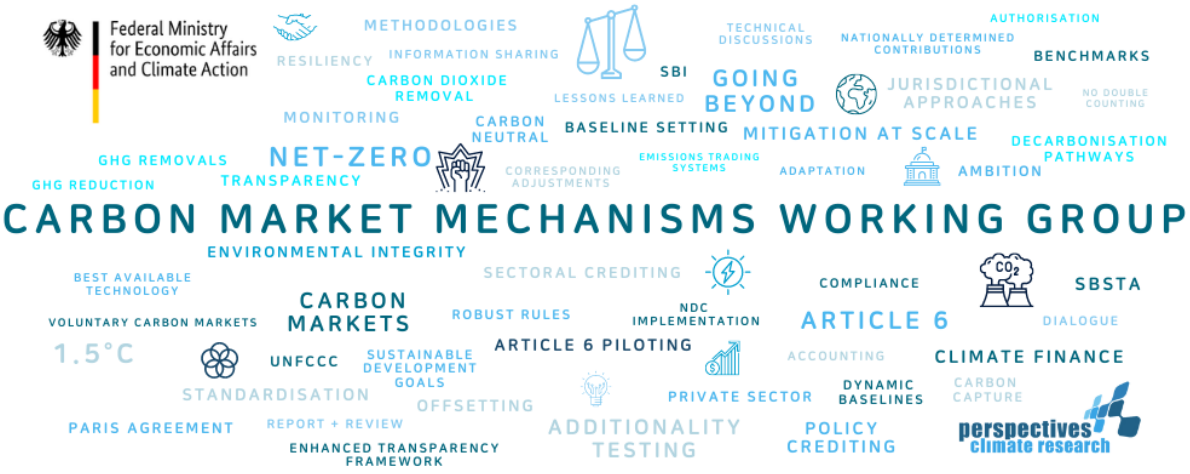

Developing an Article 6 tool to assess the additionality of mitigation activities

05/2022

Discussion Paper

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The CMM-WG is chaired by PCR and is funded and coordinated in close collaboration with the German Federal Ministry for Economic Affairs and Climate Action. The CMM-WG focuses on technical aspects of programmatic and upscaled crediting mechanisms in Article 6 of the Paris Agreement as well as results-based climate finance. The working group aims to facilitate a continuous dialogue on technical issues among key carbon market stakeholders. For more information go to:

https://www.carbon-mechanisms.de/en/news-details/cmm-wg

DISCLAIMER

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Abbreviations

CCP	Core Carbon Principles
CDM	Clean Development Mechanism
CER	Certified Emission Reduction
EB	Executive Board
FOEN	Federal Office for the Environment
GHG	Greenhouse Gas
GS	Gold Standard
IC-VCM	Integrity Council for the Voluntary Carbon Market
II-AMT	International Initiative for Development of Article 6 Methodology Tools
IRR	Internal Rate of Return
ITMO	Internationally Transferred Mitigation Outcome
JCM	Joint Crediting Mechanism
JI	Joint Implementation
JISC	Joint Implementation Supervisory Committee
LDC	Least Developed Country
LT-LEDS	Long-term Low Emissions Development Strategy
MRV	Monitoring, Reporting and Verification
NDC	Nationally Determined Contribution
PA	Paris Agreement
RE	Renewable Energy
RMP	Rules, Modalities and Procedures
SIDS	Small Island Developing State
UNFCCC	United Nations Framework Convention on Climate Change
VCS	Verified Carbon Standard

1. Objective and scope of the discussion paper

Under Article 6 of the Paris Agreement (PA), countries are free to use international market-based cooperation for achieving higher ambition in their mitigation actions enshrined in their nationally determined contributions (NDCs). The Article 6 decisions adopted at the Climate Conference in Glasgow (26th Conference of the Parties, COP26) lay down stringent principles and rules for international market-based cooperation regarding the setting of robust crediting baselines, additionality determination, monitoring and quantification of mitigation outcomes. While methodologies used under the Kyoto mechanisms, the Clean Development Mechanism (CDM) and Joint Implementation (JI), provide a good starting point for Article 6 crediting activities, the Article 6 rules specify new and frequently more stringent methodological requirements for international carbon markets under the PA than the Marrakech Accords did for the Kyoto Protocol.

With the onset of the Article 6 implementation phase, it is thus important to transform CDM methodological approaches to respect the PA rules and requirements. This paper aims to foster the discussion on how additionality determination under the CDM and JI can be appropriately transitioned to Article 6 of the PA. We build on the efforts of the International Initiative for development of Article 6 Methodology Tools (II-AMT) which is developing an additionality tool as part of a toolset for the methodological transition based on the Article 6 principles and rules. Besides, input provided by participants at the CMM-WG Article 6 methodology workshop on 4 May 2022 was incorporated in this discussion paper and will also be considered in the additionality tool development phase starting in May 2022.

2. The challenges of methodology transition and the relevance of additionality

The adoption of the Article 6 decisions at COP26 stipulating stringent principles and rules for the new era of international carbon markets requires a pragmatic, yet robust approach to transition the existing market-based methodologies and make them 'fit for Paris'. To this date, there are over 250 baseline and monitoring methodologies and 33 associated tools approved under the CDM that must be revised to ensure they are in line with the long-term targets[1] of the PA and the principle of environmental integrity and sustainable development.

