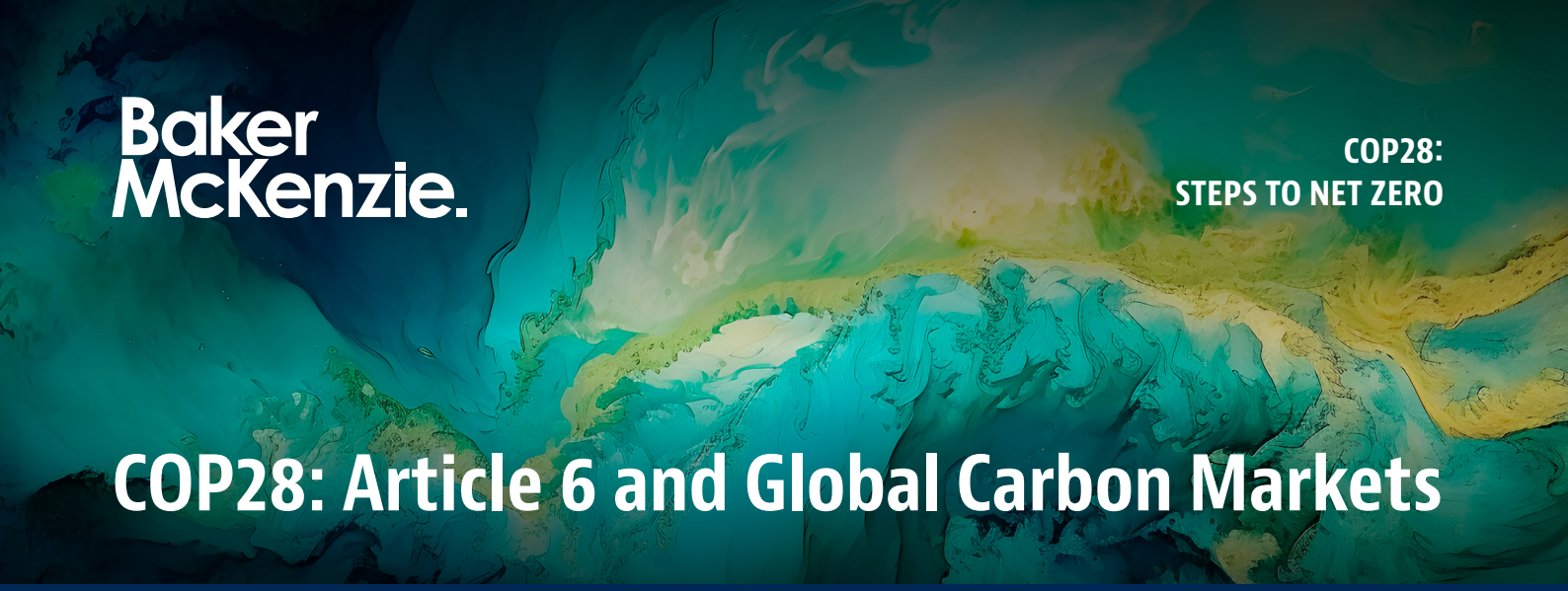

Baker McKenzie.

COP28:
STEPS TO NET ZERO

COP28: Article 6 and Global Carbon Markets

Following the establishment of the Article 6 Rules at COP26 in Glasgow, a number of countries have entered into, or are contemplating, party-to-party transactions with respect to internationally transferred mitigation outcomes under Article 6.2 of the Paris Agreement. Meanwhile, more work is needed at COP28 to finalise the technical and administrative architecture to operationalise the Article 6.4 mechanism, which could provide the platform for a global carbon market.

Carbon markets have been in existence for more than 20 years. Having advised on carbon credit transactions since their inception, we have seen carbon markets experience both significant growth and challenges. The introduction (and subsequent phasing out) of the Clean Development Mechanism (**CDM**) under the Kyoto Protocol, and the development of voluntary carbon markets, have built a deep and varied pool of experience for participants and stakeholders – both positive and negative.

A new phase for carbon markets is on the horizon as the framework for new markets under the Paris Agreement move to implementation.

These markets will be based on the overarching rules for Article 6 finalised at COP26 in Glasgow (the **Article 6 Rules**). Pursuant to the Article 6 Rules, countries may undertake cooperative approaches to pursue higher ambition to achieve Nationally Determined Contribution (**NDC**) targets and the global temperature goals under the Paris Agreement. The current Article 6 Rules enable countries and the private sector to begin actively engaging with activities under Article 6.2 and prepare for engagement with Article 6.4.

Article 6.2

Article 6.2 is best described as an accounting framework that enables internationally transferred mitigation outcomes (**ITMOs**) generated in Country A to be transferred to Country B, and ensures that such ITMOs are only counted towards Country B's NDC. That said, country A may also elect for ITMOs to be used for Other International Mitigation Purposes (such as for offsetting emission under aviation sector CORSIA obligations) (**OIMPs**). Private sector organisations may be responsible for, and play a leading role in, delivering the underlying mitigation activities or programmes subject to the relevant host country designing their domestic arrangements to allow for this.

While the architecture for an international registry has not been finalised, Article 6.2 transactions can be entered into because they are not governed by a centralised UN body. This flexibility has underpinned various pilot initiatives between countries that are moving to implementation (some of which we have advised on). Over time, we expect the reporting and technical review processes under Article 6.2 will start to create expectations around the quality of the design of mitigation activities under Article 6.2.

