November 30, 2021

Agreement Reached on International Carbon Credit Trading Rules at COP26

Negotiators at COP26 Reached an Agreement to Foster International Carbon Credit Trading Markets

SUMMARY

The 2021 United Nations Climate Change Conference, commonly referred to as "COP26", was held in Glasgow, Scotland earlier this month. Among other agreements coming out of COP26, government ministers representing nearly 200 countries reached a consensus regarding rules implementing Article 6 of the 2015 Paris Agreement, which provides a framework for the creation of voluntary international carbon credit trading markets. This agreement follows six years of negotiations over the specific characteristics of such markets, and parties to the agreement have expressed the hope that this framework will lead to the establishment and growth of an international carbon credit trading market.

A. ARTICLE 6 OF THE PARIS AGREEMENT

The Paris Agreement, sometimes referred to as the Paris Accords or the Paris Climate Accords, is an international treaty on climate change mitigation.[1] The Paris Agreement was negotiated and adopted by 196 countries at the United Nations' ("UN") COP21 meeting in Paris, France on December 12, 2015 and entered into force on November 4, 2016.[2] Its primary aim is to keep the rise in mean global temperature to below 2 degrees Celsius, and preferably to 1.5 degrees Celsius, above pre-industrial levels, in an effort to significantly reduce the effects of climate change.[3]

The Paris Agreement proposed a number of avenues through which countries can reduce their emissions, including Article 6, which sets forth a framework for the creation of a voluntary international carbon credit trading market. Article 6.4 contemplates a "mechanism" supervised by a body designated by the parties to the Paris Agreement, which is intended to (i) "promote the mitigation of greenhouse gas emissions"; (ii) "incentivize and facilitate [] the mitigation of greenhouse gas emissions by public and private entities";

(iii) "contribute to the reduction of emission levels" by each party to the agreement, including by means of mitigation activities by one party that can also be used by another party to fulfill its nationally determined contribution ("NDC", which corresponds to a country's emissions reduction commitment under the Paris Agreement); and (iv) "deliver an overall mitigation in global emissions."[4] This mechanism is intended to further the goal, articulated in Article 6.2, that countries will voluntarily engage in "cooperative approaches" that involve the use of internationally transferred mitigation outcomes ("ITMOs", emissions credits that can be traded globally) towards their NDCs.[5] However, Article 6.2 also provides that, in so doing, countries must "apply robust accounting to ensure . . . the avoidance of double counting", such that an individual credit is not counted towards two countries' NDCs.[6]

Although Article 6 lays the foundation for the creation of a global carbon credit market, it left key implementation details to be determined at a later date. Following the Paris Agreement, disagreements over certain fundamental questions, including concerns regarding potential double counting of carbon credits and the ability to trade older carbon credits from a now-defunct trading system, had stalled progress toward definitive rules implementing Article 6.[7] However, a compromise with respect to these and other issues was finally reached at COP26.

B. COP26 AGREEMENT

On November 13, 2021, negotiators from almost 200 countries agreed on final rules implementing Article 6 as part of the Glasgow Climate Pact, ending six years of negotiations over this protocol.[8] Broadly speaking, the rules implementing Article 6 provide for the creation of a UN-certified carbon credit that can be used and traded globally, thereby allowing for the standardization of carbon credits internationally.[9] In so doing, the rules implementing Article 6 enable countries to use carbon credit trading mechanisms to help achieve their NDCs. They also allow for the development of a global market based on credits that satisfy uniform standards.

The agreement reached at COP26 on the rules implementing Article 6 also resolves certain fundamental questions that had been stalling such an agreement since the Paris Agreement in 2015. With respect to the concern regarding double counting, the rules implementing Article 6 provide that the parties to the agreement will cooperate on the use of carbon credits, including with respect to governance and accounting. Specifically, the rules call for the application of "corresponding adjustments" to ensure that a single credit cannot be counted towards two countries' NDCs.[10] In a similar vein, with respect to the debate regarding the usage of older carbon credits, negotiators agreed to limit the use of legacy emissions credits from the UN's Clean Development Mechanism ("CDM"), initially created in the 1997 Kyoto Protocol.[11] Specifically, the rules implementing Article 6 state that only CDM credits registered after January 1, 2013 may be used towards the achievement of a country's NDC.[12]

