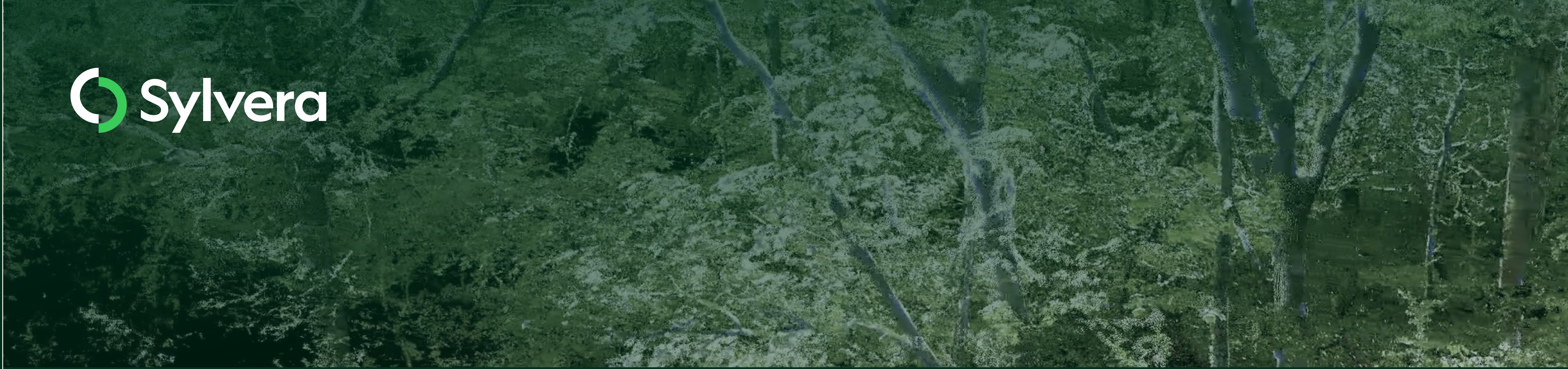


Compliance vs Voluntary

How Carbon Credit Market Convergence Creates New Opportunities

Carbon markets: a critical tool for incentivizing net zero action

To maximize our chances of limiting warming to 1.5°C and mitigate catastrophic effects of climate change, we need to achieve global net zero by 2050. Achieving this depends on three key factors, all of which demand significant amounts of investment from both the public and private sector to drive them forward:

- Corporates decarbonizing their operations;
- Preventing land use emissions from deforestation; and
- Carbon removals expanded to 10 gigatonnes per year.

While much of the world recognizes the importance of meeting net zero by 2050, the actions and investments to make it happen aren't at the scale they need to be. Right now, nearly all companies with net zero targets will fail to achieve their goals if they don't at least double the pace of emissions reduction by 2030. When it comes to investment, it will take an estimated $3.5 trillion annually over the next 30 years, from both the public and private sectors, into the technology and infrastructure required to deliver a zero-carbon economy.

While there is no substitute for organizations decarbonizing as much as possible, certain industries, particularly in hard-to-abate sectors, face complexities and high costs on the road to zero carbon. In some cases, achieving zero carbon may be currently impossible with the available technologies.

And, where it is possible, the incentives for investing in modern equipment are not yet compelling. Meanwhile, the climate system remains indifferent to these challenges and merely demands the total sum of emissions to trend towards net zero.

INTRODUCTION

Carbon markets: a critical tool for incentivizing net zero action

No single financing lever can fill this gap alone. Carbon markets have a powerful role to play in bridging this gap, encouraging businesses to take responsibility for their indirect emissions and helping them to reach much-needed progress towards net zero. Carbon markets can connect promising projects with much-needed capital. This is particularly true for carbon removal, which is not a natural fit to happen within company value chains.

One subset of the broader category of carbon credit markets is the voluntary carbon market (VCM), in which buyers, often corporations, buy carbon credits to meet voluntary climate targets or claims. Today, the voluntary carbon market is valued at around $2 billion a year, and is projected to reach about $100 billion by 2030. Meanwhile, the total value of compliance markets sits at about $800 billion today.

This falls short of the $3.5 trillion needed in annual climate investment, and it begs the question: will voluntary investment make a meaningful contribution to net zero?

Perhaps not.

All three factors to reach net zero have costs associated and no one actor is responsible for it entirely. As a result, increasing action and driving investment depends on a new system of incentives and penalties emerging. Fortunately, carbon markets – both compliance and voluntary – can help fill critical gaps in funding and incentivizing action. For example, they can help:

- Increase spend on value chain decarbonization, such as the EU compliance carbon markets
- Support the private sector driving additional funding to decarbonization outside their value chains (i.e. REDD+ voluntary credits)
- Promote the public sector's funding of decarbonization beyond borders, via energy transition credits
- Scale private or public sector funding for carbon removal, either through nature such as reforestation or new technologies like Direct Air Capture

INTRODUCTION

Carbon markets: a critical tool for incentivizing net zero action

Over the past year, there have been a number of clear signs, standards, and regulatory measures that are bringing compliance and voluntary markets closer together. Expanding the existing compliance markets to include voluntary carbon credits will drive investment and innovation, and will help lay the foundations for a real incentive system for corporate climate action to emerge.

