality tests. While real economy barriers such as limited availability of foreign currency may remain prohibitive for renewables in some low-income countries, their additionality cannot be convincingly explained in more mature emerging economies. A thorough investment test with standardization of input parameters should be mandatory for all activities except the very smallest ones.

Minimum requirements for a transparent approach

The CDM has set a benchmark for transparency of publicly accessible documentation of mitigation achieved by a market mechanism. And in a number of countries like China and India, information on CDM projects gave an insight into the performance of technologies such as wind or hydropower, for which project-specific data had previously been lacking. A key for such transparency was international oversight and comprehensive publication of documents by the UNFCCC Secretariat on its website. This means that the Secretariat should also publish all relevant documents for the Paris mechanisms and other climate financing instruments.

Transparency is not a one-way street. Like with the CDM, stakeholders need the opportunity to comment on documentation submitted to the Secretariat, and those comments need to be publicly available.

Crunching the numbers while preventing double counting: Accounting for emissions units and their transfer

Double counting or claiming of emission reductions is the key new challenge that the Paris Agreement

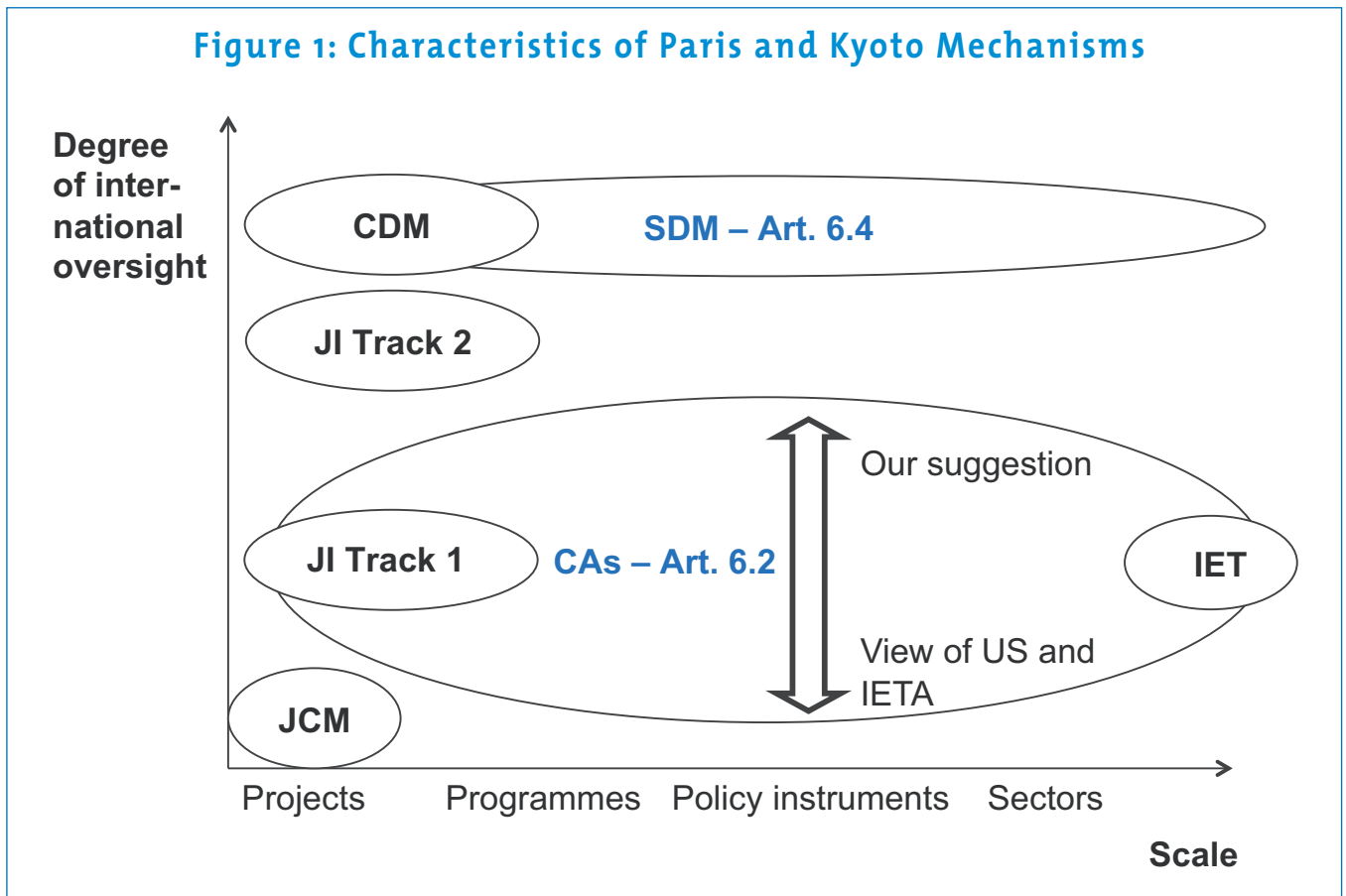
wants to prevent (see Schneider et al. 2015 for key definitions of double counting). A critical precondition for such prevention is that all mitigation units are clearly denominated in t CO₂eq. Attempts to create different units (Marcu 2017) – some for GHG and others for renewable energy – and apply artificial exchange rates should be resisted at all costs. The argument that this would be necessary due to the variety of NDC parameters is fallacious – a unit can only be a mitigation outcome if denominated in terms that are 100% linked to mitigation, and thus to GHGs. As Kreibich and Obergassel (2016) stress, the difference between single- and multi-year NDC targets is a highly relevant issue, and single year target countries should not be allowed to transfer units unless those units are converted into a multi-year logic.

