COP25 Side Event Report

Title: **International carbon markets under the Paris Agreement: evolution, status and implications for Development Finance Institutions**

Location: International Development Finance Club (IDFC) Pavilion at COP25
Date: Thursday 5 December, 2019
Time: 11:00-12:30

Mr. Peter Hilliges (KfW/IDFC) opened the side event by presenting the role of the International Development Finance Club (IDFC) in mobilising climate finance and implementing the Sustainable Development Goals. Mr. Hilliges underlined the importance of mobilize private climate finance and carbon markets as one of the potential instruments to achieve this objective. Mr. Hilliges highlighted the importance of COP25 negotiations in defining the rules of for international carbon markets under the Paris Agreement.

Mr. Axel Michaelowa (Perspectives) set the scene for the side event by presenting the speakers and explaining the rationale behind the Article 6 of the Paris Agreement. Mr. Michaelowa reminded the participants the content of the Article 6 underlying the importance of ambition raising through international carbon markets. It was highlighted that a well-implemented international carbon market has the potential to improve the economic efficiency of NDC implementation and result in savings of up to USD 250 billion / year. If these savings are reinvested in further climate action they can lead to additional emissions reductions of 5 GtCO2 / year.

Mr. Igor Shishlov (Perspectives) presented the recent publication "Evolution of international carbon markets"[1] which provides an overview of the four distinct periods of carbon markets from Kyoto to Paris. The first period 1997–2004 operationalized the mechanisms defined in the Kyoto Proto- col, the Clean Development Mechanism (CDM) and Joint Implementation (JI). Pilot activities in different

[1] https://onlinelibrary.wiley.com/doi/full/10.1002/wcc.613

sectors were undertaken by the public sector, and the first base- line and monitoring methodologies officially approved. Between 2005 and 2011, the carbon markets expanded massively. The EU emission trading scheme (EU ETS) was linked to the Kyoto mechanisms, creating demand for carbon credits from the private sector. During this “gold rush” period criticism emerged with regarding the uneven geographical distribution of projects, as well as environmental integrity problems related to baselines and additionality. The next period saw a collapse in carbon prices between 2012 and 2014, limiting the development of new projects. The quantitative limits on the use of offsets in the EU ETS were reached and the failure to agree on a new international regime resulted in a drying up of demand from governments. The 2015–2018 period is characterized by a gradual stabilization of the inter- national climate regime. The Paris Agreement adopted in 2015 increases complexity through global participation in mitigation. Future carbon markets will therefore face both old challenges—supply–demand balance, environmental integrity, transaction costs—and new ones—interactions with other policies and national targets, and sectoral/policy baselines and additionality checks preventing hot air proliferation.

Mr. Axel Michaelowa (Perspectives) then presented the landscape of Article 6 pilot activities based on the recent publication of the Climate Finance Innovators project[2]. The activities presented as pilots represent the diversity of approaches that can be pursued under Article 6. Diversified contractual structures for ITMO transfer agreements emerge. At the same time, all pilots seek to avoid double counting of mitigation outcomes and often seek to enhance the current ambition of NDCs. The relationship between the pilot activities and the NDC commitments of the host country is a relevant consideration for all stakeholders. Many pilots have arrangements in place that foresee the sharing of mitigation outcomes so that both buyer and seller countries receive a portion of the emission reductions for their own NDC. Some pilots require proof that there is NDC

[2] https://www.climatefinanceinnovators.com

“overachievement” before ITMOs can be transferred. The pilots also contribute to building up capacity for tracking and accounting for ITMOs, which is the basis for sound NDC accounting. The current pilot initiatives often work towards national-level tracking, measurement, reporting and verification (MRV), capacity and infrastructure through different approaches, including registries and proposed methodologies for corresponding adjustments.

Ms. Sandra Lindström (Swedish Energy Agency) presented the Swedish experiences with carbon finance. Sweden has been engaged in the international carbon finance for more than 20 years. Since inception, the Swedish program has aimed at contribution to the development of international flexibility mechanism and carbon market as means to contribute to sustainable development and ambition-raising. Sweden’s contribution to development of carbon market started already in 1997 when Sweden supported projects in Eastern Europe to support energy efficiency and introduction to renewable energy in district heating. These projects were used as testing ground for measuring and verifying international emission reductions and became part of UNFCCC Activities Implemented Jointly.

