IETA Input to the Article 6.4 Supervisory Body

Requirements for the Development and Assessment of Mechanism Methodologies

August 2023

INTRODUCTION

The International Emissions Trading Association (IETA) appreciates the efforts of the UNFCCC Secretariat, Parties, the Article 6.4 Supervisory Body (A6.4 SB), Observer Organizations and Non-party stakeholders in operationalising the Article 6.4 mechanism.

We welcome the structured public consultation on requirements for the development and assessment of mechanism methodologies, as requested by the Supervisory Body at its sixth meeting (SB006 meeting report, paragraph 19).

IETA's input focuses on section 4.8 "Approaches for downward adjustment and to address elements of paragraph 33 of the RMP" of the Version 05.0 of the Draft recommendation on Requirements for the development and assessment of mechanism methodologies[1].

IETA believes it is of utmost importance to make the Article 6.4 mechanism an attractive crediting mechanism for market participants; or project developers may decide to utilise other national programmes and independent crediting standards. Some of the options currently considered in the requirements seem overly restrictive, including the top-down application of baseline contraction factors, which may have uncertain impacts on the market. Limited participation may result from overly complicated requirements for the development of methodologies. This, in turn, could ultimately impede the mechanism's effectiveness in delivering emission reductions and removals, thereby hindering progress towards sustainable development and the achievement of Paris Agreement targets.

IETA's input is structured around five sections: General comments on approaches for downward adjustment; Investment risks arising from the application of BCF; Policy risks and perverse incentives from top-down/bottom-up BCF; Overarching or activity specific baselines; Equitable sharing of mitigation benefits.

1. GENERAL COMMENTS ON APPROACHES FOR DOWNWARD ADJUSTEMENT

IETA takes note of the different proposals of approaches for downward adjustment outlined in the public consultation for addressing para 33-39 of the RMPs, including the necessity for mechanism methodologies to encourage ambition over time, align with the long-term temperature goal of the Paris Agreement and be real, transparent, conservative, credible and below 'business as usual'. We recognise the efforts by the SB and UNFCCC Secretariat to lay out different options for operationalising these provisions, including through various application of baseline contraction factors (BCF).

[1] A6.4-SB007-AA-A##
Draft recommendation: Requirements for the development and assessment of mechanism methodologies Version 05.0 (link)

Additionally, we take note of the initial efforts to analyze the impacts of different options for BCFs as well as alternative or complimentary measures for BCFs[2]. Thereby, we stress the importance in further considering and analysing the impact of the various options may have on the development of the Article 6.4 mechanism before moving to conclusions.

For some in the carbon markets community, it seems that a 'Paris-aligned' baseline needs to contain all the mitigation already encompassed within a net-zero aligned NDC of the host Party. Such an approach would, however, severely limit the potential of the mechanism to deliver emission reductions and removal at scale and speed. We believe that "net-zero" alignment legitimately includes cooperation with other Parties to achieve the "net" mitigation. While IETA recognises that the market-based mechanisms of Article 6 must increase ambition in mitigation and adaption, **it is the purpose of the mechanism to enable Parties to both achieve their Nationally Determined Contributions (NDCs) and deliver more mitigation.** In the case of achievement, to ensure integrity and ambition, it is imperative that the baseline is set such that the relationship between the activity and the fulfilment of the NDC is clear.

Current options presented for operationalising BCF under the 6.4 mechanism have limited or no prior experience of being applied in other crediting schemes, and may pose significant risks to the market if not adequately studied. This includes their impact on the attractiveness of the Article 6.4 mechanism, the investments risks, technology risks, interaction with host-party policies, NDCs and LT-LEDS, equitable sharing of benefits and risks of creating perverse incentives. These risks are discussed further in the following sections.

2. INVESTMENT RISKS ARISING FROM THE APPLICATION OF BCF

To ensure a scaled-up Article 6.4 mechanism that can deliver on its dual objectives of supporting Parties' NDC achievement and raising ambition, it is of utmost importance that the investment environment be predictable and avoids volatility for project developers and investors. The functioning of any BCF across the entire crediting period must be clear, ex ante, prior to the start of a project activity. Proponents need a clear understanding of the full future credit stream arising from an activity before moving forward; even the slightest perceived risk of retroactive changes to the amounts of credits that could be awarded in the future will negatively impact upon investment decision-making today. As such, any baseline stringency should either be done at the beginning of a new crediting period or be pre-determined at the beginning of the project. If baseline reviews take place, these should be at **predictable time intervals**. For projects with large upfront investment costs and long payback periods, ensuring clarity on the baseline review cycle would be especially important.

