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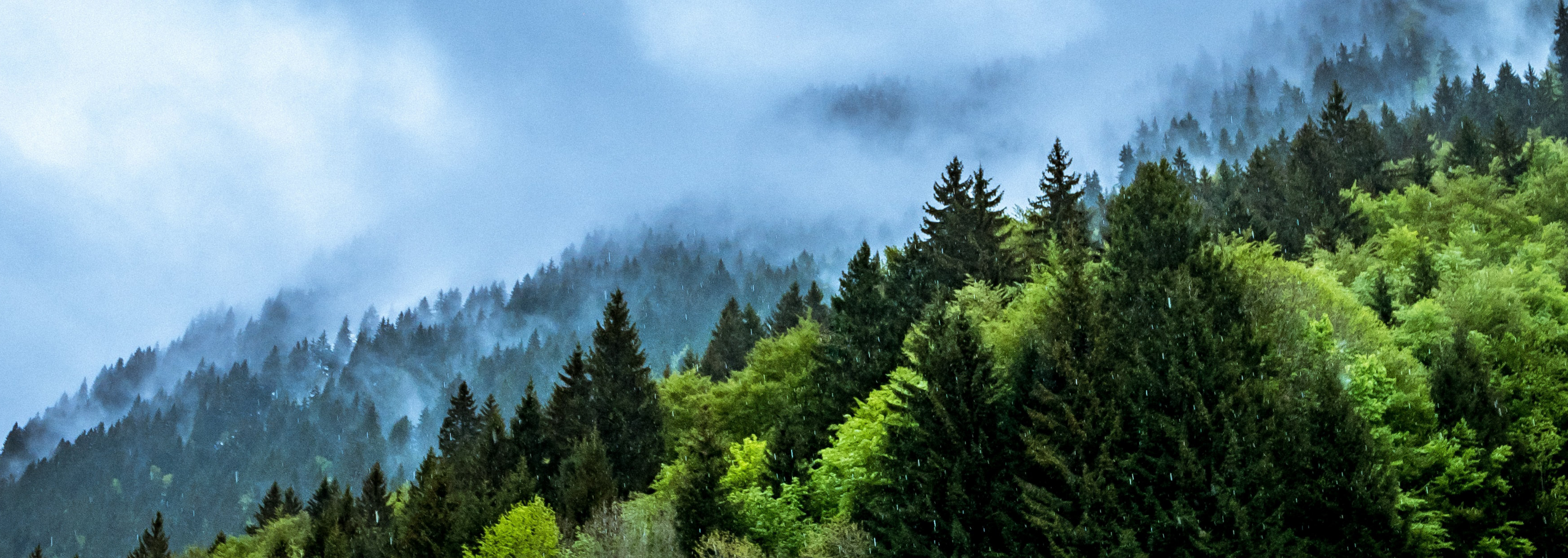
UK Voluntary Carbon Markets Forum

CLIFFORD CHANCE

Enabling the voluntary carbon market in the context of the Paris Agreement

Executive summary



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Climate change is a global issue that requires a co-ordinated global response. The Paris Agreement set the target of *"holding the increase in the global average temperature to well below 2 degrees Celsius above pre-industrial levels and pursuing efforts to limit the temperature increase even further to 1.5 degrees Celsius above pre-industrial levels".*

Decisive and coordinated actions of the Parties to the Paris Agreement (**Parties**) will be essential to achieving this target; however, there are limitations as to what can be achieved under the Paris Agreement in the short-term while the Article 6 mechanisms are still being operationalised. As António Guterres told world leaders at the opening of the recent COP27 summit "the global climate fight will be won or lost in this crucial decade"; climate action is required urgently, and private actors will need to play a principal role in this.

The Voluntary Carbon Market (**VCM**) presents an opportunity for immediate action. The past few years have demonstrated that the VCM can deliver significant private funding to climate positive investments. It also enables companies to support decarbonisation beyond their own carbon footprint and accelerate the broader transition to a lower carbon future. As the need for climate action becomes increasingly urgent, and the number of firms committing to net-zero continues to grow rapidly, the potential for this market is huge. Some commentators estimate this market could grow very rapidly, possibly reaching USD$50 billion in value by 2030. However, uncertainties surrounding Article 6 of the Paris Agreement and its implications for the VCM are holding back activity in the VCM.

