

Carbon Markets Update – Q1 2023

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Over the last few years, market conditions have changed so dramatically that today, no matter its products or services, every company is also in the environmental business. Prompted by the real-world impacts of climate change, many consumers now demand environmental action from corporations and prefer to buy products marketed as environmentally friendly. Many companies therefore market their products as “net-zero” or “carbon neutral”—and make pledges to be, as a business, “net-zero” by a certain date. In support of these pledges, companies often buy carbon credits from voluntary carbon markets to offset or mitigate their carbon emissions voluntarily.

Voluntary carbon markets present opportunity, but also create financial, regulatory, and litigation risks. Because the voluntary markets are often fragmented, suffer from a lack of transparency and, above all, are not subject to any statutory common standards, there is a lack of trust in the credits issued under these system which also limits the tradability of the credits.

This quarterly newsletter aggregates the knowledge and experience of Gibson Dunn attorneys around the globe as we help our clients across all sectors navigate the ever-changing landscape of voluntary carbon markets.

This Q1 2023 edition of the newsletter explores the question companies must ask when they buy credits on the voluntary carbon market: can we trust that we are getting what we paid for? A recent survey of more than 500 corporate sustainability officers around the world found that 40% of participants did not use carbon offsets because they did not trust them, while many companies that do buy carbon credits seek trustworthy credits by only buying from government or certified providers, working with rating agencies, or engaging in their own due diligence¹.

Verra Carbon Credits

Carbon credits that have been certified by international standards, such as Verra’s Verified Carbon Standard, have generally been considered transparent and credible.

However, recent developments involving Washington-based non-profit Verra, a world leading voluntary certification organization, have increased scrutiny of international “avoided deforestation” credits. A recent nine-month investigation conducted by The Guardian concluded that “*more than 90% of [Verra’s] rainforest offset credits...are likely to be ‘phantom credits’ and do not represent genuine carbon reductions.*”²

These forest offset credits are used by many large global corporations. Verra approves three-quarters of all voluntary offsets³ and has issued over one billion carbon credits since 2009.⁴ Its



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rainforest protection program makes up 40% of the credits it approves.⁵ The Guardian report alleges that these future forecasts have been overly pessimistic in terms of baseline deforestation rates, and hence have vastly overstated their REDD+ climate benefits.

The baseline against which avoided emissions are measured (i.e. the risk of forest loss that would occur without the carbon project) is highly significant as the number of carbon credits issued to a project is calculated by comparing the rates of avoided emissions (e.g. deforestation) in a project area against the baseline.

In its response to The Guardian report, Verra has disputed the claims on the basis that the report reached incorrect conclusions as it used “*synthetic controls*” that do not account for project-specific factors that cause deforestation in respect of the relevant REDD+ projects.⁶ Verra has argued that REDD+ projects are not randomly located and a major factor in the selection of a project area is the “*local factors that mean a particular area is at acute risk of deforestation*”. Verra’s REDD+ methodologies are designed to address the variability between the project area and surrounding areas, which synthetic controls do not effectively do.⁷ To further strengthen the accuracy of REDD+ baselines, Verra constantly refines its methodologies and is planning to transition all REDD+ projects to one methodology.⁸ This will be based on an update to REDD+ to be released in Q3 2023, which was subject to consultation for many years.⁹

Verra’s CEO David Antonioli admitted that certifying REDD+ activities is “*not easy*” due to the need to quantify the baseline, but the alternative of chasing perfection is to halt the financing of forest protection and

preservation.¹⁰ He considers the voluntary carbon market to be “*at an inflection point*”, with the urgency of the climate and biodiversity crises necessitating that much-needed finance be channeled to protect forests under threat.¹¹ The Guardian has itself previously recognized that, although carbon credits and offsets do not have a great track record, the funds they raise are a vital part in the fight against deforestation.¹²

Other industry players have disputed the claims in The Guardian report.¹³ Among them, Allister Furey, CEO of Sylvera, a London-based company that provides ratings for carbon offsets similar to credit scores, wrote that the figures in The Guardian report are overstated. Based on its analysis, Sylvera found that 31% of the REDD+ projects it has rated are high quality, compared to the 6% claimed in The Guardian report, which indicates that there are good quality projects available to buyers.¹⁴ Sylvera further found that the remaining two-thirds of projects it has rated are of mixed quality, with 25% being effectively junk, compared to the 94% worthless credits claimed in The Guardian report.

