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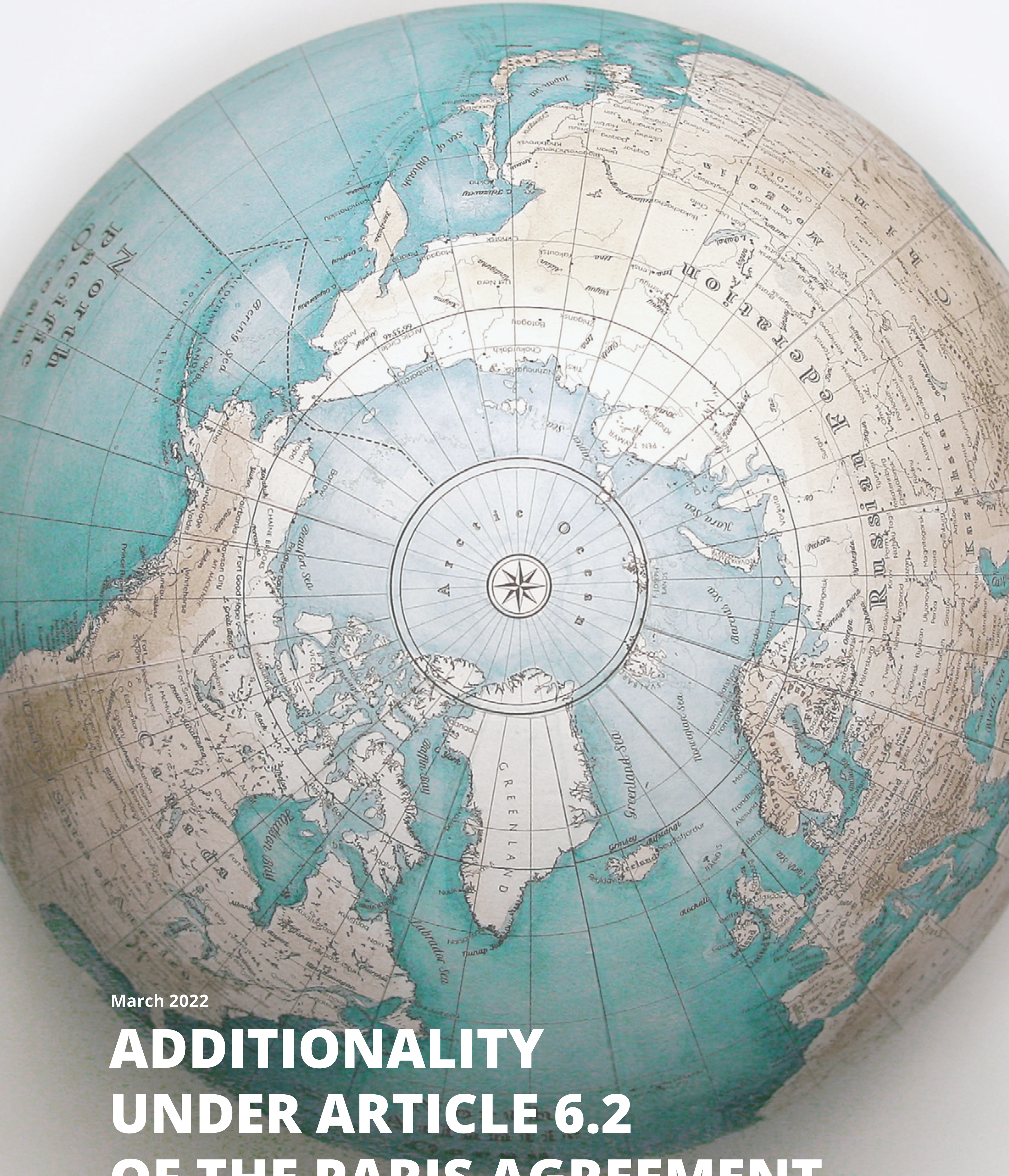

March 2022

ADDITIONALITY UNDER ARTICLE 6.2 OF THE PARIS AGREEMENT

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Chapter 1
INTRODUCTION AND CONTEXT

1.1. INTRODUCTION

Article 6 of the Paris Agreement has introduced a new era for market-based cooperation on climate change. Under Article 6.4 of the Paris Agreement, a new central crediting mechanism has been established, akin to the Clean Development Mechanism under the Kyoto Protocol. Meanwhile Article 6.2 enables Parties to cooperate through a variety of market-based approaches to support the implementation of their Nationally Determined Contributions (NDCs), provided certain principles including environmental integrity and robust accounting are followed.

The guidance underpinning Article 6.2 has intentionally been left high-level, to allow for this variety of approaches and reflect the bottom-up nature of the Paris Agreement. It does not provide specific guidance and requirements for a number of design features that are important for the achievement of Article 6's stated intention: to allow for higher ambition in Parties' mitigation and adaptation actions and to promote sustainable development and environmental integrity. One of the principles for which Article 6.2 guidance does not provide detailed instruction is the demonstration of additionality.

Additionality is a long-standing principle of carbon markets, to ensure that mitigation activities supported by carbon finance would not have taken place in the absence of this revenue stream. Market practitioners have generated significant experience in assessing and ensuring additionality over the past twenty years, much of which remains relevant. However, the implementation of the Paris Agreement introduces new considerations which must be taken into account. At the same time, it provides a new opportunity to learn from both the successes and drawbacks of past practice.

This document provides guidance and principles to support Parties and practitioners when considering the additionality of mitigation outcomes generated and transferred under Article 6.2 of the Paris Agreement. It has been written to be used by Parties intending to use Article 6.2 for government-to-government transfers, though is likely to be useful for other stakeholders involved in Article 6, as well as stakeholders applying other approaches and market-based mechanisms, for example by standards, regulators, investors and companies within compliance or voluntary markets.

This document is structured as follows:

— *Chapter 1* provides background information on the concept of additionality, its application within established market mechanisms and the new context under the Paris Agreement.

— *Chapter 2* outlines and explains a set of principles that can be used to guide approaches to additionality within cooperative approaches under Article 6.2.

— *Chapter 3* provides further information on the assessment of additionality for individual activities, considering regulatory and financial factors.

1.2. Additionality

Additionality is widely recognised as a core principle for ensuring environmental integrity under market mechanisms that involve credited mitigation outcomes. While definitions of additionality vary, it is treated in this paper as a question of whether an activity that reduces emission reductions would have occurred in the absence of the incentive created by carbon finance – by the value given to emission reductions through their representation as carbon credits (or transferrable 'mitigation outcomes') that can be traded and used by other entities.

This document considers two dimensions to ensuring additionality.

First is the upfront assessment of whether an individual activity is additional, applying the definition provided above. This is typically how additionality is determined by carbon market programmes. Testing for additionality usually involves consideration of whether the existence of carbon finance is required to overcome barriers that would prevent an activity moving forward in its absence. These barriers can include:

FINANCIAL BARRIERS:

for instance where mitigation activities are not economically viable without carbon finance, alternative technologies that achieve similar but overall lower mitigation outcomes are more economically attractive than the chosen mitigation action, or restricted access to financial capital prevents implementation.

TECHNOLOGICAL BARRIERS:

such as a lack of availability or awareness of low-carbon technologies, a lack of knowledge about their respective costs and benefits, or lack of know-how regarding their implementation.

INSTITUTIONAL BARRIERS:

for instance institutional opposition to technology implementation, limited capacity for implementation, lack of awareness of benefits or split incentives.

Beyond this upfront assessment is a higher bar for ensuring additionality in the context of the Paris Agreement.

Additionality is typically treated as a yes-no question in carbon markets, where an activity is either deemed to be additional or non-additional on the basis of an upfront assessment as described above. What this may shield is the level of confidence that actors have in the determination of whether or not an activity is additional. A robust, well-designed additionality test can provide a good level of confidence that an activity is additional, but it is inherently uncertain. There are a number of reasons for this, including that additionality by its nature must be assessed relative to a counter-factual scenario, and that there will inevitably be an information asymmetry between a project's proponent and the entity assessing its additionality[1].

At the same time, the assurance of additionality is more important than ever within the context of the Paris Agreement. Countries hosting mitigation activities now have a greater interest in ensuring additionality, as by transferring the rights to mitigation outcomes that would have occurred anyway, they risk undermining the achievement of their own NDC. Meanwhile the urgency of slowing global temperature increases and reinforces the importance of scarce carbon finance being targeted at mitigation that would not have otherwise occurred.

In recognition of this, there are other elements of the design of cooperative approaches and mitigation activities under Article 6.2 that can complement an additionality test, and help to ensure carbon finance is targeted towards genuinely additional mitigation. Specific examples of such elements are discussed further in this document, such as the identification of a 'priority list' of activity types that go beyond mitigation planned to achieve the host country's NDC.

By creating a framework in which additionality testing is supported by such complementary tools and principles, Parties can have a higher level of confidence that carbon finance is supporting additional abatement, which is in the interest of the host Party, the acquiring Party and the environment.

1 See Gillenwater (2011) What is Additionality? Part 1: a long standing problem

1.3. ADDITIONALITY UNDER THE CLEAN DEVELOPMENT MECHANISM

All crediting schemes include requirements for the demonstration of additionality, which have evolved over time based on experience, lessons and new information. One of the mechanisms that is most relevant for the purpose of this document, and Article 6.2 practitioners, is the Clean Development Mechanism (CDM) - a precursor to the new crediting mechanism established by Article 6.4 of the Paris Agreement.

Article 12.5 of the Kyoto Protocol specifies that emission reductions may only be certified under the CDM if they are additional to any that would occur in the absence of the certified project activity[2]. Since its formation nearly 20 years ago, the CDM Executive Board has approved and adopted multiple tools (and updated versions of these tools) for the demonstration and assessment of additionality. This includes tailored tools to demonstrate the additionality of specific project types, such as small-scale projects and those in the afforestation and reforestation sector.

