Climate Negotiations on New Global Carbon Market Postponed Until 2021

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As the COVID-19 pandemic continues to disrupt lives, travel and operations across the globe, international climate negotiators have decided to postpone discussions on a critical component of the Paris Agreement—developing a global carbon market—until 2021.

Between December 2 and December 15, 2019, 197 states parties to the United Nations Framework Convention on Climate Change (UNFCCC) gathered in Madrid, Spain, for the annual climate change negotiations, known as the Conference of the Parties (COP).[1] One of the main objectives of COP25 was to agree on the remaining item from the so-called Paris Rulebook of instruments that implement the Paris Agreement: the rules for Article 6 of the Paris Agreement.[2] The purpose of Article 6 is to create a new global carbon market to mitigate greenhouse gas (GHG) emissions (often called carbon trading).

As explained in this summary, while negotiators agreed to many of the technical aspects of Article 6 implementation, they could not resolve their differences in relation to environmental integrity (i.e., mitigation that would not exist but for a project), double accounting and corresponding adjustments in counterparty records, timing of emissions reduction realization across multiyear national plans, and transition of credits under existing market mechanisms (namely, the Kyoto Protocol to the UNFCCC). Negotiators could not finalize the rules for Article 6 at COP24 in Katowice, Poland.

Negotiations were scheduled to continue during 2020 leading up to COP26 in November 2020 in Glasgow, Scotland, in parallel to member states revisiting their national climate action plans (known as Nationally Determined Contributions or NDCs). In response to the unfolding COVID-19 crisis, the UNFCCC and the hosts of COP26, the UK, have postponed COP26 until a date to be confirmed in 2021.[3] The first pre-COP26 negotiation has been moved from June to October 2020.

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[1] The COP is the supreme intergovernmental decision-making body of the UNFCCC.
[2] The Paris Rulebook is similar to the Marrakesh Accords for the Kyoto Protocol.
[3] UNFCCC, "COP25 Postponed," press release 1 April 2020, available at https://unfccc.int/news/cop26-postponed.

While the immediate concern globally is managing and recovering from COVID-19, the postponement of COP26 defers discussions regarding a new global carbon market under Article 6. The postponement also provides additional time for governments to consider international (and domestic) climate change regulation more broadly. Until negotiations on Article 6 are concluded, companies will not be able to plan their operations and investments based on the proposed new global carbon market.

An interrelated development likely to impact climate negotiations (and action) in 2020 and beyond is the European Green Deal that was launched in parallel to COP25, along with the proposals for EU net-zero climate legislation and potential carbon border adjustment taxes. How those initiatives will interact and interlink with the Paris Agreement will depend on their ultimate design and will warrant close observation.

The Evolution of Climate Governance and Carbon Markets Under the UNFCCC

The UNFCCC was agreed in 1992 as the framework and parameters for global governance and action on climate change, which would be further developed through subsequent programs between member states and treaties with detailed rules for new mechanisms. The major objective of the UNFCCC is to limit global increases in GHG emissions that contribute to anthropogenic climate change.

One approach states have considered for reducing, or mitigating, GHG emissions is to create carbon markets, whereby companies can sell credits for GHG reductions generated from certain clean energy development projects to other companies to help them meet their GHG emission reduction obligations cost-effectively. This is the purpose of the 1997 Kyoto Protocol to the UNFCCC, which set legally binding GHG emissions reduction targets for its member states and created carbon trading mechanisms to achieve those targets through markets. The Kyoto Protocol provided for multilateral carbon trading collaboration, which resulted in the EU Emissions Trading Scheme, among others, but a global carbon market was not created. The Kyoto Protocol has generated over US$300 billion in climate and sustainable development investments and reduced global GHG emissions by almost two billion tonnes.[4] However, the impact of the Kyoto Protocol is limited: while 192 states are parties to the Kyoto Protocol, only 39 developed-country member states accepted binding emissions reduction obligations.

In 2015, the member states to the UNFCCC decided that universal participation is required to effectively mitigate, and adapt to, climate change, and 189 states negotiated and ratified the Paris Agreement (195 states are signatories). Our summary of the relevant mechanics of the Paris Agreement is available here. The Paris Agreement provides for the creation of bilateral carbon trading and a global carbon market. These mechanisms are intended to commence from 2020

[4] UNFCCC, “Achievements of the Clean Development Mechanism 2001–2018,” pp. 2–3.

onward, when the Kyoto Protocol expires, and to resolve many of the issues with carbon trading projects and markets experienced under the Kyoto Protocol.

The following section summarizes the outcomes of the negotiations of these mechanisms at COP25 in Spain.

