THE NO-BANKING RULE IN THE ARTICLE 6 RULEBOOK

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Introduction

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The Article 6 Rulebook foresees that mitigation outcomes must be used within the same nationally determined contribution (NDC) period in which they have been generated. This rule prevents banking (and borrowing) internationally transferred mitigation outcomes (ITMOs) for compliance purposes from one NDC period to the next.[1] In contrast to many other contentious topics on which compromise was forged during the late hours of COP 26 when the Article 6 Rulebook was adopted, the no-banking rule had never been in the spotlight of the negotiations and hence caught many stakeholders by surprise when it appeared in the final decision. It had not been one of the big-ticket items on which dedicated exchanges were held and neither been a visible option in the negotiation texts prior to the final agreement. Rather, the time-bound use of ITMOs had lingered in the cover decision of previous versions as a potential future work area of the Subsidiary Body of Scientific Advice (SBSTA). While the topic has been under the radar of many negotiators and observers alike and escaped technical scrutiny, it can nevertheless be expected to have material impacts on market participants (see Strand, 2022).

The no-banking rule represents a steep departure from the practice of the Kyoto Protocol, which allowed for limitless carry-over of assigned amount units (AAUs) and a generous carry-over of project-based credits from the Clean Development Mechanism (CDM) or Joint Implementation (JI) of up to 2.5% of a Party's initial AAU allocation from one commitment period to the next. It also contrasts with the design of national or regional carbon markets such as the EU Emission Trading Scheme (EU ETS). The latter allows for the banking of allowances from one compliance period to another without restriction. The question therefore is why the trade in ITMOs should follow different rules than those established for already functional carbon markets.

This note attempts to reconstruct the process by which the provision emerged in the Article 6.2 guidance. By that, it seeks to shed light on the main reasons for its introduction and the underlying concerns. The note then proceeds to assessing the implications and analyzing its impact from a technical perspective. Lastly, the way forward is discussed by looking at the opportunities for stakeholders to operate under the non-banking rule through choosing the right transaction structures for engaging in carbon market operations under Article 6.

The note is based on discussions with key actors who took part in the negotiations in Glasgow and played a role in shaping the final agreement. From these discussions it emerges that little time was spent examining the issue in detail due to high political pressures to reach an agreement and an overwhelming agenda of issues. Seeking to fill this gap, the note takes a closer look at the stated concerns and likely consequences of the ruling. It is clear, however, that this comes at a time where the topic is not high on the agenda. Market participants are still grabbling with more immediate challenges in operationalizing Article 6. In the climate negotiations, Parties are focusing on the operational details of the Article 6 Rulebook, having no ongoing agenda item in which the no-banking rule would be discussed and certainly no appetite to question parts of the Article 6 agreement, knowing the delicacy of the compromise with which it was achieved.

[1] This note uses the term "no-banking rule" in short for this provision. The term is the author's only and not an official UNFCCC term.

How the no-banking rule was agreed at COP 26

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According to the Article 6.2 guidance, corresponding adjustment shall be applied in such a way that mitigation outcomes are used within the same NDC implementation period as when they occurred. (UNFCCC 2021a para 8b and 9b).

The main proponent of this no-banking rule has been the EU. In its submission on the Article 6.2 reporting and review cycle dated 15 October 2021, the following arguments are made:

The Article 6.2 guidance must be more specific on the timing of the corresponding adjustment including because:

- *(…)*
- *There is also no indication on the calendar year for which the emission balance must be adjusted (also sometime referred to as "vintage based accounting"). This will result in different interpretations of the calendar year for which an emission balance must be adjusted, and in a potential large time lag between the authorization of an MO and its use possibly across different NDC periods.*
- *To avoid this situation, Para 9 should clarify that the host party must adjust its emission balance at first transfer* ***for the relevant year when the mitigation outcome was achieved****, while the using party must adjust its emission balance* ***during that same NDC period*** *(see detailed textual wording in our submission from 17 June 2021)*
- *We are also open to hear other proposals for addressing this issue, including through clarifying that MOs must be used* ***within a timebound period after its vintage date***.