The discrepancy of existing methodologies and principles as well as rules of the Article 6 decisions can be overcome by the development of specific 'Article 6 tools' that can be added to the Kyoto mechanism methodologies in a modular fashion. Experience from the CDM shows that developing new stand-alone Article 6 methodologies instead of revising existing approved methodologies would generate costs of 0.1-0.2 million USD per new methodology, and require one to two years. Not building on existing methodologies would thus burden and slow down the development of new mitigation activities, ultimately resulting in difficulties in the achievement of NDCs and no increase in ambition to achieve long-term mitigation targets.

[1] The PA's long-term targets referred to in this paper comprise the limitation of the global average temperature to well below 2°C and pursuing efforts to limit it to 1.5°C and to make finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development (UNFCCC 2015, Article 2).

The development of Article 6 tools that guide the revision of Kyoto methodologies represents a feasible compromise between those Parties that want to have a "fresh start" and those that do not want to disrupt the development of mitigation activities. The development of Article 6 tools can benefit greatly from the extensive conceptual work on PA alignment by different initiatives (see chapter 4) and on "Article 6 readiness" by buyer and host countries from a governance perspective and foster a move towards practical implementation of Article 6.

Additionality is an overarching issue that needs to be checked for any activity developed under Article 6. Therefore, the additionality tool will play a key role in the operationalisation of Article 6. Below, we first discuss the changes in the additionality concept due to the COP26 decisions and then elaborate the approach for designing the additionality tool.

3. Re-defining additionality

The additionality of activities that generate emissions credits is essential for safeguarding the environmental integrity of market-based cooperation. Additionality testing is done to show that any activity credited under a baseline-and-credit scheme would not have occurred in the absence of carbon market support (Michaelowa 2009). In case non-additional activities generate emission credits under carbon markets, limited financial resources are redirected from truly additional mitigation activities and as a consequence, global emissions will increase.

For the CDM and JI, the Kyoto Protocol specified the additionality requirements in a circular fashion, referring to the situation in the absence of the activity, without raising the question whether the activity would actually be triggered by the revenues generated from the sale of emission credits. The Marrakech Accords adopted at COP7 in Marrakech in 2001 did not provide an operational definition of additionality. Instead, this task was delegated to the Executive Board (EB) for the CDM and to the Joint Implementation Supervisory Committee (JISC). The guidance provided by the CDM EB was developed over time, starting with the definition of barrier testing for small-scale projects, followed by the adoption of a consolidated methodological 'tool for the demonstration and assessment of additionality' in 2004. This tool which comprises a choice of an investment or a barrier analysis followed by common practice analysis was since then revised and refined over the years. While the barrier analysis was increasingly seen as lacking robustness and no longer applied due to high profile rejection of registration requests by the CDM EB and massive criticism by NGOs and researchers, the investment test became the *de facto* testing approach (Michaelowa 2009). However, NGOs and researchers continued to complain about the exclusion of domestic mitigation policies from additionality assessment due to the so-called "E- policy rule". For example, renewable electricity feed-in tariffs were not considered in the investment test. While JI activities can follow the CDM approach, guidance provided by the JISC also foresees a JI-specific approach that builds on three options. For a detailed discussion of the operationalisation of additionality under the Kyoto mechanisms see a previous CMM-WG paper (Ahonen et al. 2021).

There were many controversies regarding the definition and operationalisation of additionality noticeable during formal and informal negotiations in the run-up to the adoption of the Article 6 decisions. Some of the open issues that were debated by negotiators were the inclusion of specific additionality requirements in the Article 6.2 guidance, the definition of additionality and the role of host countries in assessing additionality in the context of the Article 6.4 mechanism (A6.4M), the assessment of additionality for activities outside the scope of

countries' NDC and the identification of an appropriate strategy to transition CDM methodologies and other methodologies for determining additionality to the Paris era (Michaelowa 2019b).

These and other controversies got resolved and the Article 6 decisions were adopted at COP26 in November 2021. While the Article 6.2 decision text specifies that all internationally transferred mitigation outcomes (ITMOs) arising from cooperative approaches must be additional, there are no approaches laid down on determining additionality (UNFCCC 2021a). In contrast, the Article 6.4 decision text has several references to additionality determination. In order for an activity to be additional, it must be demonstrated that "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" (UNFCCC 2021b, para. 38). Besides, further principles relevant for additionality such as that Article 6 cooperation should contribute to the long-term low emission development strategy (LT-LEDS) and the long-term targets of the PA are laid out in the Article 6.4 decision text.

In contrast to the CDM where host country mitigation policies were explicitly excluded from additionality determination, additionality determination under the PA must now be done in the context of the obligation of Parties to implement NDCs and to increase their mitigation ambitions while contributing to the long-term targets of the PA. This implies for example that new and upcoming mitigation policies need to be considered when determining the additionality of mitigation activities. Besides, an increase in mitigation ambition hints towards a contribution that goes beyond the NDC, at least the unconditional NDC targets. In addition, additionality determination also has to take into consideration an activity's alignment with the LT-LEDS and the PA's long-term targets.

3.1. Key lessons learned from the application of additionality tests in the past

The operationalisation of the principles and rules related to additionality will also be guided by key lessons learned for additionality determination under the Kyoto Protocol mechanisms. In the following, these key lessons will be listed (for a more detailed discussion, see Ahonen et al. 2021).

