T20 Policy Brief

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Task Force 06

STRENGTHENING MULTILATERALISM AND GLOBAL GOVERNANCE

Championing Development - Friendly Carbon Markets through Trade

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Abstract

Despite the Paris Agreement's focus on carbon markets, the intersection of climate finance and trade policy remains overlooked. Developing countries, including Small Island Developing States (SIDS) and Least Developed Countries (LDCs), stand to benefit significantly from leveraging carbon markets for finance and development. Indeed, a large share of all Nationally Determined Contributions (NDCs) make reference to carbon markets. However, discussions within the World Trade Organization (WTO) predominantly revolve around defensive measures against impending border carbon adjustment (BCA) policies, neglecting broader considerations of carbon market integration. Urgent action is needed to conclude UNFCCC methodologies under Article 6 at COP29 in 2024 and clarify the role of carbon markets within NDCs. Additionally, greater engagement from key stakeholders, including the G20, is crucial to ensure the inclusivity and effectiveness of international carbon market frameworks. This policy brief summarises the key issues regarding the trade-climate and development nexus in relation to carbon markets and identifies key recommendations for the G20 to champion development friendly carbon markets.

Keywords: G20, WTO, Paris Agreement, carbon markets

Diagnosis of the issue

Whilst the Paris Agreement has drawn global attention to the role of carbon markets in leveraging opportunities for developing countries, the interface with climate finance and trade policy continues to be neglected. Specifically, Article 6 of the Paris Agreement focuses on establishing a framework for voluntary international cooperation among countries to meet their climate change mitigation targets by introducing mechanisms for countries to engage in carbon trading and other forms of collaboration, aiming to reduce greenhouse gas emissions more cost-effectively.

Article 6 holds the potential of the Paris Agreement Pact to unlock new sources of climate finance, and leverage trade opportunities, especially for developing countries.

Leveraging climate finance is key for developing countries, especially sub-groupings within that cohort, like small island developing states (SIDS) in the Africa, the Pacific and the Caribbean and Least Developed Countries, like those in Africa which account for 72% of LDCs. Indeed, it is estimated that around four fifths of all submitted Nationally Determined Contributions (NDCs) refer to the use of carbon markets.[1]

Although international carbon markets are considered a vital component of the Paris Agreement and climate policy, to date they do not feature prominently within trade policy discussions at the multilateral level. Attention has focused so far on concerns regarding the imminent application of border carbon adjustment (BCA) measures imposed by the European Union (EU), and now being proposed in other major markets, including Canada, the United Kingdom, as well as other response measures by the United States.

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[1] On trade-related content in the NDCs more generally, see Brandi (2017). See also Johnson and Reséndiz (2023)

Absent so far from the current deliberations is a broader focus on international carbon markets. There should be a much stronger spotlight on the progress being made within international carbon markets and development by the G20. This action by the G20 would take up the mantle that seems to have been lagging, especially given the lack of progress in reaching a conclusive agreement on Article 6 at COP28. For example, domestic emissions trading schemes may not only be a route to mitigate BCAs, can also support higher mitigation ambition. In addition – and, essential for LDCs, SIDS and other developing countries -carbon markets can help to finance the green transition and sustainable development by generating revenue.

There are two main ways through which Article 6 of the Paris Agreement could be used by developing countries to secure climate finance: through carbon markets and offsetting; and or through by obtaining grant-based grant- based finance. 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 therefore needed at COP29 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, which includes consideration of the framework of WTO governance and its principles; and, the provision of international support measures specifically designed to facilitate trade. Considering the essential role of G20 members in the context of supporting trade, climate and development objectives, it is vital that the G20 draws attention to these issues and seeks to secure resolution to the current difficulties in securing agreement on Article 6. There is a need to champion development friendly carbon markets and to support the creation of a supportive international architecture. This is especially pertinent within the context of imminent BCAs and the potential for resource transfers and carbon credits by 2026.