The evolution of these tools over time has attempted to improve the assessment of additionality, and correct for identified weaknesses in previous approaches. Indeed, the additionality of activities under the CDM has been the subject of detailed scrutiny. For example a 2016 report by the Okoe Institute, INFRAS and the Stockholm Environment Institute provided an in-depth analysis of the additionality of different project types under the CDM, finding significant variation in the likelihood of project additionality across sectors.

The approaches applied under the CDM to demonstrate and assess additionality are likely to inform the development of new tools for market-based cooperation in the Paris Agreement, in particular for the crediting mechanism established by Article 6.4. However, the transition to the Paris Agreement also allows for a re-consideration of how additionality is assessed, drawing on lessons and experience to date.

1.4. ARTICLE 6 OF THE PARIS AGREEMENT – A NEW CONTEXT

Article 6 of the Paris Agreement recognises that some Parties may choose to cooperate voluntarily in the pursuit of their Nationally Determined Commitments (NDCs). These NDCs include the mitigation targets of each individual country, or regional economic integration organisation in the case of the EU. This cooperation can include ‘cooperative approaches’ between Parties for the international transfer of mitigation outcomes (ITMOs), which is described under Article 6.2.

2 This definition is considered by some to be flawed; it is argued that as defined, any project – regardless of whether or not it requires the financial incentive produced by the monetisation of carbon credits – could be considered additional.

Such cooperative approaches could be based on mitigation outcomes generated by specific climate mitigation actions, such as projects and programmes of activities, or could be based on mitigation outcomes generated by policy instruments or sectoral-level interventions. Parties may choose to work with independent standards to facilitate the verification, validation and hosting of projects, or could choose instead to establish their own frameworks to do so.

Unlike Article 6.4, which establishes a centralised market mechanism with extensive governance and oversight, Article 6.2 accommodates decentralised cooperation between Parties, with no comparable oversight in place. This can enable innovation and customisation and allow Parties to adopt approaches that are suited to their national strategies. At the same time, the lack of oversight, standardisation and detailed prescription of requirements could lead to reduced integrity and rigour when contrasted with the centralised crediting mechanism under Article 6.4. It is therefore particularly important that Parties entering into cooperative approaches under Article 6.2 adopt rules and frameworks that ensure integrity and ambition.

Additionality is one such example where robust approaches are needed to fill in 'blank space' left by Article 6.2 guidance. The rules, modalities and procedures for the new mechanism established by Article 6.4 of the Paris Agreement specify that each activity will be required to demonstrate additionality, using:

> *"a robust assessment that shows the activity would not have occurred in the absence of the incentives from the mechanism, taking into account all relevant national policies, including legislation, and representing mitigation that exceeds any mitigation that is required by law or regulation, and taking a conservative approach that avoids locking in levels of emissions, technologies or carbon-intensive practices…"*

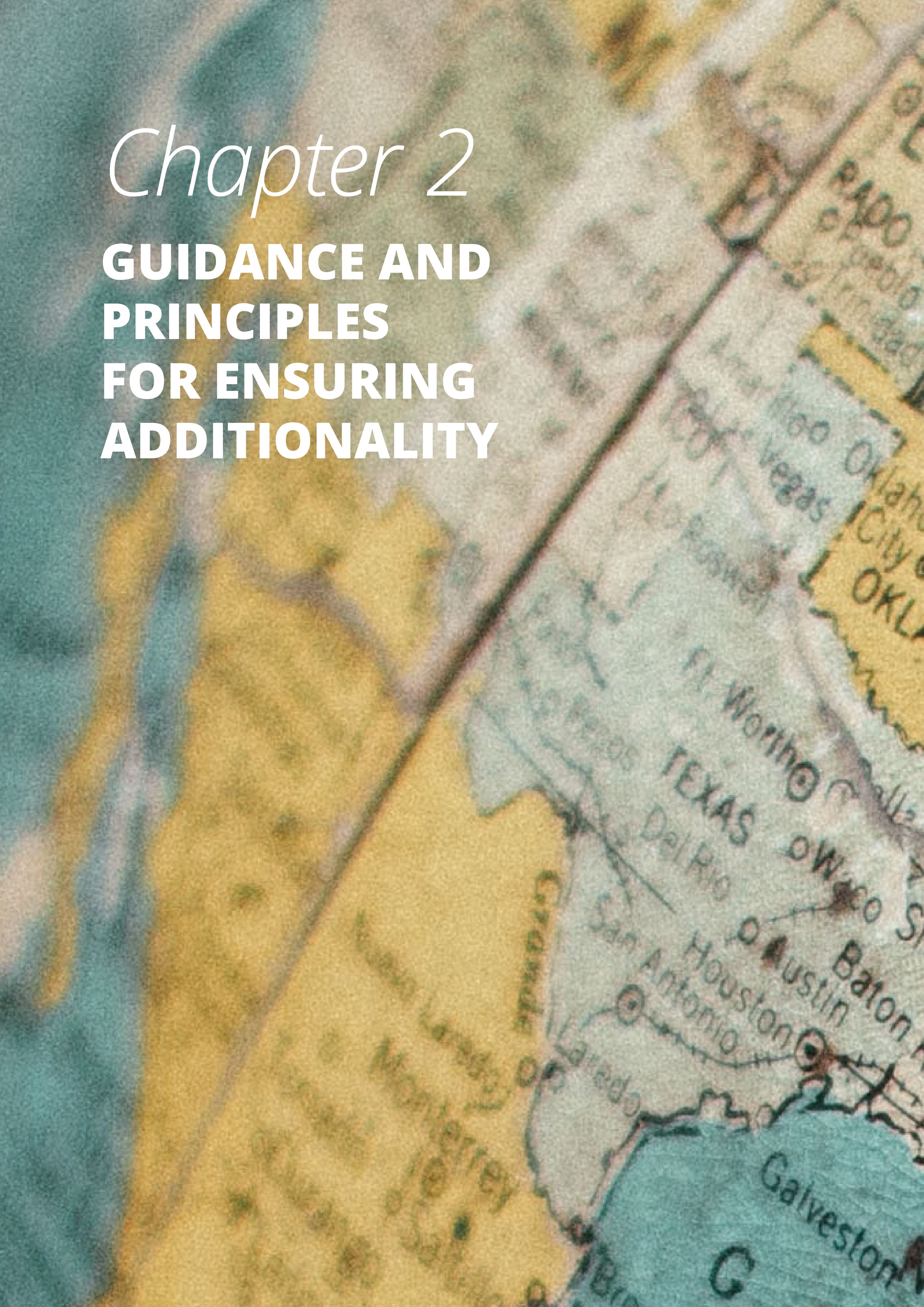
In contrast, the only direct reference to additionality within the guidance underpinning Article 6.2 is to state that ITMOs must be "*real, verified and additional*"[3].

While Article 6.2 guidance may not be prescriptive in how Parties must ensure the additionality of ITMOs, it is clearly in the interest of buyer countries, seller countries and the international community as a whole that ITMOs are additional. The additionality of mitigation outcomes is a core determinant of the integrity of cooperative approaches, and the extent to which they will drive new mitigation outcomes that would not otherwise be achieved. This matters for the reputation of Parties engaged in cooperative approaches, as well as for the achievement of the objective in Article 6.1 that cooperation should allow for 'higher ambition'.

3 Parties are also required to report biennially on how the quality of mitigation outcomes has been ensured, including through below 'business as usual' baselines that take into account all existing policies.

Chapter 2

GUIDANCE AND PRINCIPLES FOR ENSURING ADDITIONALITY



2.1. GUIDING PRINCIPLES

This Chapter outlines and describes a set of principles that can be used to guide approaches to additionality within cooperative approaches under Article 6.2. It is designed specifically for cooperative approaches that involve mitigation outcomes generated from baseline-and-crediting activities, rather than emissions trading or other possible forms of cooperation[1].

It is expected that cooperative approaches will take a variety of forms in the years ahead. Some Parties may choose to rely on established market-based programmes, such as the new crediting mechanism established by Article 6.4 or independent standards. Others may choose to develop bilateral crediting approaches, operating largely or entirely outside of such programmes. The principles described in this chapter are likely to be particularly relevant for this latter category, but applicable more broadly.

PRINCIPLE 1

PROVISIONS TO ENSURE ADDITIONALITY SHOULD BE APPLIED IN ALL COUNTRY CONTEXTS

While additionality testing may not be strictly necessary to ensure unit quality in national contexts where the host country has a below business-as-usual NDC, there are still reasons it is advisable to undertake such testing, including to avoid 'overselling' by the transferring Party.

PRINCIPLE 2

ACTIVITIES SHOULD BE REQUIRED TO DEMONSTRATE ADDITIONALITY USING TOOLS OR PROCESSES THAT INCLUDE BOTH REGULATORY AND FINANCIAL ASSESSMENTS

It is necessary to assess and determine both that emission reductions would not be achieved as a result of policies and measures in the host country, and that they would not be achieved without the financial incentive created by carbon finance.

PRINCIPLE 3

INDEPENDENT THIRD-PARTY ENTITIES SHOULD BE USED TO ASSURE THE ASSESSMENT OF ADDITIONALITY

Independent assurance is an important element of a well-designed, accurately applied additionality assessment process. Parties should work with qualified independent organisations to validate approaches taken to determine additionality as well as the application of these approaches by activity proponents.