In the EU's earlier submission from 17 June 2021 the following more in-depth explanation is provided:

We also see the need to undertake a ***work programme to elaborate on potential safeguards designed to avoid lock in of low ambition and high emissions****, including through the potential limitation on the use of ITMOs across NDC periods. Emission levels are currently far in excess of what they need to be to put us on a path to balancing emissions and removals in the second half of this century. The generation, use and banking of ITMOs in respect of "hot air" (i.e. resulting from NDCs that will be over-achieved without pursuing any further mitigation action), and any overselling of ITMOs, should be avoided.*

(…)

The Article 6 guidance should ensure that regular adjustments are undertaken and that these adjustments are representative of the impact of the approach on emissions. To ensure representativeness, adjustments should be applied to the calendar years of the emissions balance such that the adjusted balances are representative of the impact of the cooperative approach on emissions.

In consequence, we believe that paragraph 9 of Annex of the third version of the Madrid text should be complemented with the following elements:

- For the host Party, the adjustment should be undertaken at first transfer, for the relevant year in which the mitigation outcome was achieved;
- For the using Party, the adjustment should occur during the same NDC implementation period during which the mitigation outcome was achieved.

While the EU has been the key proponent of the no-banking rule, other Parties were either not strongly opposed, did not see particular harm in the provision or expected added benefits.

In speaking to Parties after the adoption of the Rulebook, some stated that the no-banking rule would not affect project activities and their ability to generate carbon credits beyond the NDC period, which would be ruled independently by the crediting period of activities. Thus, the restriction would be for bookkeeping purposes only and not have material impacts on project development.

An actual advantage seen by some Parties in the ruling was the expectation that any ITMOs generated but not used during an NDC implementation period would have to be written off, thus contributing to *overall mitigation of global emissions* (OMGE) and the long-term goals of the Paris Agreement.

The ruling also appealed to some Parties by ensuring that each NDC implementation period would start with a "clean slate". Restricting transfers across NDC implementation periods would make consistency checks easier because corresponding adjustments by transferring and acquiring Parties would correspond within the period.

The main driver, however, can be identified in the concerns of having to deal with legacy issues (again). The transition of Kyoto Protocol (KP) units to the Paris Agreement (PA) has severely burdened the negotiations of the Article 6 Rulebook and was one of the crunch issues that stood in the way of an agreement. Particularly the use of pre-2021 Certified Emission Reductions (CERs) towards NDCs and, to a lesser extent, the use of excess Assigned Amount Units (AAUs) or emission reductions generated under REDD+ before the start of the PA were major stumbling blocks in the negotiations. Another legacy issue cited were the problems experienced during the carry-over of KP units from the first to the second KP commitment period.

It is worth noting that in the final agreement of the Article 6 Rulebook, Parties have settled for a generous ruling on the transition of pre-2021 CERs. According to the Article 6.4 rules, modalities and procedures (RMP), pre-2021 (non-forestry) CERs can be used towards NDCs with practically no restriction and without the need for corresponding adjustments on the side of the host Party. The only moderate limitation consists of the fact that CERs must be used during the first NDC period and stem from a project activity that was registered on or after 1 January 2013. This is substantially more generous than previous options under negotiations. The preceding second version of the Presidency Text had a variety of possible limitations, including the use of pre-2021 CERs only by the host Party, a later registration date of the CDM activity, applying only to CERs that were issued after a certain date, restriction of the time period during which CERs may be used to 2025 as well as the requirement for corresponding adjustments to be undertaken. There also was an explicit option that no CERs may be transitioned.

