

# Using Transfers to Enhance Ambition over the NDC cycles

*September 13, 2017*

Meeting the demanding global goals called for in the Paris Agreement requires Parties to achieve their existing Nationally Determined Contributions (NDC) and ratchet up their ambition rapidly over time. In this context, Article 6 of the Paris Agreement “recognize[s] that some Parties choose to pursue voluntary cooperation in the implementation of their [NDCs] to allow for higher ambition”. This may involve the use of Internationally Transferred Mitigation Outcomes (ITMOs) towards NDCs.<sup>1</sup>

A system that allows ITMOs to be generated and exchanged can facilitate higher levels of ambition by reducing the unit cost of reductions; knowing that cheaper reductions can be acquired from abroad to meet their NDCs allows Parties that are so inclined to pledge deeper than they would otherwise. Such a system can also encourage investments in advanced technologies and sustainable development that might not otherwise occur without the ability to monetize reductions through the export of ITMOs, helping build capacity for sustainable low-carbon development.

However, a system of transfers can create perverse incentives, namely:

- **Host country Parties** may find it attractive to advance less ambitious mitigation goals than they might otherwise in order to generate transferable mitigation outcomes above and beyond their NDC.
- **ITMO user Parties** may be motivated to rely on cheaper reductions from abroad rather than pursue the necessary, but costlier, domestic transformation.

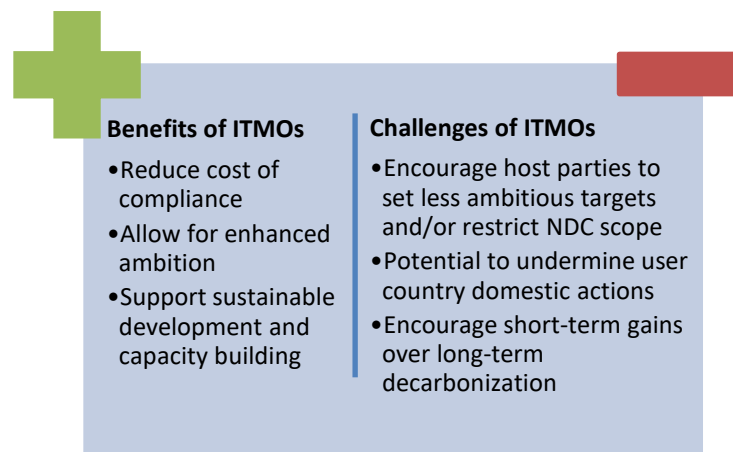


Figure 1 Example benefits and drawbacks of ITMO generation, transfer, and use

Host country Parties also face the challenge of managing their ITMO exports in a way that does not undermine achievement of their own NDC. It may be difficult up front to know precisely which

<sup>1</sup> ITMOs are widely understood to refer to emission reduction units traded through carbon markets, but can also include other forms of transfers, whether in the form of a traded security or not.

Mitigation Outcomes (MOs) they should plan to export to access finance and technology, and those they should plan to keep for their own goals. They may also be incentivized to pursue less expensive short-term mitigation options that can be monetized relatively quickly but lead to lock-in of systems that are not transformational over the long-term.<sup>2</sup>

To help overcome these perverse incentives and support the aim of the Paris Agreement to pursue higher ambition, the Center for Clean Air Policy is therefore proposing a general approach to embed ITMOs in the broader Paris Agreement. Namely, we suggest how ITMOs can be linked to the system of NDC cycles in the context of forward-looking long-term strategies for decarbonization, with a view to ensuring that, over time, all countries achieve economy-wide coverage with their NDCs.

Further discussions with Parties and others will be needed to flesh out the details of how this would work in the context of national policy and UNFCCC rules, but we believe that the basic framework included here can be a useful basis for achieving international consensus.

## ITMOs in 5-Year Cycles

The Paris Agreement defines 5-year cycles for pledging and achievement of NDCs. A number of key points under consideration in national capitals and in the international negotiations related to ITMOs should, in CCAP's view, be linked to the 5-year cycles. While the examples below relate mainly to ITMOs generated on a project or sector basis, the concept can also be applicable to linked trading programs.

**Crediting Periods:** Rather than being based on the life cycle of the ITMO-generating project, the period over which ITMOs are transferred should commence and end concurrently with relevant NDCs. This approach aims to ensure that MOs generated eventually support NDC achievement for the host country and that future transfers make additional progress towards ambition.

- For example, Party A could transfer MOs to Party B for two NDC periods, or ten years, after which reductions would accrue fully to Party A in the 3rd NDC cycle.

