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Voluntary Carbon Markets – More than Meets the Eye?

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Introduction

Parallel to the rapid growth in volumes traded in the Kyoto-based compliance carbon markets, a wide range of corporate and private non-compliance or voluntary offset buyers have developed the Voluntary Carbon Markets (VCMs) into a legitimate commodity. The growth in VCMs is primarily based on the use of project-based emission reductions by proactive corporations in achieving self-imposed carbon neutrality commitments or in offering low-carbon products and services. The offset programs underpinning these carbon neutrality commitments are consumer facing and managed by businesses or NGOs, making VCMs very different from the Kyoto markets. As a result, VCMs may actually provide the carbon markets with more than another source of financing for emission reduction projects.

Becoming a Real Response Option?

VCMs are growing on the back of issues related to climate change increasingly mainstreamed by the media, and out of individual and corporate recognition that climate change can and should also be tackled on levels beyond the scope of existing regulation. Offset programs provide individuals with an opportunity to relate to the climate change issue in a straightforward personal way. For corporations, offset initiatives offer an additional level of flexibility in mitigating carbon emissions and avoiding more intrusive regulation.

Ford, Honda and Smart all recently launched offset programs to neutralize a portion of carbon emissions from the production and/or use of some of their vehicles. In the travel industry, interest from the service industry to identify air travel carbon emissions for the purposes of reporting on corporate social responsibility, showing environmental leadership and in some cases for investing in carbon offset schemes prompted Sabre (provider of a large global travel booking engine) to launch a carbon emission management tool for travel managers. For other similar sectors with serious short-term difficulties constraining absolute growth of emissions, offset schemes provide a carbon management response option which allows for a period of transition by moving existing business through carbon neutrality towards adopting next generation low-carbon technologies.

A Test-Bed for Future Climate Policy?

Corporate offset programs are predominantly driven by company policies and consumer or business needs. Whether BSkyB's recent announcement of integrating carbon neutrality into its CSR program, or BP's launch of its target-neutral program to encourage consumers to become carbon neutral drivers, the reasons underlying these corporate decisions are inherently different from the 'sticks and carrots' used in compliance markets. Business drivers such as stakeholder acceptability, product segmentation and branding are increasingly brought into carbon management decisions in a range of businesses through offset programs. Historically, such basic business drivers have had little or no impact on managing climate policy. An increased use of VCMs not only expands the reach of carbon mitigation into sectors beyond the reach of current compliance schemes, but it also allows companies to deepen the understanding of carbon management. As a result VCMs provide a new source of knowledge of commercial carbon management to the future climate policy discussion.

Offset programs have similarities with post-Kyoto policy proposals based on "Contraction and Converge"[1]. Consumer offset programs vastly increase the individual's understanding of his/her own carbon footprint and contribution to the climate problem. An individual's carbon footprint is the amount of greenhouse gases (GHGs) emitted into the atmosphere by the individual's direct and indirect actions. This has strong links to the notion of personal carbon budgets, which is one of the proposed fundamental principles for a post-Kyoto global climate policy.

A first flavour of a potential future 'convergence' between today's offset schemes and future climate policy was presented by UK environment minister David Miliband, who unveiled a plan to introduce individual carbon budgets. Under the scheme, all UK citizens would be allocated an identical annual carbon allowance, which would be stored on an electronic card similar to loyalty cards. Consumers' exceeding the annual allowance e.g. due to extensive travel would have to buy additional credits for themselves. This

[1] The Global Commons Institute has promoted the principle of Contraction and Convergence to the UNFCCC since 1996.

particular plan may still be some time away, but nevertheless, an increasing public awareness of personal carbon budgets and growing consumer confidence in using robust offset services will allow climate policy designers to examine the functionality of personal carbon constraints as a basis for future climate policy.

Gauging Future Market Size, Scope and Scalability

Estimates in the scientific community suggest that reductions in the magnitude of 500 billion tonnes of CO_2e are necessary between now and 2050 to avoid a doubling of the pre-industrial concentration of CO_2 in the atmosphere and maintain the level of CO_2 in the atmosphere below 450-550 parts per million.

Current estimates are that the trading volumes in the voluntary emission reduction markets will double from 2005 to 2006, topping an estimated 20 million tonnes per year. Is this a level that voluntary market participants should find acceptable? For the VCMs to legitimize voluntary trading as a meaningful response option and to have an impact on the current global emissions trajectory they would need to reduce more than several hundred millions of tonnes of CO_2e per year. This can happen if the VCMs can provide a scalable alternative solution that will support additional emission reductions beyond what the Clean Development Mechanism (CDM) and Joint Implementation (JI) mechanisms will deliver.