- **Barrier testing** often led to gaming by activity developers and generated strong controversies, as it is not possible to clearly show how non-monetary barriers can be overcome through carbon credit revenue (Michaelowa 2009, 2019a).
- **Investment analysis**[2] did also face challenges including the availability and transparency of required information on financial parameters used in the calculation of the internal rate of return (IRR), causing risks of gaming the parameters. it was significantly refined over time and became more robust due to the growing expertise by auditors and regulators (Michaelowa et al. 2019a).

[2] An investment test aims to show that the proposed activity is less economically attractive than realistic alternative investment options.

- While **positive lists for automatic additionality** have clear benefits such as the reduction of controversial loopholes and gaming, there are also challenges including difficulties in considering country- or sector-specific contexts (Schneider 2007). In addition, positive lists are not a panacea as they can become obsolete rather quickly (Michaelowa et al. 2019a). Under the CDM, positive lists have been "sticky", leading to the situation where voluntary carbon market standards like Gold Standard and Verra exclude grid-connected renewable electricity projects due to the general lack of additionality (see section 4 below), while they still feature on a CDM positive list.

3.2. The three shades of additionality determination

Building on the principles and rules stipulated in the (draft) Article 6.4 decision text, the authors have conceptualised additionality determination in a previous CMM-WG paper (see Ahonen et al. 2021), defining the 'three shades of additionality determination':

- **Regulatory additionality** tests require activity developers to prove that the pursued Article 6 activity is not mandated by law or part of the GHG emission reductions required by national regulation. In case the actual implementation of a regulation is uncertain, an enforcement test threshold can be applied (Ahonen et al. 2021).
- **Financial additionality** tests or investment tests require the involved parties to prove that the proposed activity is less economically attractive than realistic alternative investment options. There exist multiple methods to conduct an investment test including a simple cost analysis (if credit sale is the project's only revenue source), an investment comparison analysis, or a benchmark approach (if there are other savings/revenues beyond the credit sale) (Shishlov and Bellassen 2012).
- **Target additionality** or **'target surplus'** tests require activity developers to prove that activity types under Article 6 do not form part of the (unconditional) NDC targets. Activities that do not go beyond the unconditional NDC targets generate a clear "overselling risk" for the host country which can undermine its own NDC achievement.

The authors have argued that all three shades of additionality determination need to be considered in Article 6 methodologies to ensure compliance with Article 6 rules and principles, especially of the A6.4M.

3.3. The role of the host country

While only few host countries actively exercised oversight beyond "rubber stamping" in the approval process of CDM projects, JI track 1 allowed for host country oversight (Ahonen et al. 2021). In the PA context, host countries are set to play a more central role than in the CDM as they will need to ensure their own NDC achievement while voluntarily cooperating under Article 6.

Under Article 6.2, host countries will need to agree with the cooperating Part(y)ies on the methodological approaches to be applied to the envisaged cooperative approach. Besides, host countries will need to authorise the transfer for ITMOs for use towards an NDC and towards other international mitigation purposes (UNFCCC 2021a, Annex, para. 1). It is vital for host countries to develop their own understanding of activity additionality taking into account

country-specific requirements. The host country could develop a positive list of mitigation activities deemed as additional that could be proactively communicated to project developers and potential buyer countries.

Article 6.4 differentiates between an approval process for activities and the authorisation of Article 6.4 emission reductions for use towards NDC achievement or other international mitigation purposes (UNFCCC 2021b, Annex, para. 40). The host country will need to provide an activity approval to the Article 6.4 Supervisory Body prior to its request for registration. Also, host countries can communicate additional methodological requirements to be applied to Article 6.4 activities in its territory prior to mechanism participation (UNFCCC 2021b, Annex, para 27). These additional requirements need to be in line with the Article 6.4 rules, modalities and procedures (RMPs). In this way, the host country can gain more control over the kind of activities it would like to see promoted and can for example also stipulate a certain positive list of additional activities or introduce further additionality requirements.

4. Trends and initiatives in re-defining additionality

Since the adoption of the PA in 2015 and in particular since the adoption of the Article 6 rulebook in 2021, an increasing number of crediting standards and initiatives in the voluntary carbon and compliance market are committing to align their operations with the PA in order to ensure the integrity of credits generated. This section summarises the ongoing efforts by these actors to align their operations with the stringent additionality requirements under Article 6 of the PA.

In 2021, **Gold Standard (GS)** established an Expert Consultation Group on alignment with the PA, to make necessary changes to the standard's rules, requirements, and procedures to ensure robust, efficient, and high-integrity alignment with requirements under the PA, particularly Article 6 (Gold Standard 2021a). Some of the objectives for alignment specific to the principles of additionality include:

- Reviewing GS' additionality requirements to align with the PA context
- Incorporating approaches to ensure regulatory additionality
- Reviewing the need to demonstrate financial additionality ('ongoing financial need test') at the renewal of crediting period or just having robust up-front additionality testing instead.

Furthermore, in collaboration with Switzerland's Federal Office for the Environment (FOEN), GS has been working on developing a framework for additionality and higher ambition in international carbon markets (Gold Standard 2021b). The project envisages close collaboration with ministries in several countries that intend on using cooperative approaches under Article 6. In this context, crediting activities in Peru were assessed in terms of whether they are still considered additional under Article 6 and can be included on a positive list. A key eligibility criterion for the determination of positive lists that the study analysed in detail was financial additionality (Michaelowa et al. 2021). While activities with no revenues are automatically deemed additional, activities with revenues from the sale of goods and services, performance benchmarks or payback period thresholds must be applied depending on the sector (Michaelowa et al. 2021). The recent updates to the GS eligibility criteria for activities deem only certain types of renewable energy (RE) activities to be additional. These RE activities must be

connected to a national or regional electricity grid located in LDCs, or SIDS; or in low to medium income countries with RE technology penetration rate of less than 5% of the total grid installed capacity (Gold Standard 2021c).