**Baseline Setting:** Related to the above, the baselines for generating mitigation outcomes in subsequent NDCs should be based on emissions levels achieved in previous NDCs, including any MOs transferred. This approach, based on similar provisions within the Doha amendment to the Kyoto protocol, would help reduce the threat of "hot air" being included in NDCs.

- In the example above, Party A's baseline for any future transfer of MOs from similar activities in the 3rd NDC cycle would have to be at least as ambitious as the emissions reductions achieved in the 1st and 2nd cycles, including those MOs transferred instead of being used against the national NDC.

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<sup>2</sup> E.g. For example, exporting mitigation outcomes based on landfill gas capture and utilization could be achieved quickly but would foreclose the greater emissions reductions possible through use of an integrated waste management system.

**Relationship to NDC Scope:** To ensure environmental integrity and avoid double counting, there should be a full corresponding adjustment for all ITMOs resulting from mitigation within the scope of an NDC. In the case of linked trading programs, this adjustment would occur automatically. However, for the transfer of mitigation outcomes originating outside of an NDC scope—typically on a project or sector basis—a corresponding adjustment may not be necessary. To address the perverse incentive that allowing transfers without a corresponding adjustment may create,<sup>3</sup> there should be a clear understanding that the activities in question will be covered after a determined number of NDC cycles.

- In our example, Party A’s unilateral NDC in the 3rd cycle would need to include all reductions from the activities previously used as the basis for ITMOs – i.e.: the scope of the NDC would need to expand to include the traded activities. The target would need to be based on achieving at least as much as the emissions reductions achieved in the 1st and 2nd cycles, including those MOs transferred instead of being used against the national NDC.

UNFCCC rules or multi-party standards<sup>4</sup> could offer guidance or place limits on the number of cycles over which a given MO can be credited, or over which baseline and crediting adjustment changes could occur. Determining how many NDC cycles a sector can produce ITMOs while outside of the scope of an NDC will require balancing a variety of interests. A shorter period will likely be viewed as having more integrity than a longer one. However, various factors will likely need to be taken into account, such as economic lifecycles of emissions-generating activities and whether certain Parties with limited capacity will require more time to be able to cover a sector in their NDC. That being said, very long crediting periods may not be necessary from a financial perspective: any revenues from transfers beyond approximately ten years become largely irrelevant due to discounting of future cash flows in project finance calculations.