In 2002, the Swedish program for CDM and JI started. Sweden developed a bilateral portfolio which over time consisted of over 90 projects in 26 countries. Beside the bilateral projects, Sweden also participated in 12 carbon funds and facilities managed by the World Bank, ADB, EBRD and NEFCO, the Nordic Environment Finance Corporation. For the purpose of contributing to increasing the geographical coverage of CDM, Swedish Energy Agency focused, on supporting CDM projects in Africa and least developing countries in 2010 and onwards. As a result, over 30 programs, which is one third of all the CDM-programs supported by Sweden in the bilateral program are in Africa. Looking forward, Sweden has a national goal of net zero emissions by 2045 at latest – this will be done mostly by national action/interventions, but Sweden also has a responsibility to contribute to the global mitigation and sustainable development in developing countries. To do this and to move

towards negative emissions, Sweden could potentially use internationally transferred mitigation outcomes if those can be proven to have environmental integrity and contribute to net mitigation.

Chandra Shekhar Sinha (World Bank Group) presented the World Bank's experience with carbon finance and vision for Article 6. The World Bank's first generation of carbon funds included several facilities aimed at purchasing carbon credits with the largest being the Umbrella Carbon Facility with over USD 900 million. These funds played an important role in piloting activities and kick-starting the nascent carbon market. The second generation (post-Kyoto Protocol) carbon funds aimed at supporting niche activities such as for example forestry (BioCarbon Fund) or activities in least developed countries (Ci-Dev). The World Bank also provided technical assistance for carbon market readiness through such programs as the PMR. Carbon funds involved both private and public sector players. The World Bank was a first mover in carbon markets and assumed multiple roles:

- Catalyzing and developing carbon markets.
- Defining carbon finance; innovating and developing tools for its operationalization.
- Helping build capacity in client countries.
- Successful mobilizing resources for carbon finance and diversifying its portfolio of carbon finance interventions.
- Engaging the private sector.
- Demonstrating the significance of carbon finance in renewable energy, energy efficiency, methane and industrial gases.

At the same time has been a number of limitations of the first generation of carbon funds:

- Governance, monitoring and evaluation, and learning across carbon funds and instruments varied extensively.
- Ineffective in demonstrating impact in in transport and agriculture; limited impact in REDD+ in the first decade.
- High transaction costs and project risks, partially due to uncertain regulatory framework.

- Carbon market instruments and pricing by itself did not achieve substantive climate change mitigation ambitions.
- The World Bank Group lacked a clear strategy for exiting the carbon market and continued to participate in low-risk and mainstream carbon market transactions, possibly narrowing the space for the private sector during some periods and in some cases.
- Carbon Finance at the World Bank has remained largely a trust-funded and project-focused activity, leading to increased fragmentation and proliferation of carbon funds and limited integration of CF activities with development operations within the World Bank Group.

Moving forward, the World Bank aims to create enabling environment, inform development of regulatory framework, and develop common and efficient market infrastructure and associated governance arrangements particularly though its Climate Warehouse program.

Luca Lo Re (IEA/OECD) discussed the current status of Article 6 negotiations at COP25 and underlined the importance of these negotiations for ensuring the environmental integrity of carbon markets. In this light, two specific unresolved issues in the negotiations of rules for Article 6 of the Paris Agreement are: (i) accounting methods for single- and multi-year NDCs under Article 6.2 and (ii) the implications of a potential transition of activities and units from the Kyoto Protocol mechanisms to the Article 6.4 mechanism. Different accounting methods can have different implications for environmental integrity, particularly if used by Parties with single-year NDCs. Different options of transition of activities and units from the Clean Development Mechanism to the Article 6.4 mechanism can also impact environmental integrity. Moreover, different options of methodological approaches for setting emission baselines are currently under consideration in the international climate negotiations. It was highlighted that the different approaches being discussed offer advantages and disadvantages in the context of Article 6.4. A one size- fits-all approach to setting baselines is unlikely to be appropriate for the new mechanism, given the variety of possible

mitigation activity types and contexts. Finally, there are benefits and implications for host Parties participating in the Article 6.4 mechanism, which may affect how Parties achieve their NDCs.

The event concluded with a Q&A session, where panelists shared their views on the expected outcomes of Article 6 negotiations at COP25.