

HERDING THE GLOBAL CARBON MARKET CATS: RECOMMENDATIONS FOR THE NEGOTIATIONS OF THE FRAMEWORK ON VARIOUS APPROACHES

Position Paper for COP-19, Warsaw · November 2013



EXECUTIVE SUMMARY

The window of opportunity to prevent catastrophic climate change is rapidly closing. Current mitigation commitments are well below the level of reductions necessary to keep warming below 2°C and we are now on an emissions path that could lead to warming of 4°C or more.

Countries agreed at COP17 in Durban that various approaches, including opportunities for using markets and non-markets, may be used to enhance the cost-effectiveness of, and to promote, mitigation actions. At COP18 in Doha it was decided that these approaches shall be governed by a Framework for Various Approaches (FVA). In November 2013, Parties will attend COP-19 in Warsaw and will continue discussing the FVA.

One of the main arguments in favour of market mechanisms has been that they create an incentive for countries to take on higher targets than they would otherwise. But to date carbon markets have not incentivised countries to take on adequate commitments.

- > **Mitigation targets need to be much more ambitious than they currently are in order to stay within the safe limits of the remaining global carbon budget.**
- > **Any agreement on an FVA covering multiple carbon markets would be premature should it precede clear and ambitious mitigation commitments from Parties.**

The argument is also often made that market mechanisms lead to more cost-effective emission reductions. But cost-effectiveness must be considered from a long-term perspective. Low-cost short-term mitigation may lead to technological lock-in. Also, cost-effectiveness can only be achieved if the offsets or allowances sold have environmental integrity. When this is not the case, scarce finance is spent on units that do not actually represent real emission reductions. This makes staying within the limited carbon budget more expensive.

Experience made to date with carbon markets must therefore be taken into account when discussing the role of future carbon markets. Although negotiations under ADP are still at an early stage, several Parties including the COP Presidency have stressed the importance of establishing the FVA in Warsaw.

Given that the scope and role of the FVA is still unclear, Carbon Market Watch believes that Parties must address the following recommendations in Warsaw first:

- > **Access to carbon markets should require ambitious reduction commitments.**
- > **The FVA should not be established and no pilot phase should be started before the negotiations under ADP have defined mitigation commitment requirements and rules for a common accounting framework.**
- > **Eligibility criteria need to be established that ensure only Parties with sufficiently ambitious reduction commitments can participate in international carbon markets.**
- > **All double-counting of emission reductions need to be addressed. In addition, financial flows should only be counted once.**
- > **Detailed and comprehensive rules need to ensure the environmental integrity of units.**
- > **All units should be assessed by an international body and should be fully accounted through a rigorous, robust and transparent common accounting framework.**

INTRODUCTION

At COP-19 in Warsaw, starting on 11 November 2013, Parties will continue to discuss the Framework for Various Approaches (FVA) which aims, inter alia, to set common rules for national and regional carbon markets that will sell market units to other countries for compliance with their climate commitments under the UNFCCC.



New national and regional carbon markets, such as emissions trading schemes and offsetting programmes, are being developed in many parts of the world, including Japan, California, China and South Korea. A crucial question is to what extent such market mechanisms should follow a common framework of rules under the UNFCCC. Parties decided at COP-17 in 2011 that a Framework for Various Approaches should be established to “enhance the cost-effectiveness of, and to promote, mitigation actions.” Parties also decided that “all such approaches must meet

HIGH AMBITION IS CRUCIAL

The window of opportunity to prevent catastrophic climate change is rapidly closing. Several studies show that current pledges are not only woefully insufficient to keep warming below 2°C, but we are now on an emissions path that could lead to warming of 4°C or more. In addition, impacts associated with 2°C have been revised upwards and are now considered ‘dangerous’ and ‘extremely dangerous.’ Retaining a reasonable likelihood of limiting temperature increases to within 2°C will require commitments from all nations in the next few years to considerably higher levels of ambition. The recent IPCC report stresses the importance of a carbon budget. An estimated additional 9-16 gigatonnes of emission reductions are necessary by 2020 to make the two-degree goal “likely.”