The International Emissions Trading Association found that The Guardian report fails to acknowledge that the majority of carbon offsetting is carried out in the global South, thus carbon trading serves as a viable way to fund projects to protect forests in lieu of government protection. Rimba Raya in Central Kalimantan in Indonesia is one such example. The Rimba Raya project is the first carbon project to receive REDD+ validation under Verra’s Verified Carbon Standard and one of the largest REDD+ projects in the world.¹⁵ Recently, The Straits Times, a newspaper based in Singapore, spoke

to Todd Lemons and Jim Procanik from InfiniteEARTH, which developed and operates the Rimba Raya project. Before InfiniteEARTH took over, the Rimba Raya forest was purportedly designated for destruction and conversion into a palm oil plantation over the course of five years. The forest conversion process would have entailed digging large underground canals to drain the peat swamp forest thereby removing the sequestration mechanism in place for carbon stocks and burning trees, which would have resulted in the release of carbon emissions in excess of a hundred million tons. The forest's biodiversity would also have been lost. To address the risk of reversal of carbon savings (e.g. in the event of illegal harvesting of a forest or a fire), the carbon credits for Rimba Raya are disbursed in 1/30th increments over its 30 year-lifetime.¹⁷

The Rimba Raya project has reportedly been subject to a rigorous audit process (which typically takes nine to twelve months) over the last ten years, with audit methodologies subject to peer review and public comments. The project has also been separately verified by Verra and Indonesia's newly formed "Sistem Registry Nasional" ("SRN"), which is responsible for the registration and issuance of Indonesian carbon credits and carbon projects. Further, non-permanence

risk in REDD+ projects such as Rimba Raya is addressed through a pooled buffer account for non-tradable buffer credits, as buffer credits equivalent to any reversal will be cancelled from the pooled buffer account.¹⁸

Carbon offsets are more than just carbon sequestration, and include many environmental, cultural, economic and social co-benefits, such as protecting biodiversity and community access to forests. For example, Rimba Raya is one of the most important Orangutan conservation projects in the world.

We now highlight developments in selected jurisdictions.

Updates from the United States

States Propose Carbon Credits Programs

The Alaskan legislature is considering two bills proposed by Governor Mike Dunleavy to allow the state to take advantage of the profitable voluntary carbon market.¹⁹ One bill creates a framework for companies to lease state land to use for belowground carbon sequestration, while the other allows companies to earn carbon credits for paying to safeguard state forests from deforestation.²⁰

The plan will likely take years to implement,²¹ but it is a significant step in popularizing government involvement as credit-producing participants in voluntary carbon markets. In August 2022, Michigan became the first state to sell carbon credits for preserving state-owned forests.²² Washington is also considering legislation to allow the state Department of Natural Resources to sell credits based on offset projects on state land in the state's new carbon compliance market.²³ While Washington's credits will feed directly into the state's compliance market, Alaska's proposed credit program would sell to the voluntary market.

A recent survey concluded that many companies find government-issued credits more trustworthy than other credits,²⁴ and government participation in voluntary carbon markets may help to increase corporate confidence in carbon credits. Government participation in voluntary markets aligns the interests of government and credit-buying companies, as government actors—so often in the position of enforcing compliance—instead act as sellers working to service buyers.



Washington State Holds First Carbon Auction

Washington state's new cap-and-invest regulatory scheme took effect at the beginning of 2023, and the state held its first auction on February 28, 2023. Both the auction and the overall regulations are largely based on California's carbon compliance market.

The first auction sold about 6.2 million carbon allowances at a settlement price of \$48.50 per ton—nearly twice as expensive as allowances in recent auctions in California and Quebec.²⁵ Washington's mandatory compliance market covers most businesses that generate more than 25,000 metric tons of CO₂ equivalent per year, including fuel suppliers, natural gas and electric utilities, and, eventually, waste-to-energy facilities and railroads.²⁶ Covered business may meet a small and declining proportion of their compliance obligations through receiving credits from investing in offset projects, similar to those that generate carbon credits on the voluntary carbon market.²⁷

Because qualifying offsets are regulated to be as trustworthy as possible—rivaling offsets certified for use in California's compliance market—Washington's offset regulations provide a possible framework for companies to follow in evaluating credits on the voluntary market, and can help companies identify more reliable credit providers.

