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Carbon markets: what to watch

As carbon markets take on increased importance, Victoria White, senior associate at Allen & Overy, discusses the outlook for carbon trading, highlighting the key developments shaping these markets

With carbon trading playing an increasingly significant role in national and corporate decarbonisation efforts, it is crucial market participants understand and closely monitor the factors affecting carbon market development.

There's no doubt that properly scaled primary and secondary carbon markets will form an important part of the global response to tackling climate change and adhering to climate regulation. Interest is growing in compliance markets (nationally or regionally mandated carbon schemes in which participants trade regulator-issued allowances) and voluntary carbon markets. As of March 2022, there were more than 24 mandatory emissions trading schemes (ETSs) in force in 36 jurisdictions worldwide, with more under development or consideration.

However, it is voluntary carbon markets where the biggest growth is expected, with the private sector leading initiatives to develop these market-based solutions. According to a 2021 McKinsey report, demand for voluntary carbon markets is projected to increase by a factor of 15 or more by 2030, and by a factor of 100 by 2050.[1]

The Taskforce on Scaling Voluntary Carbon Markets (TSVCM) projects that the value of the voluntary carbon markets could reach $5 billion–50 billion by 2030, while the UN's special envoy on climate action and finance, Mark Carney, has expressed a need for the market to grow to between $50 billion and $100 billion a year.[2,3]

Unlike compliance markets, where participation is mandated by legal or regulatory obligation, entities participate in voluntary carbon markets for a variety of reasons, including to assist transitions to net zero or other ESG targets. Both markets, however, have the common aim of establishing a platform in which carbon is priced to accurately reflect the risks and costs of carbon emissions worldwide, with the ultimate objective of driving a reduction in greenhouse gas (GHG) emissions.

By putting a price on carbon, compliance and voluntary carbon markets allow for an assessment of the risks and costs of polluting. Both markets also provide secondary market-trading opportunities.

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The need for a global carbon price has never been stronger; however, much needs to be done before a coherent and consistent voluntary market emerges worldwide.

Carbon derivatives

Many carbon market participants use carbon derivatives markets to meet ETS obligations and hedge against volatility in the price of allowances. Carbon derivatives trading can enhance price transparency and stability in the carbon markets. They also provide predictability of future cashflows to the often long-term underlying projects that generate voluntary carbon credits (VCCs).

The International Swaps and Derivatives Association (Isda) has published a number of standardised documents that can be used when trading derivatives based on compliance allowances. In the voluntary markets, industry associations are now developing standardised documentation to support derivatives trading following a call to do so by the TSVCM.

Market challenges

One challenge compliance markets face is 'carbon leakage' – where polluting industries outsource their production to other jurisdictions where emissions regulation or taxation is less stringent than the jurisdiction of the compliance market.

To combat this challenge, carbon border adjustment mechanisms (CBAMs) have been proposed in a number of jurisdictions to prevent carbon leakage by requiring importers to purchase carbon certificates or pay a levy corresponding to the carbon price that would have been paid, had the goods been produced under the jurisdiction's carbon pricing rules.

A CBAM amounts to a carbon tariff that compensates for differences in carbon prices between domestic and imported carbon-based products. The European Commission (EC), for example, presented its proposal for a regulation establishing a CBAM on July 14, 2021.

The implementation of a CBAM is a key element of the European Union's Fit for 55 package, designed to meet the its objectives under the 2015 Paris Agreement on climate change. The European Council reached agreement on the general approach of the EU CBAM on March 22, 2022; however, the CBAM proposal has been met with a mixed response, with Brics members (Brazil, Russia, India, China and South Africa) voicing criticism.[4]

A hurdle in the voluntary markets that needs to be overcome to scale up worldwide is fragmentation. Information relating to VCCs and their underlying projects is stored on a scheme registry. Isda has noted that the requirement for market participants to adhere to specific registry rules impedes the free circulation of VCCs since such credits recorded at one registry cannot be transferred to an account at another. In turn, this adds complexity to drafting trading documentation, which is intended to cover VCCs held on more than one registry.

A number of projects are under way, supported by major financial institutions, governments and other stakeholders, seeking to address the lack of uniformity and fragmentation in the voluntary carbon markets. Examples of some of these private initiatives are explored later in this article.