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1 For further information on additionality of policy instruments, see Axel Michaelowa, Lukas Hermwille, Wolfgang Obergassel & Sonja Butzengeiger (2019) Additionality revisited: guarding the integrity of market mechanisms under the Paris Agreement, Climate Policy, 19:10, 1211 -1224, DOI: 10.1080/14693062.2019.1628695

PRINCIPLE 4

ADDITIONALITY TESTING IS NECESSARY BUT INHERENTLY UNCERTAIN AND SHOULD BE COMPLEMENTED BY OTHER SUPPORTING ELEMENTS

Past experience shows that additionality testing is not a perfect science. As well as improvements to additionality testing approaches, Parties can include other design features in their cooperative approaches to ensure carbon finance is targeted towards additional abatement that would not have occurred in its absence.

2.2. PROVISIONS TO ENSURE ADDITIONALITY SHOULD BE APPLIED IN ALL COUNTRY CONTEXTS

With the introduction of NDCs in all countries, there is an argument that it may no longer be necessary to ensure the additionality of individual activities in country contexts where an NDC is set below a business-as-usual scenario, and does not generate hot air[1]. This is because any mitigation outcomes that the host country is able to transfer while achieving its NDC can be considered inherently additional.

While the rationale for this position is understood, the starting point for this guidance is that additionality should still be demonstrated for all activities generating mitigation outcomes for transfer under Article 6. This is for several reasons, as outlined below.

Given the insufficiency of many of the NDCs announced to date, a waiver on the basis of the ambition of the host country's NDC is only likely to be a material possibility for a small number of countries. The identification of which countries fall within this narrow category may require its own assessment. In most countries, a dedicated test would still be required to ensure the additionality of mitigation outcomes.

In addition, the fact that an NDC represents an ambitious emissions trajectory is not a guarantee that its emissions target will be met. Additionality testing provides assurance that a specific activity is generating emission reductions that would not otherwise have been achieved, without relying too heavily on wider efforts to achieve the host country's NDC.

1 See for instance Michaelowa, A., Hermwille, L, Obergassel, W. and Butzengeiger, S. (2019) Additionality revisited: guarding the integrity of market mechanism under the Paris Agreement. The authors suggest that activity-level additionality testing could be waived if the host country agrees to an independent assessment of its NDC and this assessment finds that the NDC does not contain 'hot air'.

Finally, it is expected that both the transferring and acquiring Party will have an interest in ensuring that activities are demonstrated to be additional, even in a context of an ambitious NDC. For the transferring Party, this can instill confidence that an activity represents mitigation that would not otherwise be achieved, and therefore that the transfer of mitigation will not raise the cost of the Party achieving its own NDC. For the acquiring Party, it instills confidence that their carbon finance budget will not be channelled to emission reductions that would have occurred regardless, and therefore represent an inefficient allocation of finance.

In sum, the assessment of an activity's additionality is needed in a context where a host country has a less ambitious NDC in order to ensure environmental integrity, and is likely to be considered desirable in a context where a host country has a more ambitious NDC in order to reduce the risk of 'overselling'. It is possible that, as the implementation of NDCs and Article 6 evolves, there is sufficient confidence in the ambition and implementation of NDCs to waive the need to demonstrate additionality in certain circumstances. For now though, it is recommended that Parties seek to ensure the additionality of all activities intended to generate mitigation outcomes for international transfer under Article 6.

2.3. ACTIVITIES SHOULD BE REQUIRED TO DEMONSTRATE ADDITIONALITY USING TOOLS OR PROCESSES THAT INCLUDE BOTH REGULATORY AND FINANCIAL ASSESSMENTS

Additionality has typically been demonstrated under established market-based programmes through a dedicated additionality test or 'tool', which requires project proponents to pass certain tests to prove that their activity would not proceed without the incentive provided by carbon finance. For activities intended to generate mitigation outcomes under Article 6.2, it is recommended that a similar approach is applied, with activities required to pass an additionality test that includes the following two elements:

1. Regulatory assessment:

Firstly, an assessment of whether mitigation activities go beyond policies and measures in place within the host country. This is needed to ensure that emission reductions would not otherwise be achieved through the enforcement of government policy in place within the country.

2. Financial assessment:

Secondly, a demonstration that the emission reductions that would be achieved by the activity would not otherwise be realised in the absence of the incentive created by carbon finance. This is needed to ensure that the a is not financially viable in the absence of the revenue stream created by the sale of mitigation outcomes.

Both of these considerations are required for a robust assessment of additionality. If host country policies are not taken into account, then an activity may be considered financially additional, but it could have taken place anyway as part of compliance with national requirements. If a financial assessment is not undertaken, then an activity may not be required by national policy, but it could in any case have taken place in the absence of carbon finance.

Additionality tests must therefore combine an assessment of regulatory requirements with other tests, criteria, benchmarks, or proxies that serve to exclude activities that are likely to occur in the absence of the incentive created by carbon finance.

There is significant variation between the different sectors from which ITMOs may be generated, and as a result, no one form of financial assessment is expected to be universally suited to all sectors. This has been recognised, for instance, in the investment analysis process within the CDM's additionality tools, which allow projects to conduct investment comparison analysis using a

financial indicator – such as Internal Rate of Return (IRR), Net Present Value (NPV), cost benefit ratio or unit cost of service - that is most suitable for the activity type and decision-making context.

In addition to a regulatory assessment, it is therefore advised that approaches and indicators selected and used for financial assessments must be appropriate to the specific sector, sub-sector or technology at hand. This can ensure more suitable assessments with a greater likelihood of accurate determinations, and lowers the risk of misuse by project proponents.

Further information on the assessment of additionality, taking into account regulatory and financial considerations, is provided in Chapter 3.

2.4. INDEPENDENT THIRD-PARTY ENTITIES SHOULD BE USED TO ASSURE THE ASSESSMENT OF ADDITIONALITY

The Article 6.2 guidance adopted at COP26 includes the establishment of an Article 6 technical expert review team, which will review the information submitted by Parties with respect to their participation under Article 6.2, and assess its consistency with Article 6.2 guidance. The review team shall, where applicable, include recommendations to the participating Party on how to improve consistency with Article 6 guidance and other relevant decisions.

Article 6.2 therefore provides for a level of independent review of the information provided by Parties, but this is not expected to provide an independent review of how additionality has been ensured for mitigation activities.

It is advised that Parties participating under Article 6.2 work with independent entities to support the process of assessing the additionality of activities. This may occur as a matter of course if Parties use established market-based programmes within their cooperative approaches. However in cases where Parties intend to establish their own bilateral arrangements, the role of independent entities would need to be built in. There are different dimensions to this, including:

1. First, working with third-party entities to provide independent review and validation of the suitability and rigour of the tests and approach(es) that will be used to determine additionality. This could take different forms, including independent review by qualified third-parties if Parties adopt their own additionality tool or approach, or reliance on an existing and established approach adopted by a third-party, such as a market-based standard.
2. Second, the use of qualified third-party organisations to verify that additionality tests and approaches have been correctly applied by activity proponents. This is the approach taken under the CDM with the use of Designated Operational Entities (DOE), which is expected to be broadly

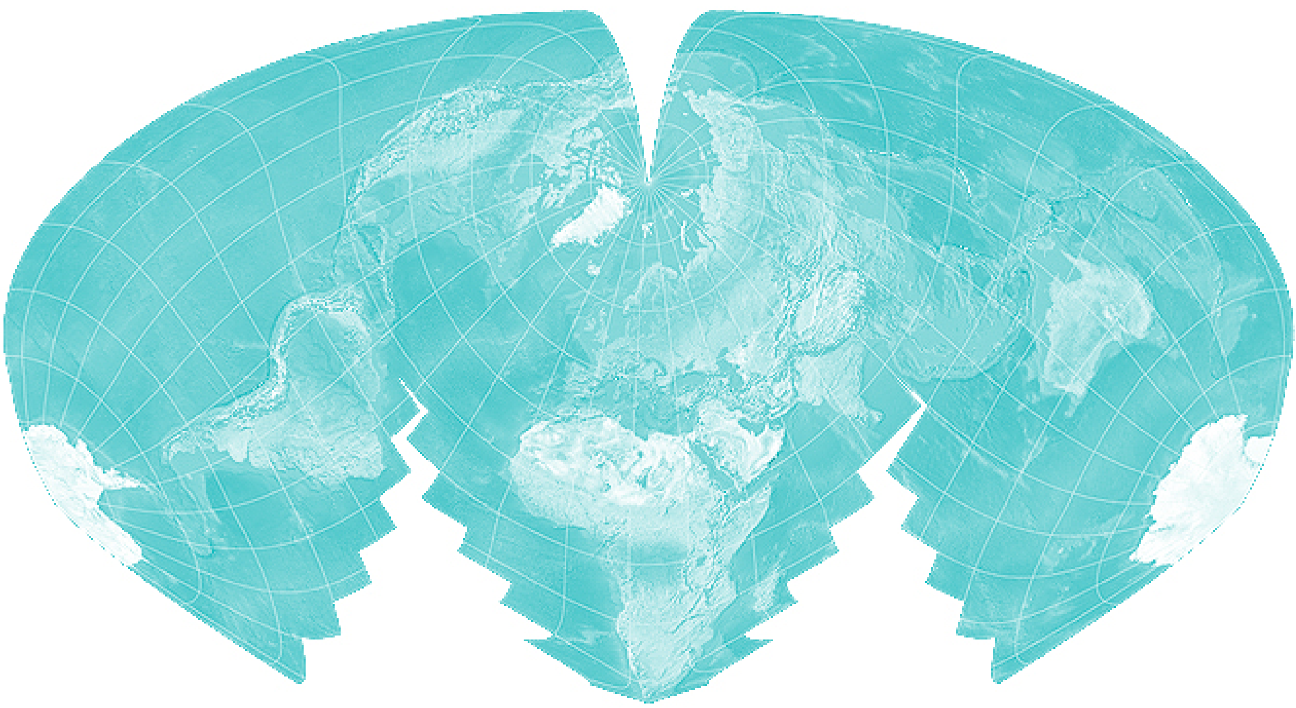
replicated under the new Article 6.4 Mechanism. As above, this would occur as a matter of course if Parties use established market-based programmes, which rely on third-party verification bodies, but would need to be integrated if Parties adopt their own approaches.

