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Reflecting the Dynamics

Baseline setting under a future
Art. 6.4 mechanism

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Reflecting the Dynamics

Baseline setting under a future Art. 6.4 mechanism

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Background

With the entry into force of the Paris Agreement, the circumstances for market-based cooperation under the UNFCCC changed fundamentally: From 2020 onwards, all Parties must communicate Nationally Determined Contributions (NDCs) and implement actions intended to achieve them. Furthermore, there is a collective commitment to limit the global mean temperature increase to well below 2° Celsius. These new framework conditions will affect the functioning of market-based cooperation under Article 6 and must therefore also be reflected in the design and operation of the Article 6.4 mechanism. This webinar analysed how these fundamental changes might affect the role and functioning of crediting baselines as a reference to determine the mitigation impact achieved by a specific activity in the context of the Article 6.4 mechanism. Taking into consideration the current status of the Article 6.4 negotiations presented at the outset of the session, the webinar discussed experiences made under the CDM to then explore innovative approaches for establishing baselines that are aligned with the Paris Agreement.

Presentations

The first presentation by **Aglaja Espalage (Perspectives)** provided an introduction to the topic and showed how the concept of baseline setting evolved from its origins under the Kyoto Protocol to its current status in the Article 6 negotiations. Ms Espalage highlighted the relevance of baseline setting as a key factor for preserving the environmental integrity of crediting. Under the Kyoto Protocol's project-based mechanisms different approaches were used and combined to define the crediting baseline as a reference scenario that depicts what would have happened in the absence of the mitigation activity. With the recent changes introduced with the Paris Agreement the applicability of these existing approaches is challenged and there are diverging views among Parties on whether and how these new circumstances should be reflected in baseline setting post-2020.

The Article 6.4 negotiations on baselines are therefore characterized by diverging positions among Parties - both regarding generic principles on how to take into account these new circumstances as well as in terms of the specific approaches for baseline setting. While some Parties (EU, AOSIS, AILAC) push for strong provisions that require methodologies to be linked to NDCs and Long-Term Strategies (LTS), others (LMDC and Arab Group) reject such requirements and instead favour less binding provisions. Differences also prevail with regard to baseline setting approaches with some Parties promoting performance-based benchmarks or Best-Available Technology (BAT) approaches (EU, AILAC Japan), while the others (LMDCs and the Arab Group) push for a menu approach that allows participants to freely choose from a list of baseline setting approaches. At

COP25 in Madrid, baseline setting became a crunch issue during the last days of the negotiations. However, Parties were unable to find an agreement on these issues and concurring approaches with different levels of conservativeness are still under discussion. Ms Espalage highlighted some of the challenges Parties will have to resolve in order to achieve a robust Article 6.4 mechanism. These include the formulation of clear and robust rules that are in line with the Paris Agreement while also being flexible enough for being applied to different types and scales of activities in different country contexts, the operationalization of key overarching principles and the development of robust processes for the development of new and revision of existing baseline setting methodologies.

Subsequently, **Luca Lo Re (IEA)** presented lessons learned from baseline setting under the CDM by focusing on the *combined margin baseline methodology*, which introduced a more sophisticated baseline setting approach for CDM projects in the power sector. The methodology combines the emission factor of existing power plants with the emission factor of prospective power plants whose construction and future operation would be affected by the proposed CDM activity. The weighted average of these two emissions factors then result in the combined margin, which is used as a crediting baseline for the proposed CDM activity.

Mr Lo Re presented findings of a recent analysis of how this approach was applied by different CDM activities, showing that the weighting of individual factors has led to very diverse crediting baselines. The findings indicate that it is crucial to robustly operationalize the conservativeness principle and to

closely monitor the application of baseline methodologies, a key lesson for future baseline setting methodologies under Article 6.4.

With regard to the transitioning methodologies from the CDM to Article 6.4. Luca Lo Re highlighted that this would require a case-by-case assessment to ensure conservativeness.