Key Challenges in COP25 Negotiations for a New Global Carbon Market

Finalizing the global carbon market mechanism at COP25 was seen as an important goal that would provide certainty for the future direction of international climate change regulation, and the conclusion of which would free up resources of member states to prepare for COP26 in 2020 (now in 2021), which will be hosted by the UK in Glasgow, Scotland, in partnership with Italy. At COP26, the parties to the Paris Agreement are supposed to consider strengthening their NDCs and emissions reductions targets through 2030, among other things. While many NDCs include the use of domestic policies and carbon markets to encourage cost-effective mitigation of GHG emissions,[5] Article 6 of the Paris Agreement also provides for voluntary international cooperation through the use of international carbon markets and trading to deliver on NDC commitments and to promote sustainable development.

It does so in two ways:

- First, countries are permitted to cooperate through the use of *bilateral carbon markets* to achieve NDC outcomes (Article 6.2).[6] This will allow a country to sell its surplus domestic GHG emissions reductions (e.g., from large-scale transition to sustainable energy) beyond its NDCs to another country, or to buy surplus GHG emissions from other countries to make up any shortfall in achieving its NDCs (e.g., where decarbonization proves challenging).
- Second, “public and private entities” may cooperate through a centralized UN-based *international emissions trading market*, which is intended to increase overall global emissions mitigation (Article 6.4). This is known as the Sustainable Development Mechanism (SDM), and it will replace the carbon trading mechanisms under the Kyoto Protocol. Under the SDM, tradable emissions reductions certificates could be produced from a host of projects, including forest restoration, solar or wind power plants, and energy efficiency programs, if those projects generate “real, measurable and long-term” benefits.[7]

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[5] *See, e.g.*, “Net Zero – The UK’s contribution to stopping global warming,” Committee on Climate Change, May 2019, which recommend the UK reach its net-zero goal without using international carbon markets.
[6] Paris Agreement, Article 6.2. The technical term for what is traded is “internationally transferred mitigation outcomes,” the definition of which is subject to debate and negotiation. It could include, among other things, credits for emissions reductions, renewable energy capacity or interlinking domestic emissions-trading systems.
[7] Decision 1/CP.21, Adoption of the Paris Agreement, Para. 37(b). Cooperation between countries to reduce GHG emissions in ways other than through carbon trading, such as through development funding, concessional finance, capacity building and technology sharing, is also permitted (Articles 6.8 and 6.9).

Article 6.7 of the Paris Agreement requires the parties to develop the detailed "rules, modalities and procedures" for the SDM, which would breathe life into the mechanism and determine when and how it can be used. These highly technical considerations were the central focus of COP25.[8] The Madrid meetings required considerable trade-offs and lengthy discussions beyond the allocated time for negotiations to find "landing zones" on the key issues among parties who had disparate interests.

Some of the key technical considerations raised in relation to Articles 6.2 and 6.4 included:

– ***Environmental integrity***—ensures that the SDM delivers real, additional benefits to GHG mitigation in the atmosphere that would not have otherwise occurred,[9] does not contain loopholes that mask inaction or undermine real mitigation action, and prevents so-called carbon leakage (where business production is relocated to countries with lower emissions and environmental standards);
– ***Double accounting and corresponding adjustments***—whether traded emission reduction units are deemed to contribute only to one country's NDC targets, with corresponding adjustments that reflect the trade (so as not to cancel out the environmental benefit by both sides claiming the reduction), and how to account for a trade when the underlying project falls outside the scope of the NDC;
– ***NDC timings***—whether and how emissions reductions could be applied to single year or multi-year NDCs, and related issues that may arise in relation to environmental integrity, and double accounting and corresponding adjustments, as described above;
– ***Transition of carbon market credits from the Kyoto Protocol***—whether existing carbon credits from the Kyoto Protocol may be used in the SDM (called "carry-over credits"), and the extent to which methodologies and projects under the Kyoto Protocol will be permitted in the SDM.

Ultimately, the member states could not agree on these technical issues and COP25 concluded without agreement on the rules for Article 6, therefore without the creation of a new global carbon market to help catalyze the global low carbon transition.

[8] Specifically, that was the focus of the Conference of the Parties serving as the meeting of the Parties to the Paris Agreement. As the membership of the UNFCCC and Paris Agreement is similar, the one administrative body operates to serve the two separate legal mechanisms (and non-members to the Paris Agreement are deemed observers in that setting).
[9] Decision 1/CP.21, Adoption of the Paris Agreement, Para. 37(d).

Implications of COP25 on Future Climate Action

The implications of COP25 on businesses and society are manifold.

First, scientific consensus indicates that the world is not on track to achieve the limits on global warming that were established by the Paris Agreement.[10] The parties to the UNFCCC have acknowledged that this disparity was exacerbated by the lack of political action at COP25. The final decision of COP25, the "Chile Madrid Time for Action," showed, for the first time, unanimous support among member states for the IPCC Special Report[11] and the emissions gap that would be produced between current NDCs and the targets of the Paris Agreement of maintaining a 2°C or 1.5°C world temperature increase.[12] In November 2019, United Nations Environment confirmed similar findings, showing that global emissions must reduce by 7.6% every year until 2030 to meet the 1.5°C goal in the Paris Agreement.[13] To date, UNFCCC parties have failed to implement policies that would achieve this goal.

