ClimDev-Africa

Policy Brief 15

The Paris Agreement: The future relevance of UNFCCC-backed carbon markets for Africa

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Key Messages

- **A fresh start for international climate policy:** The Paris Agreement removes policy uncertainty and ensures that carbon market mechanisms will continue to be an important part of the multilateral climate regime after 2020. These mechanisms will evolve along two lines: one with strong international oversight (SDM) and one with a more bilateral character (cooperative approaches, CAs). Africa would benefit if the SDM becomes quickly operationalized, building on the modalities and procedures of the CDM and taking into consideration important reform elements and lessons learned for Africa. In this context, it is crucial that existing CDM projects will be permitted to be transferred to the new SDM. Africa should also demand that the CAs are subject to stringent international rules in order to prevent a race to the bottom and subsequent crowding out of the SDM. Finally, the adaptation levy should also be placed on internationally transferred mitigation outcomes (ITMOs) rather than burdening only the SDM.
- **Not words only but action:** High ambition coalition members and industrialized countries supporting market mechanisms in Paris need to generate demand for CERs and ITMOs well before 2020. This should entail provisions that would provide investment certainty to African projects with high sustainable development co-benefits.
- **Continued CDM reform:** PoA rules are becoming more and more manageable for African entities. Linkages of CDM to climate finance institutions including the GCF are envisaged but require constant pushing by developing country negotiators.
- **Create post-2020 public CER demand and investment certainty:** African negotiators should push industrialized countries to quantify demand for credits when converting their Intended Nationally Determined Contributions (INDCs) into NDCs at the signature of the Paris Agreement.
- **The SDM should primarily work as a market mechanism, but also serve as a tool for results-based mitigation finance:** In the latter case units should voluntarily be cancelled.

The Paris Agreement in brief: focus on carbon markets

The Paris Climate Change Conference was held from 29 November to 13 December 2015 in Paris, France. It served as the 21st Conference of the Parties to the UN Framework Convention on Climate Change (UNFCCC) (COP 21) and the 11th Conference of the Parties serving as the Meeting of the Parties to the Kyoto Protocol (KP) (CMP 11). The challenging task of the Paris Conference was to decide on a universal international climate policy agreement for the time after the second commitment period of the KP ends in

2020, overcoming the failure of COP 15 in Copenhagen 2009 to do so.

Due to superb diplomacy by the French hosts, the Paris Conference crowned its work with the adoption of the Paris Agreement (PA). At first glance, it may seem surprising that the PA is an annex to a decision called "Adoption of the Paris Agreement" (Paris Decision, PD) that specifies the work plan for the next years. This structure has been selected to facilitate ratification of the PA by national governments, especially the US. The PA will only enter into force upon ratification by at least 55 parties, covering at least 55% of global GHG emissions (Art 21.2)[1]. Once the PA becomes effective, it will be legally binding for the signatory parties. As for any international treaty, withdrawal is possible with one year notice (Art. 28.2).

The key elements of the PA can be summarized as follows:

- **Surprisingly strong ambition**: global **temperature increase is to remain "well below" 2° and efforts are to be made to reach 1.5° C** (Art. 2), with a global peak in GHG emissions to be achieved as soon as possible. A critical element is the specification that a **balance of emissions by sources and removal by sinks** is to be reached by the second half of the century (Art 4.1). Progress towards this goal will be measured every 5 years, starting in **2023**, through **global stocktaking** (Art. 14.1 and 2)
- **Participation of all countries** while following the principle of "common but differentiated responsibilities": All countries are to contribute to climate change mitigation through Nationally Determined Contributions (NDCs)[2], but the different circumstances and responsibilities of developing countries are highlighted, especially regarding Least Developed Countries (LDCs) and Small Island Developing States (SIDS). There is however no regional differentiation, i.e. no special treatment for Africa as a whole. The PD acknowledges the huge gap between the target of the PA and the mitigation achieved if all NDCs are implemented in full. This means that the ambition of current INDCs needs to be strengthened as a consequence of the PA.