COP26 saw a breakthrough in agreeing the role of Article 6 market mechanisms in delivering on the Paris objective; but much of the detail on how these mechanisms will be implemented remains to be decided, with only incremental progress made at COP27. Countries are having to plan how to use these mechanisms to meet their Nationally Determined Contributions (**NDCs**) ahead of them being fully operational by developing detailed decarbonisation strategies. This important planning should not inhibit use of the VCM. Globally, we must use all means available to deliver positive climate action that is both aspirational and practical.

The ambition should be for a high-integrity, credible, scaled VCM, operating cohesively alongside Paris mechanisms. To achieve this, the uncertainties surrounding the interaction of the Paris mechanisms and the VCM need to be addressed.

The City of London Corporation, the UK VCM Forum and Clifford Chance LLP have collaborated on this paper to identify and address some of the most pertinent issues facing the Paris mechanisms and the VCM. It has been written by Nigel Howorth, Head of the Global Environment Group at Clifford Chance and Anneke Theelen, Senior Associate who both have extensive experience in carbon markets. It is intended to promote useful discussion on the topic globally and drive forward progress.

In this paper, we:

1. **Consider** the current state of the carbon markets;
2. **Describe** the key Paris mechanisms, focusing on Articles 6.2 and 6.4;
3. **Identify** key areas of uncertainty between the Paris mechanisms and the VCM; and
4. **Present** recommendations for what can be done, by countries and different market participants, to support both the Paris mechanisms and VCM initiatives; and
5. **Consider** what further work may need to be considered as the Paris mechanisms and the VCM continue to develop.

Key themes

This paper identifies ten specific issues and uncertainties that exist between the Paris mechanisms and the VCM which, if not resolved, may hinder the opportunity presented by the VCM to deliver immediate climate action whilst the Paris mechanisms continue to develop.

These issues can be summarised into three key themes.

1. **Areas of uncertainty preventing engagement in the Paris mechanisms and the VCM**
2. **Concerns regarding the integrity of carbon credits**
3. **Lack of government support**

1. Areas of uncertainty preventing engagement in the Paris mechanisms and the VCM

- **The practicalities surrounding domestic implementation of the Paris mechanisms.** The rules, modalities and procedures supporting the Paris mechanisms are complex. We expect that the Parties are now grappling with how best to give effect to these mechanisms in their own country. There is a risk of fragmentation as the Parties seek to interpret and internalise these rules, modalities and procedures within their existing legal and policy frameworks. There is also a risk that Parties inadvertently impede the VCM when implementing the Paris mechanisms. A high degree of harmonisation is needed amongst the Parties for the Paris mechanisms and the VCM to operate as effectively and efficiently as possible.
- **The impact that jurisdictional or sovereign based carbon initiatives may have on the Paris mechanisms and the VCM.** There have been a number of public announcements recently in the lead up to COP27 about jurisdictional based carbon initiatives that have the potential to generate huge quantities of voluntary carbon credits in a short amount of time. By way of example, the new African Carbon Markets Initiative (ACMI) announced at COP27 promises to deliver a further 300 million carbon credits annually by 2030. Whilst these initiatives can make a very significant contribution to achieving the Paris objectives, there is a risk that a huge influx of credits, over a relatively short period of time, may impose a significant downward pressure on the price of voluntary carbon credits and therefore have unintended consequences on the viability of other carbon projects in the near term. There is concern about the potential impact that this could have on both the VCM and the Paris mechanisms.
- **The role that avoidance emissions have in both the Paris mechanisms and the VCM.** Whilst recognising the importance of avoiding emissions, for example by preserving carbon sinks (and rewarding the countries that do), there are differing views as to whether avoidance-based credits are appropriate for recognition within the Paris mechanisms and the VCM. This uncertainty is not helped by the fact that the various carbon standards and carbon initiatives understand or use the terms “avoidance emissions” and “avoidance credits” differently. Where markets land on avoidance emissions may have ramifications for jurisdictional-based schemes such as REDD+ and the ACMI which rely heavily on forestry-based projects which, by their nature, are at least partially avoidance-based schemes.
- **Difficulties in deciphering NDCs.** NDCs represent a country’s climate action plan to cut emissions and adapt to climate impacts and are in essence the core of the Paris Agreement. At the same time, they help to inform the scope of VCM activities by indicating the types of mitigation scenarios a host country will or is likely to issue “use authorisations” for. However, NDCs tend to be drafted in broad, sweeping terms and can be difficult for project developers and prospective investors to understand. This lack of certainty may undermine participants’ confidence and prevent significant investments being made.