Any uncertainty when it comes to the predictability of BCF updates would also risk spilling over into issues around the demonstration of financial additionality. For example, if the downward adjustment over time is uncertain, the project developer would not be able to quantify and value the future credit stream. On this note, para. 38 of the RMPs requires that *"Additionality […] be demonstrated using a robust assessment that shows the activity would not have occurred in the absence of the incentives from the mechanism…"*. This requirement could be challenged if a BCF is subject to future ex post adjustment.

[2] *Concept note : Proposals and options to operationalize baseline contraction factor, avoid 'lock-in levels of emissions' and address leakage in the draft recommendation on requirements for the development and assessment of mechanism methodologies,* Appendix 7 (link)

3. POLICY RISKS AND PERVERSE INCENTIVES FROM TOP-DOWN/BOTTOM-UP BCF

Adopting a bottom-up approach in which 6.4 mechanism baselines align with NDCs requires flexibility, considering that the number of situations in which diverse, unconditional NDC targets or national levels (sometimes determined through a top-down process), can easily be translated into project-level baselines are infrequent. When utilizing jurisdictional BCF approaches intended to align with the host-country NDC, a potential perverse incentive arises. These approaches might lead host countries to artificially increase their BAU scenario, countering the impact of any BCF. This counteraction could inadvertently foster less ambitious NDCs to deliver increased credit flows. However, this option would still be preferred over the development of top-down BCF which is likely to present several further issues.

The option of a top-down development of BCF using IPCC IMPs (or other scientific pathways) to create coefficients applicable to countries, sectors or activity types seems to go against the principles of the Paris Agreement of national circumstances and common but differentiated responsibilities (CBDR). It is outlined that for Parties without net-zero targets, the SB could propose pathways. We find it difficult to see how such a process could be seen as equitable, especially considering the special circumstances of least-developed countries and small island developing states. This option seems to assume that Parties have not made an appropriate level of quantitative analysis for their future emissions development and mitigation actions in their NDC and/or LT-LEDS, or that the SB would be in a better position to develop such pathways than the host country. This provision seems to go against the bottom-up nature of the Paris Agreement and host country prerogatives.

4. OVERARCHING OR ACTIVITY SPECIFIC BASELINES

On whether the stringency over time should be in the form of an adjustment to the emission reductions achieved through all sectors and countries, or whether it should be specific to different types of activities and methodologies, IETA believes that the best approach should differentiate between activity types, sectors, and regions under consideration. In the context of removal activities such as BECCS/DACCS, as well as nature-based climate solutions, the application of forward-looking baseline contraction factors may erode the financial incentives and thereby limit the economic attractiveness of investing in these projects. Considering that in the absence of other sources of revenue, the only economic case for undertaking these climate solutions is typically the carbon revenue, the application of a BCF for such projects could have a detrimental impact on our ability to reach global net-zero targets. It would, therefore, be important to have an activity-based approach or flexibility with multiple options for project developers to apply any BCF depending on, for example, their baseline approach, activity type and local circumstances. Baseline contraction factors can be a helpful tool, but they are unlikely to be the most suitable approach for all methodologies or baseline approaches indicated in para 44 of the Draft recommendation on Requirements for the development and assessment of mechanism methodologies[3]. When applying an approach based on existing actual or historical emissions adjusted downwards, it would be important to have multiple options for downward adjustment depending on activity types and local circumstances.

The qualitative approach (Option 2) of *"Demonstrating that activities eligible under the methodologies are transformative to enable deep decarbonisation aligned with IPCC's IMPs, i.e. have the potential to*

[3] A6.4-SB007-AA-A##
Draft recommendation: Requirements for the development and assessment of mechanism methodologies Version 05.0 (link)

transform an entire sector to low carbon option, as opposed to producing incremental improvements" seems to be overly limiting the types of activities that could be eligible under the Article 6.4 mechanism, and could have a severely negative impact on the market. If an activity has successfully demonstrated additionality, it should be eligible, as it would per definition deliver emission reductions that would otherwise not have taken place in the absence of the mechanism. Limiting the mechanism to only consider 'transformative' projects could be seen as counterproductive to one of the key objectives of the mechanism, namely: supporting the cooperative achievement of Parties' current NDCs. An expanded user base of low-carbon solutions after initial deployment supported by carbon markets is also one of the critical ways to encourage ambition over time.