"The Paris Agreement is surprisingly ambitious, but the willingness of governments to close the mitigation gap remains to be seen"

- While developed countries should have absolute targets, **developing countries** should also move over time towards **"economy wide reduction or limitation targets**" (Art 4.4)
- **Increasing mitigation ambition without an end date**: Every five years from 2023 onwards, the NDCs are to be updated and made more stringent (Art. 4.3 and 4.9)
- **Transparent accounting,** albeit with **flexibility for developing countries (Art. 13.2)** and **simplifications for LDCs and SIDS (Art. 13.3).**

Before the Paris Conference some observers were skeptical whether market mechanisms would at all be mentioned in the agreement. However, Art. 6 provides elaborate wording on two types of cooperative mechanisms that shall be:

- **A centrally governed mechanism** (currently called SDM[3]) that is **building on existing features of the CDM,** but can be used by **all countries.** It shall be supervised by a body designated by the conference of the parties to the PA, similar to how the Executive Board supervises the CDM. Public and private participation in the SDM needs to be approved by Parties. The PD (para 38) makes it clear that the SDM directly takes up the principles of the CDM, such as real, measurable and long term reductions, additionality and verification and certification by DOEs, and explicitly asks to apply experience from the Kyoto

1 According to the latest national inventories.

2 Before the Paris Conference, 65 Intended NDCs (INDCs) stated the intention to use market mechanisms (IETA INDC tracker (2016). Countries can now update the INDCs before signing the PA or can directly submit the current INDC to become the NDC when signing.

3 For the purpose of this policy brief, the new mechanism identified by the PA will be referred to as Sustainable Development Mechanism (SDM). This name however has been deleted from the final text. Some Parties question the name for its missing link to mitigation.

Mechanisms. New features of the SDM are the requirement to avoid double counting and pursue an overall mitigation of global emissions.

- "**Cooperative approaches**" (CAs) **that can generate credits** (internationally transferred mitigation outcomes - **ITMOs**) are not yet defined in detail. Only the principles of environmental integrity and transparency are mentioned. Hence additional conceptual work and political decisions are required to define the framework for the CAs and also a more detailed definition of ITMOs. Many observers are of the opinion that CAs will be bilateral mechanisms with rather loose international oversight. If that happens, international carbon markets would be further fragmented and the SDM would face probably ruinous competition.

The PD also urges Parties to promote the **voluntary cancellation of CERs**, already before 2020 (para 107). In addition, urgency is given to the transparency of the reporting on the use of the ITMOs generated by the CAs for pre-2020 actions (para 108).

"Strong role of carbon markets in the post-2020 climate agreement has been secured and the CDM serves as its foundation"

Despite all its work on the long-term climate policy regime, the immediate reform of the CDM before 2020 has not been neglected by the Paris conference. In its classical guidance to the CDM Executive Board (EB), the CMP asks the EB to, inter alia:

- develop a **stand-alone guidance for Programmes of Activity (PoA)**[4]
- seek **new sources of finance for CDM activities**, from international institutions and especially in the **GCF context**
- **simplify and streamline CDM procedures in general,** including through **standardized baselines**[5]
- define more **cost-effective MRV approaches**
- allow the **revision of methodologies** without project specific information
- expand the scope of **Regional Collaboration Centres work beyond pure CDM activities**, i.e. to support development of the new mechanisms.

This guidance goes further than in the last years, which shows that the CDM continues to evolve. Many of Africa's negotiation priorities are reflected in this decision. The link of the CDM to climate finance is particularly important, as it may help to bridge the time until CER demand increases again as a result of stronger mitigation ambition.

With regards to LDCs, several decisions were taken by the CMP with relevance for the market mechanisms:

- Art. 9.9 of the PA urges to define **simplified approval procedures** for LDCs and SIDS to coordinate and deliver resources to support country-driven strategies. Para 65 PD also calls for enhancing the coordination and delivery of resources to LDCs "through simplified and efficient application and approval procedures". Such resources may be used for capacity building for the new cooperative mechanisms.

4 It refers to: a "CDM Programme of Activities standard," a "CDM Programme of Activities validation and verification standard," and a "CDM Programme of Activities cycle procedure"; Standalone PoA documentation.

5 This refers to: the project cycle, the registration and verification process, the development and approval of standardized baselines, the methodological standards and procedures, and the accreditation procedure.

- **Capacity building** to enhance ability of LDCs (and other vulnerable countries) in implementing long term climate change actions.

Substantial efforts will be needed to operationalize the general rules for market mechanisms outlined in the PA. In the next sections we discuss how Africa can engage to generate short term demand for CDM activities and immediately "hit the ground running" when the SDM becomes operational.

Priority actions for Africa in light of the results of the Paris conference

African countries will have to continue raising their voice in the international negotiation fora in order to benefit from the momentum generated by the PA.

Those African countries that so far have not done so in their INDC should include the **use of market mechanisms in their NDCs** when signing the PA. This would provide a strong signal to the international community that Africa is ready to use the mechanisms and could help to mobilize pre-2020 mitigation actions (i.e. through new CDM investments) and to speed up the operationalization of the SDM. African leaders should engage with industrialized countries that do not want to use market mechanisms in their INDC but declared at the Paris Conference that they support the mechanisms, in order to achieve inclusion of market mechanisms in the NDCs of these countries.