Though the rules implementing Article 6 lay the foundation for a global emissions trading platform, even these rules will require additional interpretation for such a marketplace to come to fruition. Therefore, the rules implementing Article 6 also establish a body that will supervise the creation and maintenance of an international carbon trading marketplace (the "Supervisory Body").[13] The mandate of the Supervisory Body will be, among other things, to develop the methodologies, registration, monitoring and other processes needed for the establishment and healthy functioning of the international carbon credit trading market for use by public and private entities.[14] The rules invite the nomination of members and alternate members, and request that the Supervisory Body hold at least two meetings during the calendar year 2022 to begin its work.[15]

C. IMPLICATIONS

The lack of agreement on the implementation of Article 6 had stalled efforts to operationalize the carbon emissions reductions required by the Paris Agreement and to develop a functional international emissions credit trading market. Currently, a patchwork of carbon credit markets exists across the globe, including markets established and regulated by individual governments. These include the European Union's Emissions Trading System and similar markets in China, the northeastern United States and California. In these systems, a regulator sets a certain limit on emissions and issues allowances for those emissions on an annual basis, and those entities that reduce their emissions below the limit set by the regulator can sell the remainder of their allowance to other businesses that are short of allowances.[16] There are also voluntary carbon markets, whereby entities can buy and sell carbon offset credits at their discretion (*e.g.*, to fulfill a voluntary commitment to reduce emissions). However, the standards set by these mandatory and voluntary markets vary significantly, which has raised numerous concerns, including with respect to the quality and validity of offsets and the associated credits.[17] The rules implementing Article 6 provide a framework for a potential global trading market operating under uniform standards.

Notably, however, the rules implementing Article 6 do not contain an enforcement mechanism, and rely instead on the good faith of individual participants to adhere to the framework that they propose.[18] Ultimately, while the rules implementing Article 6 lay the groundwork for a global carbon credit trading market, they also raise the fundamental question as to whether governments will follow through on the principles that they set forth.

* * *

ENDNOTES

1 United Nations, *Paris Agreement* (December 12, 2015), https://unfccc.int/files/essential_background/convention/application/pdf/english_paris_agreement.pdf ("Paris Agreement").

2 United Nations Climate Change, *The Paris Agreement*, https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement.

3 Paris Agreement, *supra* note 1, at 3.

4 *Id.* at 7.

5 *Id.*

6 *Id.*

7 Sarah McFarlane and Matthew Dalton, *COP26 Opens Path to International Carbon Trading, Wall Street Journal* (November 14, 2021), https://www.wsj.com/articles/cop26-opens-path-to-international-carbon-trading-11636922314.

8 United Nations Framework Convention on Climate Change, *Rules, Modalities and Procedures for the Mechanism Established by Article 6, Paragraph 4, of the Paris Agreement* (November 13, 2021), https://unfccc.int/sites/default/files/resource/cma2021_L19_adv_0.pdf ("Rules Implementing Article 6.4").

9 United Nations Framework Convention on Climate Change, *Guidance on Cooperative Approaches Referred to in Article 6, Paragraph 2 of the Paris Agreement* at 5 (November 13, 2021), https://unfccc.int/sites/default/files/resource/cma2021_L18_adv.pdf ("Rules Implementing Article 6.2").

10 *Id.* at 6-8.

11 United Nations Framework Convention on Climate Change, *Kyoto Protocol* at 11 (December 11, 1997), https://unfccc.int/resource/docs/convkp/kpeng.pdf.

12 Rules Implementing Article 6.4, *supra* note 8, at 16.

13 *Id.* at 2.

14 *Id.*

15 *Id.*

16 International Swaps and Derivatives Association, *Role of Derivatives in Carbon Markets* (September 2021) at 14, https://www.isda.org/a/soigE/Role-of-Derivatives-in-Carbon-Markets.pdf.

17 *Id.* at 21.

18 McFarlane, *supra* note 7.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.