The use of independent third-parties is, of course, not an exclusive consideration for additionality. This is also seen as important for the broader validation of information provided by project developers, and verification of the results achieved over the duration of each activity.

2.5. ADDITIONALITY TESTING IS NECESSARY BUT INHERENTLY UNCERTAIN, AND SHOULD BE COMPLEMENTED BY SUPPORTING ELEMENTS

The preceding two principles are primarily related to the upfront assessment of the additionality of an activity, to ensure – before an activity commences – that the activity would not occur without the financial incentive created by carbon finance. This upfront assessment is critical, but there are other complementary design features and requirements that can work alongside an additionality test to ensure the same collective end-goal: that carbon finance is channelled in a targeted way where it is required to achieve additional emissions reductions.

This is particularly important in the new context of the Paris Agreement, with increased urgency to channel finance towards additional emission reductions to achieve its temperature goals, and an increased incentive on the part of host countries to avoid inadvertedly transferring mitigation outcomes that would have occurred anyway, and therefore raising the cost of achieving their NDC.



PRIORITY LISTS

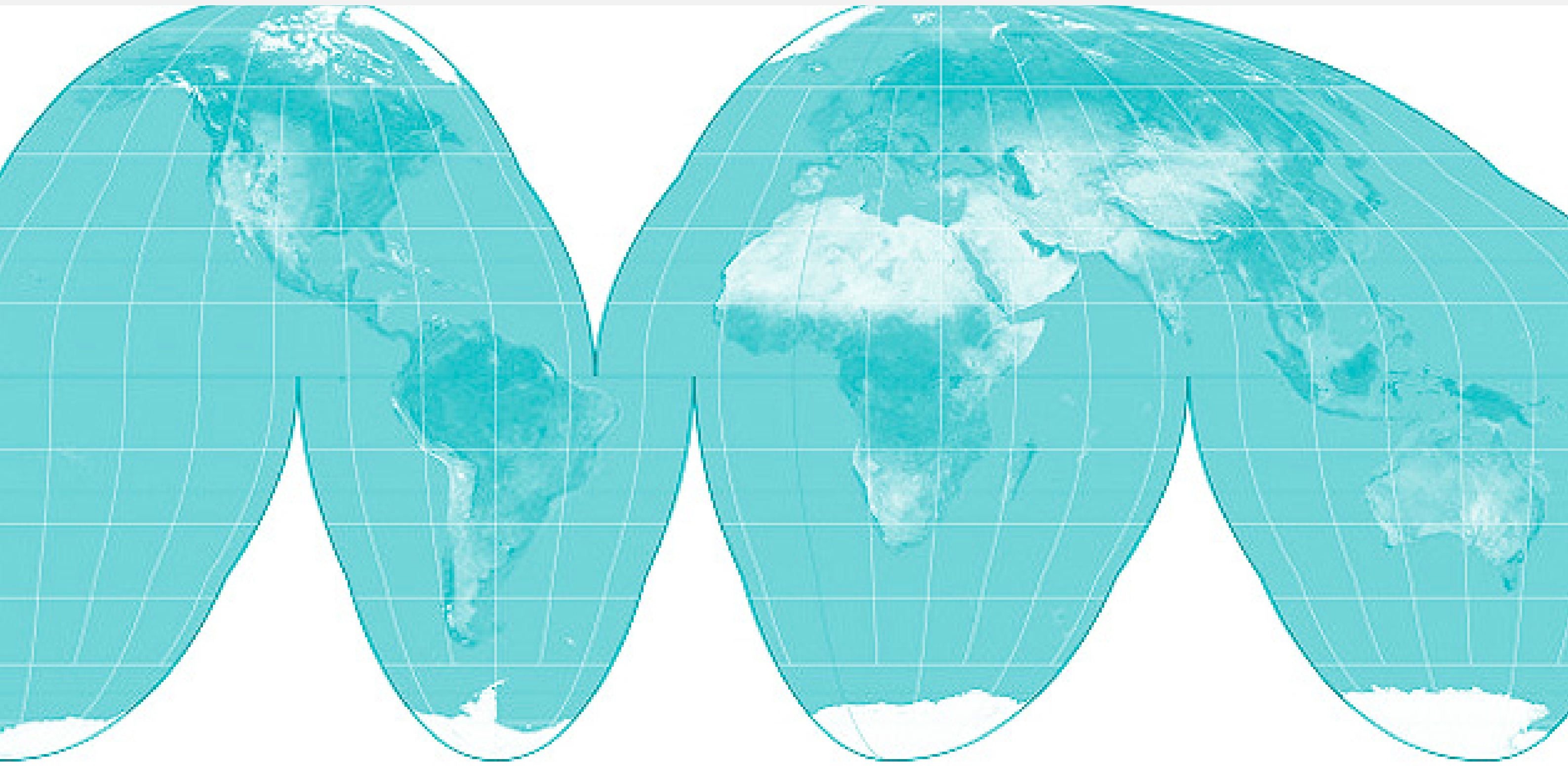
One of the primary design features that can complement and buttress additionality assessment is the upfront identification of sectors and activity types that represent 'higher-hanging fruit', i.e. those that do not form part of the host country's plan to achieve its NDC – potentially for reasons of cost, technology availability or lack of 'know-how' - but would support its longer-term mitigation plans.

The idea of identifying higher-hanging fruit in this way is associated with the concept of a 'positive' or 'priority' list, a list developed by countries intending to transfer mitigation outcomes under Article 6, which specifies sectors and/or activity types (and potentially includes other elements, such as geographic location) into which they encourage carbon finance. As the term 'positive list' is also sometimes associated with the idea of 'deemed additionality' under existing carbon crediting programmes, the term 'priority list' will be used here instead to reflect a broader concept than one focused purely on additionality. This could take the form of an official, publicised list, or may in some cases be a more informal arrangement.

A priority list can help to ensure that activities authorised under Article 6 generate climate and development benefits that directly support the priorities and needs of the host country, and at the same time are unlikely to jeopardise achievement of the country's NDC. A number of factors may go into the development of such a list. These could include the relative cost of different abatement opportunities, plans to achieve the country's current NDC, longer-term emission reduction plans, but also potentially other considerations such as an objective to promote certain development goals within the country or encourage investment into particular geographic regions.

For this reason, a priority list would support the strategic and intentional use of Article 6 by a host country, and would be expected to prove helpful for host countries (by maximising benefits and potentially streamlining authorisation decisions), as well as buying countries and project developers (by providing a reference point to guide investment decisions). It would though not 'de facto' be suitable as a benchmark for determining additionality, unless specifically designed for this purpose.

What a priority list can do is act as an additional safeguard of additionality, alongside assessment processes described earlier in this chapter and in Chapter 3. Whereas activity-level additionality assessments can give confidence that an activity would not have proceeded without the incentive created by carbon finance, the establishment and use of a priority list can give greater confidence that an activity will not undermine achievement of the host country's NDC, and that the activity represents 'higher-hanging fruit' that the host country does not intend to pursue at that time.



It is also possible that a priority list could be designed to enable a more streamlined additionality assessment process for individual activities. Chapter 3 outlines several standardised approaches to demonstrate additionality, such as performance benchmarks, that can be applied for specific sectors. Such standardised approaches could be integrated into the design of a host country's priority list, meaning in practice that activities could be deemed additional where they can demonstrate that they meet certain specified parameters.

FURTHER DESIGN FEATURES

There are also other elements that can be built into the design of cooperative approaches to complement and support additionality testing. These include:

— *Baseline-setting approach*: By setting baselines in a conservative way, as is required under Article 6.2 guidance, Parties can have greater confidence that only those emission reductions actually achieved as a result of an activity are treated as mitigation outcomes and can be monetised for this purpose. While this does not provide assurance that the activity would not have been achieved anyway, as is the purpose of additionality testing, it can act as a further safeguard against 'over-selling' on the part of the host country. In the same way as for additionality, setting baselines conservatively is in the interest of the host country: if a baseline is set too loosely, and if it is not regularly updated to reflect any new policies, measures and other developments, it could lead to the crediting of mitigation outcomes that would have occurred without the activity.

— *Accurate attribution*: In some, possibly many cases, activities will have a combination of funding sources, including both carbon finance under Article 6 of the Paris Agreement and 'climate finance' under Article 9. Where this is the case, there is the potential that more mitigation outcomes may be attributed to carbon finance than were actually achieved as a result of its existence as a revenue stream. This could act to undermine the intention of additionality testing and conservative baseline-setting, as mitigation outcomes may be transferred and used that were not caused by the incentive created by carbon finance. This in turn, would mean that the host country would have to surrender mitigation that it would otherwise be able to use towards its NDC if attributed to sources of finance other than under Article 6. Parties also have an obligation created by Decision 18/CMA.1 to report on how double counting has been avoided between resources reported as provided or mobilised climate finance, and resources used by the acquiring Party under Article 6. While complex to achieve, there is, as such, a need to establish a proportional, accurate attribution of mitigation outcomes between the different sources of finance.

