

COP26 and the Article 6 rulebook - The impact on carbon markets

One of the most important issues negotiated on the COP26 in Glasgow was the rulebook on the interpretation and implementation of the article 6 in the Paris Agreement. Article 6 regulates “Cooperative approaches” in fulfilling the agreement and it describes how emissions can be reduced by carbon trade and international cooperation. By reaching an agreement on the rulebook, countries and public or private companies would be able to engage in joint climate mitigation activities, provide valuable financial contributions to green development and carbon sinks, such as restoration and protection of forests. Some commentators argue that article 6 is the most important component of the Paris Agreement since it provides both a system and an incentive for global climate cooperation.

Short introduction to Article 6

The Paris Agreement requires parties to regularly report National Determined Contributions (NDC) in which they need to present the efforts they are to undertake to limit the warming of global average temperature to well below 2°C above pre-industrial levels. In reaching the pledges set in their NDCs, they can anticipate the usage of voluntary cooperation under article 6.

Article 6 foresees three different mechanisms for voluntary cooperation: two market-based and one non-market approach. Article 6 is essential as it motivates countries to cooperate in their efforts to reduce emissions and since it can unlock financial flows from developed to developing countries. It is regulated in nine paragraphs (6.1-6.9) and the technical interpretation of these articles are spelled out in a rulebook that was almost fully completed in COP26 Glasgow.

Article 6.2 enables country-to-country transfers or trade of “internationally traded mitigation outcomes” (ITMOs), which can be used in fulfilling the NDC. One country can for instance invest in renewable energy or plant trees in another country and claim these reductions in their NDC. The general idea is that a country that has accomplished its NDC-pledges, may sell credits to another nation that has fallen short against its own goals.

According to article 6.4. an international carbon trading market should be set up under the supervision of a UN body. This second trading mechanism could be used by countries or public or private enterprises to offset emissions. Article 6 is in these respects partly a continuation of the Clean Development Mechanism, which operated under the Kyoto Protocol, however the regulation under the Paris Agreement is wider and more complex as it encompasses both activities of individual nations and private companies and since it correlates with the NDC-pledges.

Finally, article 6.8. prescribes a non-market approach according to which one country can support another by “mitigation, adaptation, finance, technology transfer and capacity building”. This could be done by micro loans, aid or other types of direct financing. Article 6 is partly overlapping article 5 on compensation on restoration or preservation of forests (REDD+), article 9 on financing and article 11 on capacity building.

What was discussed in Glasgow?

Article 6 entered the Paris Agreement at a late stage of the negotiations and attempts to reach an agreement on the rulebook have been on going ever since. The article 6 regulations are rather complex and different countries have conflicting interests. It has particularly been difficult to satisfy rainforest

countries, such as Brazil, and some other credit receiving countries (India), as they have been unwilling to adopt stricter reporting rules. Nevertheless, in Glasgow the rulebook was nearly finalised, which many see as a success, partly because of the more pragmatic and flexible approach of Brazil and by the help of some frontrunning projects, facilitating the negotiations.

The main issues that had to be decided upon in Glasgow were the issues of double-counting (or double-claiming) and corresponding adjustments, thus the need to prevent that both the offsetting and selling party would claim the emission reduction in their NDCs. This is also related to the issues of transparency and supervision. Moreover, ensuring environmental integrity and additionality was important, seeing to it that certified projects were not such that would have been undertaken irrespective of article 6 contribution. Another difficult issue was the potential transfer of carbon credits issued under the Kyoto system and how to regulate the share of proceeds (further explained below). Finally, several countries, and non-governmental organisations (particularly representing indigenous communities), were requiring that the respect of human right principles would be a requirement in projects authorised under the new system.

What was decided in Glasgow?

Glasgow did indeed achieve success on several key issues. Most importantly, an agreement was reached on how to avoid most of the double-counting. For all certified carbon units traded under 6.4, corresponding adjustments need to be made without exception. This means that when one country transfers or sells emissions reductions to another, it must increase the emissions reductions pledged in its NDC to make up for the fact that it transferred or sold some emissions reductions to another country.

One major problem is that the NDCs are often not compatible for carbon trading since the time-periods of each NDC (annual or stretching over several years) and the pledges (if they are in increase of mwh renewable energy or metric tons co2) varies. There was agreement on a standardising, requiring all units to be quantified in metric tons, yet the reporting periods might still differ.

