

CASPAR CHIQUET

## OFFSETS UNDER THE PARIS AGREEMENT

Caspar Chiquet considers how offsets and their accounting treatment may be handled under the Paris Agreement.

The adoption of the Paris Agreement in December 2015 marked a major breakthrough in international action against climate change. It significantly improves on its predecessor, the Kyoto Protocol, in uniting developing and developed countries, basing the Agreement on national planning and policymaking in the form of nationally determined contributions (NDCs). With a universally agreed on ambition to limit global warming to below 2 degrees, the Agreement sends a clear signal to policymakers, the private sector, and the public, that the transition to a low-carbon economy is unavoidable.

The Paris Agreement includes an article on cooperative approaches, transfer of mitigation outcomes, and a new offset mechanism. Given that pre-Paris negotiations on market mechanisms stalled, it was a great success that the issue was taken forward in the Agreement, allowing space for Parties to advance conversations around cooperative approaches to implementation.<sup>1</sup> This article summarizes the main features of this article, and how it will enable international transfer of mitigation outcomes, including (but not limited to) offsets originating from a newly created mitigation mechanism under the Paris Agreement.

### BILATERAL TRANSFERS BETWEEN PARTIES

Article 6.2 and 6.3 of the Paris Agreement lay the foundation for collaboration on mitigation between parties in recognizing the fact that parties can transfer Internationally Transferable Mitigation Outcomes (ITMOs) between them. These ITMOs can be transferred between parties

without approval from the Conference of the Parties Serving as the Meeting of the Parties to the Paris Agreement (CMA), provided they observe requirements on sustainable development, environmental integrity and transparency, and apply accounting consistent with guidance developed by the UNFCCC's Subsidiary Body on Scientific and Technical Advice (SBSTA), especially to avoid any occurrence of double-counting.

Interestingly, these two articles do not limit the exact form or nature of such collaboration and the transferred "outcomes", nor do they require such transfers to be unit-based. Nevertheless, the ITMO provision enables the concept of bilateral offsets between parties, and constitutes the infrastructure for exchanging mitigation outcomes of any kind, including unit-based offsets under the new offset mechanism of the Paris Agreement, or any other offset mechanisms put in place by parties to the agreement.

One of the key elements of the ITMO provision is the requirement of consistent accounting and observation of transparency standards. The specifics of these accounting and transparency rules need to be worked out by SBSTA, but have to be seen in the context of the work done by the Ad Hoc Working Group on the Paris Agreement (APA)<sup>2</sup>, which is in charge of designing the overarching rules and guidelines governing reporting and accounting of NDCs. Furthermore, accounting and transparency is also cross-cutting into other Articles, such as the mechanism under Article 6.4 (see below). Since ITMOs support the implementation

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of a party's NDC, APA and SBSTA need to work together on the design of accounting rules for both NDCs and ITMOs. APA and SBSTA should aim to follow a common timeframe in order to adopt accounting guidance at the same time.<sup>3</sup>

Another important element that needs to be further clarified is the question of compliance. There is no specific reference to any compliance provisions regarding the accounting guidance developed by the SBSTA, raising the question of what will happen if parties do not follow the guidance.<sup>4</sup> The Paris Agreement contains general transparency and compliance provisions (Articles 13 and 15), but it is not clear if the CMA (or another body) will have to authority to oversee compliance with the requirements in the ITMO provisions.

### ACCOUNTING CHALLENGES LINKING ITMOs TO NDCs

A considerable amount of research has been done already on the many challenges brought by the heterogeneous nature of different NDCs. A study by the Wuppertal Institute on NDCs provides an overview over the different forms of pledges in

NDCs: out of 105 NDCs containing GHG emission targets, 33 are absolute targets (but with vastly different base years), 5 are fixed level targets, 7 are emission intensity targets, and 76 are reductions compared to a baseline scenario.<sup>5</sup>

It is highly likely that different accounting treatments will be required, depending on the type of NDC. These could eventually resemble the two tracks of the Kyoto Protocol's Joint Implementation mechanism.<sup>6</sup> Other approaches, such as work done by the World Bank<sup>7</sup> and the Networked Carbon Markets Initiative, try to establish the mitigation value of specific outcomes, based on which adjustments could be made when transacting ITMOs from parties with different forms of NDCs.<sup>8</sup> Johannes Heister of the World Bank proposes a matrix of bilateral exchange rates between different parties based on their share in the global carbon budget vis-a-vis their mitigation ambitions in their NDCs.<sup>9</sup>

Alternatively, it is conceivable that market forces, following eligibility restrictions from individual parties, will determine the ultimate value of an ITMO originating from a particular party, as was the case under the Kyoto Protocol where market participants applied price discounts to CERs from certain project types, completely outside of the UNFCCC process.

