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Carbon Markets: Leveraging the Interface between Climate Policy and Trade Policy to secure Climate Finance for Small Island Developing States

Clara Brandi and Jodie Keane

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Clara Brandi[1] and Jodie Keane[2]

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Abstract

Securing the integrity of sovereign carbon markets within the Paris Agreement (PA) has been paramount within the continuing negotiations to conclude Article 6 by COP28. Additional pressure comes from the need to drastically scale up sources of climate finance to address the goals of the PA. Whilst some of the issues regarding carbon markets, trade in carbon and carbon standards are finally becoming more visible within different discussions related to environmental sustainability at the World Trade Organisation, it is fair to say that these issues have risen to prominence rather more defensively, than proactively. This paper argues that a more proactive approach is needed to ensure development friendly carbon markets, especially for Small Island Developing states (SIDS) within the context of nature-based solutions; it explores the interface between climate and trade policy to secure climate finance for SIDS and provides policy recommendations to this effect.

[1] German Institute of Development and Sustainability (IDOS) / University of Bonn
[2] ODI, London.

1. Introduction

There is already a substantial literature on the successes and challenges of the sovereign carbon market established under the Kyoto Protocol (KP) (known as the Clean Development Mechanism (CDM)) and how its successor, agreed under the Paris Agreement (PA), can overcome these. However, consideration of the interface between trade and climate policy, and climate finance, continues to be a neglected: the trade policy community is seemingly preoccupied with a more defensive approach in view of the imminent application of border carbon adjustment (BCA) measures imposed by the European Union (EU); this is despite the recognition by the climate community of the potential for the SDM to unlock new sources of climate finance for developing countries, especially Small Island Developing States (SIDS) and Least Developed Countries (LDCs).

The number of countries now pricing carbon either through taxation measures or emissions trading schemes is growing rapidly. Under the KP international trade in certified emissions reductions between different ETS's was provided for by the CDM. The successor under the PA will provide for similar access once the framework has been fully agreed at the forthcoming UNFCCC conference COP28. However, several issues remain outstanding including coverage and whether carbon removals will be included, as well as ensuring effective governance to avoid the double counting of CERs and, more broadly, securing environmental integrity. For LDCs and SIDS that were unable to benefit from the CDM previously, the new framework for the SDM under Article 6 of the PA provides for important new trade opportunities in carbon and therefore the ability to secure climate finance. However, market access must be secured; in addition, technical as well as financial barriers to realise these new opportunities must be overcome.

The international trade dimension of sovereign carbon markets helps to reduce emissions in the most cost-effective way and supports cap and trade systems. Not only are there economic benefits, but if the savings made possible through carbon trading are re-invested, then climate ambition can be further increased. However, whilst international carbon markets are considered a vital component of the PA and climate policy, they do not yet feature prominently within trade policy discussions at the multilateral level.

Rising in prominence within trade policy discussions, however, are the issues regarding ensuring that carbon is priced using agreed methodologies and approaches. Currently, there are no common carbon standards in use by the international trading system. In its recent series of briefings on trade and climate the WTO has referred to the numerous standards at both the international and national levels, this includes the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard;[3] at the sectoral level, a recent assessment by the WTO identified around 20 different decarbonisation standards and initiatives for the steel sector.[4] These issues have begun to become more visible within different discussions on environmental sustainability at the WTO, including the Committee on Trade and the Environment, as well as the Trade and Environmental Sustainability Structured Discussions (TESSD).

Absent so far from the current deliberations, however, is a focus on carbon markets: developing carbon markets (for example, domestic emissions trading schemes) may not only be a route to mitigate BCAs, but also to finance the green transition and sustainable development (through cap and trade schemes like those under the KP and envisaged under Article 6 of the PA). Unfortunately, the trade community remains fixated on BCAs to ensure foreign competitors

[3] See: clim_03nov21-6_e.pdf (wto.org)
[4] See: trade-climate-change_info_brief_no7_e.pdf (wto.org)

face similar carbon costs as domestic producers.[2] Linking BCAs to the broader issues regarding carbon markets and standards provides a more proactive approach whereby new trade opportunities could be also considered. These pertinent issues, especially important for SIDS that seek to limit global temperature rises to not more than 1.5 degrees, deserve greater attention by the WTO. Actions to support the development of sovereign carbon markets under Article 6 of the PA will also help raise additional climate finance given the levy on carbon market transactions for adaptation, which can strengthen climate-resilient development: 5% of all credits under Article. 6.4 will be given to the Adaptation Fund (a major increase from the 2% levy under the KP).