ACCESS TO MARKETS MUST BE LINKED TO HIGH AMBITION

Requirements for clear and ambitious mitigation commitments need to be established first, before any new carbon markets are established. The FVA should not lead to the sanctioning of low quality carbon market units and inflated targets that are met with substandard offsets or allowances.

One of the main arguments in favour of market mechanisms has been that they create an incentive for countries to take on higher targets than they would otherwise. To what extent countries would indeed have chosen even weaker targets is difficult to establish. What we do know is that current mitigation commitments are woefully inadequate, and offsetting mechanisms have been marred by

standards that deliver real, permanent, additional and verified mitigation outcomes, avoid double counting of effort and achieve a net decrease and/or avoidance of greenhouse gas emissions.”

So far, countries have not agreed on the role and scope of the FVA. Some countries see the FVA as including non-market based approaches. Others see it as including the New Market Based Mechanism (NMM) and the existing Kyoto offsetting mechanisms CDM and JI. And some countries oppose the FVA altogether.

Some Parties, such as New Zealand, Japan and the US, would like to establish minimal international guidance under the UNFCCC and allow for maximum flexibility for countries to establish their own governance structures. Other Parties such as the members of the Alliance of Small Island States (AOSIS) have been calling for comprehensive rules and centralised international oversight. Parties also disagree on the scope of the rules. While some advocate that the FVA should include only general rules for standards and unit tracking, others believe that the FVA should contain specific rules, for example on how to set baselines, validate, verify and issue credits. Some Parties also insist on ambitious climate mitigation commitments being a requirement to participation in the framework either as buyers or sellers.

- > **Mitigation commitments need to be much more ambitious than they currently are in order to stay within the safe limits of the remaining global carbon budget.**
- > **Mitigation commitments furthermore need to be comparable and based on multi-year budgets. Only then can an accounting framework protect the of targets, especially when there is international trading of allowances or offsets.**

insufficient environmental quality (see below). It is therefore safe to say that carbon markets have not incentivised countries to take on adequate commitments.

The argument is also often made that market mechanisms lead to more cost-effective emission reductions. But cost-effectiveness must be considered from a long-term perspective. Some mitigation actions may be cheaper in the short term, but may not lead to sufficient transformation to enable long-term decarbonisation. Low-cost short-term mitigation may lead to technological lock-in. Also, cost-effectiveness can only be achieved if the offsets or allowances sold have environmental integrity. When this is not the case, scarce finance is spent on units that do not

actually represent real emission reductions. This makes staying within the limited carbon budget more expensive. Also, carbon markets cannot function without sufficient ambition and demand for units. Experience with carbon markets has shown that inadequate mitigation ambition leads to inadequate demand. For the period until 2020,

demand for any type of market will remain very limited. The CDM, for example, could generate as many as six billion offsets until 2020, but projections put global demand at three billion or less. The oversupply of market units has led to a severe price drop. Under such conditions markets can no longer function properly.

COMMITMENT REQUIREMENTS FOR A POST-2020 AGREEMENT MUST COME FIRST

Clear and ambitious mitigation commitments are also a prerequisite for the establishment of an effective FVA. The FVA discussions need to follow the negotiations for an agreement under the Ad Hoc Working Group on the Durban Platform for Enhanced Action (ADP).