USDA To Help Grow US-Based Carbon Credits

Congress's December 2022 omnibus spending package included a bill that had been sitting in limbo since 2020, the Growing Climate Solutions Act. The bill is meant to encourage farmers to generate carbon credits by storing carbon in soil and trees and to help farmers sell the credits on the voluntary carbon market.²⁸

USDA will help to spread information about how farmers can generate and sell credits, and through federal involvement, will bring a level of government scrutiny to the US-based voluntary carbon market. The bill aims to use the monetary incentive of carbon credit revenue to encourage farmers to engage in the ecologically beneficial practices that generate carbon credits, such as cover cropping, reduced tilling, and cropland conversion. While the USDA will not directly

regulate these credits, it will connect farmers to organizations that can help them generate and verify credits. This may lead to a class of carbon credits that are more trustworthy, backed by a connection to the federal government, though critics suggest that the program will only create the illusion of trustworthy credits, as USDA will not standardize credit-generation requirements.²⁹

Innovative Credit Types Hit The Market

As carbon markets grow, companies continue to innovate new projects to generate carbon credits. Recent examples include:

- **Oil Well Capping:** The median cost of capping an end-of-life oil well is about \$76,000.³⁰ Uncapped wells are a significant source of methane emissions.³¹ Methane has 27 - 30 times the Global Warming Potential (GWP) of CO₂ measured over a 100 year period. Companies are incentivizing oil well capping by offering carbon credits for capped oil wells. One company, Carbon Path, has finished two pilot projects in Montana and is waiting for the state permit to issue credits for the well capping.³² Another company, ZeroSix, aims to issue its first credits this year.³³ Helpfully, because states permit oil wells, state records verify when oil wells are capped.³⁴ There are approximately 3 million decommissioned oil and gas wells in the US and 225,000 in Canada, making this a potential growing space for carbon credit projects in North America.³⁵
- **Refrigerants:** Commercial refrigeration owners in five California supermarkets recently sold refrigerant carbon credits after installing natural refrigerant-based systems in place of HFC-based alternatives.³⁶ One company that helps obtain carbon credits from this transition in refrigeration systems estimates that supermarkets can receive \$60,000-\$100,000 per store from selling the carbon credits earned from retrofitting existing refrigeration systems to a CO₂-based system.³⁷
- **Kelp:** A sea urchin aquaculture company secured the first carbon credit for kelp-bed restoration.³⁸ By harvesting urchins, which graze on kelp beds, the company allows kelp beds to recover and flourish.³⁹ The benefits from the

kelp-bed restoration extend beyond carbon sequestration to co-benefits such as biodiversity, oxygen production, absorption of excess nitrogen from agricultural runoff, reduced ocean acidification, and protection from wave-related erosion.⁴⁰ In 2023, credits from kelp-bed restoration are expected to be integrated into Japan's J-Credit Scheme, a marketplace for voluntary carbon credits.⁴¹

- **Biochar:** Biochar is growing in interest as a carbon sink that can potentially sequester carbon for hundreds of years.⁴² Biochar is created by burning biomass in the absence of oxygen (a process called pyrolysis). Companies such as Microsoft and Shopify have recently purchased biochar CO₂ removal certificates from the Finnish company Puro.Earth.⁴³
- **Plastics:** Similar to carbon offsets, companies are developing offsets credits related to plastics, which allow companies and individuals to offset their plastic use and support permanent solutions for plastic waste.⁴⁴ As with carbon markets, the credits are subject to independent verification, and are expected to be recognized by the leading carbon markets and global sustainability initiatives.⁴⁵

The development new credits may help companies diversify their portfolios and thus reduce the legal risks of relying on carbon credits by decreasing the chances that a plurality of a

company's credits will be revealed to be worth less in carbon reductions than advertised—an issue presented in the KLM lawsuit, below.

Litigation Update

Dukas v. Kininklijke Luchtvaart Maatschappij, N.V. (filed September 2022 in the U.S. District Court for the Southern District of New York).

In this putative class action suit against KLM Royal Dutch Airlines, the plaintiffs allege that KLM's advertising and use of carbon credits to allow passengers to purchase offsets for their flights misled consumers. Plaintiffs filed an amended complaint, and now KLM has moved to dismiss the suit. The motion to dismiss argues that subjective belief that carbon offsets are insufficient and have a negligible climate impact is insufficient to state a claim, and that the suit merely expresses a disagreement over the effectiveness of KLM's efforts—while KLM had never promised that use of offsets was a perfect climate solution or would negate the environmental impact of flying. This strategy focuses on how KLM markets carbon offsets instead of arguing about the merits of offsets.

