Provisions for Markets in the 2015 Climate Change Agreement

Briefing Paper by Andrei Marcu

This paper outlines provisions that seem necessary for the 2015 Paris Climate Change Agreement to ensure that an international GHG market for compliance with commitments under the INDCs is available to Parties as a tool they may choose to use.

- Two approaches, or possible outcomes in Paris, are elaborated below:
  - **A General Option** that would allow for the elaboration of detailed modalities and procedures. Such an outcome would imply a significant negotiating effort post-Paris, and a longer period before a 2.0 GHG market for international compliance may emerge;
  - **Detailed Provisions**, which would provide a clearer indication of the direction Parties wish to move in and allow for a more rapid emergence of markets for compliance with international obligations under the UNFCCC.

Background

- In recent years carbon pricing has played an important role in advancing work to address the challenge of global warming.
- In spite of their imperfections, the two most important components have been the domestic markets created as part of efforts to meet commitments under the Kyoto Protocol (KP), such as the EU ETS, as well as the voluntary domestic commitments in Japan; and the UNFCCC market mechanisms (the Clean Development Mechanism (CDM), Joint Implementation (JI)). These components created a considerable number of credits and led to a world-wide movement, whose long-term importance cannot be over-emphasised.
- As part of the negotiation of a new post-2020 global climate change agreement, the role and architecture of markets has been re-opened, as has the role that the UNFCCC and the COP can and should play in the creation and running of an international GHG market.

Assumptions

- A few observations/assumptions on the future are needed in this discussion:
Carbon pricing will take different forms and the role of the international agreement should primarily be to provide the international tools, framework and infrastructure to integrate different approaches and initiatives towards accounting for international compliance.

Units in international markets will emerge from:
- International approaches run by the COP (e.g. a CDM-like protocol)
- Markets and mechanisms that will emerge at the domestic level (e.g. EU ETS, California ETS, etc.)

Units will be created from:
- Cap-and-trade systems (will issue allowances)
- Baseline-and credit mechanisms (e.g. CDM, domestic offsets under Article 24a of the EU ETS Directive)

Parties will have commitments under their INDCs that will take the form of:
- Economy-wide caps (EWC) similar to Annex 1 Parties under the KP, which can be put in a budget form
- Other types of commitments that cannot be put in a budget form.

Provisions

- It is unlikely, and probably undesirable, that detailed provisions on GHG markets are included in a future Paris agreement. There is no time to go into the details seen in the Marrakesh Accords. Furthermore, markets require flexibility and the ability to adapt, which should not imply demanding processes such as those needed to amend a global climate change agreement every time a change is required.
- Consequently, the provisions that need to appear in the Paris agreement should be general in nature and allow for the development of more detailed modalities and procedures in COP decisions. However, depending on the circumstances, two levels of provisions may be envisaged.

General Provision
- This will require significantly more work after Paris and could lead to hard negotiations on its interpretation, and as such create more uncertainty and delay the creation of a new generation of international markets (Markets 2.0).
- Such a provision could simply state that Parties will develop cooperative approaches to meet the commitments in the INDC. Such a provision would find support in the UNFCCC Article 3.3 and would allow for the further development of markets post-Paris.

Detailed Provisions
A number of provisions define ‘hooks’ that would provide the main elements needed to develop an international GHG markets for UNFCCC compliance. The pros and cons of including such provisions are outlined below.

- **Provision 1: Principles of international GHG markets**
  Such a provision would include certain principles that would provide guidance in developing modalities and procedures post-COP 21. They should be well defined and understood. They could include, but are not limited to:
  - No double counting
  - Net mitigation, but with a clear definition
• Technology neutrality
• Both emissions and removals should be accounted for
• Recognise the sustainable development priorities of Parties
• Etc.

Provision 2: International cooperative approaches.
To meet compliance obligations with their INDCs, Parties may cooperate internationally, including by transferring emissions reductions. This should make reference to Article 3.3 of the UNFCCC, and would be similar to Articles 3.10 to 3.12 of the KP. It would also allow for the creation by the UNFCCC of market infrastructure, such as an international registry that Parties may choose to use in the absence of developing national ones.