➤ **Commitment requirements for a post-2020 agreement must come first. The FVA should not be established before the negotiations under ADP have defined mitigation commitment requirements and rules for a common accounting framework.**

ELIGIBILITY REQUIREMENTS FOR MARKET PARTICIPATION MUST BE ESTABLISHED

The experience with Joint Implementation (JI) shows that sound accounting rules for market mechanisms alone are not enough. Countries with a large surplus of Kyoto allowances (AAUs) – a result of insufficient ambition – issued hundreds of millions of JI credits without any international oversight. To date, these credits account for over 90 per cent of all JI offsets. In addition, low ambition often leads to low quality market units because of a lack of incentive to set stringent baselines. Countries with ambitious targets are more likely to set crediting baselines, whereby activities under offsetting mechanisms lead to emission reductions that, while not credited, will help them meet their targets. On the other hand, countries with lenient targets have less need to worry about meeting their objectives, and can therefore issue large numbers of international offsets.

Only countries with sufficiently ambitious reduction commitments should therefore be allowed to trade units under an FVA. If no such eligibility requirements are established, the FVA could enable new ‘hot air’ and spurious offsets to be used to meet emission targets. This will undermine the two-degree goal all countries have agreed to meet.

➤ **Eligibility criteria need to be established that ensure only Parties with sufficiently ambitious reduction commitments can participate in the international trade of allowances and offsets.**

USE OF CREDITS COULD SEVERELY WEAKEN 2020 COMMITMENTS

The use of international credits to meet reduction pledges has been controversial. Some Parties, such as AOSIS members, tried to limit access to CDM and JI offsets to countries that have a reduction target for the second commitment period of the Kyoto Protocol. But in 2012 in Doha, Parties decided against such use restrictions. All Parties, including those without emission targets in the second commitment period, can participate in existing and new CDM projects and can buy CERs (UNFCCC FAQ).

It is unclear if, and under what conditions, countries that only have a 2020 reduction pledge under the Convention,

and lack a multi-year reduction target under the Kyoto Protocol, will be able to use other types of internationally traded credits. In Doha, Parties agreed to include a table detailing ‘other market-based mechanisms’ for reporting emissions and reductions.

The use of such international credits is very troubling. It would open the door for the use of credits from non-Kyoto mechanisms that have not been approved through a UN process. Such credits are very likely to be of even lower quality than CDM and JI offsets.

NO PILOT PHASE PRIOR TO ADP AGREEMENT, AS IT WOULD SET A DANGEROUS PRECEDENT

Rules adopted under the FVA will likely endure and continue to apply to a post-2020 climate deal. But discussions on a new climate deal under the ADP have been general and high-level to date, lacking specifics on the types of commitments countries would make, and how these would be accounted. Also, the use of markets under a new regime has not been mentioned.

Some organisations and Parties, most notably Poland who is hosting COP-19, have been advocating establishing an

FVA pilot phase under the UNFCCC. In principle, piloting new schemes and mechanisms is a good idea as it can help build capacity and ensure quality. Yet an FVA pilot could risk the integrity of a future climate deal. Advocates of a pilot phase under FVA have stressed that the resulting units should be recognised under a post-2020 climate deal. This means that countries participating in such a pilot FVA would be able to claim benefits for early actions under the new post-2020 climate treaty, for

example in the form of receiving reduction units that they could use for compliance under the new climate regime. Early recognition under a pilot phase would set a dangerous precedent. Once units are eligible for compliance it would be difficult to retroactively tighten accounting rules or exclude low quality units. The experience with both the CDM and JI indicate that establishing only minimal rules to get a mechanism off the ground in the hopes of strengthening rules later on is difficult at best, and in many cases is politically impossible.

- > **No FVA pilot should be established before the climate negotiations under ADP have progressed and key conditions for the new climate deal have been elaborated.**
- > **It is premature and potentially damaging to allow for the recognition of any early action under a post-2020 agreement before the negotiations on the fundamental principles for the new post-2020 climate regime have been established.**

WHY WE NEED AN INTERNATIONAL ACCOUNTING FRAMEWORK

Internationally traded units need to be rigorously accounted for to ensure, inter alia, that the emission reductions are only counted once. An international accounting framework is needed to track and account for units that are used to meet mitigation pledges and targets.

