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# Spotlight on COP26:
# Is this the start of a new era for the carbon markets?

Carbon markets are not working as effectively as they could, write **Matthew Townsend**, **Deborah North** and **Danae Wheeler**

Efficient, liquid and competitive carbon markets can play a vital role in fostering green innovation and ultimately reducing emissions of $CO_2$ and other greenhouse gases. Private sector interest in carbon markets is increasing as companies adopt more ambitious climate commitments. Prices for carbon credits have grown strongly this year. CORSIA-eligible carbon (CEC) credits have seen a price surge of 888% since launching on 4 January 2021[1].

Well-functioning carbon markets have enormous potential for governments and the private sector in particular. Compliance based markets create the opportunity to drive emissions reductions. Voluntary carbon markets will play a significant role in helping corporates meet their net zero targets. Both types of market can act as a mechanism to transfer significant funds into emissions reduction or avoidance projects across developed and developing countries.

Lofty aspirations but why have carbon markets not delivered in the way hoped? Clearly, major challenges need to be addressed. These include fragmented markets, the lack of a global price for carbon, and widely differing rules, regulations, and enforcement procedures across jurisdictions. It's also taken time to finally agree the rule book for a new UN-backed emissions trading scheme envisaged under Article 6 of the Paris Agreement (2015).

[1] S&P Global Platts "**Cop26: Article 6 hangs in balance as climate summit enters final week**" (8 November 2021)

# Fragmentation, Inadequate Transparency and Lack of a Global Market Price for Carbon

Today's carbon market is fragmented and complex with over 64 carbon-pricing initiatives planned or in place globally. However, they cover just 22 per cent of greenhouse gas emissions[2]. Carbon prices have also been volatile. The IMF reports that the global average price is currently USD3 per ton, well short of the USD75 per ton that it believes necessary to keep global warming below 2°C.[3]

Without a coherent global market price (or a very low price), buyers face difficulty in assessing the real impact of emissions reduction incentives have on their investment decisions. There also remains the long-standing risk of carbon leakage which has recently led trading blocs such as the EU to consider carbon border adjustment mechanisms. It is therefore critical that carbon markets benefit from robust and transparent pricing.

Compliance schemes, such as the EU emissions trading scheme, have also struggled to deliver given the very low carbon price. This is now changing as we see demand rise and structural adjustments made to tighten supply.

The voluntary carbon markets have a critical role to play in helping the private sector meet their Net Zero commitments. At least in the short term, it's recognised that many businesses will need to use off-sets in order to meet their commitments. Mark Carney, United Nations special envoy on climate change, suggests that the global trading market could reach USD 100 billion a year by 2030.[4] McKinsey estimates that annual global demand for carbon credits could reach up to 1.5 to 2.0 gigatons of carbon dioxide ($GtCO_2$) by 2030 and up to 7 to 13 $GtCO_2$ by 2050.[5]

However, the voluntary market is fragmented and lacks a single governance framework or rule book. This needs to change and all eyes are on the work of the Task Force on Scaling Voluntary Carbon Markets in this regard. This is particularly so given growing concerns over greenwashing – corporates will need to have confidence that the off-sets they rely on do what they say on the tin and that there is no risk of double counting.

# What role did COP26 have to play?

The road to establishing a global market for off-sets has been beset with difficulties. The Kyoto Protocol established a number of so-called flexible mechanisms including the Clean Development Mechanism. However, that failed to deliver. At the COP21 Conference in Paris in 2015, leaders pledged to establish a new mechanism that would allow governments to trade credits between nations and an international carbon market that would enable the private and public sector to trade credits (as envisaged under Article 6 of the Paris Agreement).

[2] Financial Times "**The merits of a global carbon offset market**" (6 December 2020)
[3] IMF "**Five Things to Know About Carbon Pricing**" (Fall 2021)
[4] Bloomberg "**Wall Street's Favorite Climate Solution Is Mired in Disagreements**" (2 June 2021)
[5] McKinsey "**A blueprint for scaling voluntary carbon markets to meet the climate challenge**" (29 January 2021)

However, Article 6 contained only nine paragraphs and it was not possible in the discussions in Paris or in Madrid, at COP25, to agree on the rules for operationalising the new trading framework. Issues that proved complex involved how best to move to a harmonised trading system, how to avoid double counting of carbon credits through off-set arrangements, and how best to include carbon credits earned during older, and often now defunct, carbon trading schemes. Achieving a "rulebook" to operationalise Article 6 of the Paris Agreement was a key objective of the UK Presidency in Glasgow.

In this regard, the agreement reached at COP26 was a success. Significant progress has been made on the rules and procedures for two key trading mechanisms. While ultimately relying on good faith efforts of the world's governments, the deal nevertheless provides concrete steps towards creating a UN backed global carbon trading framework. This is a major step forward. Development of a U.N. standard for credits may ultimately have the potential for enhancing and ultimately even merging liquidity in both regulated and voluntary carbon markets. We move closer to a new international trading regime which should play a key role in driving private funds into projects capable of reducing and removing emissions. Whilst off-setting isn't for everyone, this development should be welcomed as a step towards a more coherent international framework.

Despite emissions trading schemes having been around for over two decades, they've yet to fully achieve their potential. They've been beset by global fragmentation, over supply and questions over the emissions reductions actually achieved. However, they will have a critical role to play in the transition and the work at COP26 is a very positive step in the right direction.

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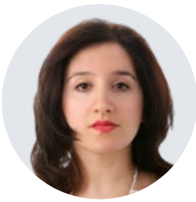

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