Within this context, this paper first provides some of the history of discussions regarding carbon markets at the UNFCCC (Section 2). It then proceeds to review how trade in carbon, carbon markets and carbon standard have been deliberated so far at the WTO (Section 3). The interface between trade and climate policy to leverage climate finance is finally explored within the context of securing development friendly carbon markets. We conclude with policy recommendations regarding how the WTO and international support measures could more effectively leverage the interface of climate, trade, and finance especially for SIDS.

2. The Governance of Carbon Markets within the United Nations Framework Convention on Climate Change (UNFCCC)

Article 6 of the PA recognizes that some countries choose to pursue voluntary cooperation in the implementation of their nationally determined contributions to allow for higher ambition in their mitigation and adaptation actions and to promote sustainable development and environmental integrity.[5] Article 6 of the Paris Agreement, under Article 6.2, provides an accounting framework for bilateral or multilateral cooperation that results in the international transfer of mitigation outcomes. Article 6.4 allows emission reductions to be implemented in one country and the credit to be transferred to another and be counted towards its commitments (known as nationally determined contributions or NDCs). This system overall is referred to as the SDM and it is essentially the successor of the CDM. However, several critical aspects regarding the governance of carbon markets provided for by Article 6 must be resolved at COP28.

For the new sovereign carbon market and the SDM to work, it must be transparent and accountable to ensure emission reductions are not counted twice. The so-called San José Principles aim to achieve this goal. These principles for High Ambition and Integrity in International Carbon Markets" were agreed in 2019 by a coalition working together since the pre-COP25 in Costa Rica to secure an ambitious outcome on Article 6. The San José Principles demand environmental integrity, robust accounting rules and the avoidance of double counting.

[5] See: Cooperative Implementation | UNFCCC

Whilst COP26 and COP27 saw some progress on incorporating the San José principles into the rulebook for Article 6, the methodology requirements agreed at COP 26 must be developed and approved at COP28. The overall objective remains to ensure these principles are enshrined into the rulebook. Given this, the G7 recently agreed on principles of high integrity of carbon markets, garnering further momentum.[6] However, to date a similar statement of support has not been issued by the G20. Moreover, even if there was agreement in the G20, SIDS do not formally participate in this group.

Box 1: Moving from the CDM to the SDM

Previously, the **CDM** permitted emission-reduction projects in developing countries to earn certified emission reduction (CER) credits, each equivalent to one tonne of CO2. These CERs were traded and sold, and used by industrialized countries to a meet a part of their emission reduction targets under the Kyoto Protocol. The CDM was the main source of income for the UNFCCC Adaptation Fund, which was established to finance adaptation projects and programmes in developing country Parties to the Kyoto Protocol that are particularly vulnerable to the adverse effects of climate change. The Adaptation Fund is financed by a 2% levy on CERs issued by the CDM.

This levy is increased to 5% under the new framework for carbon trade provided by Article 6 under the Paris Agreement, which is also referred to as the Sustainable Development Mechanism. Many of the pitfalls of the CDM have been sought to be overcome, this includes the track record in lowering emissions as well as concerns regarding the social impacts of projects.

Sources: CDM: About CDM (unfccc.int); Emissions Trading | UNFCCC

Interest by the G20 may be more subdued because the sectoral coverage of carbon markets under Article 6 remains unclear. For example, it remains unclear whether the removal of carbon, for example, carbon sequestration projects will feature within Article 6. This issue is critical for SIDS, who have no experience of the CDM, but remain hopeful that recognition of the ocean as a carbon sink, as well as other nature-based solutions like forestry reserves, can be recognized under Article 6 and therefore provide new trade opportunities to gain climate finance.