The FVA discussions are currently taking place under a broad work program under the Subsidiary Body for Scientific and Technical Advice (SBSTA). However, neither the scope nor the purpose of the FVA has been defined, and there is no link to negotiations under the ADP. To ensure the tracking and accounting of units that are used to

meet mitigation pledges and targets, an international accounting framework needs to be established:

- > **Accounting rules for the post-2020 agreement should be discussed under the ADP, taking into account ambition and equity considerations.**
- > **Accounting issues that pertain to the period until 2020 should be discussed under the SBSTA work programme on clarification of pledges.**

ALL TYPES OF DOUBLE-COUNTING MUST BE ADDRESSED

Double-counting undermines mitigation goals and economic efficiency, and must be avoided. In both the Cancun and Durban agreements, the necessity of avoiding double-counting is mentioned but not clearly defined. The most significant being “double claiming,” where both host and buyer country count the emission reductions achieved through an offset mechanism towards their mitigation targets. Existing accounting rules under the Kyoto Protocol for the period from 2013-2020 are not sufficient to ensure that no double-counting occurs. Current rules do not include any provisions on how host countries selling CDM offset credits must account for these emission reductions in their own greenhouse gas accounting. This can lead to double counting if the host country has a reduction target or pledge. Emission reductions may then be counted twice towards meeting mitigation commitments, once by the buyer country who has purchased the CDM offsets and once by the host country. It is important to note that all major CDM host countries have made emission reduction pledges for 2020. Double-counting of international offsets could reduce the ambition of current pledges (of both developed and developing

countries) by up to 1.6 billion tonnes CO₂e in 2020, equivalent to roughly 10 per cent of the total abatement required in 2020 to stay on a 2°C pathway.

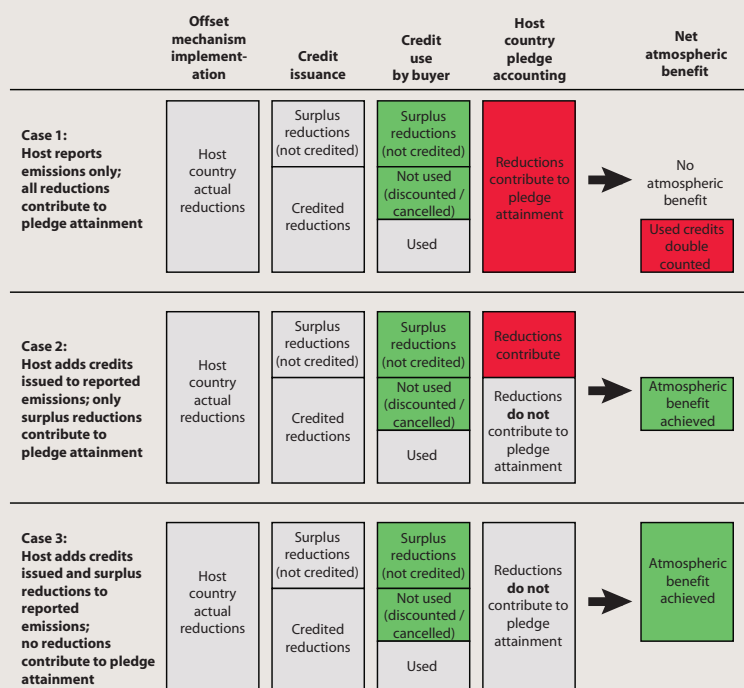
- > **All double-counting of emission reductions need to be addressed. Double-claiming is avoided if the host country is required to add emissions equivalent to the units sold when accounting for their pledge attainment, or if the buyer country does not use the purchased units for meeting their pledge.**
- > **In addition, financial flows should only be counted once. Double-counting of financial flows may reduce the total amount of financial support from developed to developing countries, and thus reduce the emission reductions that could occur otherwise. The financial flow related to the purchase of credits should not be counted as financial assistance to host countries if buyer countries use the credits to meet their mitigation targets.**

NET ATMOSPHERIC BENEFIT MUST BE ACHIEVED

Parties agreed that the FVA should lead to “net decrease and/or avoidance of greenhouse gas emissions.” It is important to note that any net reduction in GHG emissions can only be achieved if all double-counting issues are addressed. A recent study illustrates how double-claiming could be avoided and net atmospheric benefits achieved, (see inset below).