Other issues also remain unclear, in particular under 6.2. Here corresponding adjustments are not required, and therefore the practice on cooperation needs to be developed. Certain guidelines have been developed by the co-called San Jose principles (an initiative of Costa Rica, Switzerland and a few other likeminded nations), which are backed by a number of ambitious countries and practice will be further developed through bilateral collaboration.

Most importantly, with the agreement made on the rulebook, the UN supervisory body will be established. This institution will hopefully boost the credibility of system by authorizing credits and thereby avoiding some of double counting. It will ensure a certain degree of transparency, environmental integrity and social safeguards. There will be a grievance mechanism, enabling governments and project developers to appeal decisions, which could possibly satisfy some of the human rights concerns.

One another problem is that the agreement will allow approximately 2.8 billion carbon credits to be carried over to from the Kyoto system to the new (projects started from 2013). These so-called “zombie credits” could possibly inflate the market. On the other hand, an agreement was reached on the contested issue of REDD+, which means that credits generated historically from reduced deforestation and forest degradation, under REDD+, would be excluded. Credits from 2021 onwards regarding such projects could be used.

An aspect deemed as a success was the agreement on share of proceeds, requiring at least 5 percent of traded offsets under 6.4 (public and private companies) to be cancelled and transferred to the Adaptation fund and another 2 percent to deliver “overall mitigation”. This percentage is rather limited but was still considered as a positive first step that would make carbon trading less of a zero-sum game and add financial resources. There are no such requirements under 6.2, yet the text say it is “strongly recommended”.

What will the impact of the new rulebook be on carbon markets and climate policies?

The finalisation of the rulebook could help to enhance the credibility of carbon trading and will most likely stimulate and develop the carbon market. Even though the “new” system is not yet up and running, there is an increasing demand for fresh credits, which seem to have had an impact on prices. It is however difficult to say how the market will develop in a short or long-term perspective, although a few general predictions can be drawn, presented beneath.

The market will be formalised, regulated and monitored

One important outcome of the COP26 is the establishment of the UN supervisory body. Once it is up and running, credits will get an “UN stamp”, and these will surely be seen as more reliable than current credits. Establishing this body will thus be of great importance since it will have a role in overseeing the market and making sure that the parties are complying with the rulebook, avoiding double-counting and paying respect to additionality. In Glasgow the parties committed to finalise the establishment of the UN body within two years. The establishment could be facilitated by the transferring of knowledge and experience from the old system, however international cooperation is known to be slow and cumbersome and therefore it will most likely take another 2-3 years before it is fully set up.

With the finalisation of the rulebook and the establishment of the supervisory body, the system of carbon trade will be better regulated. It is possible that this will motivate new actors to start to buy credits, unlocking financial resources. The quality of the projects could be improved, and some commentators claim that it would be easier to hold companies that are frivolously claiming that they are carbon neutral responsible. Also, when the market is formalised, more countries, organisations and companies will be motivated to identify and certify projects, and developers of negative emissions would be able to receive financing.

A unified system, but standard and quality of credits will differ

It is possible that independent carbon trading systems, such as Gold standards and Verra, will enter the UN-system in order to get a UN-label. Prices and quality of the credits will still differ. Currently, prices differ from up to 1000 US\$ per credit for direct air capture, to below 5 US\$ per credit. Prices will properly increase, but the variations will remain. However, it is also likely that other independent systems (possibly Verra) will continue to operate outside of the system issuing uncertified credits.

The impact of zombie credits

The price of carbon credits might be deflated by the influx of “zombie” credits, transferred from the old system. Some commentators claim that this might not have a major impact since these credits might be considered to be of lower quality. Responsible carbon retailers and buyers will hopefully decline these credits and countries buying them named and shamed. Also, some NGOs, such as the crypto currency initiative Klima DAO, have purchased and cancelled credits, in order to remove poor quality products and boost the market, and such initiatives might continue to have an impact on markets.

The demand for credits is unclear

It is difficult to predict how the demand of carbon credits will develop. At least half of all countries, constituting roughly a third of global emissions, include the use of international cooperation through carbon markets. However, some economical powerful countries, such as the US and Canada are envisaging offsets as a method to meet NDC-pledges, while the EU has decided not to offset emissions from 2020 (Sweden is an exception since it has a more ambitious target). On the other hand, petrol and gas producing states such as Saudi Arabia and Qatar as well as Japan, South Korea, Switzerland, Australia and New Zealand are envisaging the usage of article 6 and competition between them might push up the price.