These areas of uncertainty have led a number of countries to introduce moratoria on the issuance and/or international trading of carbon credits, spurred on by a desire amongst governments to exercise more control over the trading of carbon credits generated within their jurisdiction. The success of both the Paris mechanisms and the VCM rests on attracting sufficient investment in carbon activities that generate ITMOs, Paris registered carbon credits (i.e., A6.4ERs) and/or voluntary carbon credits. It is critical that these existing uncertainties are resolved so that project developers and prospective investors achieve a sufficient level of certainty to support investment of the scale needed to deliver on the Paris objectives, and countries are able to create domestic environments that fosters such investment.

2. Concerns regarding the integrity of carbon credits

Whilst the VCM has been growing rapidly in recent years, its growth has been marred somewhat by concerns surrounding the integrity of carbon credits available in the VCM. The emergence of internationally recognised carbon standards such as Verra and Gold Standard and the ongoing work of the Integrity Council for the Voluntary Carbon Markets (**Integrity Council**) to develop Core Carbon Principles and the Voluntary Carbon Markets Integrity Initiative (**VCMI**) a Claims Code of Practice have done a lot to address these concerns and we have confidence that the necessary motions are in place to create a high-integrity market.

However, one of the remaining concerns is around double counting and double claiming across the Paris mechanisms and the VCM which is causing hesitancy amongst many would-be participants. Double counting is when more than one country counts the same emission reduction or removal for the purposes of its NDC. The Paris Agreement expressly prohibits double counting and imposes requirements on countries to effect corresponding adjustments to ensure this is avoided. A corresponding adjustment is when a transferring Party adds back the transferred emissions into its national account whilst the receiving Party subtracts them from its account. The Paris Agreement is less clear on the issue of double claiming. This is where a country and a private purchaser both claim the same emission reduction or removal.

It is important that double counting and double claiming are not conflated. Double counting is an accounting concept for the purposes of NDCs; it is not concerned with whether or how private entities may seek to claim the benefit of emission reductions or removals. Nevertheless, some argue that double claiming threatens the integrity of the VCM, and therefore, corresponding adjustments should also be applied to voluntary actions in the VCM. The decision at COP27 to define carbon credits that are not authorised for use towards NDCs as “mitigation contribution” credits appears to be an attempt to address the issue of double claiming. Exactly how this new concept of “mitigation contribution” credits is interpreted by countries, and the VCM, remains to be seen, and there remains no clear market consensus as to whether carbon credits purchased by private actors for use as carbon offsets, should require a corresponding adjustment in all or some cases. We understand this remains a live issue for the VCM governing bodies and further work to address this issue is expected.

3. Lack of government support

To date, there has been limited engagement in, or express support for, the VCM by governments. The VCM is operating in a huge number of jurisdictions but this has largely been with little to no deliberate involvement from or engagement with host countries. This lack of involvement and clear governmental support for the VCM is causing hesitancy amongst many potential market participants, including project developers, investors and buyers.

To capitalise on the huge potential of the VCM, particularly for developing countries, governments need to begin engaging more strategically in the VCM. Part of this is so that governments can create domestic environments that are enabling of voluntary carbon activities to attract investment. Developed countries also need to send strong signals to buyers and investors that involvement in the VCM is a critical part of the climate action required to meet the Paris objectives. At the same time, however, countries will need to juggle the emerging Paris mechanisms and ensure that any action they take furthers both market mechanisms.

Our recommendations

The international community needs to act with urgency on climate change. Negotiations on Article 6 are complex and contentious. It is becoming clear that the UN-developed Article 6.4 mechanism will take some time to become operational, meaning that capital flows to support climate action must be directed through other means. Fortunately, Article 6.2 is more established and the VCM is fully operational; and it is encouraging to see the momentum taking place in both of these markets as evidenced by the number of announcements made at COP27. There is clearly motivation to put these markets to work now, and the private sector has demonstrated clear ambition to do more.