The full paper on which the presentation was based is available here:

<https://www.oecd.org/environment/cc/Designing-the-Article-6.4-mechanism-assessing-selected-baseline-approaches-and-their-implications.pdf>

How to deal with the discrepancy between the current (insufficient) status of climate policy and the action needed to address climate change in the context of setting crediting baselines was the focus of the third presentation. **Lukas Hermwille (Wuppertal Institute)** presented his *Situation-Ambition Approach* for baseline setting that is inspired by the combined margin methodology (see above) and which combines three elements: An *IS-margin* that represents where a specific sector stands at the moment, an *OUGHT-margin* as a normative element that defines how this specific sector should develop in the future, and a transition factor that defines how the crediting baseline will transition from the IS towards the OUGHT margin.

The current situation (IS-margin) could be determined by building on existing methodologies, BAU scenarios as well as econometric models. The OUGHT-margin could be derived from best available technology benchmarks. This, however, will only be possible for some sectors with homogenous products and/or production processes. Alternatively, the OUGHT-margin could be derived from host country's NDC, provided it is ambitious enough to be compatible with the well below 2°C target and can be broken-down into

sectors. Other possibilities to determine the OUGHT margin are deep decarbonisation scenarios derived from low GHG emission development strategies (LTS) or absolute mitigation targets, such as a full decarbonisation of the sector by a specific point in time.

The transition factor and specifically the transition period over which the shift in the relative weights of IS-margin and OUGHT-margin occurs needs to be aligned on the basis of which the OUGHT-margin is determined. If it is based on an NDC, for instance, the transition period should be the NDC period. By combining the three elements, this approach goes beyond the practice under the CDM that focused on improving the representation of the current status of climate policy. The Situation-Ambition-Approach, by contrast, introduces a normative factor and aligns the process of setting crediting baselines with the Paris Agreement.

The full paper on which the presentation was based is available here:

www.carbon-mechanisms.de/en/dyn_baselines

Panel discussion and Q&A session

In the subsequent panel discussion, **Axel Michaelowa (Perspectives)** and **Jürg Füssler (INFRAS)** shared their views and discussed key aspects with the presenters.

In his intervention, Axel Michaelowa reasserted the observations made by Luca Lo Re and he highlighted that the application of the combined margin approach had indeed led to perverse incentives regarding the choice of parameters and their weighting. The fact that the regulators have not identified and reacted upon these flaws shows the relevance of establishing a robust governance framework under the Article 6.4 mechanism.

Building on the *Situation-Ambition Approach* which he welcomed as being one of the few really new approaches on baseline setting he had seen for several years, Mr Michaelowa briefly outlined his own idea of how to align baseline setting with the long-term mitigation pathway of the Paris Agreement. The approach combines a classical baseline derived from existing methodologies with a so-called *ambition coefficient* that reflects the pathway of the Paris Agreement towards a net-zero world in the second half of the century. This *ambition coefficient* could transition from being 100% at the beginning towards zero. The point in time at which zero is to be reached would differ by country type and could be 2030 for developed countries and 2050 for developing countries. The coefficient could further be differentiated by building on a yet to define set of indicators, such as GDP per capita, cumulated historical emissions, mitigation potentials and possibly also

vulnerability. Mr Michaelowa highlighted that even ambitious crediting baseline will not eliminate the need to test the additionality of individual activities in the future if market mechanisms are to make a valuable contribution to climate change mitigation.

The second discussant, Jürg Füssler, stated that the analysis of the application of the combined margin approach is highly relevant as the findings indicate how important a robust governance structure is for dealing with conflicts of interests and that having a strong rulebook is not sufficient. He underscored that in order to avoid future conflicts of interest, baselines will have to be set in a way that allows NDCs to progress and become more ambitious over time. The *Situation-Ambition Approach* and other dynamic baseline approaches could be a good starting point for dealing with this challenge and they could also be used for dealing with the risk of overselling, which currently discourages many countries from engaging under Article 6. With regard to the individual parameters used for defining the baseline, one key question relates to the level at which these will be defined: While some parameters could be defined globally, others could be set at country level or for a group of countries. Mr Füssler underscored that finding robust baseline setting approaches will be crucial for the future role of market-based cooperation.

During the subsequent Q&A session, the participants highlighted individual aspects and identified aspects that require further analysis.