Recommendations

It is vital to conclude the UNFCCC methodologies agreed under Article 6 to support international carbon markets by COP29 in 2024. Article 6 can cover a range of different projects. Examples[2] include: investments in renewable energy that exceed emission reductions targets and so generate a surplus (e.g. under Article 6.2 – the so called cooperative approaches), which can then be purchased by another country to support their NDC; and purchase of carbon credits from reforestation projects (Article 6.4, referred to as the Sustainable Development Mechanism); as well as the provision of access to blueprints for national energy efficiency (Article 6.8), for which a draft decision text was agreed at COP28.[3]

The absence of discussion on carbon markets in the WTO may partly reflect the fact that the rule book for Article 6 is being finalised. But there are compelling reasons to improve the interface between carbon markets, climate finance and trade policy now. Increasingly countries are including references to carbon markets in their NDCs; currently estimated at around four fifths of UNFCCC members, this number is likely to grow.[4] As trade becomes more integrated within NDCs[i] the role of carbon markets and their trade-related implications must be clarified.

Specific issues to consider include those related ensuring WTO principles. For example, the principles of non-discrimination and national treatment. Brazil has voiced its concerns regarding the European Union's approach to its border carbon adjustment

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[2] As referred to BY Johnson and Reséndiz (2023)

[3] See: [COP28 Blog: Wrapping up – the Global Stocktake and Article 6 Negotiations | Global law firm | Norton Rose Fulbright]

[4] See Johnson and Reséndiz (2023).

mechanism, as well as other green trade measures. South Africa, likely to be affected by the EU BCA in view of its energy supply, has also called out the disregard for the UNFCCC principle of common bur differentiated responsibility. However, other African countries and SIDS have so far not been as vociferous.

The WTO can play a role in promoting clarity in the context of carbon markets as carbon markets are underpinned by common metrics and measurement systems to ensure transparency and consistency. While the UNFCCC already has its process for measurement, reporting and verification (MRV), the WTO does not perform the role of a standard setter in relation to traded emissions and carbon standards. 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[5]. The recent outcomes of the 13th WTO Ministerial Conference and the decision on the TBT regulation signals this intent by members. However, as carbon markets are being designed now to support the ambition specified in NDCs, there is a need to ensure WTO principles are adhered to regarding their international interoperability.

The G7 has made strong statements regarding carbon markets which includes support for high-integrity carbon markets. However, so far these discussions have been absent from the G20. This omission must be addressed, especially within the context of new green trade measures affecting G20 members key export sectors, as well as the implications for SIDS and LDCs. In the past, under the Kyoto Protocol, the Clean

Development Mechanism was able to support beneficiaries and contribute to global emissions reductions. The opportunity for other countries, including some G20 members

[5] See WTO (2022).

and SIDS and LDCs, to benefit from the Sustainable Development Mechanism proposed under Article 6 requires development friendly international carbon markets and G20 support.

We thus recommend the following:

1. **Engaging the G20 on carbon markets**: The first step should be to engage the G20 to add its voice to the issue of making carbon markets work for developing countries. The absence of strong statements regarding carbon markets from the G20, despite the G7's emphasis on this issue, calls for urgent attention, especially concerning new green trade measures impacting key export sectors and broader competitiveness in many relevant countries. The G20 can facilitate advancements through several measures including by fostering open channels of communication to facilitate constructive exchanges of best practices and lessons learned.

2. **Concluding UNFCCC Methodologies under Article 6**: Urgent attention should be given to concluding UNFCCC methodologies agreed upon under Article 6 by 2024. The ongoing finalization of the Paris Agreement's rulebook may have contributed to the absence of carbon market discussions in the WTO. However, the need to improve the interface between carbon markets, climate finance, and trade policy is now most pressing. Given the membership of the G20 and the key role played by G20 members in the UNFCCC as well as the WTO, an escalation of the issues are now essential.