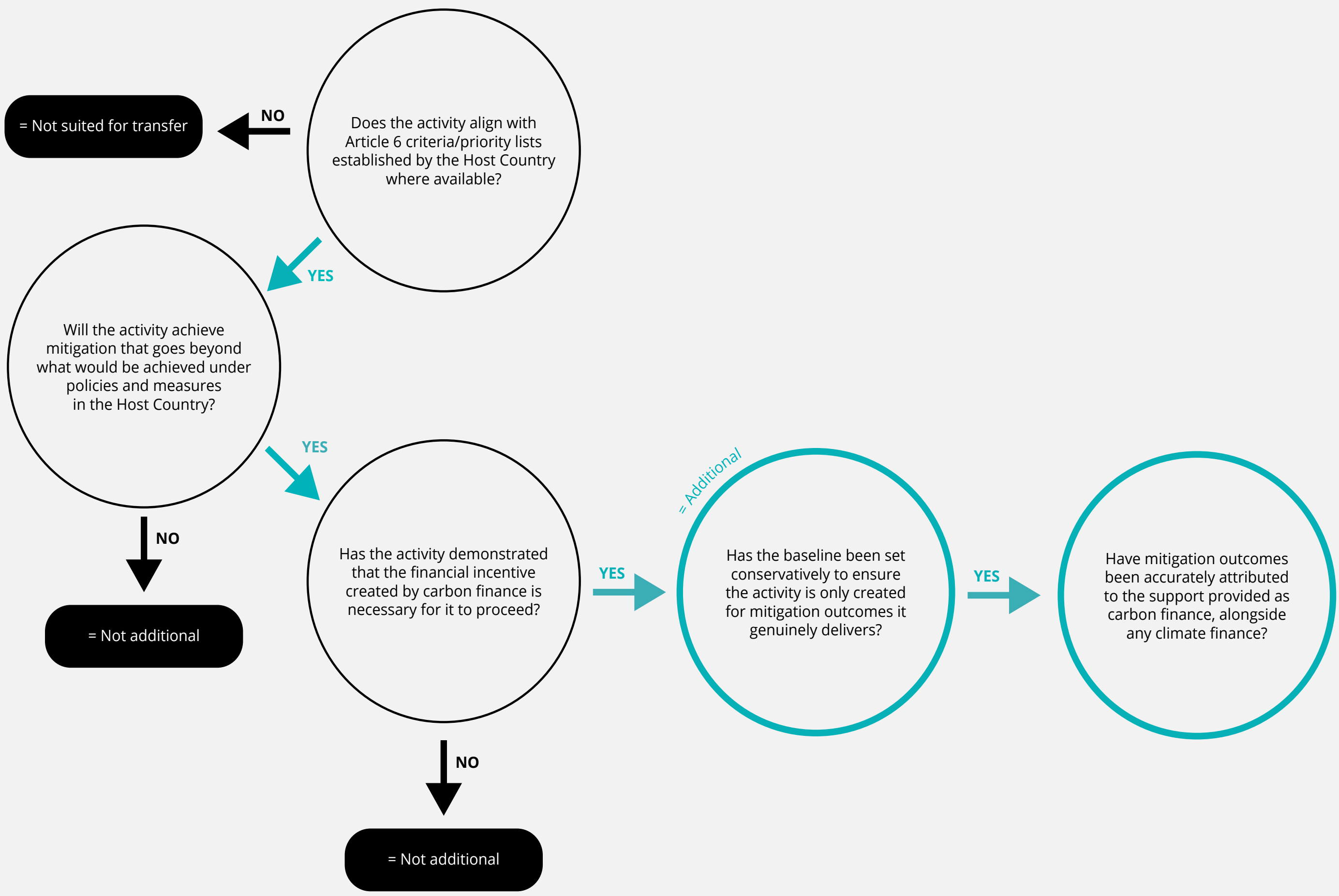
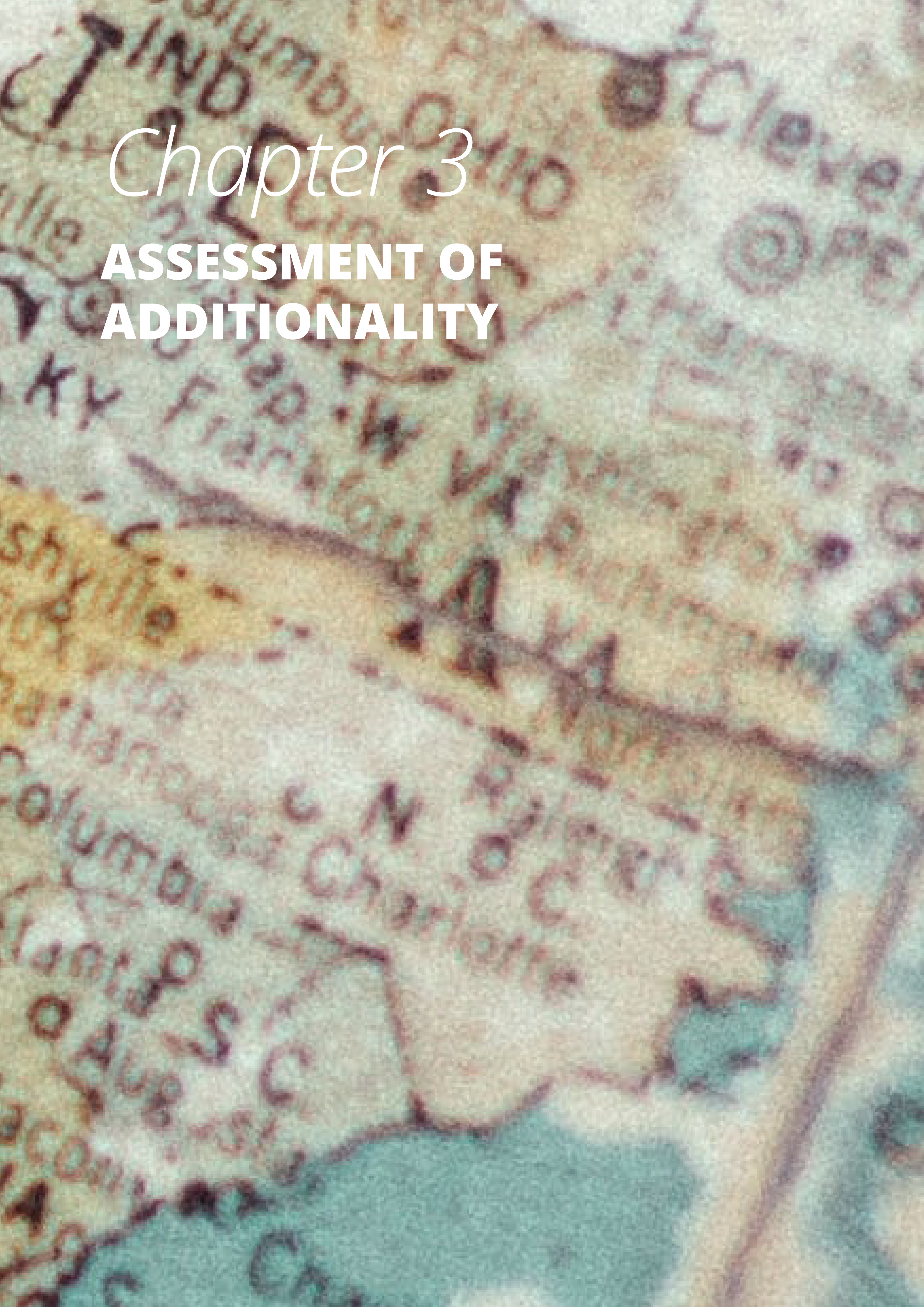


Figure 1 – Overview of key procedural steps outlined in the above principles



Chapter 3
ASSESSMENT OF ADDITIONALITY

3.1. INTRODUCTION

This chapter elaborates on the second principle described in Chapter 2, to provide more detailed information and guidance on how regulatory and financial assessments can be used to demonstrate the additionality of individual activities intended to generate mitigation outcomes. In many cases, Parties may choose to work through existing market-based mechanisms, such as the new crediting mechanism under Article 6.4 or existing independent standards, and therefore rely on the requirements established by such mechanisms for the determination of additionality. In other cases, Parties may cooperate outside of established standards.

The information provided in this chapter may be particularly helpful for such cases, where Parties do not intend to rely on an established standard. The guidance provided below is not intended as an additionality tool that can be directly adopted, but instead to build understanding of how additionality can be assessed, taking into account both regulatory and financial considerations.

3.2. REGULATORY ASSESSMENT – TAKING INTO ACCOUNT HOST COUNTRY POLICY AND MEASURES

As part of the assessment of a given activity's additionality, it should be demonstrated that a mitigation activity will achieve emission reductions over and above a business-as-usual scenario that takes into account all relevant measures within the host country, including laws, regulatory frameworks and policies (hereafter described as host country 'policies and measures')[1]. The following steps provide guidance for how Parties could seek to ensure this.

3.2.1. PRESENCE OF POLICIES AND MEASURES WITHIN THE HOST COUNTRY

It should be demonstrated that a given mitigation activity is not part of a scenario that would occur as a result of policies and measures within the host country. In certain cases, it will be straightforward to identify relevant policies and measures within the host country and assess the additionality of an activity relevant to such policies and measures. In others, this may be more complicated.

1 This principle was reflected in rules, modalities and procedures for the Article 6.4 mechanism adopted at COP26, which specify that additionality assessments shall take into account "*all relevant national policies, including legislation, and representing mitigation that exceeds any mitigation that is required by law or regulation...*"

Below are examples of types of policies and measures that may exist within host countries, and guidance for how these may be treated under a regulatory assessment. This is not intended to be an exhaustive list, but provides a framework to inform treatment of any other examples that may arise.

— *Tax and subsidy regimes* The assessment of regulatory additionality should take into account tax and subsidy regimes as well as regulations.