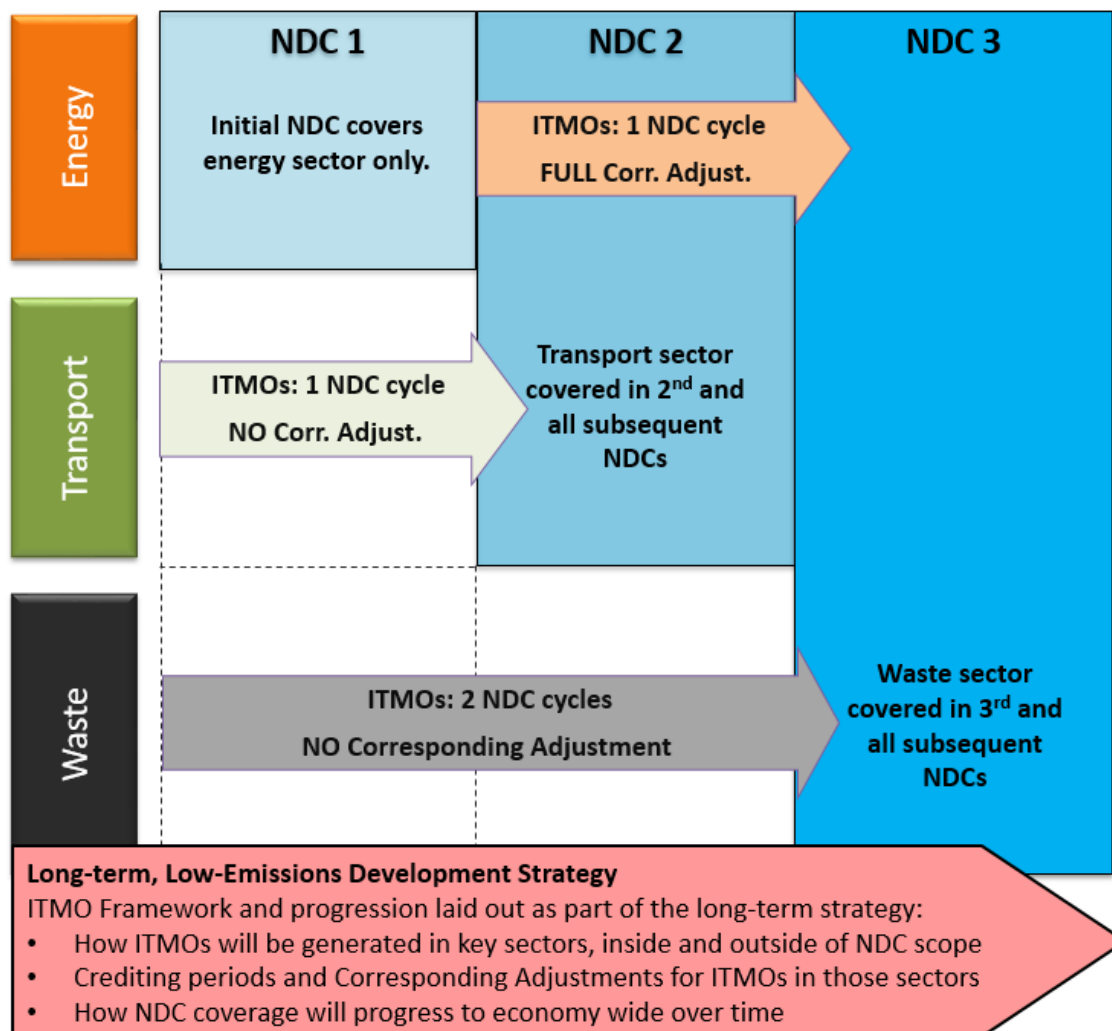
Figure 2 below provides an illustration of how these recommendations might be implemented. The figure shows a host country Party with a three-sector economy, namely energy, transport and waste. Its first NDC covers energy only, but its long-term strategy aims to achieve full coverage in the third NDC period. Such a Party would therefore be able to transfer mitigation outcomes from sectors outside of the scope of the NDC for a limited period. In this model, it has been determined that transport emissions can be transferred outside of the scope of the NDC for one NDC period, whereas the country can take two NDC periods before including the waste sector. Energy sector ITMOs are transferred, but as they are within the scope of the NDC, a full corresponding adjustment would need to be made.

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<sup>3</sup> Namely, allowing transfers without a corresponding adjustment for sectors outside the NDC scope creates a perverse incentive for Parties to restrict the scope and ambition of their NDC. This runs counter to the spirit of the Paris Agreement, which encourages Parties to move toward economy-wide targets (Article 4.4).

<sup>4</sup> This might include bilateral or multiparty agreements, existing plurilateral frameworks like the G7 or G20, or the ad hoc “carbon clubs.”