- > **A net decrease should not simply help host countries achieve their emission targets. It should instead lead to emission reductions beyond the mitigation targets, i.e. a net atmospheric benefit. Only a net atmospheric benefit will lead to additional mitigation action beyond the targets and pledges.**

HOW NET ATMOSPHERIC BENEFITS CAN BE ACHIEVED



Source: Potential for International Offsets to Provide a Net Decrease of GHG Emissions. Stockholm Environment Institute, WP 2013-06

In case 1 both the buyer and seller country use the sold units towards meeting their pledges. Therefore double-counting occurs and global GHG emissions would increase.

In case 2 the seller country adds the amount of issued offset credits to its reported emissions, avoiding double-counting. The credits that are cancelled by the buyer, and not used for meeting their target, lead to a net atmospheric benefit.

In case 3 the host country adds both the offset credits used and the emission reductions to its reported emissions, leading to the greatest net atmospheric benefit.

UNITS MUST HAVE ENVIRONMENTAL INTEGRITY

Parties need to agree on clear definitions and rules for the general unit quality requirements agreed at the COP-17 in Durban. The wealth of experience gained through the CDM and JI, especially in relation to additionality, baseline setting and verification, must be taken into account. The units that are used to meet mitigation commitments must represent actual emission reductions. They must, inter alia, be additional, based on conservative baselines and address the non-permanence of reductions. Only general FVA principles have been agreed upon so far. None of the principles that would ensure environmental integrity of the market units, such as “real, permanent, additional and verified,” have been defined, let alone rules and governance structures established to implement these principles.

Parties have agreed that the FVA should enable cost-effective “mitigation outcomes.” This definition is vague and could potentially open doors to the inclusion of REDD activities in a global carbon market. However, concerns

that led to the exclusion of forest conservation activities from the CDM about ten years ago have not yet been addressed. There are inherent high risks such as leakage, impermanence, and difficulties in establishing baselines and additionality that make REDD+ unsuitable for carbon markets, especially project-based offsetting. Alternative financing options for REDD+ exist and should be prioritised.

- **Stringent and comprehensive requirements for the quality of units need to be established, and detailed rules must be developed on how the recommended principles are to be implemented.**
- **Projects or sectors with clearly detrimental climate impacts, such as coal power, should not be eligible**
- **REDD+ activities should not be included under the FVA..**

ENSURE A ROBUST GOVERNANCE STRUCTURE

Integrity of markets can only be achieved under binding and robust international governance structures. Having little or no international oversight and quality control over the issuance of units that are traded internationally and used for meeting targets is dangerous, as it lies in the interest of the host-country to maximise credit generation.

Governance structures established under the UN must ensure the environmental integrity of the units and full accounting for target attainment. A common international transaction-tracking mechanism must be established for all international units used to meet mitigation pledges, with the assignment of unique serial numbers to each

tonne transacted or registered. Detailed rules need to be established to address double-counting and enable a net atmospheric benefit. For example, clear rules are needed regarding the complementary relationship between different trading mechanisms.

- **An appointed UN body should function as a standards-setting organisation. The environmental integrity of all units should be assessed by this international body and should be fully accounted through a rigorous, robust and transparent common accounting framework.**

RECOMMENDATIONS AT A GLANCE

HIGH AMBITION IS CRUCIAL

- Mitigation commitments need to be much more ambitious than they currently are in order to stay within the safe limits of the remaining global carbon budget.
- Mitigation commitments furthermore need to be comparable and based on multi-year budgets. Only then can an accounting framework protect the integrity of targets, especially when there is international trading of allowances or offsets.