Example *The host government has a tax and subsidy regime in place for electricity generation, under which fossil fuel generation is taxed and renewable energy generation is subsidised. If a planned mitigation activity would not have an emission impact higher than that expected as a result of the government's tax and subsidy regime, it is not considered to go beyond host country policies and measures.*

— *Sub-national level policies* Policies and measures at the sub-national level should be taken into account where these are directly relevant to the mitigation activity, as well as those at the national level.

Example *An afforestation activity is planned that would be implemented across two states within a federal government system. One of the states has introduced a policy that will lead to increased afforestation over the course of the NDC period; the other state has no such law in place, nor does the federal government. The afforestation activity would be considered beyond host country policy and measures in the second state, but with respect to the first state, would need to move to Step 1(b) below to assess its additionality.*

— *Low-compliance policies* There are many examples globally of policies or measures that are in place but are not enforced, with low compliance levels as a result. In some country types, in particular Least Developed Countries, it may be reasonable to permit crediting in such sectors despite the existence of a policy. This could be conditioned on there being evidence that the level of compliance has been below 50% for the past five years or more, and crediting could be limited to 5 years to avoid a prolonged disincentive for national or sub-national authorities to address levels of non-compliance. The level of compliance should also be taken into account in the baseline-setting process.

Example An LDC host government introduced a law seven years ago that requires farmers to adopt improved agricultural practices to enhance soil organic carbon stocks. Several independent studies and a government analysis have demonstrated that the law is not being enforced effectively and that compliance levels are around 25%. An activity intended to improve soil organic carbon stocks could be considered beyond host country policy where it can be demonstrated that it will be implemented in places where the law has not been complied with. It should only be credited for five years, and it is encouraged that a plan is introduced to encourage legal compliance following the crediting period.

— *Intended policies* The assessment of regulatory additionality should consider policies or measures that are intended but have not yet been adopted. This could for instance include policies or measures included in election pledges, or outlined in official long-term plans such as the country's NDC.

As a general rule, activities may still be considered beyond host country policies and measures until the time that the policy or measure comes into effect. In practice, such activities may nonetheless be unattractive for the generation of mitigation outcomes for use under Article 6. The host country may be reluctant to authorise activities to take place in a sector in which it intends or may in the near future wish to regulate; and the fact that the allowable crediting period would be temporally limited by the policy or measure coming into effect may make the activity financially unattractive.

Example A recently-elected government ran on a manifesto that included a pledge to introduce new legislation within their first three years of office to require the use of feed supplements to directly reduce methane emissions from enteric fermentation for dairy cows. A planned mitigation activity seeking crediting for the same intervention could be considered beyond host country policy and measures until the time that the legislation comes into force, after which point the mitigation activity should no longer be eligible.

Example A developing country host government has adopted legislation that will ban all inefficient light bulbs, with the enforcement period scheduled under the legislation to commence in three years' time. A mitigation activity that avoids emissions by incentivising uptake of more efficient light bulbs may

be considered beyond host country policies and measures for the time until the enforcement period commences, but should not be credited beyond this date.

3.2.2. BEYOND MITIGATION REQUIRED UNDER HOST COUNTRY POLICIES AND MEASURES

Where a mitigation activity is planned in a sector which is subject to government policy or regulation, it may still be deemed to go beyond host country policies and measures if it can be justified that the mitigation activity is not the only option that fulfills the legislative and/or policy requirements and that the activity would achieve a level of mitigation that exceeds other possible and more financially attractive options under the policy or measure. In other words, the mitigation impact of the activity would still be higher than that expected as a result of the policy or measure, despite its existence.

Example *A law may require that landfill gas shall be collected and destroyed at all landfills. This collection and destruction may happen through (a) active flaring or (b) putting a power generation plant at the landfill to recover and use the landfill gas to generate electricity for supply to grid. If the latter option is the mitigation activity, then it is justified that it is not the only option and that its implementation would achieve a level of mitigation beyond that of the former option.*

In cases where this step is applied in the assessment of a mitigation activity's additionality, the activity should only be credited for mitigation outcomes that exceed the expected effect of the policy. The mitigation activity should therefore be credited for the difference between its mitigation impact and the impact that would occur if the policy were met through another lower-impact technology or approach.

If a mitigation activity meets the conditions for regulatory additionality outlined above, it could proceed to financial assessment, as described below.

3.3. FINANCIAL ADDITIONALITY – DEMONSTRATING FINANCIAL NEED FOR CARBON REVENUE

As well as consideration of regulatory requirements, a mitigation activity should be required to pass a financial assessment: that the incentive created by carbon finance is needed for the activity to occur and the projected emission reductions to be realised. This should be done by applying a test designed to establish that the activity would not progress without the revenue generated from the sale of carbon credits, or mitigation outcomes under Article 6.2. This could follow a standardised assessment approach or a standalone assessment for individual activities.

3.3.1. STANDARDISED ASSESSMENTS

Where practical, standardised approaches can be adopted to streamline the additionality assessment process for particular sectors or technologies. There are several such approaches that can be applied, with the choice between these dependent on the sector at hand. As described below, certain approaches will work well for certain sectors but not for others due to their particular characteristics.

i. Performance benchmarks[1]

Performance benchmarks are a means to assess additionality and/or set a baseline for crediting activities, for instance based on the distribution of greenhouse gas emissions intensity for activities in a sector, sub-sector or for a specific technology. Under such an approach, activities would be ordered according to their emissions intensity, starting from the best and ending with the worst. With this order in place, a benchmark could be set at a specific percentile.

For instance, an emissions intensity-based benchmark set at the 20th percentile would mean that any activity with an emissions intensity that is better than 80% of all ordered activities can be considered financially additional. In order for this to work effectively, the selected benchmark must be set at the right level to ensure activities above the baseline are those that would not be financially attractive without the revenue from the sale of ITMOs/carbon credits. The assumption behind this is that, for the sector at hand, there must be a correlation between emissions intensity and cost.

1 For more information on each of the standardised approaches described in this paper, please see *Perspectives (2021): Financial additionality tests for cooperation under Article 6 of the Paris Agreement*, from which the included descriptions have been drawn.

For this reason, a performance benchmark based on emissions intensity is likely to be more appropriate for some sectors than others. It may be suitable in the household and SME energy demand sector, for instance, where the performance characteristics of appliances is broadly similar. This may also be true of the cement sector.

On the other hand, in sectors like electricity generation and steel-making, it is possible in many places to produce the same good or service at costs that are comparable despite strongly different emissions intensity. This is the case in electricity generation where renewable energy is cost-competitive with fossil-fuel based sources, and in steelmaking between electric arc furnaces and blast furnaces. In these and sectors with the same or similar features, performance benchmarks based on emissions intensity are unlikely to be appropriate.

Example sectors Cement production; boilers and cooling appliances for industry; cooking, heating and cooling devices for households.

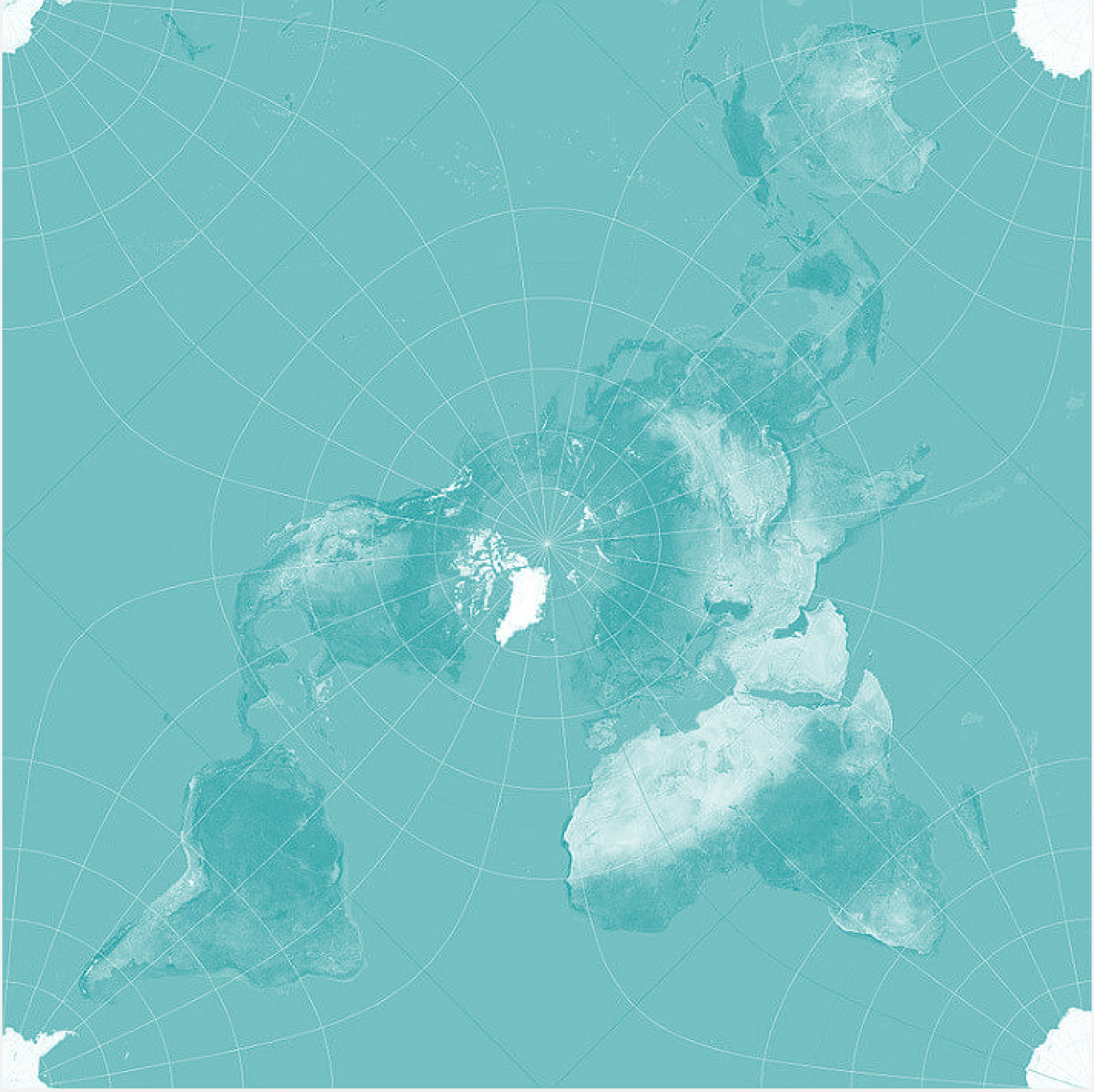
ii. Payback periods

A payback period refers to the amount of time it takes to recover the cost of an investment. Applied for the purpose of determining financial additionality, a payback period threshold can be set for a particular sector, sub-sector or technology based on evidence of the financial attractiveness of investing, with activities with a payback period longer than the defined threshold considered more likely to be additional.