Figure 2 A Model for ITMOs and NDC Scope



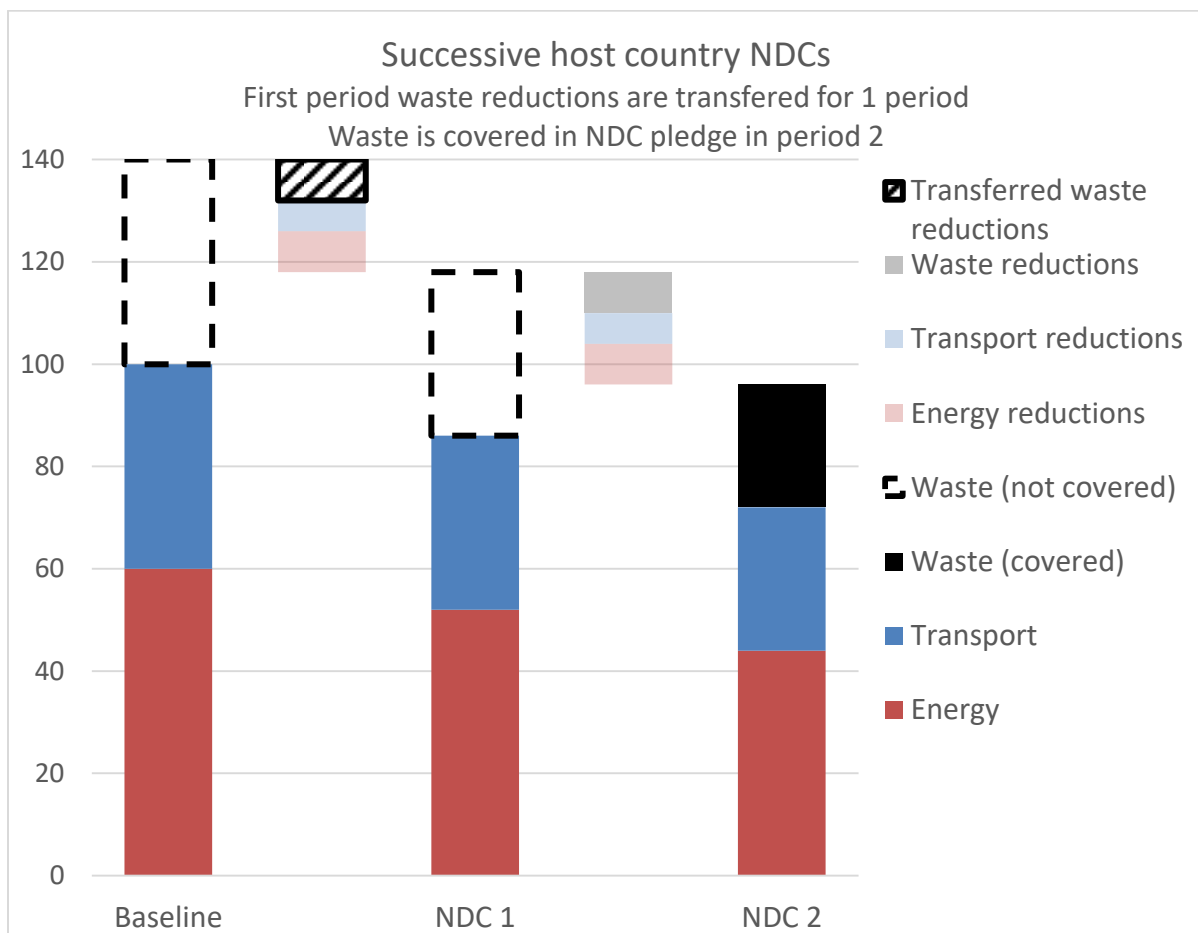
Linking the function of an ITMO transfer system to the NDC cycles could offer a number of advantages. It could help host country Parties accelerate ambition by building capacity and experience to limit emissions in new sectors. This would make it easier for those Parties to effectively include those sectors in future NDCs, and move over time to economy-wide NDC coverage, as the Paris Agreement encourages. Linking ITMO transfers to NDC cycles would also encourage actions beyond existing mitigation goals and requirements, supporting higher levels of ambition than might be initially feasible for the host country to require, but ensuring that such reductions support higher ambition by the host country by a date certain.

In Figure 3 below, we illustrate how ITMO transfers would impact reported emissions in a country that seeks to generate and transfer waste sector ITMOs for 1 NDC period with a view to achieving coverage of waste in its NDC in the second period. The economy has two other sectors, namely transport and

energy. As can be seen in the figure, the second NDC actually aims to achieve higher emissions than the first NDC, but that reflects an increased scope. Economy-wide emissions are on a downward trend.

The transfer of ITMOs for one NDC period means that total global emissions may be higher than if the waste sector reductions had been undertaken autonomously. However, if the host Party did not have the capacity to undertake those emissions, the short term transfer of ITMOs could lead to transformation in the waste sector that would not otherwise occur as rapidly. If the country is able to pledge increasingly ambitious reductions, autonomously, for the waste sector in all future NDCs, promote sustainable development and poverty reduction, and build domestic emissions reduction capacity, the trade-off could be justifiable from an environmental integrity perspective.

Figure 3: Accounting for emissions reductions from ITMOs in host country



For Parties *using* ITMOs to achieve their targets, this approach offers certainty on the value of transfers in the near-term (since the baseline is fixed) and clarity on the duration of the MOs. Knowing that purchased MOs can help meet near-term commitments, user country Parties can plan longer-term investments geared towards decarbonization of their domestic economies but where significant

emissions reductions may take longer to realize. In facilitating such investments, ITMOs can allow user country Parties to adopt more ambitious NDCs in future cycles.

## ITMOs in Long-Term Strategies

The Paris Agreement and decision called on Parties to formulate and communicate low greenhouse gas emission development strategies by 2020. As of August 2017, 6 countries have submitted them – including the United States, Canada, Mexico, Germany, France and Benin.<sup>5</sup> Of these, only Canada makes any significant mention of the use of ITMOs, highlighting how ITMOs can help the country contribute to global mitigation despite structural challenges to cost-effective mitigation in the Canadian economy.