Promoting specific activities (through a so-called positive list) through simplified regulatory requirements and fast-track processes could reduce barriers for certain technologies and regions. However, it could also skew market incentives, and establishing criteria to determine such a list of activities may be challenging. In addition, when assessing "lock-in" levels, it is important to be pragmatic, as by definition, any project that generates residual emissions would lock-in some emissions. Instead of promoting positive or negative lists, a broader assessment – focused on how the activity promotes low-emission and sustainable development pathways aligned with long-term goals of the Paris Agreement - should be conducted. Great caution should be exercised if attempting to establish a global negative list mentioned in para 91, considering the vast differences in Parties' NDCs and their unique national circumstances.

5. EQUITABLE SHARING OF MITIGATION BENEFITS

We believe that the 6.4 mechanism contributes to the **equitable sharing of mitigation benefits between participating Parties by design**, thanks to its short-crediting periods, strict methodological requirements, and host country approval plus the authorisation process for ITMOs. In addition, the mandatory cancellation of credits towards the Overall Mitigation in Global Emissions (OMGE) and the Share of Proceeds (SoP) towards adaptation further strengthens this aspect. Further credit sharing arrangements may be considered by Designated National Authorities (DNAs), but we caution against excessive "haircuts" that may undermine the economic viability of projects and/or the competitiveness of the Article 6.4 mechanism in relation to other crediting programmes.

Application of a BCF that reflects host Party preferences with regards to retaining certain shares of emissions reductions would add another layer of complexity and uncertainty for project developers, further hampering the scale and speed of the mechanism to contribute to additional mitigation activities. Ensuring capacity building regarding authorisation of ITMOs and low barriers of access to the mechanism is crucial, especially for least-developed countries and small island developing states facing special circumstances. This will be the most crucial aspect in delivering on this provision. In our view, neither option for application of baseline contraction factors should therefore be targeted in order to address the equitable sharing of mitigation benefits.

6. CONCLUSION

Before deciding on one or the other of existing options for addressing the provisions in para 33-39 in the RMPs, for example through the application of BCF, the SB should outline clear scenarios for how options, when applied with various factors, would impact the stream of credits towards project developers over the full lifetime of different types of projects. This analysis should also include an assessment of potential impacts on host Party NDCs and project participants' willingness to invest in additional mitigation projects.

Ultimately, the Article 6.4 mechanism will not, through severely limiting the amount of crediting from project activities, be the policy tool that brings us towards net-zero in a timely manner. This is ultimately determined by the ambition in Parties' NDCs. Just like any other crediting mechanism, the Article 6.4 mechanism needs to ensure that credits represent emission reductions or removals that are real, verifiable and additional. However, in the end, it will be up to each Party to the Paris Agreement to deliver increasing ambition over time, ensure avoidance of lock-in to emissions intensive practices and the achievement of NDCs and LT-LEDS through the built-in ratchet mechanism of the Agreement.

Whilst the various options for implementing BCF in the 6.4 mechanism represent some interesting conceptual alternatives that could ultimately help achieve this, it is not the only, nor necessarily preferable, manner of raising ambition. As highlighted in previous submissions, *"the Article 6.4 mechanism is not in itself the driver of ambition, since that comes from the progression in NDC ambition over time".*[4]

ABOUT IETA

IETA is a non-profit business organisation with a membership of over 300 leading international organisations operating in compliance and voluntary carbon markets. Since its foundation in 1999, IETA has been the leading voice of business on market-based ambitious solutions to climate change. We are a trusted adviser to governments to support them build international policy and market frameworks to reduce greenhouse gases at lowest cost, increase ambition, and build a credible path to net-zero emissions. See www.ieta.org for more information.

IETA and its members look forward to further engaging with the Secretariat on these topics. Do not hesitate to contact Björn Fondén (fonden@ieta.org), Pedro Venzon (venzon@ieta.org) or Andrea Bonzanni (bonzanni@ieta.org) if you would like to discuss further.

[4] *Luca Lo Re, et. al. (2019), "Designing the Article 6.4 mechanism: assessing selected baseline approaches and their implications",* Climate Change Expert Group Paper No. 2019(5) (link)