Additionally, under the GS-FOEN project partnership, an additionality framework was recommended for Parties entering into Article 6.2 cooperative approaches. The framework includes integrating principles of additionality into cooperative approaches, relying on the best available additionality assessment approaches, and using host country 'priority lists' as a tool for additionality assessment (Gold Standard 2022).

In addition to GS, Verra welcomed the adoption of the Article 6 rulebook and recognises the role of its **Verified Carbon Standard (VCS)** to create high-quality carbon credits under Article 6.2 that can be used towards the achievement of NDCs by participating countries (Verra 2021). Verra has also communicated that it is open to reflecting the new principles on additionality, baselines, and crediting periods under the VCS programme requirements to ensure projects contribute to climate action by host countries and drive climate finance (Verra 2021). One of the recent updates to the VCS programme includes the introduction of new requirements for dynamic performance benchmarks for additionality determination, wherein real-time performance changes in a sector or activity type need to be considered (Verra 2022). After a public consultation, Verra revised the scope of the VCS programme and removed certain RE activities from future eligibility under the programme. Only small-scale grid-connected hydro activities and small- and large-scale grid-connected geothermal, wind and solar activities located in LDCs or SIDS are now eligible under the VCS programme (Verra 2019).

The **Integrity Council for the Voluntary Carbon Market (IC-VCM)** has developed a set of threshold standards for high-quality carbon credits and carbon-crediting programmes based on the Core Carbon Principles (CCPs) and Assessment Framework, to allow the VCM to play a greater role in accelerating the global transition to the 1.5° target (IC-VCM 2022). The CCPs will include principles of additionality determination and are due to be published in 2022 for stakeholder consultation.

Prior to the finalisation of the Article 6 rulebook, the **Joint Crediting Mechanism (JCM)** was the leading project-based standard that employed bilateral market-based cooperation. After the adoption of the PA, the mechanism has been striving for alignment with Article 6.2 of the PA. The JCM framework requires emission reductions to be real and verified, as is required under Article 6.2 (ADB 2021). As per the Joint Crediting Mechanism Guidelines for Developing Proposed Methodology, baselines must be below BAU and quantified using approved JCM methodologies (ADB 2021). With regards to additionality determination, the JCM substitutes additionality determination with 'eligibility criteria' similar to a positive list for each methodology (ADB 2016).

Another initiative that seeks the re-definition of additionality in the context of the PA is the **"International Initiative for development of Article 6 Methodology Tools" (II-AMT).** Launched in January 2022, the II-AMT aims to develop a practical and robust approach to transitioning CDM methodologies to make them suitable for Article 6 rather than developing methodological tools from scratch (Perspectives Climate Research 2022). An appropriate transition of CDM methodologies will present a large range of existing methodologies to Article 6 developers while adhering to the guardrails of Article 6. A team of international experts from all continents with long-standing expertise in developing methodologies under the Kyoto Protocol and leading conceptual work on methodological issues under Article 6 was put together

to consolidate their insights and perspectives, and translate them into well-rounded methodological tools.

Under the II-AMT, the tools and guidance to be developed will address four central issues that require updates to make them fit for Article 6 due to the stringency of the adopted Article 6 rulebook including the additionality determination of activities (Perspectives Climate Research 2022).

April 2022 marked the conclusion of the concept phase of the II-AMT which was supported by the Swedish Energy Agency, the Ministry of Environment of Japan, and the African Development Bank. Next to a concept note for robust baseline setting, one for monitoring, reporting and verification (MRV) of emission reduction and the contributions to the host country NDC and long-term low emissions development strategies, a concept note for additionality determination of mitigation activities has been developed by the international experts. The additionality concept note elaborates on the objectives, scope and applicability, set of key principles and guardrails to guide the development of the additionality tool and identifies the central elements and key challenges, and potential strategies to address the latter. After several rounds of iterative revisions of the concept notes by the experts, the notes were shared with the initiative's interdisciplinary advisory group before being published (II-AMT 2022a-d).

Chapter 5 describes the main features of the future II-AMT tool to assess the additionality of mitigation activities, as currently anticipated by the authors in the corresponding concept note (II-AMT 2022a).

5. Elements of a future II-AMT additionality tool

In this chapter, first, the key challenges identified during the development phase of the additionality concept note (II-AMT 2022a) are highlighted before the second sub-chapter provides an overview of the stepwise approach proposed by the international methodology experts. Subsequently, aspects like the determination of the length of the crediting period, the re-assessment of additionality at crediting period renewal and guidance for positive lists as presented in the concept note are summarised.

5.1. Key challenges identified

A key challenge was how to assess the additionality of an activity in light of the host country's NDC and to find a balance between methodological requirements and the host country's prerogative to determine which measures are part of its NDC. A key objective, based on the interpretation of the Article 6 principles is to ensure that an activity does not jeopardise the host country's ability to meet its NDC, if the resulting mitigation is authorised for international transfer. The experts discussed whether an assessment of regulatory additionality was sufficient in the context of Article 6 and how to deal with activities that are not triggered by an existing regulation but by strong anticipation of a policy or host country government measure.