Compliance markets set regulated carbon prices and control carbon credit availability to encourage emission reductions, while in the voluntary market, organizations have the option to trade carbon credits that are verified by certification bodies – however, there is currently no centralized regulation system. For more than 10 years, these markets have operated in separate spheres, but today, the lines are blurring – and for corporates, the implications and opportunities are numerous.

This whitepaper explores what a convergence of voluntary and compliance carbon credit markets would look like, what it means for corporations, and how to take advantage of the opportunities that will inevitably arise.

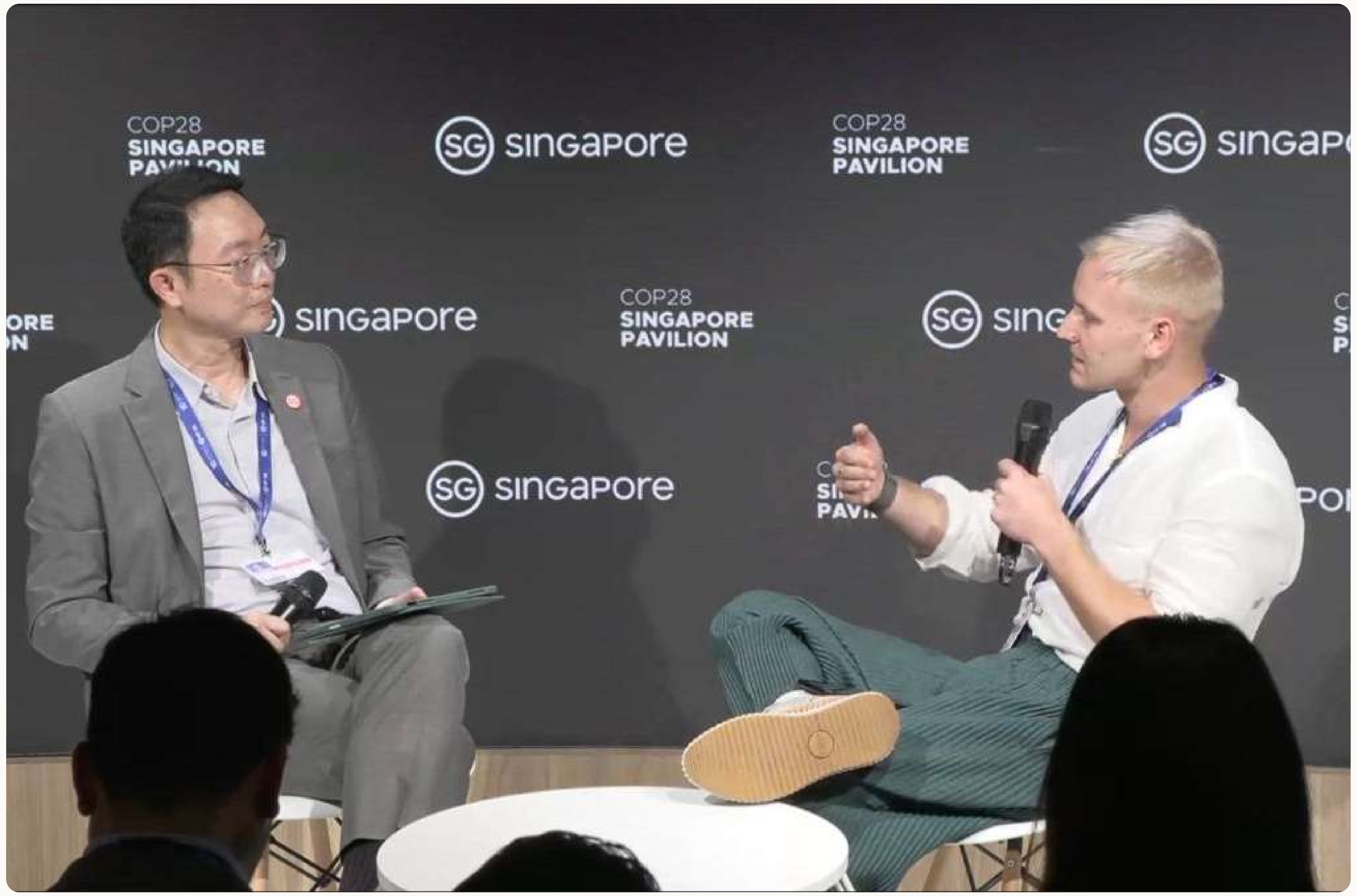
WHAT'S HAPPENING

What will convergence between voluntary and compliance carbon markets look like?

Since the rise of the VCM in around 2014, it has largely operated separately from compliance markets – except for the limited number of voluntary credits allowed for use in compliance schemes such as California, South Korea, and Colombia.