Regulation

In contrast to the highly regulated compliance carbon markets, voluntary carbon markets are currently not subject to any specific government authority oversight, although certain products may be subject to existing regulatory regimes. In addition, the UN has a key role to play. Over many years, the UN has developed a framework for the issuance of certified emissions reductions generated from clean development mechanism projects, and is doing the same in connection with new mechanisms created by Article 6 of the Paris Agreement.

In the US, where there is no overarching federal regulation that addresses the legal nature of VCCs, there have been significant efforts in recent years by the Commodities Futures Trading Commission (CFTC) to take steps to assess its potential role in supervising the voluntary carbon markets. For example, in June 2022, the CFTC held the first ever Voluntary Carbon Markets Convening to discuss issues related to supply and demand for high-quality carbon offsets, product standardisation and market integrity concerns.

Existing US Securities and Exchange Commission (SEC) rules already require climate risks to be disclosed if they are material, which may require disclosure of voluntary carbon market participation of an SEC registrant in some circumstances. This year, the SEC proposed an extensive climate-related disclosure regime covering all SEC registrants, which would require the disclosure of information about climate-related targets, goals or transition plans. If implemented, it has the potential to bolster the adoption of VCCs and the broader development of the voluntary carbon markets. However, the SEC's ability to implement its climate change agenda may be hampered by the recent US Supreme Court's ruling in the case of *West Virginia vs the Environmental Protection Agency*, which limits administrative agencies' abilities to implement far-reaching regulatory regimes without "clear congressional authorisation" behind such actions. It is uncertain whether some of the SEC's proposed rules related to climate change will meet this new standard.

Historically, EU and UK regulators have been predominantly concerned with the regulation of the compliance markets. Recently, however, there has been increased regulatory interest in the voluntary carbon markets, albeit at a less developed stage than the US. The increased regulatory attention has, to date, taken the form of consultations and regulatory statements, with a view to supporting the development of the voluntary carbon markets. This includes the EC's call for evidence with respect to a proposed framework for the certification of carbon removals, with the EC due to propose an EU regulatory framework by the end of 2022 and the UK government's consultation to update its Green Finance Strategy.

This consultation highlights the importance of ensuring the market integrity of the voluntary carbon markets, and explores how the UK could support the growth of a high-integrity voluntary market for carbon.

On July 28, 2022, the Law Commission also published its *Consultation paper 256* on digital assets.[5] While this is not specifically focused on carbon markets, it proposes that the law should recognise a new category of personal property: data objects. It applies its proposed criteria for data objects to compliance allowances and VCCs. The consultation is open for response until November 4, 2022.

Private initiatives

In addition to government focus on supporting the growth of the voluntary carbon markets, a number of private initiatives – such as the City of London UK Voluntary Carbon Markets Forum – are seeking to scale-up the voluntary carbon markets. This is being done, for example, by establishing exchanges, marketplaces and platforms with a view to reducing fragmentation in the voluntary markets, with initiatives including the use of distributed ledger technology.

The TSVCM proposed the development of a set of Core Carbon Principles to promote integrity, liquidity and growth as well as providing a high-threshold standard for the trading and creation of quality carbon credits.[6] The TSVCM formed the Integrity Council for the Voluntary Carbon Market (IC-VCM) in September 2021.

The IC-VCM has now published draft Core Carbon Principles, along with a proposed assessment framework and assessment procedure for public consultation, with a deadline of September 27, 2022 for submitting comments.[7] Adoption of the Core Carbon Principles by the voluntary carbon markets would promote uniformity of VCCs.

The work of the IC-VCM is intended to complement the work of the Voluntary Carbon Markets Integrity Initiative (VCMI), which is developing a Claims Code of Practice to provide governance around use of carbon credits. Between June and August 2022, the VCMI ran road tests and a public consultation around this proposal.

It is clear from the proliferation of task forces and projects that the voluntary carbon markets are considered ripe for improvement and growth. It is key that, as these markets continue to grow, they do so in a manner that encourages transparency, liquidity and veracity when trading, building a robust market that allows for investor and stakeholder certainty. The use of derivatives pro ducts can support these goals.