The international experts agreed that regulatory additionality is understood to be a necessary yet insufficient condition to prove that an activity goes beyond the NDC, and that further analysis would be needed to determine the "target surplus" of an activity. Against the background of target changes that may occur during an NDC implementation period and host country choice as where to focus its efforts on mobilising mitigation, another challenge that arises is

how to interpret a negative result of the "target surplus" assessment. The experts propose that activity developers should at least flag the risks in public communication to the host country but leave the final decision on whether the activity is fully "target additional" or not to the respective host country. Target surplus is not only to be assessed before the activity's approval but also at crediting period renewal if the NDC has been updated in the meantime.

Another key challenge during the development phase of the additionality concept note was how to deal with the activities that are "on the edge" of being financially additional, meaning that these can only by a relatively narrow margin show that they are financially not attractive without the expected carbon revenue. While some activities are clearly less attractive than best available technology or fully reliant on carbon revenues only, other activities may become financially attractive in a relatively short timeframe, e.g., through rising domestic carbon prices and other effects of host country policies, etc. Any investment analysis must make assumptions about the risk aversion of the actors involved and the eradication of all subjectivity is difficult to achieve. At the same time, financing activities through different revenue streams, of which only one is carbon finance, can be important in the context of scaling up activities and also ensuring that payments through international carbon markets can be "phased out" and replaced fully by other sources of finance in the longer term to sustain the activity beyond the crediting periods.

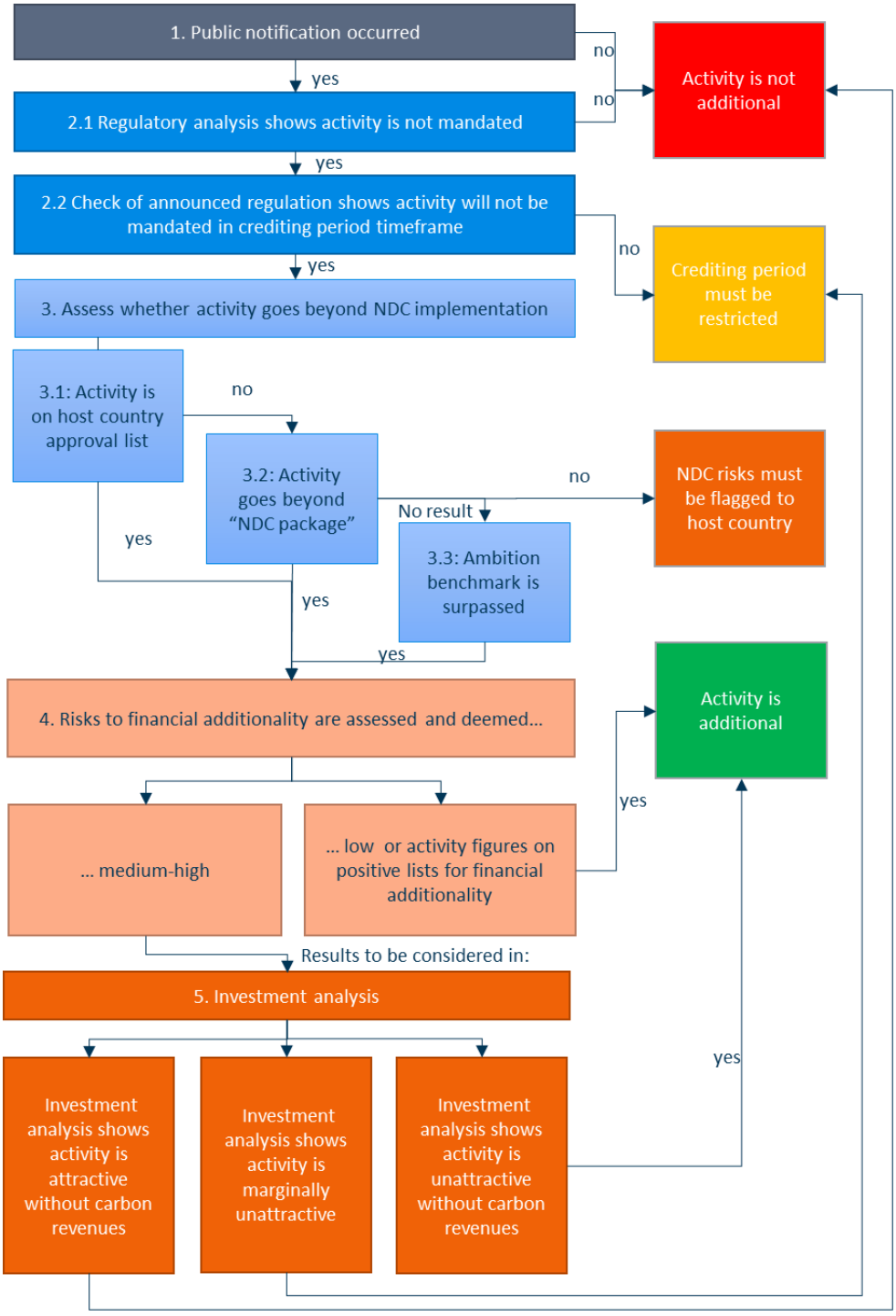
With regard to financial additionality, experts also discussed whether some form of barrier analysis should be retained for LDCs and SIDS. In the end, experts included a disclaimer in the concept note that it is to be further discussed in the II-AMT development phase whether barriers to implementation may be considered as a complement to the investment analysis for LDCs and SIDS. Generally, monetary repercussions of barriers should always be dealt with in the investment analysis.