3. **Incorporating WTO principles** in **carbon market frameworks:** As trade becomes increasingly integrated into NDCs under the Paris Agreement, it is imperative

to clarify the role of carbon markets and their trade-related implications. This includes ensuring that WTO principles on market access, such as non-discrimination and national treatment, are considered within National carbon market frameworks. 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 used in carbon markets 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.[6] However, there are also other issues regarding for example, free emissions permits, an how these are classified under WTO rules and are therefore actionable.[7]

4. **Supporting efforts for SIDS and LDCs to benefit from carbon trade:** Consideration of specific market access arrangements for SIDS and LDCs should be considered given their high vulnerability to the physical effects of climate change. 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 in G20 countries and beyond.[8]

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[6] See WTO (2022).

[7] See Keane et al., (2010).

[8] See also Brandi and Keane (2023a).

Scenario of Outcomes

If the suggested recommendations are embraced by decision-makers within the G20, several scenarios could unfold, each with its own set of synergies and trade-offs:

1. **Enhanced Climate Finance and Trade Policy Integration**

Embracing the recommendations would lead to a more integrated approach to climate finance and trade policy. This alignment could unlock new sources of climate finance, benefiting developing countries, particularly SIDS and LDCs. By integrating carbon markets into Nationally Determined Contributions NDCs, countries can leverage trade-related implications to foster greater mitigation ambition while ensuring compliance with WTO principles. This synergy could result in streamlined policy frameworks that simultaneously address climate goals and trade barriers.

At the same time, achieving this synergy would require complex negotiations and careful implementation. Harmonizing carbon market rules with WTO principles may present challenges, potentially slowing down progress in both domains. Moreover, integrating carbon markets into NDCs could add layers of complexity to countries' climate pledges, requiring additional capacity-building efforts to ensure effective implementation.

2. **Strengthened Multilateral Cooperation**

Embracing the recommendations could lead to strengthened multilateral cooperation, particularly between the UNFCCC and the WTO. Concluding UNFCCC methodologies under Article 6 at COP29 in 2024 would demonstrate a commitment to fulfilling the Paris Agreement's goals, while also helping to address the interface between carbon markets, climate finance and trade policy. Engagement of the G20 in these discussions would signal broader international support for integrating carbon markets into climate and trade frameworks.

This could help to open up the discussion regarding BCAs at the WTO: it could assist members as they seek to respond to the potential transfer of carbon credits to the EU by 2026; response measures could include the development of domestic carbon markets.

At the same time, resistance from certain stakeholders, such as Brazil and potentially other developing countries, could pose challenges. Brazil has expressed concerns about EU trade measures and the erosion of multilateralism. Convincing stakeholders of the benefits of embracing the recommendation to engage on the creation of development friendly carbon markets will diplomatic efforts.

3. Unlocking Economic Opportunities

Embracing the recommendations could unlock economic opportunities for green and blue growth and sustainable development, particularly in developing countries. By leveraging carbon markets to finance the green and blue transitions, countries could generate much needed revenue and invest in low-carbon technologies and infrastructure. This could stimulate economic growth while contributing to climate mitigation efforts. The bigger point though is that without effective global carbon markets, it will not be possible to achieve the ambition of the Paris Agreement. The new framework for the sustainable development mechanism must be effective and high-integrity.

There is a need to respond to new green trade measures. There are major concerns about the redistribution of economic benefits and potential impacts on competitiveness. There are important distributional issues that require careful consideration. Developing countries, particularly those reliant on carbon-intensive industries, have called out the inequity of BCAs. Effective international interoperable carbon markets can help to support countries own green transitions as well as adapt to the changing global trading landscape. But support is needed to respond and a recognition that carbon markets are part of the Paris Agreement and require conclusion.

Overall, embracing the recommendations to improve the interface between carbon markets, climate finance, and trade policy offers the potential to overcome some of the major challenges within the international trade arena, as well as secure new sources of climate finance, so urgently needed. It must be emphasised that Article 6 will provide new financial resources to support adaptation. Carbon markets are therefore integral to the new international architecture related to climate finance as well climate-related trade policy. To get the right frameworks in place, there will be a need to navigate complex negotiations and trade-offs to ensure equitable outcomes for all stakeholders. Effective implementation will require continued dialogue, cooperation, and support from the international community.

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