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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

COP29 Offers Pathway To A Global Carbon Market

By **Jennifer Josefson, Christina Renner and Levi McAllister** (December 20, 2024, 5:26 PM EST)

Jennifer Josefson

Christina Renner

Levi McAllister

The Conference of the Parties, the decision-making body responsible for monitoring and reviewing the implementation of the United Nations Framework Convention on Climate Change, wrapped up its meeting in Baku, Azerbaijan, on Nov. 22.

This meeting, known as COP29, adopted a series of decisions expanding the role of carbon markets under the Paris Agreement, and made a breakthrough in pursuit of the establishment of a U.N.-managed global carbon market.

By way of background, COP meetings are aimed at fostering a sense of shared responsibility and setting a path for nations to tackle climate change collectively. The Paris Agreement, the breakthrough accord reached in 2016 following COP21, set goals to hold "the increase in the global average temperature to well below 2°C above pre-industrial levels," and pursue efforts "to limit the temperature increase to 1.5°C above pre-industrial levels."

The progress made at COP29 regarding carbon markets reflects the global commitment to enhancing cooperative approaches to address climate change, while balancing the interests of diverse stakeholders.

Voluntary carbon market participants in the U.S. and elsewhere should familiarize themselves with the standards endorsed at COP29, so that they have the opportunity to enhance the value of their projects by aligning them with international norms.

Paris Agreement Crediting Mechanism

Under Article 6 of the Paris Agreement, parties can voluntarily pursue cooperative approaches to reach or even increase their climate targets via multiple tools:

- Article 6.2 foresees an international cooperation between countries that allows carbon emissions units generated by a host country, known as the Internationally Transferred Mitigation Outcomes, to be used by another country to count toward its nationally determined contributions.

- Article 6.8 establishes a framework for nonmarket-based cooperation.

- Article 6.4, which made headlines out of COP29, establishes the U.N.-managed carbon crediting mechanism known as the Paris Agreement Crediting Mechanism, or PACM.

The PACM is open to public and private participants. The units generated by the PACM are known as Article 6.4 emission reductions, or A6.4ERs.

Explained in simple terms, the PACM is a high-integrity global carbon market that will allow a participant — which can be a state or a company — in one country to reduce emissions, have these emission reductions credited as A6.4ERs, and trade them internationally to another participant in another country.

The main idea of the PACM is the creation of an international certification system for carbon units with the legitimacy of being developed through the U.N.'s multilateral system. This is intended to create a channel for private-sector and ordinary nonparty stakeholders to engage in Paris Agreement activities.

But this mechanism has been dormant for years due to the absence of underlying regulations, which have faced years of negotiation deadlock. COP26, held in Glasgow in 2021, agreed to the rules, modalities and procedures for the PACM in Decision 3/CMA.3.

The development of concrete guidance under the PACM has been left to the Supervisory Body under the Article 6.4 mechanism. COP29 endorsed the important standards for operationalizing the PACM framework that the Supervisory Body has developed.

Standard for Methodologies

The Standard for Methodologies sets out the requirements for the development and assessment of Article 6.4 mechanism methodologies. It elaborates on and further develops the recommendations for application of the requirements set out in Chapter V.B (Methodologies) of the PACM rules, modalities and procedures.

The methodologies are intended to provide the basis for claims and assessments of creditable emission reductions or removals, and apply to all activities under the PACM.

Compared to previous experience under the Kyoto Protocol's Clean Development Mechanism, and also to voluntary carbon markets, the requirements established by the Standard for Methodologies are viewed as more stringent — particularly with respect to the baseline for crediting and additionality requirements.

Baseline Setting

From the outset, the baseline must be below the business-as-usual projection — that is, benchmarks or scenarios for emissions prior to or in the absence of the implementation of the emission reduction activity. This will need to be demonstrated in the project design document, and at each renewal of the crediting period.

The baseline is also subject to downward adjustment over time — as COP29 resolved that the "mechanism methodologies shall encourage ambition over time" — which reduces the supply of units being offered by an activity over time.

The Standard for Methodologies allows a choice of approaches for the baseline-setting based on:

- Best available technologies;
- Benchmarking with comparable activities; or
- Historical emissions.

The downward adjustment applies to all three approaches.

Cumulative Additionality

Additionality is a key concept for voluntary carbon markets. Explained in simple terms, additionality requires that credits only be issued for activities that would not happen in the absence of the incentives of the carbon crediting mechanism. This usually focuses on the financial aspect of additionality.

The Standard for Methodologies establishes the cumulative requirements to additionality, which go beyond previous expectations. To exhibit additionality, activity must demonstrate the following:

- Benefit considerations — i.e., how the PACM can benefit from the emission reduction activity;

- Avoidance of lock-in — i.e., demonstration that, by incentivizing emission trading under the PACM, certain emission levels are not being locked in;

- Financial additionality — i.e., monetary gains of the PACM are necessary for the emissions reduction activity to exist; and

- Regulatory framework — i.e., activities must go beyond the existing host country's laws and regulations.

The Supervisory Body may apply simplified approaches for demonstration of additionality for projects implemented in any least-developed country.