These so-called “Long-term Strategies” (LTS) provide an opportunity for countries to communicate their longer-term vision for achieving the goals of the Paris Agreement by elaborating a pathway for successive NDCs of increasing ambition in the context of the country’s sustainable development and poverty reduction. Ideally, for countries intending to generate or use ITMOs, this vision could include how ITMOs could help achieve long-term goals over successive NDC cycles. Transparency on use of ITMOs in LTS will also help relevant actors understand how ITMOs are generated and used in a manner that enhances ambition, increasing confidence in their integrity.

Table 1 explores a few ways in which the effective development of LTS can help address some of the risks associated with the generation, transfer, and use of ITMOs.

Table 1 ITMO challenges and how LTS can help

Challenge	How LTS can help
<b>Perverse incentives to restrict scope and ambition</b>	<ul style="list-style-type: none"> <li>• Show pathway for long-term decarbonization and long-term goals, including how NDC scope will expand over time</li> <li>• Demonstrate how ITMOs use is expected to improve capacity to incorporate sectors into subsequent NDCs</li> </ul>
<b>Undermine host country NDC achievement</b>	<ul style="list-style-type: none"> <li>• Show mitigation pathways for achievement of current and future NDCs that allow for ITMO use</li> </ul>
<b>Prioritize short-term gains over long-term decarbonization</b>	<ul style="list-style-type: none"> <li>• Allow host country Parties to strategically address drivers of emissions and/or enhance sinks</li> <li>• Transparently show domestic criteria used to authorize transfers based on achieving long-term transformation</li> <li>• Allow ITMO-using Parties to demonstrate how this use is <i>supplemental</i> to ambitious domestic action, and not a replacement</li> </ul>

<sup>5</sup> [http://unfccc.int/focus/long-term\\_strategies/items/9971.php](http://unfccc.int/focus/long-term_strategies/items/9971.php)

**For ITMO host country Parties, the LTS** could highlight elements such as:

- Which sectors will be the source of MOs, how finance and technology inflows from this activity could support transformation in that sector, and how ITMOs will allow for higher domestic ambition over the NDC cycles.
- Plans and expected timing to enhance the scope of NDCs over NDC cycles, including a target period for when full economy wide coverage is envisaged to be achieved and the expected timing for making full corresponding adjustments for all transferred MOs.
- Emissions projections without export of ITMOs, the total volume of MOs to be generated and exported while still fulfilling the NDC; as well as projections identifying the impact of sector transformation catalyzed by the technology and finance generated through ITMO export.

**ITMO user Party LTS** should demonstrate how the acquisition of ITMOs is complementary to domestic action to decarbonize their economy, and may need to highlight:

- Which sectors present mitigation challenges that justify the use of international offsets and how policy will advance to promote transformation even as offsets are accessed;
- The period of time over which ITMOs will be needed to complement domestic reductions, including a planned phase out date for ITMOs (particularly those that don't entail a corresponding adjustment); and
- Emissions and compliance projections without the import of ITMOs, how projects could be improved through the use of ITMOs, the volume of ITMOs to be used over time, and projected emissions/compliance with use of ITMOs.

In addition to mitigating the risks associated with ITMOs, LTS that explicitly plan for the use of ITMOs can contribute to the achievement of global goals by providing indications to private sector investors of where mitigation opportunities may lie, improving inter-ministerial coordination, and providing a guiding framework for policy development and ITMO approvals.

## Conclusions and Next Steps

Internationally Transferred Mitigation Outcomes can play an important role in enhancing global ambition and improving Parties' capacity for mitigation and long-term transformation, but precautions must be taken by both source and user countries to mitigate the perverse incentives that could compromise ambition.

We propose that Parties align key aspects of ITMO generation and use—crediting periods, crediting baselines and corresponding adjustments—with the 5-year NDC cycles. This can help boost ambition in both host and user countries and encourage inclusion of more sectors in the NDC while providing



certainty and transparency on the duration of MOs and clarity on Party plans for ensuring additionality and use of corresponding adjustments.

We further suggest that Parties explain their detailed plans for use of ITMOs as part of their Long-Term Strategies. Incorporating ITMO plans into long-term planning can improve Parties' capacity to manage their greenhouse gas emissions and guide domestic ITMO sales and purchases. In doing so, these strategies can help address a number of the perverse incentives associated with ITMO generation, transfer, and use and thereby improve trust among Parties and with ITMO stakeholders.

CCAP looks forward to engaging with Parties and others to support responsible generation and use of ITMOs that leads to enhanced ambition and achieves the goals of the Paris agreement. We see an important role for Long-Term Strategies in these efforts, and welcome the opportunity to engage further on how best to apply the recommendations above in practice, and in specific instances.

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