Finally, experts discussed under which conditions a renewed investment test would be required before approving crediting period renewal. The financial additionality of an investment decision does not "expire". Even if the activity has no ongoing need for finance a few years into implementation, this does not mean the investment decision would have been taken at the time without the prospect of carbon revenue. However, experts acknowledged that an activity may require not only one, but several investment decisions over time, e.g., if an activity requires investments into the replacement of technologies with short lifetimes. For investment decisions at a later point in time, during activity implementation, a new investment test has to be applied to justify the prolongation of a crediting period.

5.2. Proposed stepwise approach to determine additionality

Figure 1 provides an overview of the proposed stepwise approach to determine additionality in the developed concept note. The international experts propose a five-step approach to the determination and assessment of additionality of mitigation activities in line with the Article 6.2 guidance and the Article 6.4 RMPs (II-AMT 2022a).

Figure 1: Flowchart of proposed stepwise process for the demonstration of additionality



Source: II-AMT /2022a)

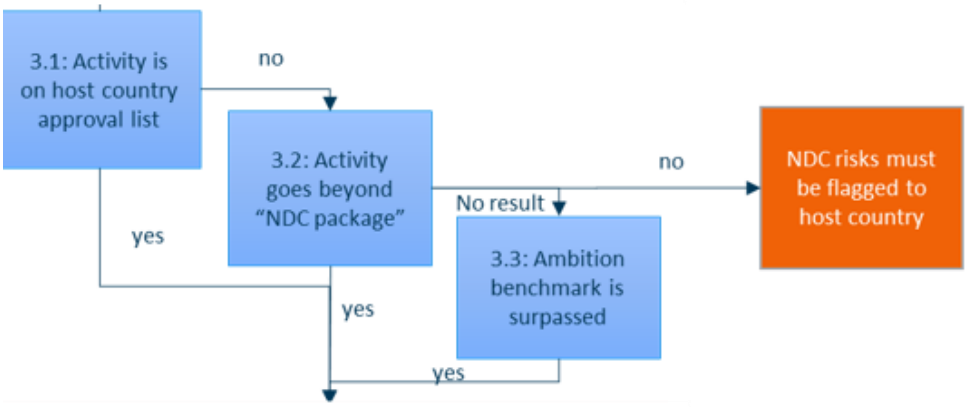
Prior to the start of the activity[3], the activity participants must provide proof of their intention to earn carbon revenues from the activity. This is a safeguard to weed out the activities with the highest risks of non-additionality.

[3] The 'start of the activity' represents the date on which the activity participant commits to making significant expenditures for activity implementation.

Next, activity participants must ensure the regulatory additionality of the activity by showing that the proposed activity is neither mandated by law nor forming part of the planned GHG emission reductions required by regulation. Furthermore, formal government announcements of new laws or regulations that require mitigation measures or outcomes to be introduced during the crediting period timeframe need to be checked. If the check of announced regulation shows that the activity will be mandated in the duration of the crediting period, then the crediting period must be restricted accordingly.

If the activity is not mandated in the crediting period, then further dimensions of additionality have to be checked: It must be assessed if the mitigation activity can be deemed part of the host country's efforts to achieve the unconditional NDC targets. This assessment aims to mitigate the risk of 'overselling' by the host country as crediting activities should go beyond the (unconditional) NDC. If the proposed activity is in the host country approval list[4], it is – according to official host country planning documents – not necessary to achieve its unconditional NDC target or conditional target[5] for which the use of carbon finance has explicitly been excluded or generates mitigation that is greater than the ambition benchmark[6], then the activity can be deemed to contribute to "target surplus[7]" and activity developers can move on to the assessment of financial additionality (step 4) (see Figure 2). The concept note recommends flagging the negative list of "non-additional activities" of the "target surplus" assessment to the host country authorities rather than declaring the activity right away non-additional. The host country has the final authority to deem the activity 'target' additional or otherwise.

Figure 2: Step 3 of additionality determination



Source: II-AMT (2022a)

[4] Public communication of (a list of) activities by the host country which are deemed to go beyond the efforts for achieving its NDC

[5] In case the host country NDC does not distinguish between unconditional and conditional NDC targets, the overall NDC target is to be assessed

[6] Ambition benchmark guidance will be developed during the development phase of the tool.

[7] Target surplus assessment implies that the activity represents target surplus mitigation based on the host country's targets and implementation plans. The risk of this target surplus not holding at a later point in time due to delays in NDC achievement must be mitigated by agreements between host country and activity developers.

In order to determine the financial additionality, two steps must be undertaken by activity developers. First, as a pre-condition to determine the financial additionality, activity developers must identify and evaluate inherent financial additionality risks as well as risks to the activity implementation[8] for the specific activity type. In case of the former, if the only source of revenue or savings from the activity is the revenue from sale of emission credits, then such an activity is deemed to have a 'low' inherent additionality risk. The possible outcomes of the risk assessment are presented in Table 1 below.