Against the surprisingly lenient final agreement on CER transition, the avoidance of future legacy issues may have become more urgent and the need for safeguards on the side of those wishing to limit transition of units more pronounced. This might explain the elevation of the no-banking rule from a potential future work program of the SBSTA to a hard provision in the final agreement. Concerns were also expressed that without the limitation of carry-over between NDC periods, any CERs transitioned from the KP to A6.4ERs could simply be waived into the next NDC period, leading to windfall gains or undermining future NDCs. More generally, some Parties are concerned that Article 6.2 does not provide strong safeguards for the prevention of "hot air", i.e. ITMOs arising from non-ambitious NDCs rather than actual additional mitigation.

Lastly, some Parties mentioned concerns of using mitigation outcomes generated today far into the future when climate targets must be tightened in order to get to a net-zero trajectory.

From the plurality of reasons stated in support of the no-banking rule, there clearly was no overriding argument but rather a conglomerate of narratives and there was little assessment of the implications for the market.

Assessment of the provision

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While the previous section looked at the genesis of the no-banking rule in the negotiations and the supporting political arguments, the focus of this section is on an assessment of the ruling from a technical perspective and particularly its implications on the market. So far, not much analytical work is available on the subject. The origin of the debate can perhaps be traced back to a paper by L. Schneider and S. Healy 2019 on *Avoiding double counting between CORSIA and Nationally Determined Contributions – Options for accounting under the Paris Agreement*, which discusses different options for the timing of corresponding adjustments for the transferring and the acquiring countries. The paper flags the concern of corresponding adjustments falling into different NDC periods and briefly mentions the option of limiting the use of ITMOs to the NDC period in which they have been generated. The authors however stop short of recommending such restriction.[2]

Another brief discussion of the no-banking rule can be found in Michaelowa, A. (2022) who challenges the main assumption of hermetically sealed off NDC periods on which the ruling is based, pointing to the fact that overlapping NDC periods have already been agreed under the "common timeframes" decision of COP 26.

The most in-depth discussion of the implication of the ruling on the market to date is available in a discussion paper by Strand, J. (2022). Key arguments of the paper are largely repeated in section 3.2 of this chapter.

Given the lack of a comprehensive analysis of both the potential benefits and costs of the ruling, there is a lot of new ground to cover.

3.1 Arguments in favor of restricting banking

As discussed in the previous chapter, various arguments have been put forward in favor of restricting banking.

The key rationale as presented in the EU submission from 17 June 2021 is to "avoid lock in of low ambition and high emissions" given that "emission levels are currently far in excess of what they need to be to put us on a path to balancing emissions and removals in the second half of this century." Unlike under the KP, Parties cannot directly carry over unused allowances to the subsequent NDC implementation period. They could do so, however, if the excess emission reductions were converted into ITMOs and banked.[3]

This is the most serious of the arguments presented. It is based on the concern that ITMOs may not always represent real and additional emission reductions and that the safeguards put in place in the form of reporting and review can only insufficiently guarantee the environmental integrity of cooperative approaches. As reemphasized by Parties in Sharm El Sheikh, the function of the Article 6 technical expert review is not to make judgements on the appropriateness of a cooperative approach but only to assess its consistency with the Article 6.2 guidance (UNFCCC 2022 para 10c).

On the other hand, advancing the generation of mitigation action while postponing the use of the resulting emission reductions is generally beneficial given the urgency of the climate crises. The more climate action is happening and at a faster rate, the better. In that sense, banking could also be beneficial for the climate, especially if not all the assets end up being used.