One aspect that has been identified to be of key relevance and which needs further consideration in the future is the **governance of baseline-setting**. A robust governance structure will be crucial for the operationalisation of the baseline setting approach as such. Experience from the CDM has shown that is not only important to develop a robust rulebook but that its application must also be governed by legitimate and robust bodies. Governance will be relevant to ensure that the baseline setting process aligns with basic principles, such as conservativeness and transparency. Participants agreed that there is a need to further explore the roles and functions required to ensure robust governance and how these could be integrated into existing governance of Article 6.4. Robust procedures with clear timelines and responsibilities where deemed to be particularly relevant if baselines are adjusted over time.

The actual need and degree by which key parameters of the **baseline should be adjusted** was an issue intensively discussed among participants. While some maintained that only the current situation (IS-margin) should be adjusted while the OUGHT-margin is to remain fix against pre-defined Paris objectives, others pointed towards adjusting both. While a majority of participants underscored the need to adjust both parameters in order to reflect political realities many raised concerns that these adjustments could lead to increased uncertainty.

More generally, participants highlighted that innovative crediting baseline setting approaches such as the Situation-Ambition-Approach could have **adverse impacts on activity proponents and investors**. Some participants raised concerns that the supply of credits could become even less predictable than today if the crediting baseline is adjusted over time. Participants also highlighted that it will be important to take into

account the effect the adjustments of crediting baselines could have on different types of activities and how they could impact projects in the course of their implementation. Multiple revisions could for instance make smaller projects in least developed countries unviable. Activity proponents will also need certainty regarding the applicability of baselines. Will existing baselines remain eligible after they have been updated? In reacting towards these concerns, panellists indicated that there are different ways to strengthen trust and predictability of activity proponents and investors from the private sector. One possibility is to build the adjustment process into the design of the baseline setting approach. By including key assumptions into the structure of the baseline setting approach these could provide increased levels of trust and reduce uncertainty.

Another aspect highlighted by participants is the impact the introduction of the Situation-Ambition-Approach under the Art. 6.4 mechanism could have on the **relationship between Article 6.4 and Article 6.2**. Some participants raised concerns that introducing such an ambitious approach could lead to a preference for implementing activities under Article 6.2. While it was generally agreed that this issue will be difficult to solve, it was highlighted that the lack of grip on Article 6.2 should not lead to a situation in which 6.4 is designed with limited integrity. Instead, Parties willing to promote environmentally sound market-based cooperation could form high ambition carbon clubs and integrate these approaches into their Article 6.2 activities. Consequently, participants further highlighted that it will be important to explore ways to include ambitious baseline-setting approaches also under Article 6.2.

Closely linked to the need to establish a level playing field between Article 6.2 and Article 6.4 some participants highlighted that there

is a need to explore possibilities to expand the **applicability beyond specific sectors and technologies**. While the presented approaches are particularly well suited to sectors with homogenous products and/or production processes, their applicability to entire economies or sectors with more diverse products is still unanswered.

Outlook

With more than 100 participants, the webinar showed that there is large interest within the community to explore the question of how baselines should be developed post-2020 and to exchange with other stakeholders on this topic. By bringing together researchers, practitioners, negotiators and other stakeholders, the webinar marked the beginning of a broader discussion process that will become ever more relevant as we get closer to the implementation of Article 6.4 activities on the ground.

The webinar provided participants with an overview on the issue of crediting baselines. How it has been applied and evolved under the CDM towards the current discussion in the UNFCCC negotiations and the emergence of innovative baseline setting approaches that systematically take into account future policy developments.

The presentations, the panel discussion and the Q&A session highlighted that baseline setting approaches will be a key element of the future implementation of Article 6.4. The adoption of a rulebook with strong baseline

setting provisions will have to be complemented by a robust and legitimate governance framework. In this regard, the diversity of individual activities and the country contexts in which they are implemented should play a key role. While some countries' NDCs might be a good indicator of where the national climate policy stands, other countries lack the data and capacities required to develop a robust NDC. Here, alternative approaches such as performance-benchmarks could be a better solution.

When developing baseline methodologies and respective governance approaches, policy-makers will have to take these realities into account while at the same time ensuring that the approaches and their application do not undermine environmental integrity, ambition and sustainable development contributions as the main primary objectives of the Article 6.4 mechanism.

Further information:

Download all presentations, the underlying papers and watch the video documentation of the event at

www.carbon-mechanisms.de/en/baselines_webinar

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