Updates from Singapore

The Singapore Government is taking the developments involving Verra into account as it finalizes the environmental integrity criteria for International Carbon Credits ("ICCs") that are eligible for carbon tax offset from 2024, with plans



to publish a whitelist of acceptable ICCs later this year. Singapore's carbon tax applies to major emitters⁴⁷, who will from 2024 be entitled to purchase and surrender high-quality international carbon credits to offset up to 5% of taxable emissions. The offset limit was determined for alignment with comparable jurisdictions with similar climate ambitions, such as South Korea and California, and to prioritise domestic abatement efforts, but the Singapore Government may make changes as the carbon market develops.⁴⁸ The whitelist of acceptable ICCs will include eligible host countries, carbon crediting programs and methodologies.

In July 2022, memorandums of understanding (“MOUs”) were signed by the National Environment Agency of Singapore with Verra and Gold Standard, planning to enable companies to surrender their verified carbon credits to offset taxable emissions. The Minister for Sustainability and the Environment, Ms Grace Fu, has explained that Verra and Gold Standard had been selected as MOU partners as they are two of the largest carbon crediting programs which have been accepted by the International Civil Aviation Organisation to issue carbon credits for compliance under the Carbon Offsetting and Reduction Scheme for International Aviation.⁴⁹ However, Ms Grace Fu, has clarified that the MOUs are not legally binding and do not qualify all ICCs issued by Verra and Gold Standard as being eligible to partially offset carbon tax, as companies that develop projects which generate such credits must also meet the environmental integrity criteria of the Singapore Government. This means that there will be a level of regulatory oversight of such credits and the underlying projects exercised by the Singapore Government. It is currently unclear how this oversight will be exercised.

In light of the independent review being undertaken by the Singapore Government, it remains to be seen whether all credits issued by Verra or Gold Standard would qualify for carbon tax offsets, or whether only those on the whitelist of acceptable ICCs to be published by the Singapore Government later this year would qualify.⁵⁰ As the Singapore Government has reiterated it will be strict on the quality of credits to be used to offset emissions, this should allay some concerns that offsets will not be sufficiently scrutinized.⁵¹ While the Verra developments will inevitably give pause to investors in nature-

based solutions in the short-term, Professor Koh Lian Pin (head of the Centre for Nature-based Climate Solutions at the National University of Singapore) does not foresee any long-term impact on Singapore's efforts to develop a carbon trading hub. Singapore has ambitions to become a regional hub⁵² for carbon services and trading and currently houses global voluntary exchange platforms, such as Air Carbon Exchange and Climate Impact X.

Indonesia Carbon Credit Issuances

Further to the temporary suspension of vintage carbon issuances in Indonesia, the issuance of post-2020 voluntary carbon credits from Indonesia is likely to resume in the middle of 2023, based on Quantum Commodity Intelligence's sources⁵³. There are reportedly several REDD+ projects under way in Indonesia's eastern Papua province according to developer Carbon Offset Asia, which announced the region's first avoided deforestation project on a 28,161 hectare concession previously marked as “forest to be converted” by Indonesia's Ministry of Environment and Forestry.⁵⁴

Indonesia's regulatory framework for carbon pricing, Presidential Regulation No. 98 of 2021 (“PR 98/2021”) was issued in October 2021 as a climate financing instrument to achieve Indonesia's Nationally Determined Contribution goal of reducing carbon emissions by 31.89% by 2030 – 43.2% with international finance support.⁵⁵ PR 98/2021 empowers the Indonesian Government to introduce several carbon pricing mechanisms, including carbon trading. A “carbon unit” is expressed in one ton of CO₂ and as recorded in SRN implemented under PR 98/2021. The Rimba Raya project (discussed above) is the first REDD+ carbon project to be validated by Indonesia's SRN.⁵⁶

Verra is in discussions to develop a mutual recognition agreement with the Indonesian authorities, but it remains unclear whether Indonesia will agree to recognize existing VCS methodologies or create its own under the SRN. Uncertainty also stems from the development of a new REDD+ consolidated methodology that Verra plans to transition its REDD+ projects to (as discussed above).⁵⁷