These accounting challenges will need to be solved to enable international transfers of offsets and mitigation outcomes. Potentially regulated border-adjustments between parties with different types of NDCs, based on concepts such as mitigation value, market forces, or a

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combination of both, will determine the individual value of a particular ITMO, as well as any offsets that might originate from the new mechanism which was introduced by Article 6.4 of the Paris Agreement.

### OFFSETS UNDER THE NEW MECHANISM OF THE PARIS AGREEMENT

The Paris agreement creates a new mechanism with the aim to “contribute to mitigation... and support sustainable development.” Articles 6.4.-6.7 define this new article, which has not yet been given an official name, but already received a few different nicknames, all with their respective three-letter acronym.<sup>10</sup> For the purpose of this article, simply “mechanism” will be used.

The mechanism will be under the authority of the CMA, and a body designated by the CMA, all but certain the UNFCCC, will supervise it. It is possible that the form of governance significantly differs from the way the UNFCCC supervised the CDM in the past, with split responsibilities between the UNFCCC as a central body, and the host country to coordinate issuance of units under the mechanism with accounting against the host country's NDC, more akin to the way JI worked under the Kyoto Protocol.

Another important difference to the CDM is the fact that the mechanism is open to participation from all parties to the Paris Agreement. In the negotiations leading up to Paris, the concept of “CDM+” was brought forward in submissions by Brazil and the EU, which still differentiated between Annex 1 and non-Annex 1 countries.<sup>11</sup> The mechanism under the Paris Agreement puts no such limitation on participation. It also explicitly encourages participation of private sector entities.

Finally, the mechanism under the Paris Agreement has the goal to deliver “overall mitigation in global emissions”. How this article 6.4(d) is interpreted by different

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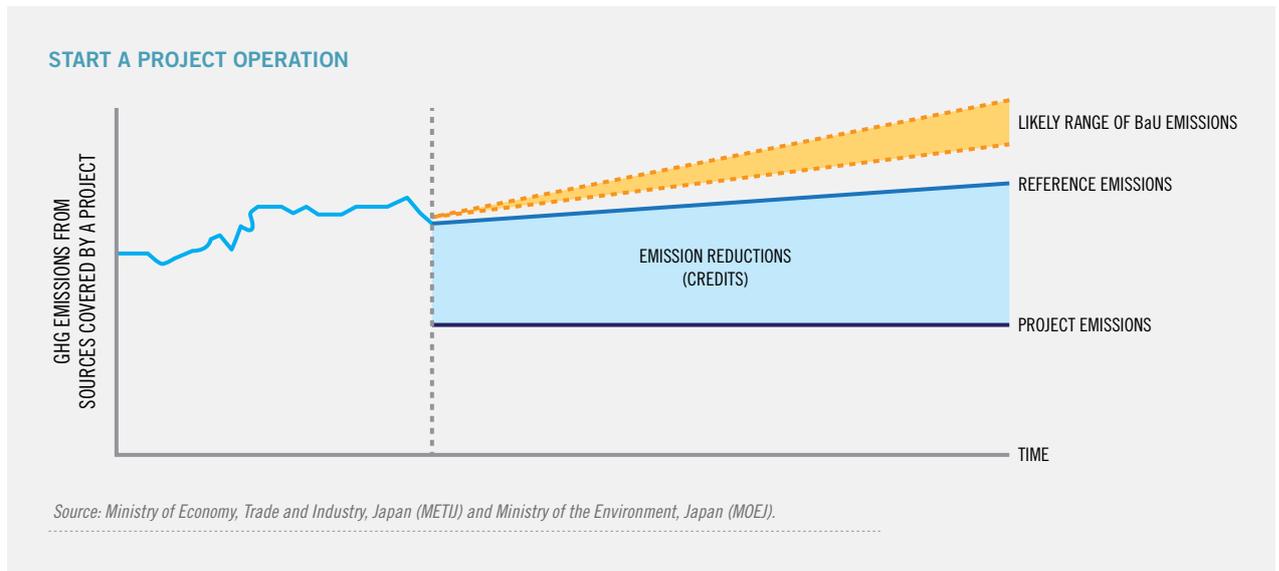
parties and operationalised by the SBSTA will have a major impact on the utility and adoption of offsets under the new mechanism.