These recommendations have increased the pressure on all member states, and the COP26 host, the UK, to ensure that the outcomes of COP26 accommodate the concerns of business, investors, civil society, scientists and other stakeholders. Notwithstanding the UK's commitment to climate action and its declaration of a climate emergency in 2019,[14] its initial effort to organize COP26, and its replacement of the president of COP26, received mixed responses.[15]

Second, failure to reach agreement on the rules for Article 6 of the Paris Agreement delays the creation of a mechanism that could assist with scaling up public and private climate action necessary to meet the goals of the Paris Agreement. It is estimated that over $90 trillion in capital allocation is required from businesses and investors to deliver the net-zero carbon transition

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[10] In October 2018, the Intergovernmental Panel on Climate Change ("IPCC") indicated that even with full compliance of existing NDCs, global warming would likely increase by 3°C above pre-industrial levels by 2100: IPCC, *Special Report on Global Warming of 1.5ºC* (found at https://www.ipcc.ch/sr15).
[11] Decision 1/CP.25, Chile Madrid Time for Action, para. 6.
[12] Decision 1/CP.25, Chile Madrid Time for Action, para. 8.
[13] United Nations Environment, *The Emissions Gap Report 2019* (found at https://newclimate.org/2019/11/26/emissions-gap-report-2019). *See also* Carbon Brief, "UNEP: 1.5C Climate Target 'Slipping Out of Reach'", 26 November 2019, available at https://www.carbonbrief.org/unep-1-5c-climate-target-slipping-out-of-reach.
[14] *See e.g.*, WilmerHale, "UK Becomes First G7 Country to Legislate for 'Net-Zero' Emissions", 17 July 2019 (found at https://www.wilmerhale.com/en/insights/client-alerts/20190717-uk-becomes-first-g7-country-to-legislate-for-net-zero-emissions).
[15] Camilla Hodgson and Jim Pickard, "UK Under Pressure to Re-energise UN Climate Summit in Glasgow," 18 February 2020 (*Financial Times*); Camilla Cavendish, "With COP26, Britain Has a Chance to Take the Lead on Climate Change," 7 February 2020 (*Financial Times*).

envisioned in the Paris Agreement.[16] A global carbon market is likely to provide some investment and price certainty that would encourage those projects.[17]

Third, in the absence of clear agreement among states on climate action (and rules for global carbon markets), some businesses and investors (increasingly driven by changes in investor and consumer sentiment) have started to take steps to align their operations with the goals of the Paris Agreement. The pressure on businesses to decarbonize continues to grow. As of December 2019, over 177 companies with 5.8 million employees and worth over US$2.8 trillion had pledged to set science-based emissions targets for their operations, and over 1,200 investors managing US$35 trillion in assets have asked states to set more ambitious climate change policies and targets than are in current NDCs.[18]

Along with these considerations, the European Green Deal that was launched in parallel to COP25, and the related proposed EU net-zero climate legislation (to bring about climate-neutrality in the European Union by 2050) and carbon border adjustment taxes (to prevent carbon leakage), will have implications for a broad range of businesses. The European Green Deal requires the EU to produce net-zero emissions by 2050, and intends to encourage other states to adopt more ambitious programs on energy decarbonization and transition. Precisely how these regulatory developments will interact with the Paris Agreement and other international treaties (including international trade agreements and rules) remains unknown. Public consultations on the proposed EU climate legislation and carbon border adjustment tax are underway.

WilmerHale's International Arbitration and Government and Regulatory Affairs teams will continue to monitor and can advise on developments related to the international climate negotiations, the European Green Deal, border adjustment taxes, and the associated implications for businesses, trade and investment.

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[16] International Finance Corporation, *Creating Markets for Climate Business - An IFC Climate Investment Opportunities Report* (2017), p. 140.

[17] International Emissions Trading Association, "The Economic Potential of Article 6 of the Paris Agreement and Implementation Challenges," September 2019; Carbon Pricing Leadership Coalition "Report of the High-Level Commission on Carbon Pricing and Competitiveness," 2019. On June 1, 2017, the US gave notice of its intention to withdraw from the Paris Agreement and it will observe and influence the negotiations until November 4, 2020, when it withdraws from the treaty. Only businesses of member states to the Paris Agreement are permitted to participate in its SDM.

[18] The Investor Agenda, December 2019, available at https://theinvestoragenda.org. *See also* UN Climate Change News, "Investors with $34 Trillion Urge Policies for Paris 1.5°C Goal," 26 June 2019, available at https://unfccc.int/news/investors-with-34-trillion-urge-policies-for-paris-15degc-goal.

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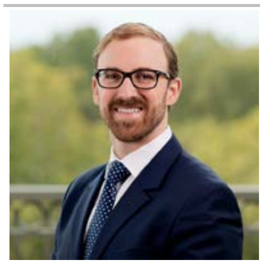

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