Standard for Removals

The PACM rules, modalities and procedures established a more technologically neutral approach to removal activities than that of the Kyoto Protocol's Clean Development Mechanism.

That being the case, the Standard for Removals applies to potentially all carbon removal activities — i.e., not only afforestation, but also carbon capture and storage and other emission reduction activities, can qualify to generate A6.4ERs under the PACM.

Positive Net Change in Carbon Stock

The definition for removals considers only positive net changes in the carbon stock, meaning emission avoidance would not qualify. Only an emission reduction, or a positive change in the carbon stock between two periods of time, would qualify.

Another major innovation is that the Standard for Removals moves away from the concept of temporary credits for removal activities, and instead uses a risk evaluation and buffer pool approach — including with respect to emission reduction activities that may have a significant risk of reversal.

Risk Evaluation and Buffer for Reversals

The details for risk evaluations are yet to be further developed by the Supervisory Body. But, in general, the risk evaluation will determine how many units need to be deposited in the buffer pool — the Reversal Risk Buffer Pool Account — and canceled in case of reversal.

The Supervisory Body will establish the Reversal Risk Buffer Pool Account in the PACM registry to serve to remediate avoidable and unavoidable reversals in full, through cancelation of an equivalent amount of units.

In simple terms, the activity participant will be liable for replenishing the buffer in the case of a reversal. The participant may do so by transferring units from other accounts under its name in the same project, or by acquiring units in the market.

The Supervisory Body also continues to investigate other approaches for increasing resilience of the buffer.

Avoidable vs. Unavoidable Reversals

The Standard for Removals differentiates between avoidable and unavoidable reversals, recognizing that certain reversals are out of the control of an activity participant — including reversals due to the factors of climate change itself.

The activity participant should conduct a risk analysis that takes into account unavoidable reversals, and deposit respective units into the buffer discussed above.

Sustainable Development Tool and Appeals Procedure

In addition to the standards that made headlines at COP29, the Supervisory Body adopted two other important instruments earlier this year, the Sustainable Development Tool and the Appeals Procedure.

The Sustainable Development Tool creates a safeguard ratification system, which is a set of mandatory requirements before issuance of an emission reduction unit.

The Sustainable Development Tool is divided into three key sections:

- Environmental and social safeguards;
- Sustainable development impacts; and
- Validation and verification

PACM participants are required to identify, evaluate, avoid, minimize and mitigate potential risk associated with their activities. They also need to monitor their activities against specific indicators developed through the environmental and social safeguards.

The Appeals Procedure is an administrative tool that allows for appeals against a decision of the Supervisory Body, or submision of grievances by those affected by an activity, including affected individuals, communities or businesses.

It creates a framework of responsibility for both governing bodies and participants. The outcome may lead to, among other things, suspension or cancellation of A6.4ERs.

Takeaways

COP29 made history by adopting new international standards. While the PACM offers a lot of potential for global carbon market growth, to become fully operational it will need to have its own methodologies, registry and third-party auditors — known as the designated operational entities.

Once established, the PACM will interact, and potentially integrate, with compliance carbon markets, such as the European Union's Emissions Trading System and voluntary carbon markets.

The EU has just given the final green light to a regulation establishing the first EU-level certification framework for permanent carbon removals, carbon farming and carbon storage in products — the Carbon Removals and Carbon Farming Regulation. This voluntary framework will facilitate and encourage high-quality carbon removal in the EU, as a complement to sustained emission reductions.

By 2026, the EU will assess the possibility of including permanent carbon removals in its Emissions Trading System. It remains to be seen whether the EU will look into potentially integrating A6.4ERs from PACM into its systems, including the Carbon Removals and Carbon Farming Regulation and, at a later stage, the Emissions Trading System, allowing European companies to offset some emissions through global projects.

In the U.S., the Carbon Dioxide Removal Investment Act, which proposes a new tax credit to incentivize the U.S. carbon removal industry, has been just introduced into the U.S. Senate. The act appears to be technology-neutral, with its main criteria being durability and a net-negative lifecycle assessment for carbon removal projects.

This means it potentially allows the generation of verified carbon credits. In conjunction with PACM developments, it may present an opportunity for carbon removal projects in the U.S.

The PACM also appears to be in line with the key principles for building high-integrity voluntary carbon markets expressed in the Voluntary Carbon Markets Joint Policy Statement and Principles issued by the U.S. earlier this year.

Incorporating A6.4ERs into voluntary carbon markets would enhance the credibility and integrity of those markets. To maximize their project value, voluntary carbon market participants may want to bring their credits in line with the international carbon credits.

That being said, not all projects operating in the voluntary carbon markets will be eligible for the PACM, due to more stringent requirements such as cumulative additionality. Further, the flexibility and cost efficiency offered by voluntary carbon markets may remain critical for certain market participants.

Jennifer Josefson, Christina Renner and Levi McAllister are partners at Morgan Lewis & Bockius LLP.

Morgan Lewis associate Maciej Bernard Plotka and legal consultant Alexandra Rotar contributed to this article.