Table 1 : Outcomes of financial additionality risk assessment

Consolidated inherent additionality risk	Consolidated implementation risk
Low → activity is additional and can be included in the positive list (step 5 is not required)	**Low** → no inclusion of technical barriers in investment analysis (under step 5)
Medium to High → Investment analysis (step 5) is required	**Medium to High** → Technical barriers to implementation must be incorporated in the investment analysis + explanation of impacts on investment decision is required (in step 5)

Source: II-AMT (2022a)

If the risk to financial additionality is medium or high, activity developers must demonstrate financial additionality through investment analysis[9] (step 5). To do so, financial feasibility and realistic alternatives to the activity must first be identified. This is critical as it helps to develop an economic assessment parameter at which the project is not financially feasible. Some key parameters to be included in an investment analysis are:

- all revenues and savings generated for the activity, including any subsidies, avoided carbon taxes, financial impacts of emissions trading schemes, etc.
- any identified medium and high risks to implementation expressed in monetary terms, e.g., in changes in cash flow due to slower activity implementation, lower load factors, etc.

An activity is considered to be financially additional if according to the investment analysis, there is a medium-to-high level of confidence that the activity is not attractive without revenues from credit sales.

5.3. Links to determining crediting period length

The A6.4 RMPs specify that crediting periods for emission reduction activities are fixed either at a maximum of five years renewable twice or at ten years which is non-renewable. The II-AMT concept note for the additionality foresees certain cases in which crediting periods should be shortened or restricted:

[8] Risks to activity implementation include long-payback periods, lack of financing sources, poor access to financing, lack of technical capacities among others.

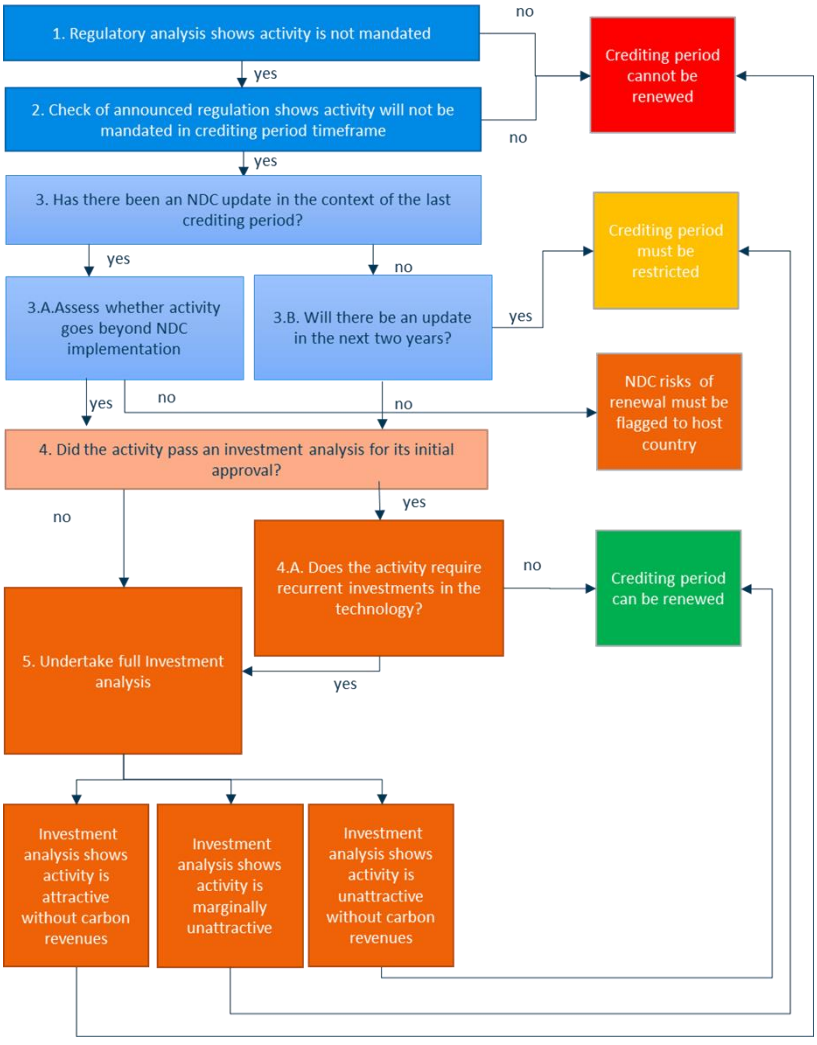
[9] Investment analysis determines that the activity is not financially feasible without the expected revenues from the sale of the ITMOs.

- In anticipation of the introduction of a policy instrument, law, or regulation, eliminating regulatory additionality of the activity after that date.
- If the activity is only marginally unattractive and a short crediting period is deemed sufficient to "tip" the balance in the investment decision. Shorter crediting periods here avoid windfall profits for activity owners and inefficient allocation of carbon finance.
- If an activity requires replacement and additional investments and a technology with a short lifetime, activity developers must go for an initial crediting period of five years (renewable twice) instead of a crediting period of ten years non-renewable. This ensures the activity undergoes a re-assessment of financial additionality of the replacement and additional investments after five years.

5.4. Re-assessment of additionality at crediting period renewal

Figure 3 below presents the flowchart of the proposed approach for re-assessing additionality at crediting period renewal.