Looking ahead

In the compliance markets, the establishment of more regimes and more discussions being held around linkage of different regimes can be expected. A number of potential changes to the EU ETS and UK ETS are currently under consultation. In the voluntary carbon markets, efforts to scale trading are seeking to address challenges around quality of VCCs, veracity, avoiding double spending and effectively retiring VCCs.

The voluntary carbon markets are smaller than the compliance markets, have grown rapidly and look set to expand even further in the future. Growth of the voluntary carbon markets may be impacted by the EU Corporate Sustainability Reporting Directive, the EU Corporate Sustainability Due Diligence Directive, the 2022 SEC Disclosure Proposal and growing political and societal pressure on businesses to demonstrate their commitment to reducing GHG emissions.

Trading compliance allowances and VCCs in the derivatives market creates a real opportunity for entities to reach net-zero goals and provides transparency in regard to the underlying compliance allowances and VCCs. By bringing together the elements of transparency, price stability and standardisation across the voluntary carbon markets, it is hoped this will unlock private sector financing for the underlying projects seeking to tackle GHG emissions.

Standards in the voluntary carbon markets will continue to proliferate until more authoritative regulatory views are taken. Nevertheless, given the varying nature of standards applicable to underlying projects and resulting VCCs, the impact of regulation is likely to be idiosyncratic. It is crucial, therefore, that market participants closely monitor this space and carefully evaluate their carbon reduction strategies and holdings based on these changes.

MARKET DEVELOPMENTS AT A GLANCE

Standardised contracts

While standardised documentation supporting trading derivatives based on compliance allowances has been available for years, the equivalent is now being developed in the voluntary space following calls from the Taskforce on Scaling Voluntary Carbon Markets (TSVCM).

Carbon leakage

A number of jurisdictions have proposed Carbon Border Adjustment Mechanisms (CBAMs) to deal with the challenge of carbon leakage. The European Union's CBAM proposal has so far met with a mixed response.

Disclosure

The US Securities and Exchange Commission has proposed an extensive climate-related disclosure regime covering its registrants. If implemented, it could significantly bolster the development of voluntary carbon markets. Potential obstacles stand in the way of its implementation, however.

Regulating voluntary markets

While the US leads the way in this area, there has recently been increased regulatory interest in the voluntary carbon markets in the EU and UK. The European Commission is due to propose an EU regulatory framework by the end of 2022, and the UK government is updating its Green Finance Strategy, which looks at how the UK could support the growth of a high-integrity voluntary market for carbon.

Private initiatives

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You can find further insights into carbon trading in the mandatory and voluntary carbon markets in the latest *Market Horizons* podcast by Allen & Overy (*https://bit.ly/3REsdeh*), which discusses key expected developments and provides an overview of some of the questions Allen & Overy has received from derivatives clients. For broader news and insights on ESG and the transition to a sustainable economy, please visit Allen & Overy's Sustainability Transition Hub (*https://bit.ly/3U33odl*).

[1] *C Blaufelder, C Levy, P Mannion, and D Pinner (January 2021),* A blueprint for scaling voluntary carbon markets to meet the climate challenge, *McKinsey Sustainability, https://mck.co/3LcFc4t*
[2] *Taskforce on Scaling Voluntary Carbon Markets (January 2021),* Final report, *https://bit.ly/3UcDHY7*
[3] *L Hook and P Temple-West (December 2020), Carney calls for '$100 billion a year' global carbon offset market,* Financial Times, *https://on.ft.com/3LcFOHj*
[4] *European Council (March 2022),* Council agrees on the Carbon Border Adjustment Mechanism (CBAM), *https://bit.ly/3BBBPB5*
[5] *Law Commission (July 2022),* Consultation paper 256, *https://bit.ly/3Bd2MK4*
[6] *D Riddle (January 2021),* Taskforce establishes Core Carbon Principles, publishes roadmap for scaling voluntary carbon markets, *Taskforce on Scaling Voluntary Carbon Markets, https://bit.ly/3RGLdcn*
[7] *Integrity Council for the Voluntary Carbon Market (September 2022),* Public consultation, *https://bit.ly/3LklNib*