[6] Energy ministers outlined principles to underpin high integrity carbon markets alongside a wider communique, see: G7 Hiroshima Leaders' Communiqué | The White House

The cost-saving potential for developed countries of well-functioning crediting mechanisms is known to be large: even limited use of credits would nearly halve mitigation costs. However, an open issue is whether these gains can be fully reaped in reality: the direct linking and the use of crediting mechanisms both raise complex system design and implementation issues; these governance issues are hoped to be resolved at COP28.[7]

There are two main ways in which Article 6 of the PA could be used by developing countries to secure climate finance: through carbon markets and offsetting or through obtaining grant-based finance. For example, the final text of Article 6.4 at COP27 included a "forests" section and a reference to "nature-based solutions." By referencing Reducing Emissions from Deforestation and Forest Degradation (REDD), Article 6 could be a game-changer in the fight against deforestation. In addition, the language under Article 6.8 indicates that the aim is to finance the protection of ecosystems through "non-market approaches" like grants rather than with carbon credits. Important choices are needed at COP28 regarding whether Article 6.4 activities can include emission avoidance and conservation enhancement activities and therefore obtain carbon credits. Alternatively, grant-based sources of finance could be secured under Article 6.8 for these activities. Missing from all of these discussions so far, however, is the trade perspective or consideration of the framework of WTO governance and provision of international support measures specifically designed to facilitate trade, like aid for trade.

In the absence of consideration within the WTO of carbon markets many members are moving rapidly ahead to secure bilateral arrangements. Despite the rulebook of Article 6 still being finalized, the first internationally transferred mitigation outcomes were already authorized in

[7] See: towards-global-carbon-pricing-direct-and-indirect-linking-of-carbon-markets.pdf (oecd.org)

2022. At COP27, Switzerland and Ghana announced the first authorization of internationally transferred mitigation outcomes. Switzerland installed efficient lighting and cleaner stoves in Ghana so up to five million households there will no longer need to burn carbon-polluting wood for cooking. Switzerland can now count those emission cuts in Ghana toward its own goal of halving Swiss greenhouse gas output by 2030. It has signed similar agreements with 10 other low-income countries.

Within the African Union's Green Recovery Action Plan, carbon markets as a source of climate finance are prominent and trade policy links with the African Continental Free Trade Area have also been considered to secure development-orientated carbon markets. As Africa currently produces only a tiny percentage of its carbon credit potential, countries from the continent launched the Africa Carbon Markets Initiative at COP27, seeking to produce 300 million carbon credits annually, unlocking $6 billion in revenue and creating 30 million jobs by 2030. The West African Alliance on Carbon Markets and Climate Finance (WAACMCF), aiming to "participate in international carbon markets, benefit from technology transfer and access result-based climate finance for NDC implementation", is an example for regional collaboration, which aims to better unleash the potential of carbon markets.

In the Caribbean, there are various sectors of interest regarding carbon markets, but these are not conventional ones. For example, the Bahamas has its own climate change and carbon market initiative bill and is accessing the blue carbon voluntary market related to the role of the ocean as a carbon sink. Other countries within the region such as Guyana, could make use of their forestry reserves to access carbon markets. Finally, the use of seagrass could also be explored. There is a handbook on the practical application of Article 6 of the Paris Agreement by CARICOM. But there is not currently a regional framework and different countries are

moving at different speeds. So far voluntary markets have been pursued to secure opportunities, but the new opportunities becoming available through the conclusion of Article 6 negotiations at COP28 must also be carefully considered.

3.The World Trade Organization: A role in carbon market governance?

The absence of discussions on carbon markets in the WTO may partly reflect the fact that the overall rule book is still being finalised: the UNFCCC methodologies being agreed under Article 6 at COP28 should be concluded by 2024. At the same time, however, there are good reasons now to improve the UNFCCC and WTO interplay on carbon markets. This is especially the case when considering market access issues and the potential of carbon markets to secure climate finance.

There is scope to reconcile preferential treatment for CERs with WTO rules on market access for developing countries (Keane et al. 2010). More generally, WTO members should reflect on how WTO principles on market access could be considered within carbon markets. Already there are first movers within global carbon markets like Switzerland, which should be commended. Nonetheless, the basis of decisions to enable, as well as support, country x or country y to secure market access should also be considered within the context of WTO members commitments to sustainable development and the needs of LDCs and SIDS.