Various streams of action are of great importance for enabling short-term mitigation actions.

- **Early action**. Existing CDM activities should have a clear future under the PA; and countries making use of the CDM until 2020 should have their activities recognized as early action under the PA. For this purpose, eligibility criteria under which CDM activities would be permitted to transition to the SDM need to be defined.
- **CDM reform.** It is crucial that the review of **CDM Modalities & Procedures** (M&P) will be concluded swiftly and successfully to establish the CDM as a solid building block of the SDM. To unblock the current stalemate and avoid a proliferation of issues, African negotiators should support a minimal consensus and a focus on priority issues, such as the inclusion of PoAs, rather than a long wish list of detailed reform items.
- **Immediate linkage of CDM activities with new sources of climate finance, in particular the GCF**. The CMP encouraged the CDM EB to explore opportunities for financing CDM projects through the GCF. This would provide high-quality investment mitigation opportunities for the GCF, while stalled CDM activities would benefit from a ready-to-access source of finance. African countries should seek new approaches for successfully channelling GCF finance into CDM activities well before 2020, inter alia by pushing for direct acquisition of CERs by the GCF. Moreover, innovative sources of climate finance could be tested in conjunction with CDM activities such as green bonds, low carbon equity funds or loan guarantees.
- **CDM as MRV tool**. Promote the use of CDM methodologies for calculating emissions reductions for other mitigation initiatives supported with international climate finance. This increases comparability across mechanisms, and lowers transaction costs for host countries, as they do not need to apply different results indicators for mitigation impacts
- **New sources of demand for African carbon credits**, through:
  - ✓ **Upscaling existing public procurement programs** such as CI-DEV, Swedish Energy Agency and Nordic Environment Finance
  - ✓ A **global market-based measure (GMBM) in the aviation sector by 2016**, which could generate additional demand for carbon credits[6] as the sector aims to achieve carbon neutral growth and a 50% cut in emissions

6 Annual demand is estimated to reach around 2.6 tCO2eq between 2021-2035 (Oeko Institut 2015)

on 2010 levels by 2050. An ICAO high level meeting on the GMBM will be held in May 2016, with the aim of preparing a text and recommendations for the 39th Session of the ICAO Assembly, to be held in October 2016.

- ✓ Strengthening domestic uses of the CDM, allowing the creation of national demand for CERs from projects implemented internally, for instance allowing their utilization under a carbon tax – such as the approach planned in South Africa - or other carbon pricing initiatives, and strengthen the role of market mechanisms under their NDCs.
- ✓ Voluntary markets, exploiting the potential of these markets in supporting actions in specific sectors (e.g. REDD+ and other activities with high sustainable development co-benefits) for which buyers have an interest in providing support: This could also involve South-South transactions such as a credit sale from Ecosur Afrique to Voltacars in 20157.
- ✓ New international initiatives such as the Solar Alliance as vehicles to harness CDM.

Making the Paris Agreement work for Africa in the long term

The Paris Agreement presents a number of opportunities for further improving the participation of African nations in market mechanisms. However, ensuring that these opportunities are not missed requires active African engagement in the further operationalization and implementation of the Paris Agreement.

Firstly, African governments should continue their active participation in shaping the new SDM to ensure that it builds on the M&P of the CDM, and that the new mechanism reflects African needs and priorities. The SDM explicitly has a number of parallels with the existing CDM framework; including the need for additionality, real and measurable mitigation, verification by a DOE and encouraging the participation of public and private entities. However, what is not yet clear is the nature of the relationship between these two mechanisms.

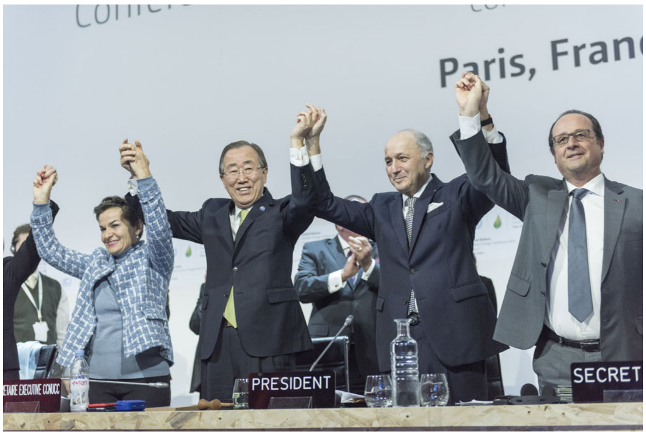
Incorporating those ongoing CDM reforms into the SDM that have led to more CDM activities in Africa – especially PoAs – is a key priority. African nations should also have sufficient representation on the governing body, such as through having LDC representatives on the board (which is currently not the case for the CDM EB). The role of Designated National Authorities (DNAs) in accounting for emission reductions achieved under the SDM and how these relate to NDCs should also be considered. Due to the risk of double counting, it may be that DNAs will play a more prominent role in the SDM than they currently do under the CDM.