The payback period approach is more appropriate for activities driven by commercial considerations, where revenue is generated from the sale of goods and services. Like performance benchmarks, it is important that payback period thresholds are set in an appropriate, evidence-based way, so as to avoid deeming as additional activities that would have been invested in regardless of revenue from the sale of ITMOs/carbon credits, and to reflect commercial decision-making practices. For instance, it would be appropriate to set shorter payback period thresholds for SMEs and for technologies with lower-levels of maturity.

Practitioners might also consider linking the permitted crediting period for an activity to its payback period, for instance by not permitting an activity to renew its crediting period once it has reached the end of its payback period. In this way, activities that are financially additional could be incentivised, but not over-credited once the initial investment has been recouped.

Example sectors Energy production, industrial sector activities for which performance benchmarks are not suitable, and activities within SME sector.



3.3.2. INDIVIDUAL ACTIVITY-LEVEL ASSESSMENT

Standardised approaches to additionality assessment may not be suitable or available in all circumstances, for instance due to the costs associated with establishing and maintaining the approaches listed above. For this reason, it is expected that individual activity-level assessments will remain relevant into the future.

As described in the Introduction, there has been significant experience to date with the use of tools to demonstrate additionality under the CDM, as well as within independent standards. The CDM's additionality tools have been revised over time to reflect practical experience, new techniques, and to correct for recognised flaws in earlier versions[1].

1 See, for instance, Michaelowa, A. (2009) *Intepreting the Additionality of CDM Projects: Changes in Additionality Definitions and Regulatory Practices over Time*

The CDM's latest *Tool for the demonstration and assessment of additionality*, requires project developers to follow the below steps, which are illustrated in Annex A:

1. Assess whether an activity is a first of its kind;
2. Consider alternatives to the project activity that are consistent with mandatory laws and regulations;
3. Undertake investment analysis to determine whether the proposed activity is likely to be financially attractive, or;
4. Consider barriers to the implementation of the activity and whether other approaches could overcome those barriers, and;
5. Consider whether the proposed activity is common practice.

It is expected that the Supervisory Body for the new Article 6.4 crediting mechanism will develop new tools for the assessment of additionality, drawing on and revising as appropriate the latest tools available under the CDM. There will however be a period of time before such tools are available.

For cooperative approaches planned under Article 6.2, it would be reasonable for Parties to require activities to apply the latest available tool adopted by a UN crediting mechanism, meaning in practice that the latest version of a relevant tool adopted under the CDM may be used until new tools are established for use within the Article 6.4 mechanism. Parties may want to impose additional or tailored requirements if they consider these necessary for a more robust analysis. They may also want to rely on other available approaches for financial assessments established outside of a UN crediting mechanism, for instance if they work with an independent standard that has adopted an alternative approach.

3.3.3. ADDITIONAL CONSIDERATIONS

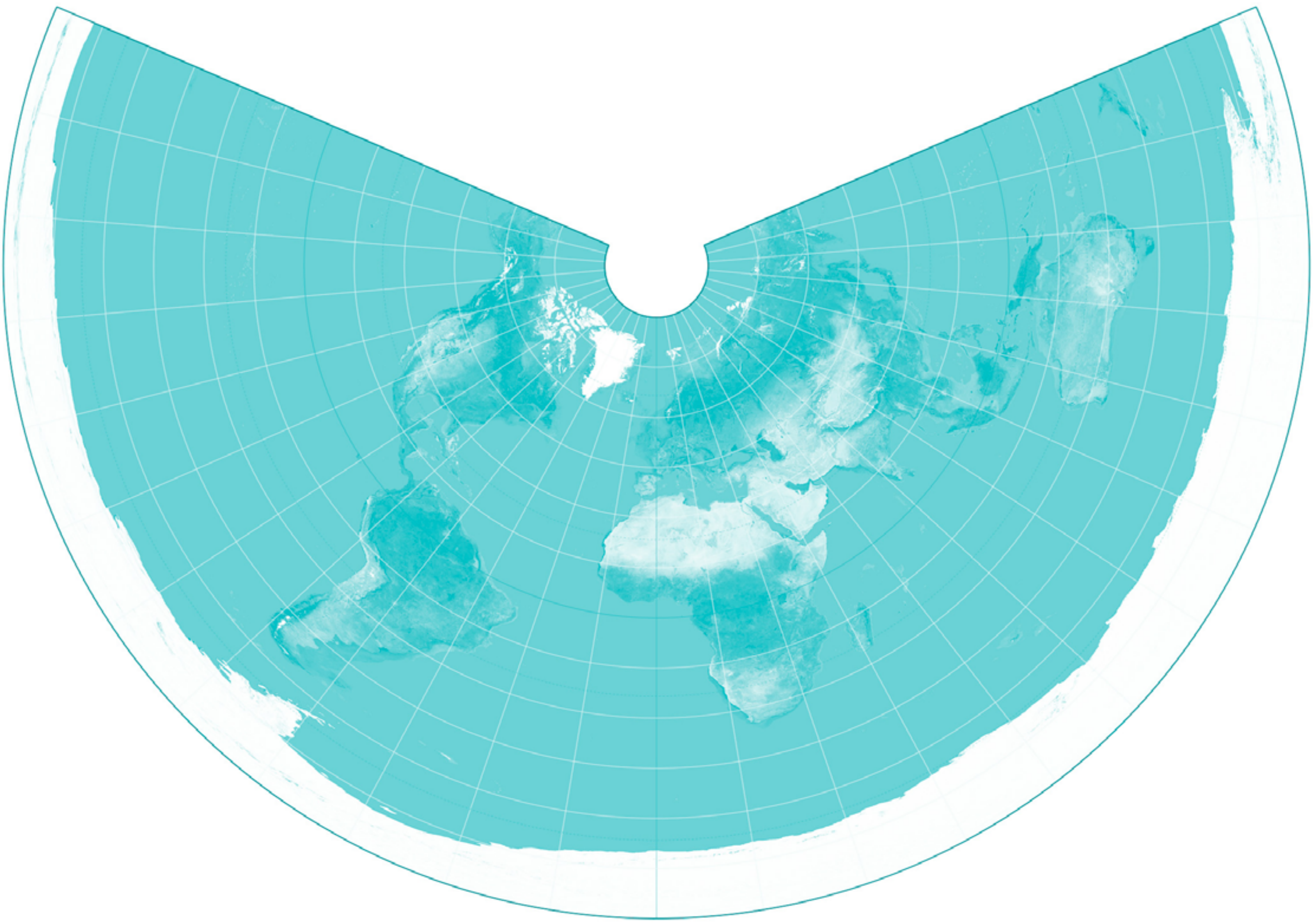
Two further considerations that can be incorporated into cooperative approaches to support robust additionality assessments are described below.

— *Prior consideration* Requiring project developers to prove that revenue from the sale of carbon credits was a material consideration in the initiation of the project at hand. This can be done, for instance, by requiring that mitigation activities are submitted for consideration prior to the activity commencing, or at the very latest within one year of the start date of construction, implementation or real action (whichever is relevant and earlier)[1].