### NET ZERO EMISSIONS AND OVERALL MITIGATION

At present, the concept of “overall mitigation in global emissions” is ill-defined, and the concept has found its way into negotiations at rather late stage, but was at one point more explicit, mentioning the “cancellation of a share of units generated, transferred, or acquired”.<sup>12</sup> As it stands now, however, the SBSTA is left with the challenge of working out the details of how the ambition of the long-term net zero emission target and overall mitigation can be operationalised under the mechanism.

In a sense, this is a reopened additionality discussion, which was a major concern with the CDM. Under perfect conditions, an additional CER used against a Kyoto target meant that there was zero benefit for the global atmosphere beyond that target itself. If the new mechanism wants to achieve overall mitigation, then somewhere along the process of issuing, transferring and applying offsets against an NDC, a voluntary contribution has to be undertaken by one, or several parties to the transaction.

One potential approach to solve this problem is directly at the baseline level, in setting extra conservative baselines and thus guaranteeing overall mitigation. Apart from the considerable technical challenges in defining standardised



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baselines for the new mechanism, taking into account its intended broader scope with sustainable development co-benefits, as well as the many implications

of vastly different NDCs from host country to host country, this would also put the burden of contributing to overall mitigation on the host, more likely than not a LDC, SIDS or a developing country.<sup>13</sup>

Although still in its early stages, Japan's Joint Crediting Mechanism (JCM) might prove a pragmatic example of how the concept of overall mitigation may be put into practice under the mechanism. The JCM introduces the concept of "reference emissions", which are set below business as usual and thus ensure the "additionality" of a JCM project. Furthermore, to alleviate the scenario described above, where the cost of the

contribution is borne by the host country due to a reduced output of offsets, the JCM credits 20% of issued credits back to the host country of a project activity.

Whether the approach under the JCM proves workable within the context of the Paris Agreement and the negotiations under the SBSTA remains to be seen. What is certain however, the concept of overall mitigation needs to be addressed in a fair, transparent and simple manner to ensure uptake of the mechanism.

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(1) Dagnet, Waskow et al. Staying on track from Paris: Advancing the key elements of the Paris Agreement, (2016): page 35. (2) Dagnet, Waskow et al. (2016): 8. (3) Dagnet, Waskow et al. (2016): 36. (4) Marcu, Andrei. 2016. International Cooperation Under Article 6 of the Paris Agreement: Reflections before SB 44. Geneva: International Centre for Trade and Sustainable Development (ICTSD): p 10. (5) Kreibich, Nicolas, Obergassel, Wolfgang. 2016. Carbon Markets After Paris - How to Account for the Transfer of Mitigation Results? JIKO Policy Paper 01/2016. Wuppertal Institute for Climate, Environment and Energy: p 7. (6) Marcu, Andrei. 2016. Carbon Market Provisions in the Paris Agreement (Article 6). Brussels: Centre for European Policy Studies (CEPS). Special Report No. 128, p 10. (7) World Bank. 2016. Mitigation Action Assessment Protocol. Available at: [www.worldbank.org/en/topic/climatechange/brief/globally-networked-carbon-markets](http://www.worldbank.org/en/topic/climatechange/brief/globally-networked-carbon-markets) (8) Macinante, Justin. 2016. Networking Carbon Markets – Key Elements of the Process. Paper for the World Bank Group, pp 24-27. (9) Heister, Johannes. 2016. Mitigation Value to Enable International Linkage of Domestic Programs. Presentation at the Partners & Strategy Workshop of the Networked Carbon Markets Initiative. Cologne, May 28, 2016. (10) Proposed names include: Sustainable Development Mechanism (SDM), Sustainable Mitigation Mechanism (SMM), Emissions Mitigation Mechanism (EMM). The differences in naming cover the potential range of the mechanism, with an emphasis on sustainable development on one end (SDM), to a clear priority for mitigation (EMM) on the other, and SMM trying to reconcile the two aspects. (11) Marcu, Andrei. 2016. Carbon Market Provisions in the Paris Agreement (Article 6). Brussels: Centre for European Policy Studies (CEPS). Special Report No. 128, p 14. (12) Marcu, Andrei. 2016. Carbon Market Provisions in the Paris Agreement (Article 6). Brussels: Centre for European Policy Studies (CEPS). Special Report No. 128, p 19. (13) Brewer, Thomas L., Derwent, Henry & Blachowicz, Andrzej. 2016. Carbon Market Clubs and the New Paris Regime. Paper for the World Bank Group, p 38.