This leads to another suspected windfall benefit of the no-banking ruling, which was not openly argued

[2] "Timing issue for final accounting balance: Paragraph 70 of the MPGs* envisages that countries demonstrate the achievement of their NDC in their biennial transparency report following the end of the NDC implementation period. For the first NDC implementation period until 2030, this would likely be in 2032 or 2034. Option 2 [*which refers to the transferring country applying corresponding adjustments in the year in which the mitigation outcome took place, as opposed to Option 1 where corresponding adjustments are made in the year in which the first transfer took place*] raises timing issues for demonstrating the achievement of NDCs because offset credits are sometimes issued and transferred several years after the emission reductions occurred. For example, if an emission reduction achieved in 2030 would be issued and transferred in 2035, the country has, by that time, already demonstrated achievement of its 2030 NDC. The country could thus no longer apply an adjustment to the year 2030. **To address this issue, countries could adopt decisions that require that ITMOs would need to be used within the same NDC implementation period in which they have been generated. However, this would limit the flexibility of how ITMOs may be used and might therefore be politically controversial.**" See Schneider, L. and Healy, S. (2019) page 26. *MPG = Modalities, procedures and guidelines for the transparency framework for action and support referred to in Article 13 of the Paris Agreement

[3] At some point it was also feared that pre-2021 CERs that are generously allowed into the Paris Agreement context could further percolate into second NDC period, so the restriction on ITMO banking would hedge against the risk. This can no longer be a real concern as according to the Article 6.4 rules, modalities and procedures (RMP), pre-2021 may only be used towards achievement of the first NDC.

but one could still think of: forcibly cancelling unused ITMOs at the end of the NDC period would lead to overall mitigation of global emissions (OMGE). This idea however ignores that much less mitigation action will be undertaken in the first place if those who are investing in it must fear that their assets will be written off.

The argument that Parties should balance out all ITMOs at the end of an NDC period to better see if the various transfers and acquisition add up equally and start each new period with a clean slate does not seem technically convincing. There already is a structural mismatch between ITMOs authorized for transfer and ITMOs used towards NDCs due to the option of authorizing ITMOs towards other international mitigation purposes (OIMP), including for example voluntary markets. This does not seem to be an issue however, because if more ITMOs were generated than used, it would simply mean that cooperative approaches enhanced collective ambition during the previous NDC period by the amount of ITMOs saved. It seems possible to transparently report this without threatening the consistency of the bookkeeping system.

In conclusion, different factors are at play that determine whether the restriction on ITMO transfers are a necessary safeguard for ensuring environmental integrity of the Paris Agreement. The main concern it seeks to address is that the banking of low-quality ITMOs could provide an avenue for non-ambitious NDC targets to undermine the ambition of the next NDC period. If ITMOs represent real and additional emission reductions, on the other hand, banking would be beneficial for the climate as it would result in fast-tracking climate action. In that case, as laid out further in the section below, the no-banking rule could even have detrimental impacts on the implementation of Paris Agreement goals by making markets less effective.

3.2 Implications for market participants

The lack of intertemporal flexibility has repercussions on both the buyer and the seller of ITMOs. As Strand points out, the difficulty comes from the high degree of uncertainty about a Party reaching its NDC target at or close to 2030. The firm cut-off date, together with the no-banking constraint on ITMOs, imply that any country will seek to have neither a surplus nor deficit at the end of the trading period so that trading will tend towards a "knife's edge" solution (Strand 2022).

Strand first explores the implications on the seller side. Due to a country's priority to meet its NDC and the requirement for corresponding adjustments, selling countries could become highly conservative on selling ITMOs forward, which might severely curtail the supply side. This in turn would have "knock-on effects for the buying side". As buyers expect limited supply near 2030, they would reduce their reliance on ITMOs for their NDC requirements and thus "make the ITMO markets redundant." Strand concludes: "Potential market participants might end up with a self-fulfilling belief that ITMO markets will not exist as demand fails due to lack of supply, and supply fails due to lack of demand."

One could also start the argument from the buyer side. As the end of the NDC period draws nearer, uncertainty whether cooperative approaches will still deliver the required amount of ITMOs during the NDC period increases as delays may occur. Buyers might therefore be cautious to rely on ITMOs the closer the cut-off date approaches and conservatively reduce their purchases. While selling countries have always been mindful to not oversell ITMOs, the no-banking rule imposes an additional risk on buyers.