One very important aspect of accounting is the setup of registries and transaction logs. The experience gained with the CDM registry has been very positive as it allowed private actors to keep CERs away from potentially greedy national governments. Given that under the Paris regime governments could be tempted to want to expropriate units in order to show compliance with their NDC, a system of national registries would be problematic.

Building trust within the private sector: Honouring CDM investments and defining a process for transition

Many policymakers, especially in the EU, seem to think that the CDM should be discarded in its entirety. Others, like Brazil and African nations, argue that the existing CDM pipeline should be fully integrated into Article 6. From an economic perspective, a compromise between these approaches is preferable, one which takes into account new interpretations of additionality as discussed. However, a more balanced approach would acknowledge successful CDM reforms, existing high quality projects and secure

Figure 1: Characteristics of Paris and Kyoto Mechanisms



Notes: IET = International Emissions Trading (Art. 17 Kyoto Protocol), JCM = Joint Crediting Mechanism (Japan); Source: the authors

investor confidence, given that the private sector invested heavily in the CDM due to its long-term nature. The post-2012 market crisis resulting from the politically motivated reduction in demand for CERs shook the trust of the private sector that politically framed market mechanisms and dried up investments. Destroying all CDM investments with the stroke of a pen, independently of their merits, would shatter private sector trust completely and make it very difficult to attract new private sector investments in the coming decades. Defining the eligibility of CDM activities for transitioning from the Kyoto to the Paris mechanisms depends on the progress made with the Paris mechanism rulebook. For a way forward on the transition of the CDM pipeline see Michaelowa and Hoch (2016).

Key role of international oversight to prevent the opening of loopholes

While many lobbyists and government representatives fight for a complete absence of international oversight for the cooperative approaches under Article 6.2, lessons from the past as well as the need to create a level playing field between the mechanisms call for international oversight for Article 6.2 activities as well. Given that the design of emissions trading systems around the world has been prone to over-allocation owing to intense lobbying efforts by affected industries, close scrutiny of such systems is required before they can generate transferable units.

Without such scrutiny, a “race to the bottom” could quickly ensue.

Approaches to unfreeze the market mechanism negotiations

Given that in Paris a group of market mechanism proponents was instrumental in getting Article 6 into the Agreement, a similar kind of activism is required during the next two COPs. Moreover, learning by doing based on practical experience can inspire progress in multilateral rule-making. In order to unlock progress, concrete investments into pilot activities to test innovative carbon market approaches could be very helpful. We call on progressive governments and international organizations to accelerate their activities, and spread their results widely. Also, a strong involvement of private sector actors could help to restore the level of trust that existed in the early days of the CDM. Last but not least, NGO support needs to be harnessed, for example by means of sustainable development safeguards (Spalding-Fecher and Schneider 2017; Hoch et al 2015).

Key guardrails for the Paris mechanisms

Summarizing our recommendations for the Paris mechanisms rule-setting, we stress the following:

- International oversight is required for both Article 6.2 and Article 6.4, particularly with regard to prevention of “hot air” contaminating the entire Paris system
- The difference between conditional and non-conditional parts of NDCs is not relevant for the Paris mechanisms if additionality testing on all levels of aggregation (including policy instruments) – is robust and conservative
- Additionality testing of policy instruments is crucial for the robustness of Article 6. Regulatory policy instruments need to be checked with regard to the payback period of the technologies required by the regulation. Carbon pricing instruments should undergo a cost-benefit analysis, taking into account political economy barriers. This could be operationalized in the form of minimum price thresholds required for carbon pricing to qualify as additional.
- Additionality of projects and programmes should be assessed by an investment test that uses standardized input parameters.
- All relevant activity documentation needs to be made publicly available.
- Accounting should be done through a centralized registry system.
- In order to safeguard private sector trust, all CDM activities fulfilling the principles described above should be transitioned into Article 6.4

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