Underpinning carbon markets are common metrics and measurement systems to ensure transparency, accuracy, completeness, comparability and consistency; carbon markets need to be underpinned by adequate measurement, reporting and verification (MRV) systems. The UNFCCC already has its process. However, in relation to traded emissions and carbon standards, the WTO does not perform the role of a standard setter. Instead, the Secretariat has begun to advocate for common standards given the current proliferation. This is because of the uncertainty for producers, increased transaction costs, and risks of trade frictions. Looking

ahead, the disciplines of the WTO's Agreement on Technical Barriers to Trade (the TBT Agreement) can help to incentivize WTO members to align standards and regulations to common international standards; this may contribute to members' climate goals by ensuring that effective methods are employed when measuring carbon emissions or a product's carbon content (WTO, 2022). Some progress on sustainability standards is being made in different WTO discussions like the TESSD. However, the participation of WTO members from the Caribbean is weak (with only Suriname involved to date). Moreover, greater reference must be made to carbon markets in order to transform what tends to be considered a mostly defensive agenda (i.e. reacting to the imposition of BCAs) into a more proactive approach to overcoming the barriers to participation in a new burgeoning market in CERs.

Whilst it is generally recognized that greater technical support is needed for SIDS and LDCs to enhance their participation in the development of new relevant international standards, questions remain as to how far support will go, and if instead there is a need for more dedicated aid for trade support programmes to support carbon standards and development friendly carbon markets. The lessons of the experiences of the CDM suggest technical, as well as financial barriers, will need to be overcome to ensure SIDS and LDCs can access the SDM. There are issues around scale, as well as the ability to access technologies to assist in accessing carbon markets.

This dimension is relevant to WTO discussions on technology transfer and obligations to developing countries. While the WTO argues that TRIPS Agreement (Article 66.2) can help to ease the transfer of environmental technologies through commitments to offer incentives for enterprises and institutions to encourage technology transfer to LDCs (WTO, 2022), others are of the view that more support should be provided to developing countries. At the same time, there are commitments under the PA to ensure collaborative climate technology development

and transfers, as well as to contribute more to the climate innovation facillity and technology mechanism established.

Other areas where the WTO should clarify its role in relation to the governance of carbon markets include in relation to how trade in carbon is itself classified. New markets in certified emissions reductions, or emission reduction units are being created that are being regulated by national authorities. The financial market is possibly included in the schedules of financial services commitments of WTO members and, if so, subject to the principles on Most Favoured Nation (MFN) and NDT of the General Agreement on Trade in Services (GATS). Any discrimination among countries could create conflict between the regimes. In addition, there may be implications for the use of support measures (e.g. free allocation of CERs in relation to WTO rules on subsidies and investment incentives). For example, financial mechanisms or funding programs to support specific activities such as an increase in the use of renewable energy or, new technologies inn energy, or a carbon sequestration technology can include fiscal measures or investment support measures that affect the costs and prices of goods and services.

4. Conclusion

This paper has reviewed the interface between the climate and trade regimes for carbon markets to leverage climate finance. It has shown that there are several areas where action is needed at the multilateral level and by the WTO. However, actions are also needed at the national and regional levels too for SIDS including within the Caribbean. Some countries within the region are moving faster than others in relation to the development of carbon markets, but these efforts have so far been focused on the voluntary market. There is a need to develop clear a national and regional position on sovereign carbon markets as enshrined within the PA. This basis can

inform engagement at the multilateral level, to try to shift the discourse towards more proactive engagement with development orientated carbon markets.

Specific areas that could be pursued include ensuring that WTO principles on market access are considered within carbon markets, like non-discrimination and national treatment. In addition, consideration of specific market access arrangements for SIDS and LDCs could also be considered given their high vulnerability to the physical effects of climate change. In addition, there is a need to ensure that developing countries, especially SIDS and LDCs are provided with support to access new carbon trade opportunities; this may require a new role for aid for trade, but could also have implications for technology transfer.

Many developing countries have stated their intentions to develop sovereign carbon markets to achieve the ambitions specified within their Nationally Determined Contributions (NDCs) submitted as part of UNFCCC processes. As trade becomes more integrated within NDCs the role of carbon markets and their trade-related implications must be clarified. More systematic engagement between the WTO and UNFCCC should confront the issues head-on, which are now longstanding. The failure to address the interface between the climate and trade regimes of carbon markets is in turn reducing the amount of climate finance so urgently needed, both for adaptation as well as mitigation purposes.

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[2] The EU has decided to introduce a carbon border adjustment mechanism (CBAM) in 2023 to charge imported goods according to their CO_2 emissions during production. This is the first such measure, but more may follow as countries implement domestic climate policies at different speeds and with varying ambition.