The regulatory changes in Indonesia are expected to mobilize

more green financing and investments. For example, the mandatory carbon trading for coal power plants launched in Indonesia in February 2023 should incentivize companies to become greener, as power plants that emit more carbon than their allocated quota can buy carbon credits from plants with below-quota emissions or from renewable power plants.⁵⁸ However, the key to the success of any carbon trading mechanism lies in price and a very low minimum price for the carbon tax was set by Tax Regulation Harmonisation Law (Law No. 7/2021).⁵⁹ According to the Indonesian energy ministry, market mechanism would set the price for the carbon trading mechanism for coal power plants, but the price may range between \$2 and \$18 per ton.⁶⁰

Despite challenges, Indonesia's carbon market offers significant opportunities given the potential for green investment in areas such as peatland and mangrove restoration, with the Indonesian Government targeting the restoration of 1.6 million hectares of peatlands and rehabilitation of 50,000 hectares of mangroves by 2024.⁶¹ Indonesia was the first country in the East Asia Pacific region to receive payments through the World Bank's Forest Carbon Partnership Facility, having received an advance payment of \$20.9 million for reducing emissions from deforestation and forest degradation in East Kalimantan province.⁶²

Perspectives on Carbon Offsets in Australia

There is growing scrutiny of claims relating to carbon offsets in Australia, at the regulator and consumer levels. In parallel, there is a growing number of operators in Australia looking to monetize the abatement of carbon emissions through the issue of Australian carbon credit units ("ACCUs") that can be sold to companies wanting to offset their emissions.⁶³ The ACCU scheme was designed to mitigate climate change by incentivizing projects that draw down greenhouse gas and has been in operation for eleven years.⁶⁴

The Australian Government published a report prepared by Professor Ian Chubb, The Hon Dr Annabelle Bennett, Ariadne Gorrington and Dr Steve Hatfield-Dodds (the "**Chubb Report**") in December 2022 which found the ACCU scheme to be "*essentially sound*."⁶⁵ The integrity of the ACCU scheme had

been questioned, primarily on the basis that abatement had been overstated (i.e. that payments were made for activities that fail to absorb additional carbon or avoid emissions that would never have happened).⁶⁶ While the review of the ACCU scheme rejected claims that the ACCUs produced by landowners and used by business were ineffective to offset emissions,⁶⁷ it recommended measures to change how credits from "*avoided deforestation*" are earned, which would restrict the supply of such carbon credits in Australia.⁶⁸ The Chubb Report encourages new methods to be developed to incentivize the maintenance of vegetation with potential to become a forest and forests at risk of land-use conversion, on the basis that "*the length of time that has elapsed since the issue of any remaining unused land clearing permits imply that it would be hard to establish intent to clear land, raising questions about the additionality of any new projects that might be registered under the current method*".⁶⁹

The Chubb Report attributed the differences in perception of the scheme's integrity and impacts to lack of regional co-ordination, planning and consistency between local, state and federal policies, which impeded landholder participation in the scheme, and an absence of re-investment into regional communities.⁷⁰ To address some of these issues, the Chubb report recommends that there be an increase in "*transparency of different project characteristics and types of co-benefits associated with ACCUs*". Co-benefits may include (i) economic benefits in the form of revenue from carbon credits for landholders, (ii) social benefits as the financial viability of living in the rural areas encourages younger generations to return to rural and remote living, and (iii) cultural benefits through growing community recognition and interest in cultural land management practices.⁷¹

Australia currently does not levy an explicit carbon price,⁷² although the Australian government has announced a mandatory cap on big emitters after the Chubb Report was released.⁷³ The use of carbon credits is a market-based solution seen as "*the least costly way for a fossil fuel-based nation such as Australia to decarbonize*," while "*carbon tax talk remains politically poisonous*".⁷⁵

While generally seen as an endorsement of the Australian carbon

industry, it remains to be seen whether the Chubb Report will substantially change skeptical perceptions surrounding the market, as there has been criticism that the findings of the Chubb Report are “whitewash”.⁷⁶ Under the ACCU scheme, participants can use offsets from a variety of sources, including ACCUs and international units such as Verified Carbon Units (“VCUs”) issued by Verra.⁷⁷ Nevertheless, the spot price for ACCUs reached an 11-month high in January 2023⁷⁸ and the Clean Energy Regulator has issued first credits for 2023.⁷⁸ and the Clean Energy Regulator has issued first credits for 2023.⁷⁹

Consumer choices are increasingly tied to environmental considerations, which may be based on misleading carbon neutrality claims. In particular, it may not be the case that a carbon neutral badge of honor worn by a company includes all emissions from its total operations. Unlawful greenwashing practices deprive consumers of the ability to make informed purchasing decisions and harm businesses that are taking emissions reductions to ensure sustainability.