In a nutshell, the problem of lacking intertemporal flexibility is that countries cannot easily commit to corresponding adjustments if there is no market liquidity and the latter is challenging to build-up without banking. An intuitive explanation for that is that lack of market liquidity does not allow for "buying back" in case sellers should find out later in their NDC period that they initially "oversold". Buyers on the other hand will be reluctant to purchase ITMOs if those lose their compliance value at the end of the NDC period whereas otherwise these ITMOs could create exactly the market liquidity sellers would need to trust in in order to sell ITMOs in the first place.

Intertemporal flexibility, at least availability of banking, is important to overcome the barriers to market participation of countries working under constraining NDC targets. Banking would allow and even incentivize to generate mitigation and related ITMOs going beyond current targets as such ITMOs could potentially be sold in future NDC periods at a higher price – a reasonable assumption if countries build rationale expectations in increasing ambition over time.

Not only could banking therefore contribute to increasing ambition in mitigation in the current NDC period, a highly desirable effect in itself, but it could also help to create market liquidity in which countries could tap if at the end of an NDC period they realize that they are short in mitigation.

It is worth noting that the existing and functional carbon market mechanisms such as ETSs include intertemporal flexibility. A generous degree of intertemporal flexibility was also provided under the Kyoto Protocol.[4]

A further issue with not allowing for intertemporal flexibility is creating an artificial "market short-termism". At least in theory carbon markets could be designed to achieve a global net-zero (or net negative) target in 2050 required to limit global warming to 1.5 degrees. This is however not the case if trading periods are artificially fragmented and sealed for carbon asset exchange because the ITMO price could then only reflect the scarcity introduced by the first generation of NDCs but not by the long-term decarbonization goal, i.e., it would be too low to incentivize sufficiently ambitious mitigation.

It is then possible that the market incentivizes mitigation activities that are effective to achieve, say, 2030 NDC targets but at the same time these mitigation activities might not be good enough or even undermining achieving 2050 long-term targets. This would be the case if long-living technology gets locked in that is insufficient for long-term decarbonization.

Not allowing for intertemporal flexibility eliminates whatever incentives a market could generate for implementing net-zero compatible mitigation activities and market participants would then need to rely exclusively on Article 6 regulatory requirements on alignment with long-term decarbonization such as, for example, baseline contraction factors and eligibility lists.

This is however only the case if environmental integrity of banked ITMOs could be ensured. Otherwise, banking could indeed negatively affect mitigation in subsequent NDC periods. This is exactly the risk that the non-banking rule aims to address.

For market participants it is important to understand that context and to find ways to best operate under the existing Article 6 rules including the requirement to use ITMOs in the NDC period of their generation. The next section discusses possible transaction structures to find market access under the non-banking rule.

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4 Assigned Amount Units (AAUs) can be carried over without limitation; Certified Emission Reductions (CERs) and Emission Reduction Units (ERUs), respectively, from emission reduction projects may each be carried over up to a quantity equal to 2.5 per cent of the Party's initial assigned amount. Any units issued on the basis of a land use, land use change and forestry (LULUCF) activity, may not be carried over. Decision 13/CMP.1, annex, paragraphs 15, 16 and 49.

Options for market participants

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There are several ways to approach ITMO markets under uncertainty including the following:

1. Optional contracts (including also rights of first refusal). The most commonly used contract type to date (for example under the Kyoto Protocol) is simple forward contracts, where ITMOs are contracted between two parties for future delivery at a given contracted price. For the reasons discussed above, simple forward contracts alone might not be a workable solution as host countries would need to commit to corresponding adjustments long before knowing their NDC compliance position.