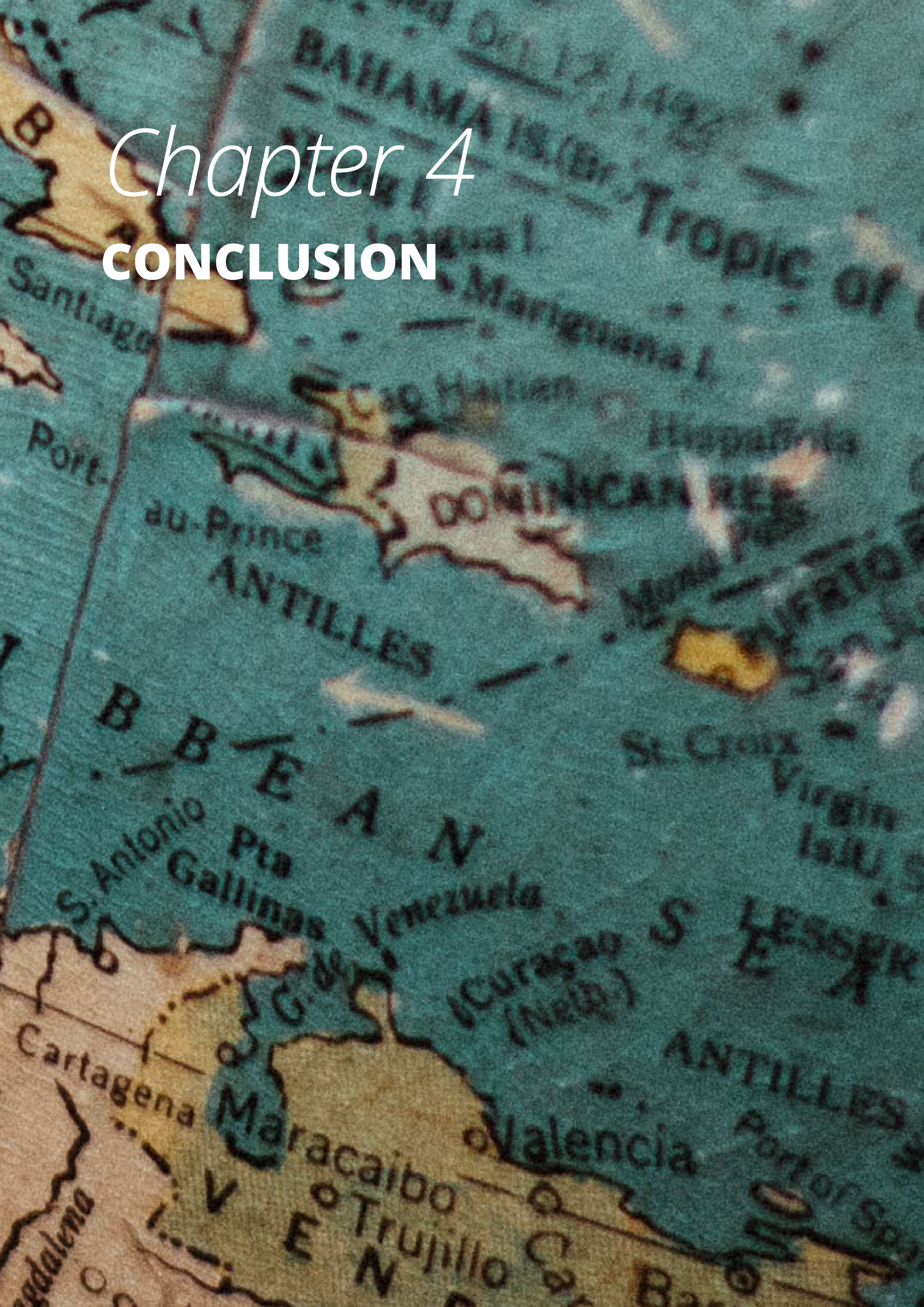
1 Under the Clean Development Mechanism, a demonstration of prior consideration is required within six months.

— This can help to ensure that the anticipated revenue from selling mitigation outcomes is material to the project proceeding, and is not simply a means to generate more revenue for an activity that would in any case move forward.

Ongoing financial need An upfront additionality assessment, in particular when coupled with other steps such as a priority list, can help to ensure that activities are additional at the time that they are established. However circumstances, such as the relative cost of technologies, can change over the duration of an activity's operation, meaning that activities that required carbon finance at the beginning of their operation may no longer require this revenue stream at a later date. For this reason, activities could be required to demonstrate that they still require revenue from the sale of carbon credits as a condition for their crediting periods being renewed. The parameters for this demonstration would need to be carefully designed, to accommodate different financial models and characteristics between sectors, for instance not to penalise activities that require high upfront capital expenditure but lower ongoing operational costs.



Chapter 4
CONCLUSION



Article 6.2 of the Paris Agreement provides Parties with significant flexibility to adopt their own approaches to market-based cooperation, within the parameters of limited, high-level guidance. With respect to additionality, Article 6.2 guidance says little more than that mitigation outcomes must be additional.

At the same time, the principle of additionality – ensuring that activities would not proceed in the absence of the incentive provided by carbon finance – is arguably more important in the context of the Paris Agreement than it has ever been. The urgency of scaling up global mitigation action is clear if the Paris Agreement's temperature goal is to be met, making it increasingly important that carbon finance is targeted towards genuinely additional emission reductions. Meanwhile countries hosting Article 6 activities have a new incentive to ensure they authorise the transfer of additional mitigation outcomes, to avoid raising the cost of achieving their own NDC.

With this in mind, Parties cooperating under Article 6.2 are encouraged to do three things, as reflected through this guidance:

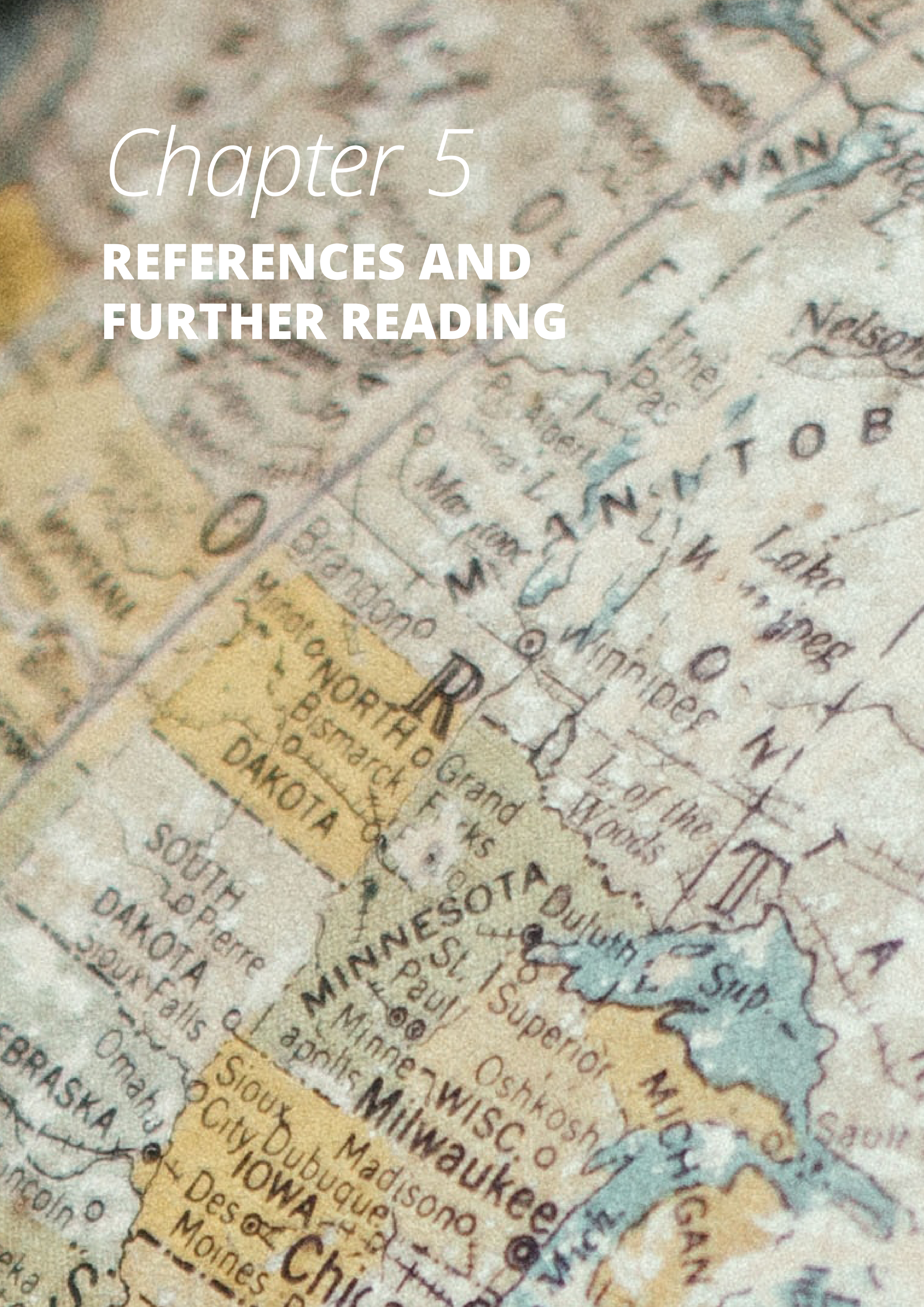
1. Integrate the principle of additionality into their cooperative approaches;
2. Draw on the experience generated to date in the assessment of additionality and rely on the best available approaches, and;
3. Consider the role that other design elements within cooperative approaches can play to buttress additionality assessments, in particular the role of 'priority lists' established within host countries.

These recommendations, and the guidance provided in this document, reflect a two-fold reality:

First, that there remains a role for the type of approaches and principles applied under market mechanisms to date. Parties will still want to have confidence that individual activities would not have proceeded without the incentive created by carbon finance, and existing tools and techniques – which will evolve over time – can enable this.

Second, that the Paris era provides both an opportunity and a need to apply a higher bar for additionality. The application of an activity-level assessment can typically tell us whether an activity would have proceeded without carbon finance; but it does not tell us whether that activity should have formed part of a host country's own efforts to meet its NDC. To adopt a metaphor, it can prevent carbon finance going to fruit lying on the ground, but cannot distinguish between fruit on lower branches and the 'higher-hanging fruit' for which carbon finance is arguably most valuable. This is the role that approaches such as the establishment of 'priority lists' can play.

The difference between high-integrity application of Article 6.2 and minimal compliance could translate into a difference between Article 6 genuinely acting to raise ambition under the Paris Agreement while driving transformational sustainable development in host countries, and it acting – intentionally or otherwise - to undermine progress towards the Paris Agreement's goals. By integrating a robust approach to additionality within their cooperative approaches, Parties can take one sure step down the first of these paths.



Chapter 5

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Annex A

STEP-WISE APPROACH UNDER THE CDM'S METHODOLOGICAL TOOL FOR THE DEMONSTRATION AND ASSESSMENT OF ADDITIONALITY (V0.7)