Australia has a government-backed carbon neutrality certification program, Climate Active, which claims its carbon neutral certification is “one of the most rigorous in the world.”⁸⁰ Several large corporations in Australia, such as National Australia Bank, claim to be carbon neutral based on credentials from Climate Active.⁸¹ Offsets eligible under the Climate Active scheme include ACCUs, Certified Emissions Reductions issued per the rules of the Kyoto Protocol, Verified Emissions Reductions issued by Gold Standard and VCUs issued by Verra.⁸² However, many companies that claim they are carbon-neutral certified by Climate Active are only focused on Scopes 1 and 2 and are not taking into consideration all emissions in the value chain (i.e. including Scope 3) to net zero, which has attracted the scrutiny of regulators and consumers.

In February 2023, the Australia Institute lodged a complaint with the Australian Competition and Consumer Commission (“ACCC”), asking the ACCC to investigate whether the Climate Active trademark program, including its use by companies involved with the program, was misleading or deceptive under Australian Consumer Law.⁸³ The scrutiny arises from the “emissions boundaries” of Climate Active’s certification system, which depends on the type of certification

being granted.⁸⁴ To certify the business operations of an organization as carbon neutral, all emissions identified as occurring as a consequence of an organization’s business activities must be considered for relevance. Organizations have excluded international emissions, use of sold products, and upstream and downstream transportation and distribution from their relevant emissions.⁸⁵ This means that Scope 3 emissions are largely excluded from the assessment.⁸⁶ Accordingly, there is criticism that statements of carbon neutrality by an organization should be confined to the portion of its operations that are carbon neutral or it would be more accurate for a company to state that they have a carbon neutral certification, as opposed to being “carbon neutral”.

In March 2023, the ACCC announced that it is investigating a number of businesses for potential ‘greenwashing’, “*following an internet sweep which found more than half of the businesses reviewed made concerning claims about their environmental or sustainability practices,*” which includes “*vague or unclear environmental claims*” that warrant further scrutiny.⁸⁷ The ACCC stated that “[t]he cosmetic, clothing and footwear and food and drink sectors were found to have the highest proportion of concerning claims among the industries targeted.”⁸⁸

Updates from the United Kingdom

“Mission Zero: Independent Review of Net Zero” Report

The final “Mission Zero” report, authored by former energy minister Chris Skidmore, was published on January 13, 2023.⁸⁹ The report was commissioned by the Secretary of State for Business, Energy & Industrial Strategy as an independent review of the UK Government’s strategy for decarbonising all sectors of the economy and achieving net zero by 2050.

The report evaluates how the UK can better achieve its net zero goals. Its terms of reference outline that it aims to explore how the UK Government could promote economic growth and private investment, create jobs, drive innovation and exports, and support energy security and affordability throughout the UK in accordance with the country’s net zero commitments. The report also seeks to identify ways to reduce costs for businesses and consumers, with a particular focus on short-term solutions.

There are 129 recommendations on how to take economic advantage of the transition to net zero, with five key recommendations for the UK Government to implement:

1. Reviewing regulation for emerging net zero technologies to enable their rapid and safe introduction;
2. Reviewing policy incentives for decarbonisation, including via the tax system and capital allowances;
3. Providing longer-term certainty for a small number of net zero priorities at the next Spending Review;
4. Setting out a clear and ambitious approach to disclosure, standard setting, and scaling up green finance; and
5. Publishing an overarching financing strategy covering how existing and future government spending, policies, and regulation will scale up private finance to deliver the UK's net zero enabled growth and energy security ambitions.

Perhaps most relevant for carbon markets, the report recommends that the UK Government work with the UK Emissions Trading Scheme (“ETS”) Authority to develop a plan for the UK ETS through to 2040.