Figure 3: Flowchart of proposed stepwise approach to re-assess additionality at crediting period renewal



Source: II-AMT (2022a)

At the renewal of the crediting period, the activity developers must follow the steps on assessing regulatory additionality and target surplus as discussed in section 5.2. However, assessing target surplus is only mandatory if there has been an NDC update or a new NDC implementation period since the start of the activity. If an NDC update is expected, the crediting period renewal must be restricted up to the date of the start of the new implementation period. If an activity was not required to undergo an investment analysis for the initial crediting period, an analysis may be required now. The same is true for all activities that involve replacement and additional investments.

5.5. Guidance for positive lists

Creating positive lists for technologies and activity types where present value of costs significantly exceeds revenues and savings not taking into account revenues from emission credit sales simplifies the determination of financial additionality and reduces transaction costs. Under the tool, further guidance will be developed to meet the minimum quality criteria for positive lists including guidance on regular updates to positive lists, role of experts and public inputs, process of developing and accepting positive lists at national and international level, role of independent validation and verification among others.

Furthermore, II-AMT TOOL01 acknowledges that parties may develop their own 'host country approval lists' that indicate the activity types that go beyond the host country's NDC efforts. These lists can be used for undertaking the first step for evaluating target surplus ('activity is on host country approval list') described in section 5.2. The tool will provide guidance on the process of developing and accepting host country approval lists, the role of experts and public input, the role of independent verification and regular updates to host country approval lists.

6. Recommendations for the additionality tool's development phase

Based on the issues raised by speakers and discussion with the broader audience at the CMM-WG workshop, the key considerations for the experts developing the II-AMT tool to determine additionality are as follows:

Recommendations for Step 2: Determination of regulatory additionality

- The tool should provide further clarification on the fine line between targets enshrined in law and policy instruments. The reason for this is because many NDCs do not specify specific measures, which would only be done in concrete legislation. Moreover, there may be high-level legislation on net-zero targets, but no specifications of underlying measures. If a net-zero target without any underpinning mitigation policies was considered as law, not many mitigation activities would pass the additionality test. Therefore, it would need to be further specified which specific type of legislation should be considered in step 2 of II-AMT TOOL01.

Recommendations for Step 3: Target surplus

- Strong and robust capacity building of the designated national authority is required to enable them to effectively assess additionality of an activity against NDC targets and Paris Agreement goals as specified in the concept note under step 3. The designated national authority must work in cooperation with the country's NDC implementation

authority to make this assessment. Therefore, it is crucial that the additionality tool provides guidance on how the assessment will be done by the project proponents in cooperation with the national authority and how this assessment will be verified and validated.

- With regards to the step that assesses whether an activity goes beyond the NDC package under the 'target additionality' determination step (step [3.2]), the tool must discuss options to determine and/or revise additionality assessment in cases where: a) NDCs do not contain sufficient information that allows the derivation of a trajectory; and b) NDC achievement is considerably slower than originally planned.
- Furthermore, it was recognised that the sub-step 3.2.3 on determining 'marginal cost related target surplus' is a complex one as it is difficult to determine who determines the cost thresholds and conducts marginal costs assessments in a centralized and continuous manner. Therefore, to ensure simplicity, it is recommended that if the result of the prior sub-step i.e., assessing if it the mitigation is beyond the mitigation trajectory of implementation needed for the NDC target is unclear, then the mitigation activity should be automatically deemed as non-additional. These options should be further explored by the international expert team during the development phase of the tool.
- The tool should also capture how additionality should be tested for activities that are implemented due to auctions or through contracts for difference (CfD), as these do not have legal requirements and therefore may not be additional.

Recommendations for Guidance for the development of positive and host country approval lists

- It is appreciated that the tool considers developing a guidance on positive lists. However, it must also reflect the special circumstances of LDCs and SIDS. Specific considerations for those countries should be further explored in the development phase.

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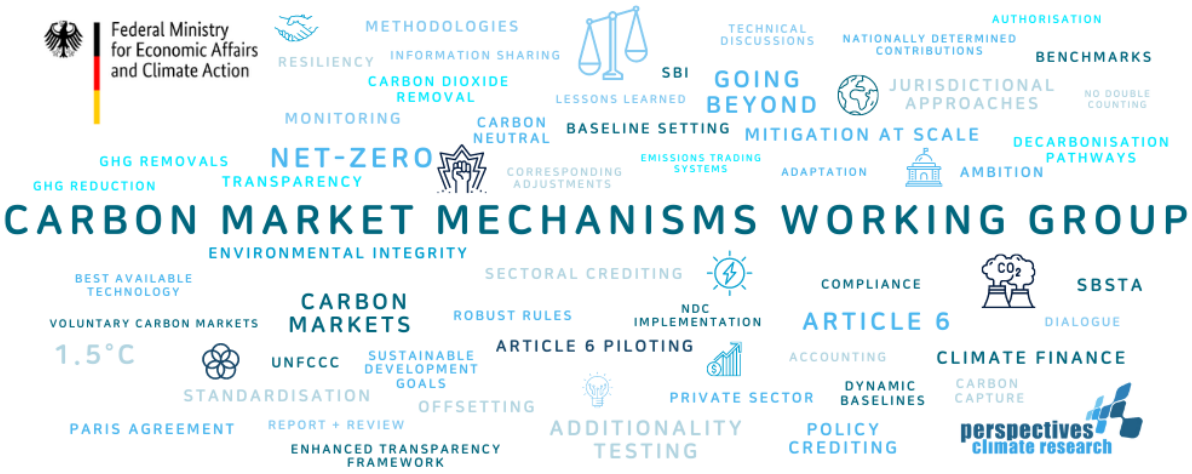

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