Put options for future ITMO sales may serve to guarantee future ITMO market access without imposing on the selling country any obligation to offer the ITMOs, but instead to open up this possibility, and guarantee that the ITMOs need not be sold by hosts which otherwise have problems with fulfilling their NDCs. Call options, for the purchase of ITMOs at future dates (by the PA end point), can be relevant for net ITMO buyers, most likely high-income countries. They can however also be relevant (in principle) for prospective ITMO sellers, when combined with forward sales contracts for ITMOs at fixed (pre-determined) prices, by serving as a hedge against overselling risk created by the forward sale of ITMOs. No option markets for ITMOs have so far been set up nor seriously contemplated. It is currently unclear whether option contract markets can be made available to PA market participants ahead of 2030; and who would in case sponsor, support, and guarantee their existence and sufficient liquidity. Institutionally, they can be set up as simple bilateral trades between two parties, or as structured markets with sufficient liquidity.

A limitation of option contracts is that – different from forward contracts – they do not provide revenues when mitigation outcomes are generated but only at a later stage. This can become a major limitation for lower income countries facing financial constraints. Options might work better for higher income countries.

Note however that call option contracts, combined with forward contracted ITMO sales, could in principle be beneficial also for low-income countries, by providing revenues early, and at the same time ensuring that hosts will stay in compliance in cases of potential forward overselling.

2. Other interventions, support and facilitation, by donors and/or International Financial Institutions (IFIs), or by other funds and institutions supported mainly by donors. Funds or facilities can be established and created by donors to establish, enable and facilitate the existence and operation of the necessary markets, and access for hosts to these markets, to reduce or eliminate the uncertainties for countries which rely on forward and options markets for ITMOs. Few examples of such support programs exist to date. They typically require resource inputs by donors, but not necessarily very large net donor commitments. Climate finance cannot be used for direct purchase of ITMOs but can be used to pilot ITMO-like transactions. If (put and call) options markets, as considered above, are open and available to the parties, donor funds can also productively serve as guarantees for option issuers that their option contracts will be upheld and honored (otherwise this may sometimes be problematic in particular for call options when late ITMO prices turn out to be "very high"), thus creating greater certainty for the forward ITMO market. Directly subsidizing carbon markets is however often inefficient if it does not serve to correct particular market inefficiencies, and does not lead to higher ambition (see Strand 2019).

Results-based climate finance (RBCF) can play a key role in facilitating ITMO markets. RBCF comes without any corresponding adjustment requirement and mitigation outcomes generated by RBCF supported activities can remain in host countries and be accounted for host country NDC achievement. Host countries could opt at a later stage for selling these mitigation outcomes as ITMOs and undertaking corresponding adjustments while reimbursing any received RBCF payments. Under such an approach RBCF could become a revolving carbon market catalyst.

3. Counting on host countries to come up with their own strategies and solutions, for eliminating possible NDC achievement deficits, either "ex ante" (in a preparatory phase); or "ex post", toward the end of the NDC period. One (expensive) way to accomplish this is to plan for a "buffer" of backstop mitigation activities, that can be activated at a late stage of the NDC period to guard against unexpected NDC deficits.

Conclusions

05

The limitation of ITMO usage for compliance purposes to the NDC period of their generation ("no-banking rule") can help to avoid spilling over of low NDC ambition from one NDC period to the next. On the other hand, it could also restrict buyers' appetite for purchasing ITMOs that have a diminishing compliance value at the end of an NDC period and dampen mitigation activities that might have been undertaken in expectation of future NDC period market opportunities. This reduces the effectiveness of the ITMO market to achieve long-term mitigation goals.

It is difficult to navigate this trade-off. In any case under current Article 6 rules banking of ITMO in subsequent NDC periods is not allowed and market participants need to accommodate to this ruling.[5]

While option contracts hold potential for ITMO market access, lower-income countries might need to rely on facilitating solutions such as the use of preparatory RBCF operations.

[5] The first opportunity for revisiting the rule is in the context of the review of the Article 6.2 guidance, which is scheduled to begin in 2028 and be completed by 2030. This will thus only affect the second NDC period.

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