ACCESS TO MARKETS MUST BE LINKED TO HIGH AMBITION

- Commitment requirements for a post-2020 agreement must come first. The FVA should not be established before the negotiations under ADP have defined mitigation commitment requirements and rules for a common accounting framework.
- Eligibility criteria need to be established that ensure only Parties with sufficiently ambitious reduction commitments can participate in the international trade of allowances and offsets.
- No FVA pilot should be established before the climate negotiations under ADP have progressed and key conditions for the new climate deal have been elaborated.
- It is premature and potentially damaging to allow for the recognition of any early action under a post-2020 agreement before the negotiations on the fundamental principles for the new post-2020 climate regime have been established.

ESTABLISH AN INTERNATIONAL ACCOUNTING FRAMEWORK

- Accounting rules for the post-2020 agreement should be discussed under the ADP, taking into account ambition and equity considerations.
- Accounting issues that pertain to the period until 2020 should be discussed under the SBSTA work programme on clarification of pledges.

ALL TYPES OF DOUBLE-COUNTING MUST BE ADDRESSED

- All double-counting of emission reductions need to be addressed. Double-claiming is avoided if the host country is required to add emissions equivalent to the units sold when accounting for their pledge attainment, or if the buyer country does not use the purchased units for meeting their pledge.
- In addition, financial flows should only be counted once. Double-counting of financial flows may reduce the total amount of financial support from developed to developing countries, and thus reduce the emission reductions that could occur otherwise. The financial flow related to the purchase of credits should not be counted as a financial assistance to the host countries if buyer countries use the credits to meet their mitigation targets.

NET ATMOSPHERIC BENEFIT MUST BE ACHIEVED

- A net decrease should not simply help host countries achieve their emission targets. It should instead lead to emission reductions beyond the mitigation targets, i.e. a net atmospheric benefit. Only a net atmospheric benefit will lead to additional mitigation action beyond the targets and pledges.

UNITS MUST HAVE ENVIRONMENTAL INTEGRITY

- Parties need to agree on clear definitions of the general unit quality requirements agreed at the COP-17 in Durban. Detailed and comprehensive rules then need to be developed on how these principles are implemented.
- Projects or sectors with clearly detrimental climate impacts, such as coal power should not be eligible.
- REDD+ activities should not be included under the FVA.

ENSURE A ROBUST GOVERNANCE STRUCTURE

- An appointed UN body should function as a standards-setting organisation. The environmental integrity of all units should be assessed by this international body and should be fully accounted through a rigorous, robust and transparent common accounting framework.



About Carbon Market Watch

Carbon Market Watch is a project of Nature Code – Centre of Development & Environment. For more information about Nature Code, see www.naturecode.org. Carbon Market Watch scrutinises carbon markets and advocates for fair and effective climate protection.

