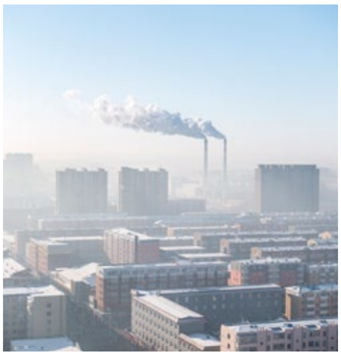
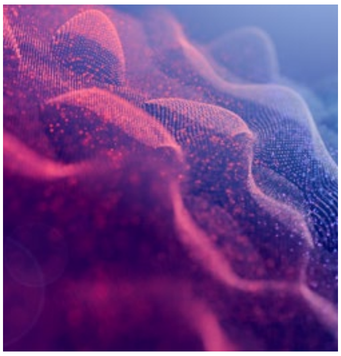
Carbon market mechanisms and COP26





Overview

The Paris Agreement, adopted by 196 Parties at COP21 in Paris, aims to limit global warming to below 2, preferably to 1.5, degrees Celsius compared to pre-industrial levels. The Paris Agreement included a number of methods and goals for achieving this target. In particular, Article 6 contains three carbon pricing mechanisms, two of which are market-based (see below).

However, the Paris Agreement does not contain detailed rules regarding the operation of these carbon pricing mechanisms. Despite discussions at subsequent COPs, the Parties have yet to reach agreement in relation to a number of key issues, meaning a final 'rulebook' for these mechanisms has not yet been established.

If agreement is reached regarding these issues at COP26, businesses may be impacted in a number of ways. Some businesses may experience a difference in the cost of their compliance with carbon market regimes, whilst other businesses may see their competitiveness affected by a harmonised carbon price. For further on these potential impacts, please see below.

Carbon pricing mechanisms under Article 6 of the Paris Agreement

Outline of the carbon pricing mechanisms

Article 6 provides for three carbon pricing mechanisms, each of which are explained below.

1. Voluntary bilateral arrangements

Under Article 6.2 State Parties can reach bilateral agreements, pursuant to which emission reductions achieved in a Country A could be transferred to a Country B and count towards Country B's Nationally Determined Contribution (**NDCs**). For more information on NDCs, please see our NDC post here.

This mechanism would require a transparent process with accurate accounting of emission reductions in order to avoid double counting (ie to prevent the same reduction counting towards both Country A and Country B's NDCs). Commentators have noted that although this mechanism may potentially provide a more flexible approach, it is also likely to be less transparent than the mechanism implemented under Article 6.4.

2. An international carbon market

Article 6.4 aims to create an international carbon market, the 'Sustainable Development Mechanism', which would be supervised by a body designated by the Conference of the Parties. Under this mechanism, which would replace the Clean Development Mechanism (**CDM**) under the Kyoto Protocol 1997, both States and private actors would be able to trade emissions reductions.

The Paris Agreement does not provide any details regarding the proposed form or operation of such a carbon market. This will be agreed by the Parties in the rules and modalities to be adopted. It is likely that the Parties will aim to ensure that standardised procedures are adopted in the design, implementation and verification of emission reduction activities.

3. Non-market-based approach

Article 6.8 provides for a framework for co-operation which is not based on a market mechanism, but would instead be designed to cover other forms of assistance which would target "mitigation, adaptation, finance, technology transfer and capacity-building". This may include cooperation on climate policy, fiscal measures (such as a carbon price) or similar activities to those under Articles 6.2 and 6.4 but without trading. The 'rulebook' for the carbon pricing mechanisms will determine how this non-market-based approach will operate in practice and how it will interface with the market based approaches.

Outstanding issues to be discussed at COP26

A consensus of the Parties is required in order to adopt the rules and procedures that are necessary to implement the above mechanisms in Article 6 of the Paris Agreement. However, there are a number of issues which have proven to be obstacles to reaching this consensus; these will need to be resolved before the 'rulebook' can be agreed and the mechanisms under Article 6 can be implemented.