However, to deliver this climate action at scale and within a timeframe necessary to deliver on the Paris objective, the issues identified in this paper will need resolving. At the heart of this, greater clarity and communication is needed from (and between) VCM governing bodies, the Conference of the Parties (**COP**) to the United Nations Framework Convention on Climate Change (**UNFCCC**), market participants and governments as to how the Paris mechanisms and the VCM should operate alongside each other.

The report recommends several key actions that these different stakeholders should consider taking which are aimed at delivering this certainty and unlocking the true potential of the Paris mechanisms and the VCM, some of which are highlighted below.

The full set of recommendations can be found in **Appendix 1** and are discussed in full in the body of this paper.

FOR VCM GOVERNING BODIES TO:

- **Issue** a definitive position on corresponding adjustments and “double claiming” and the role of sovereign or jurisdictional based credits.
- **Highlight** the importance of the VCM in achieving the Paris objectives, and the important work being done to ensure the integrity and legitimacy of the VCM.
- **Work** closely with the UN Supervisory Body and other regulatory bodies to ensure that these markets remain complementary, and work done on integrity standards in the VCM can be adopted into compliance markets.

FOR THE COP TO THE UNFCCC AND THE SUPERVISORY BODY TO:

- **Continue** to operationalise the Paris mechanism in a way that delivers sufficient clarity on how the Paris mechanisms are intended to work.
- **Clarify** the position on avoidance credits qualifying for the Article 6 Paris mechanisms.

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FOR GOVERNMENTS TO:

- **Demonstrate** clear support for and engagement with the VCM, including by using the VCM in their own climate action agendas.
- **Maintain** a clear and well-defined NDC.
- **Enter** into government-to-government or business-to-government arrangements to deliver certainty to project developers and investors.
- **Establish** the policy (and where necessary, the legal) framework to operationalise Article 6 mechanisms and develop clear parameters for use authorisations required by the Paris mechanisms.
- **Establish** a registry for the tracking of internationally traded mitigation outcomes (**ITMOs**) and possibly VCM activities.
- **Address** legal uncertainties that exist within the VCM such as formalising the legal nature of, and ownership rights over, carbon credits.

FOR MARKET PARTICIPANTS TO:

- **Increase** transparency and information sharing within the market to improve integrity, credibility, and trust in the VCM.
- **Engage** with host governments to ensure a shared understanding of procedures and policy frameworks governing the use of the Paris mechanisms and the VCM.
- **Recognise** the importance of high-integrity carbon credits and ensure that offsetting remains secondary to emission reduction.

The issues and recommendations identified in this paper are by no means a perfect solution. Both the Paris mechanisms and the VCM remain evolving areas of climate action and new initiatives, understandings and developments are being reached every week. It is also expected that the role of the VCM will change over time and could eventually converge with compliance markets and the Paris mechanisms. It is important that the VCM is recognised as a separate and fully functioning market capable of delivering positive climate action now. The thinking in this paper is intended to demonstrate this and to act as a catalyst for further discussion on how the VCM and the Paris mechanisms can be used more effectively to support urgently needed climate action.

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The UK Voluntary Carbon Markets Forum was established in April 2021 to support the growth of a high-integrity scaled Voluntary Carbon Market in the UK and to support and amplify the work of global governing bodies such as the Integrity Council for Voluntary Carbon Markets and the Voluntary Carbon Markets Integrity Initiative.

The Forum is chaired by Dame Clara Furse, with City of London providing secretariat support.

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Clifford Chance is a global law firm, with 30 offices across five continents. The firm advises clients from all commercial and industrial sectors, governments, regulators, trade bodies and not-for-profit organisations.

Clifford Chance has a specialist practice advising on:
- voluntary carbon trading, offsetting and project investment;
- regulatory carbon markets; and
- broader climate change, ESG and energy matters.

The authors were:
Nigel Howorth, Partner
nigel.howorth@cliffordchance.com
Anneke Theelen, Senior Associate
anneke.theelen@cliffordchance.com

Please reach out if you would like advice on, or to discuss, the content of this paper.

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