Where will this growth come from? In the short-term offset services are likely to continue to increase rapidly in non-regulated market segments such as services, finance, transport and housing through consumer offset companies. For instance, in the US, the number offset service providers has grown in number from 4 to 10 in 2006 alone. The consumer-facing marketing channel provides a broad audience for carbon neutrality, with an entrepreneurial attitude towards creating consumer friendly and easily adaptable carbon offset services and products.

Businesses, however, need to lead the charge and act as examples by managing unavoidable carbon emissions through offsetting and expanding their offset programs into their products and services. This will provide a natural link between consumer awareness of offsets with corporate aspiration to manage carbon emissions throughout their product's life-cycle. This would vastly expand the scope of offset programs, as for instance auto and oil manufacturers have typically 8-12 times higher product emissions than their direct emissions.

Over time, consumer offset programs could also gain some governmental recognition and allow regulated companies to meet some portion of their legal targets with the sale of GHG neutral products. Whether product offsets will be recognized within the "Global Warming Solutions Act" in California, by a future multi-state Australian scheme or some other future scheme is still uncertain. Regardless of that, VCMs are starting to pave the way for policy makers.

Moving to the Next Level

How can VCMs match their potential and become an effective transitional corporate and personal carbon management strategy, or future Government policy? In today's VCMs there exists no uniform globally accepted standard or even definition of a verified or certified emission reduction in GHG. This undermines corporate and consumer confidence in the robustness of the emission reductions offered in the currently fragmented market. Corporations and financial institutions need more certainty in the market infrastructure to increase engagement in VCMs.

First, the market requires a common standard. The Voluntary Carbon Standard (VCS)[2] launched by IETA, WEF and The Climate Group, is a productive first step towards a credible, high-quality standard. The VCS utilizes the large set of project-specific methodologies that have been road tested with thousands of CDM projects, and several experienced UNFCCC Designated Operational Entities (DOE). The VCS works independently but it builds on the WBCSD/WRI GHG Project Protocol and ISO GHG audit guidelines to provide project developers and offset purchasers a consistent and partly familiar framework within which to build their services.

Second, liquidity is a prerequisite for the creation of any commoditized trading market and the voluntary market needs to have a commoditized, fully fungible, and tradable emission reduction unit. The VCS addresses this issue through the creation of a Voluntary Carbon Unit (VCU). If the VCM is ever to be scalable all emission reduction offsets must be considered equal and achievable at realistic costs. The VCS leads the market towards a public standard that ensures the integrity of all emission reduction projects, credible verification, high-quality emission reductions, and a robust registration system will instil the trust and confidence necessary in the corporate and individual end – users to make all VCUs equal.

[2]The VCS can be found at The Climate Group's website: http://www.theclimategroup.org/index.php?pid=778

Third, the voluntary market must be able to store and retire its emission reductions in an industrial-strength custodial and trading registry. The registry will need to require proof of title and evidence of ownership chain back to the point of origination, as well as a warranty by the depositor that the emission reductions have not been previously sold or double-counted elsewhere. To meet the growing needs of the voluntary market The Bank of New York has recently launched a custodial registry service for voluntary carbon that addresses these concerns and should give confidence to investors and corporate-end users alike that voluntary carbon assets can be managed with the same rigor and security as other financial assets.

Realistic Development

The VCMs have the potential of making a meaningful contribution to mitigating the climate problem in its own right, if given the right tools to grow. At the same time policy makers and legislators can learn from the business driven test bed for new carbon management ideas that the VCMs are providing.

The VCMs have much to gain, but much can also be lost unless a few basic principles are kept in mind. Although offset schemes can provide valuable ideas for future regulation, carbon neutrality is not a substitute for mandatory regulation. Public concerns that companies may use offsetting schemes to disguise a failure to reduce direct emissions through energy efficiency measures must be taken seriously. Offsetting is one of many policy options for corporate management and for best effect offsetting needs to complement direct emission reductions at the source. Service providers must make a coherent effort of portraying offsets as a mitigation solution for unavoidable emissions and ensure that they start to scale offset systems to the point at which they actually reduce emissions beyond business-as-usual consumption. This will build long-term consumer and stakeholder confidence.

Market growth must be balanced against public trust. This can only be achieved through a defined approach, such as the VCS, to solidify market structures and establish a transparent development process of standards. Offsets provide a great opportunity to empower the individual and move policy towards the long-term idea of personal carbon responsibility while creating meaningful emission reductions. These benefits are too large for the VCM to be left without coherent support and guidance from stakeholders in the carbon markets.

Cheyne Climate Wedge Fund Limited

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