**Why it should be included:**
- There is a precedent for including such a provision under the KP
- Some Parties seem to believe that legal opinion supports the need to include such a provision.
- It will eliminate regulatory uncertainty that would prevent the rapid engagement of market actors.
- No provision may imply that the use of any units, without conditions, is possible to meet INDC commitments.

**Why it should NOT be included:**
- If it is not specifically forbidden, it is allowed.
- Will require some (even if simple, e.g. Art 17 of KP) conditionality.
- Agreement on such conditionality may prove impossible to reach post-Paris, effectively blocking the development of a carbon market for international compliance.

• Provision 3: Allow Parties with EWC, and which meet certain conditionality, to transfer reduction units.
Similar to Article 17 of the KP. Such a provision may not be necessary, and be submerged in Provision 2. It would be a more precise elaboration of Provision 2.

**Why it should be included:**
- Would provide clarity under what conditions Parties with ECW can transfer reduction units among themselves.
- Could help to create liquidity in inter-Party transactions if it refers to a specific type of unit that can be transferred at the Party level (e.g. a newly minted International Compliance Unit) that Parties can issue, backed by its inventory.
- May help create an accounting framework to link domestic ETS.

**Why it should NOT be included:**
- Trading international units at the Party level has not been liquid at the KP level – is it needed, or a simple complication?
- May create an expectation for the elaboration of new ICUs, which many Parties may resist, seeing a parallel to AAUs (even if unfounded).

• Provision 4: Definition of international baseline-and-credit mechanism, operated by the COP (e.g. as referred to in the Geneva ADP text as CDM+). There could be one or more such mechanisms (e.g. CDM+, REDD+, etc.).
• Such a mechanism could be
  o Used by all Parties, with different levels of international oversight (i.e. merging CDM and JI) and be usable, if desired by a Party, as a protocol for domestic offsets.
  o Parties could be allowed to use the whole protocol or parts of it, under certain conditionality.
  o Would have improved Modalities and Procedures, compared to the current CDM, but include such features as a Share of Proceeds, CDM EB, etc.

**Why it should be included:**
  o Parties are used to having such a mechanism available and there seems to be demand for the continuation of the CDM.
  o Some Parties may not wish, or may not have the capacity, to develop domestic approaches and would welcome the continued availability of such a tool.
  o On the demand side, some Parties and domestic compliance installations may welcome the option of having access to a UNFCCC-operated mechanism, including for reputational reasons.

• **Provision 5: Provide for the future definition by the COP of a protocol to validate domestically created units, transferred internationally**, to be used to meet INDC commitments.
  o Such a provision may be important to Parties that are developing market mechanisms that they intend to use bilaterally, or in a small multilateral ‘club’. The Bilateral Offset Credit Mechanism (BOCM) that Japan is currently developing with other Parties is an illustration of such an approach.

**Why it should be included:**
  o Will reinforce the bottom-up nature of the Paris agreement.
  o Will allow for the recognition of a variety approaches and encourages mitigation approaches.

**Why it should NOT be included:**
  o It may not be needed, as Parties that do not have EWC are more likely to use a UNFCCC mechanism as defined in Provision 3 above. In addition, over time, such provision may become unnecessary, as market approaches will converge.
  o Defining such a protocol will be a difficult, if not impossible, negotiation.
  o Operationalising such a protocol would be demanding, since it will imply passing judgement on markets set up domestically by Parties.

One approach that some stakeholders seem to favour for the post-2020 carbon market is the creation of a ‘trading club’ within the confines of a limited number of Parties to the agreement. The idea that a provision or hook should be included has been mentioned in informal discussions.

While such an idea may or may not be challengeable under the WTO, the fact is that under the UNFCCC, unless specifically forbidden, there is little that Parties could do to prevent the formation of such a ‘trading club’, as long as the accounting is synchronised.