Whilst there are sufficient rules in place to enable Article 6.2 initiatives to commence, there remain issues for COP28. One key issue is the process for authorization for Article 6.2 activities, particularly whether there is to be scope for changes to the authorization issued to ITMOs regarding their use and participating entities.

Article 6.4

Among the key issues at COP28 will be the continued attempts to resolve important design issues that, if resolved, could unlock the rapid implementation of the Article 6.4 mitigation mechanism. Article 6.4 sets out principles for the establishment of a centralised UNFCCC crediting mechanism governed by a Supervisory Body. The Article 6.4 mechanism would enable mitigation outcomes to be generated pursuant to methodologies approved by the Supervisory Body (**A6.4ERs**), being classified as either:

1. **authorized A6.4ERs**: which may be used towards NDCs or OIMPs (which would thereby require the host country to make a 'corresponding adjustment' to their NDC target); or
2. **mitigation contribution A6.4ERs**: if not so authorised, may be used, "inter alia", for results-based climate finance, domestic mitigation pricing schemes or domestic price-based measures, for the purpose of contributing to reduction of emissions in the host country (which would not require a corresponding adjustment to the host country NDC).

The Article 6.4 mechanism cannot be fully operational until the rules, modalities, and procedures of the mechanism are in place. The Supervisory Body has been working over the last year to push forward on elements that will then need to be approved by the countries at COP28. Key elements that were a point of contention, although did not progress at COP27 and have been a focus of efforts throughout 2023 relate primarily to methodological guidance for the Article 6.4 mechanism.

Firstly, what methodological principles should govern removals (i.e., where carbon dioxide is stored by natural or technological means) is an important issue. This was hotly debated at COP27 and reflects wider market discussions around the best approaches to managing issues such as the permanence of removals. Further negotiations have continued throughout this year, with the Supervisory Board making progress in September on narrowing the issues to be finalised in the run-up to COP28. This work has included a significant amount of public consultation with carbon market participants.

Secondly, what principles should inform the development and assessment of the Article 6.4 mechanism methodologies, such as appropriate approaches to baselines and additionality tests, will underpin negotiations. Baselines are critical to the level of credits that can be generated and a particularly fraught discussion across the sector, with a close focus on the tension between integrity and practicality. Similarly, additionality considers how to determine whether an activity should be eligible as one which would not occur without the support and registration under Article 6.4.

These are not the only issues. Others include whether or not emissions avoidance activities and conservation enhancement activities (such as REDD+ projects) should be permitted to generate A6.4ERs under the mechanism. However, we are confident that there will be progress this year. Based on our discussions with stakeholders, participants are motivated to not allow more time to slip. However, the challenge (as occurred with CDM rules) is to reach clear decisions that have sufficient detail to enable the Supervisory Board to move forward.

Considerations for carbon market participants

The implementation of the Article 6 Rules and a subsequent transition to global carbon markets could create significant investment opportunities for the private sector. Well-designed implementation could unlock climate finance for large scale mitigation investments, particularly for the implementation of game-changing technology across key emissions intensive sectors within developing countries. However, success will not just rely on Article 6 rules being finalised but countries creating demand for mitigation outcomes. By way of example, the rapid growth of the CDM under the Kyoto Protocol was tied to the EU creating demand through its emissions trading system. Whether such schemes facilitate the Article 6 carbon markets may depend on the integration of the Article 6 with domestic and regional carbon markets and initiatives.

As we progress through a transition phase to global carbon markets linked through Article 6 mechanisms, the current core of demand for mitigation outcomes remains the voluntary sector. Despite critiques to the contrary, there are strong arguments that the voluntary sector remains a critical tool for delivering mitigation outcomes that are robust and grounded in integrity. This is demonstrated through the continued evolution of leading standards (such as under Verra and the Gold Standard) and the release of Integrity Council for Voluntary Carbon Market's Core Carbon Principles and Assessment Framework (supply-side) and Voluntary Carbon Markets Integrity Initiative's Claims Code of Practice (demand-side).

In coming years, investors and corporates with voluntary commitments will need to navigate an evolving market where the manner in which host countries regulate greenhouse gas emission reduction and removal projects comes to the fore. With the continued relevance of voluntary standards meeting integrity expectations, it is our hope that an increasing number of host countries realise that creating the investment conditions for both voluntary sector projects and Article 6 initiatives will create the conditions for increased climate finance through carbon markets. We are seeing examples of this approach occurring, as well as less well-thought out approaches.

Beyond the continued work on Article 6, each COP is an opportunity for multiple stakeholders to come together and share views on approaches that work for all. As has been the case for many years, the Baker McKenzie team will be on the ground to help those discussions occur.

With a long-standing history of participation and involvement at COP events, Baker McKenzie is leading on the development of both international and domestic climate change markets and climate finance. As the only law firm ranked Band 1 – Climate Change Global Market Leaders Chambers for 15 consecutive years, we have unrivalled knowledge and expertise in climate change law and climate finance.

We are currently engaged on multiple levels advising governments, companies and other entities on the implementation of the Paris Agreement, emerging compliance and disclosure regimes and innovative approaches to carbon markets and climate finance transactions. Our team will be on the ground in Dubai for COP28 and look forward to engaging in ground-breaking discussions with all key stakeholders to share insights and continue to offer cutting-edge advice to our clients.