Structure of an international carbon market

The first issue which will need to be addressed by the Parties concerns the underlying structure of the international carbon market under Article 6.4. As of September 2021, there are 64 carbon pricing initiatives in place around the world. Differences in the structure and operation of these has created a patchwork of carbon pricing regimes. This has created significant differences in the prices paid for carbon. For example, the price of carbon in the UK under the UK ETS has reached over £50 per ton, whilst in the EU it has reached over €57 per ton under the EU ETS. However, the closing price of carbon in China on the first day of trading (16 July 2021) was reported as USD 7.89 per ton.

It has not yet been decided whether an entirely new carbon trading mechanism will be created, or whether an existing regime will be expanded. It is also yet to be decided whether the international carbon market will apply globally, or whether regional variations will be permitted. In light of the significant differences which currently exist between different carbon market regimes, it seems that it would be difficult to reach the consensus that would be required to expand an existing regime. Some Parties have also voiced concerns that the requirement for a consensus of the Parties may lead to the creation and implementation of a less onerous or effective carbon pricing regime.

Features of an international carbon market

Another issue which would need to be resolved relates to the use of credits generated under the Kyoto Protocol. The CDM, established by the Kyoto Protocol, allowed a country to earn a tradeable certified emission reduction credit (which counted towards Kyoto targets) by implementing an emission reduction project in a developing country. A number of countries, including Brazil and India, want to be able to trade these credits on the new market established under the Paris Agreement. However, this suggestion has been resisted by other Parties due to concerns that this may undermine the global effort to curb emissions.

Questions have also been raised regarding how the double counting of emission reductions can be avoided. It has been suggested that a 'corresponding adjustment' may resolve this issue (ie a country that sold its credits would need to increase its reported emissions by the same amount). However, although the majority of Parties agree that emission reductions cannot be claimed by both the country who sold the credit and the country who purchased it, some Parties have resisted this proposal.

Moreover, a share of the proceeds from the carbon market mechanisms must be provided to developing countries in order to assist with the adaptation to climate impacts. However, it has not yet been decided whether this requirement will only apply to proceeds from the Sustainable Development Mechanism (Article 6.4), or whether it will apply to all proceeds from carbon trading (Articles 6.2 and 6.4) under the Paris Agreement.

Potential impacts of Article 6 mechanisms on businesses

Cost of compliance

For businesses currently subject to more than one carbon pricing regime, the implementation of the mechanisms under Article 6 may reduce the cost of compliance:

- the voluntary bilateral mechanism under Article 6.2 may facilitate the linking of carbon pricing systems (as is already the case with the EU and the Swiss Emissions Trading Schemes (**ETS**)). This may reduce the compliance requirements a business is subject to, which may therefore reduce the cost of compliance with carbon pricing or emissions trading schemes; and
- the international carbon market under Article 6.4 may standardise the carbon pricing process. Currently, even where the underlying scope and requirements of systems are similar (eg the UK ETS and the EU ETS – for further information on these ETS, please see our previous post here), businesses must comply with each system separately which increases the compliance burden on businesses subject to multiple regimes. Further, different regimes are designed differently. For example, the UK ETS and EU ETS are based on absolute emissions, whereas the recently launched Chinese ETS is based on the intensity of emissions. An international carbon market with common standards and approaches would ameliorate this issue.

However, for businesses who are not currently subject to carbon pricing regimes, or who are subject to less onerous emissions reporting requirements, the cost of compliance with these new carbon pricing mechanisms may increase. This may be the case particularly under an international carbon market, which would require the measuring, reporting and verification of emissions: some businesses may not currently be subject to similar requirements.

Harmonisation of carbon prices

As discussed above, the current patchwork of carbon pricing regimes has created significant differences in carbon prices across the globe, Businesses which are subject to certain carbon pricing regimes may therefore be less competitive than businesses which are not subject to carbon pricing.

Although measures are currently being designed to redress this (for example, the European Parliament has approved the implementation of a Carbon Border Adjustment Mechanism – for further information on this, please see our post on the draft regulation here), an international carbon market, and therefore a harmonised carbon price, could help to create a level playing field. This may increase the competitiveness of businesses impacted by national and regional carbon regimes.

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