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- i. Report of the Conference of the Parties on its eighteenth session, held in Doha from 26 November to 8 December 2012, 28 February 2013, Decision 1/CP.18.
- ii. UNEP (2011). Bridging the Emissions Gap. A UNEP Synthesis Report; Kartha, S. & Erickson, P. (2011). Comparison of Annex 1 and non-Annex 1 pledges under the Cancun Agreements. SEI Policy Brief. Available at: <http://sei-us.org/publications/id/424>;
- iii. Rogelj, J., Nabel, J., Chen, C., Hare, W., Markmann, K., Meinshausen, M. et al. (2010). "Copenhagen Accord pledges are paltry." *Nature* 464, 1126-28;
- iv. Meinshausen, M., Meinshausen, N., Hare, W., Raper, S.C.B., Frieler, K., Knutti, R. et al. (2009). "Greenhouse-gas emission targets for limiting global warming to 2°C." *Nature* 458, 1158-63. Available at: <http://dx.doi.org/10.1038/nature08017>.
- v. Betts R., Collins M., Hemming D., Jones C., Lowe J., & Sanderson, M. (2011). When could global warming reach 4°C? *Philosophical Transactions of the Royal Society A*, Vol. 369, 1934 pp. 67-84, doi: 10.1098/rsta.2010.0290.
- vi. Anderson K., & Bows A. (2011). Beyond 'dangerous' climate change: emission scenarios for a new world. *Philosophical Transactions of the Royal Society A*, Vol. 369, 1934 pp. 20-44, doi: 10.1098/rsta.2010.0290.
- vii. See ii.
- viii. The Ad Hoc Working Group on the Durban Platform for Enhanced Action (ADP) is a subsidiary body that was established by Decision 1/CP.17 in December 2011. The mandate of the ADP is to develop a protocol, another legal instrument or an agreed outcome with legal force under the Convention applicable to all Parties, which is to be completed no later than 2015 in order for it to be adopted at the twenty-first session of the Conference of the Parties (COP) and for it to come into effect and be implemented from 2020.
- ix. Decision CMP8:
- x. 13. Clarifies also that for the purposes of the second commitment period, from 1 January 2013 onwards, a Party included in Annex I may continue to participate in ongoing project activities under Article 12 and in any project activities to be registered after 31 December 2012, but only a Party with a quantified emission limitation and reduction commitment inscribed in the third column of Annex B as contained in annex I to this decision shall be eligible to transfer and acquire certified emission reductions (CERs) in accordance with decision 3/CMP.1 and with paragraph 15 below;
- xi. 14. Decides that a Party referred to in paragraphs 15 and 16 below shall be eligible to use CERs to contribute to compliance with part of its commitment under Article 3 of the Kyoto Protocol for the second commitment period upon the entry into force for that Party of the amendment contained in annex I to this decision and upon that Party meeting the requirements set out in paragraph 31 of the annex to decision 3/CMP.1;
- xii. 15. Decides, with respect to joint implementation under Article 6 and emissions trading under Article 17 of the Kyoto Protocol, that:
- xiii. (a) As of 1 January 2013, only a Party with a commitment inscribed in the third column of Annex B as contained in annex I to this decision whose eligibility has been established in accordance with the provisions of paragraph 3 of the annex to decision 11/CMP.1 in the first commitment period, shall be eligible to transfer and acquire CERs and assigned amount units (AAUs), emission reduction units (ERUs) and removal units (RMs) valid for the second commitment period under Article 17 of the Kyoto Protocol, subject to the provisions of paragraph 3(b) of the annex to decision 11/CMP.1.
- xiv. Also see: UNFCCC FAQ
- xv. Table 2(e)II) of the Common tabular format for "UNFCCC biennial reporting guidelines for developed country Parties" Decision 19/CP.18.
- xvi. 1/CP.18 para 8. Decides to establish a work programme under the Subsidiary Body for Scientific and Technological Advice to continue the process of clarifying the quantified economy-wide emission reduction targets of developed country Parties, particularly in relation to the elements contained in decision 2/CP.17, paragraph 5.
- xvii. Erickson, P., Lazarus, M., & Larsen, J. (2011). The Implications of International Greenhouse Gas Offsets on Global Climate Mitigation. Stockholm Environment Institute Working Paper WP-US-1106;
- xviii. UNEP report (2012). The Emissions Gap Report 2012. <http://www.unep.org/publications/ebooks/emissionsgap2012/>
- xix. See v.
- xx. Erickson, P., & Lazarus, M. (2013). Potential for International Offsets to Provide a Net Decrease of GHG Emissions. Stockholm Environment Institute Working Paper 2013-06.
- xxi. Para 79 of FCCC/CP/2011/9/Add.1
- xxii. Report of the Conference of the Parties on its eighteenth session, held in Doha from 26 November to 8 December 2012, 28 February 2013, Decision 1/CP.18.
- xxiii. Ibid.