Moreover, several developing countries will try to enter the carbon market, identify projects and certify them for the carbon market. Today, most developing countries have conditional pledges in their NDCs that can only be met if financial resources are added by international contributions or through article 6. In the longer perspective, the supply of credits will increase, but for the time being, there is a shortage of high-quality projects, partly because several developing countries still lack capacity to participate in the trade. Verra and Gold Standard have also decided not to register renewable energy projects outside of the Least Developing Countries, limiting the amount of low-priced credits.

Once the system is formalised, it is likely that an increasing number of private companies will engage in the market and start to offset their emissions. There are however a few reservations. First, the credibility of the market might be affected by the general debate and criticism of carbon offsets. On a shorter time span, this will probably only have a marginal affect on the interest of buying credits. On the other hand, an increasing demand will be generated by CORSIA, the offsetting-system of international aviation that was initiate in 2021, when international air traffic returns to pre-pandemic levels. To summarise, carbon markets are expected to be further developed, and in effect the cost of carbon credits will gradually increase.

Is carbon offsetting contributing to climate actions?

Achieving a functioning global carbon market is a big deal. With a properly designed carbon market, an estimated cost saving of US\$ 250 billion per year could be achieved in 2030, facilitating additional abatement under the Paris Agreement by 5 billion CO₂ per [year](#). The logic of the system is that investment are places in countries were reductions are more cost effective.

However, without a regulated market, the trade might just result in a zero-sum game without actually reducing emissions, and in the worst-case scenario, undermine the Paris agreement as the reported reductions could be highly inflated. Offsets could be used for greenwashing and as an excuse for

business as usual. Carbon offsetting has also been criticised for delaying necessary infrastructure investments in developed countries, for contributing to inefficient and sometimes unethical projects.

On the other hand, there are several studies showing that under well-defined regulations, carbon markets could help to reduce emission in an interim period when green technology is under development and transitions of industrialised countries in progress. Most importantly, carbon markets could be used to finance carbon sinks. According to a study from 2017, protection and restoration of forests and mangroves can deliver a third of the emissions cuts needed by 2030 to avert climate [disaster](#). However, for this to materialise, communities that are protecting and restoring forests needs to be compensated. Resources could be pooled to develop negative emission technology, and as an example, Switzerland has entered a contract under 6.2 cooperation with Iceland, to offset carbon by the usage of direct air capture. Also, studies show that businesses that offset emissions, tend to take their climate commitments [seriously](#).

The finalisation of the article 6 rulebook as well as the establishment of the supervisory body will help to improve and develop carbon markets and in the long run the cost of carbon credits is likely to increase. This is a positive trend and, in this respect, companies should be advised to enter the carbon market and thereby contribute to climate action and compensate for restoration and protection of carbon sinks.

However, regardless of the improvement of the system, companies should be careful on how they label and communicate this activity. According to the definition of the organisation [Science-based-targets](#), a company can only claim to be “net zero” if it has managed to decarbonize 90-95 percent in all value-chain emissions (scope 1 to 3). The Science Based Targets initiative, and other organisations such as Carbon Market Watch, are not telling companies not to buy credits on their path to reach net-zero. The primary focus should first and foremost be on reducing its own direct or indirect emissions, however since it is often impossible for most companies to achieve a transition to net-zero in the foreseeable future, companies should act to support compensatory measures by buying carbon credits. These activities must however not be labelled as climate compensation or carbon offsetting, but as contribution [claims](#).

Companies can buy carbon credits, but instead of claiming that this is a method to counterbalance emissions, they should declare that they contribute to climate actions by for instance supporting project x, which will restore and protect x hectares of mangrove forest or bring clean electricity to x number or people. This model of contribution claims represents a more accurate, honest and transparent description of the activity of carbon trade and will contribute to climate action without requiring complex ton for ton calculations and not risk double-counting. The method of contribution claims is advocated and endorsed by Carbon Market Watch, Gold Standard and the Science Based Targets initiative.

Another crucial aspect to any activity related to carbon markets – both offsetting and contribution claims – is transparency. Any company buying credits should report on its own targets, policies and activities undertaken to reach net-zero and disclose all relevant information regarding the credits purchased, including the selling company, the price of the credits, information on the project and its potential contribution.