Secondly, African countries should ensure that the SDM not only serves as a generally accepted market mechanism with significant demand from industrialized countries and emerging economies, but also as a tool to access results-based mitigation financing. When used in the context of results-based climate finance, units generated under the SDM could be voluntarily cancelled. The SDM should thus be designed as a tool to produce highly credible units for various uses.

Accounting of the units in the context of a host country's NDC should however be left out of the modalities and procedures of the SDM. Adjusting the NDCs for units issued by the SDM is only important in the case where units are transferred out of the country. Then double claiming of the emission reductions by both the host country and the acquiring Party towards their NDCs has to be avoided. When units are voluntarily cancelled, however, this problem is avoided. Just like the CDM, the SDM should operate on the principle of certifying units that are additional compared to a stringent baseline, i.e. the most likely development of policy instruments / emissions of a sector in the host country. The baselines of the NDCs are currently not sufficiently granular to serve as SDM baselines and may still contain aspirational targets rather than forecasting a likely development of emissions.

Where units are transferred out of the country, the accounting challenges are the same under the

7 http://www.ecosurafrique.com/news_release.php?id=219&f=



SDM and CAs. Hence any rules on adjusting host country's NDCs for mitigation outcomes transferred internationally should apply consistently and be developed under the guidance for CAs. These issues are only vaguely defined in the PA, and require further analysis and negotiation in order to ensure that Africa benefits adequately.

"The new central mechanism agreed in Paris opens the door for an evolution of the CDM, but needs to be supported by reliable demand to allow for new investments"

Thirdly, African negotiators should ensure that the SDM does not become unreasonably disadvantaged due to stricter requirements applying to the SDM than to the CAs. CAs offer the ability for direct bilateral engagement with (financing) nations and/or linking with their regional carbon markets but historically, bilateral schemes have been more focused on developed country linking of emission trading schemes. Experience under the Kyoto Mechanisms has shown that lack of international oversight is likely to lead to outcomes that violate the principles of environmental integrity and transparency, as happened under Joint Implementation which was used to "launder" hot air. Thus CAs should be subject to binding international rules regarding these two principles. Equal opportunities in accessing carbon markets should be awarded to activities under the SDM. It is a mechanism that promises to be more closely aligned with African interests as it is multilaterally governed, and should thus be operating on a level playing field with CAs. For example, African negotiators should work to ensure that a share of proceeds for adaptation financing is also integrated into the transferred ITMOs from CAs, since this is also applied to SDM activities. Furthermore, the requirement that activities under the SDM must contribute to an overall reduction in global emissions (which some equate with net mitigation) while no such requirement is placed on CAs could be considered an unfair burden.

Recommended Actions

For the UNFCCC negotiations

- Engage in shaping the rules for the new SDM and cooperative approaches, based on the lessons of the CDM
  - ✓ Integrate progress made in CDM reforms that have benefited Africa into the new SDM Transition the CDM into post-2020 regime through developing eligibility criteria for African projects to transition to the SDM
  - ✓ Ensure that requirements for CAs to contribute to sustainable development and environmental integrity are strictly adhered to
  - ✓ Ensure that mitigation actions supported through the SDM or CAs using climate finance can be counted towards a host country's NDC
  - ✓ Ensure that CAs generate a share of proceeds for adaptation
- Explore convergence of interest between African countries and other Parties on market mechanisms to increase demand

For the restoration of demand and mobilization of new investments

- Provide a sufficient degree of investment certainty for carbon market project developers
  - ✓ Introduce long-term acquisition programmes with a clear indication of a minimum value of CERs

- ✓ Establish clarity on what can count as early action for post-2020 market mechanisms
- Link climate finance and carbon market demand sources to Africa's CDM portfolio
  - ✓ Work out practical options and establish precedents for funding of African CDM activities by climate finance institutions in particular the GCF
  - ✓ Actively mobilize new demand sources such as aviation and CER cancellation before 2020 and African climate negotiators to engage in the discussion of ICAO
  - ✓ Follow up on the Paris declaration of the "friends of market mechanisms"8 to generate demand through their NDCs. This could be led through Senegal who is signatory of this initiative
- Encourage the payment of a premium for high SD contributions
- Encourage buyers to prioritize acquisition of credits from Africa

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