The UK ETS is the UK's replacement for its participation in the EU ETS and comprises the regulators responsible for enforcing compliance with the ETS Regulations as well as issuing permits and approving emissions plans. According to the report, the recommended UK ETS plan should include: (i) a vision for the ETS design and operation, (ii) a timeline for expanding coverage to other sectors, (iii) addressing the inclusion of greenhouse gas removals to incentivise early investment in new technologies, and (iv) providing reassurance to businesses around mitigating the risk of carbon leakage as a result of expanding the ETS.

The report further recommends endorsing international Voluntary Carbon Markets (“VCM”) standards, consulting on formally adopting regulated standards for VCMs and setting up a regulator for carbon credits and offsets by 2024.

Finally, the report suggests that the UK Government should establish a program for offsets and carbon credits to provide guidance for businesses to invest in carbon credits and offsets

and exploring the creation of a UK market for offsets through energy efficiency measures.

UK publishes its Emissions Trading Scheme Provisional Common Framework

On February 28, 2023, the Department for Energy Security & Net Zero published the UK Emissions Trading Scheme Provisional Common Framework (the “**Framework**”), which establishes a common framework through which decisions relating to the UK ETS can be made.⁹⁰ This has been agreed jointly by the relevant Ministers from the UK Government, Scottish Government, Welsh Government and Northern Ireland Executive, who collectively constitute the UK ETS Authority.

Under the Framework, the ETS Authority commits to the following principles in the joint governance of the UK ETS:

- Proposals relating to all areas of UK ETS policy should be considered using the joint governance process in the Framework – such process includes an ETS Working Group (comprised of officials of all governments), an ETS Senior Board (comprised of senior civil servants from all governments) and a Net Zero, Energy and Climate Change Inter-ministerial Group (comprised of the portfolio Ministers leading on Net Zero, Energy and Climate issues within the four governments);
- The ETS Authority is committed to, wherever possible, taking decisions jointly;
- The ETS Authority will endeavour to ensure market and legislative stability throughout the agreed ETS phases; and
- The Working Group shall meet regularly to monitor the Framework, which meetings shall consider, among other matters, whether the four governments are implementing and complying with the Framework and whether any divergence has taken place either in contravention of the Framework or which impacts negatively on the UK ETS.

The power to establish individual trading schemes in Scotland, Wales, and Northern Ireland is devolved to national administrations. Nonetheless, through the Framework, the

UK Government and the devolved administrations have signalled a commitment to collaborate in creating a unified ETS with uniform rules. The stated goal of this unified UK-wide scheme is to offer a larger carbon market, greater liquidity, and consistent carbon prices, which can enhance emissions reduction and the cost efficiency of trading. This increases the potential for cost-effective opportunities for emissions reduction, aligning with the UK's climate ambitions and net zero target.

Updates from the European Union

On December 13, 2022, the European Parliament and the Council reached an agreement on the Carbon Border Adjustment Mechanism (“**CBAM**”) as part of the EU Green Deal which aims to reduce greenhouse gas emissions by 55% compared to 1990 levels by 2030.⁹¹

CBAM is the world's first carbon tariff. It applies a carbon tax on certain high-emission goods entering the EU that is equal to the cost of allowances under the EU's cap and trade system (the ETS). Importers will have to purchase and surrender CBAM allowances with each allowance corresponding to the emission of one ton of CO₂. This is to ensure that the carbon price of imports is equal to the carbon price of domestic production in order to prevent “carbon leakage”, i.e. the migration of EU companies to third countries with lower carbon emission standards and obligations.

The CBAM will begin to apply on October 1, 2023 only with a reporting obligation of the greenhouse gas footprint of the products involved. It will then be fully applicable as of January 1, 2026. It will initially apply to sectors that are considered high-risk for carbon leakage, i.e. iron, steel, cement, aluminum, fertilizers, electricity and hydrogen. Before the end of the transition period in 2026, the Commission will assess whether the scope of the CBAM should be extended to other sectors with the ultimate goal of covering all the sectors under the ETS (i.e. electricity and heat generation, energy-intensive industry sectors, including oil refineries, steel works, and production of iron, aluminium, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids and bulk organic chemicals, aviation within the European Economic Area, and the production of nitric, adipic and glyoxylic acids and glyoxal).

As the application of the CBAM means that importers will have to buy and surrender certificates at the price of carbon, it is important to note that carbon prices have skyrocketed. In January 2023, the price of one ton of carbon in the EU reached EUR 100, while the price was around EUR 34 in the beginning of 2021.

Endnotes

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