Under compliance markets, companies purchase compliance allowances to meet regulatory obligations, whereas voluntary credits generated by emissions reduction and removal projects were largely used to meet voluntary targets.

A converged market would break down these walls, increasing the coverage and efficiency of carbon markets.



Why does it matter?

01 More competition

The most obvious consequence of such convergence, for voluntary buyers, is the presence of newfound competition from buyers in compliance markets. This will likely have the effect of reducing available volume and raising VCM prices. Additionally, more complex market interactions will mean more complex supply and demand dynamics.

02 Better quality standards

Convergence would also result in the standards or requirements for compliance market credits bleeding over into the VCM. We're already seeing this take shape with the introduction of CORSIA, the Carbon Offsetting and Reduction Scheme for International Aviation, which encourages airlines to account for a portion of emissions with credits from the voluntary market that adhere to specific standards. All of this is good news for buyers and overall climate action. Anything that strengthens quality and transparency gives buyers more confidence in their carbon credit investments and sends more capital to critical climate solutions.

In addition, VCM standards could start to influence compliance markets. We've already seen the UK commit to regulate its carbon markets based on the ICVCM's Core Carbon Principles (CCPs) (developed for the VCM). Additionally, the California Compliance Offset Program adapted carbon credit protocols developed by the Climate Action Reserve (CAR), a voluntary registry, and a number of voluntary market methods and quality standards are being used to inform the frameworks for Article 6 of the Paris Agreement. The voluntary carbon market's approach to quality has already influenced a number of compliance markets, and it is poised to play an even stronger role in setting the standards for what high-quality looks like as compliance markets expand and evolve.

03 Greater innovation

The VCM has a reputation for innovation and speed, being less encumbered by compliance market requirements. Greater convergence between markets means compliance markets can also benefit from innovation taking place in the voluntary sphere, expanding the reach and impact of necessary climate solutions.

WHAT'S HAPPENING

Key global compliance-led carbon markets

The European Union Emissions Trading System (ETS)

The EU ETS is the largest carbon market in the world. It is a cap and trade system that limits greenhouse gas emissions, with the cap being reduced annually to mandate emission reductions. It covers a number of industries, including electricity and heat generation, energy-intensive industry sectors, aviation, and maritime transport.

CORSIA (Carbon Offsetting and Reduction Scheme for International Aviation)

CORSIA is the first global sector-based offsetting scheme. Airlines and aircraft operators must offset any growth in carbon emissions for international flights above 2020 levels using credits from the Aviation Carbon Exchange (ACE), sourced from the voluntary market. CORSIA's pilot phase ran from 2021-2023, and the first phase began on 1 January 2024.

Article 6 of the Paris Agreement

Drafted in 2015 and expanded on in 2021 at COP26, Article 6 of the Paris Agreement allows countries to cooperate to meet emissions targets, such as transferring emission reductions between countries. Article 6 allows countries to buy voluntary carbon credits to meet their nationally determined contributions (NDCs), bringing more demand — and complexity — to the VCM.

WHAT'S DRIVING IT

Why now? Two key trends driving convergence.

01 The VCM is becoming increasingly regulated

Buyers of voluntary carbon credits are well aware of the rise of regulation and scrutiny around corporate use of carbon credits. Much of it has been driven by a focus on misleading climate claims, particularly in the European Union.

In turn, we've seen a growing regulatory interest in the use of credits within corporate climate strategies, such as the International Organization of Securities Commission (IOSCO), the U.S. Commodity Futures Trading Commission (CFTC), and recent bills like California's AB 1305 carbon credit disclosure requirements. So the VCM, despite its name, is looking more like a compliance market every day.

02 Compliance markets want what the VCM has

At the same time as regulatory interest in the VCM is growing, we're seeing the expansion of compliance markets such as emissions trading schemes (ETSs) into sectors not previously covered by these mandates, such as the inclusion of maritime transport into the EU ETS.

Additionally, compliance markets are aligning with the goals of the Paris Agreement — that is, with the imperative to achieve net-negative emissions in the coming decades. And one of the core components of net zero and beyond is carbon removal.

Currently, carbon removal credits exist only on the voluntary carbon market. Compliance markets will need to expand to allow for durable removal credits — and this may mean opening their doors to VCM carbon projects. This has been heavily hinted at by authorities running both the EU ETS and the UK ETS.

Additionally, Article 6 of the Paris Agreement presents a compelling dynamic that bridges the compliance and voluntary carbon markets, fostering a more interconnected relationship between the two. Functioning as a mechanism overseen by the UNFCCC, it establishes a structured framework for governments choosing to participate on a voluntary basis. This arrangement instils confidence in countries as they navigate their carbon market commitments. The voluntary nature of government participation in Article 6 reflects the characteristics of the voluntary market. However, the oversight by the UNFCCC also gives Article 6 attributes of a compliance market. Consequently, Article 6 acts as a channel, facilitating cooperation between compliance and voluntary markets.

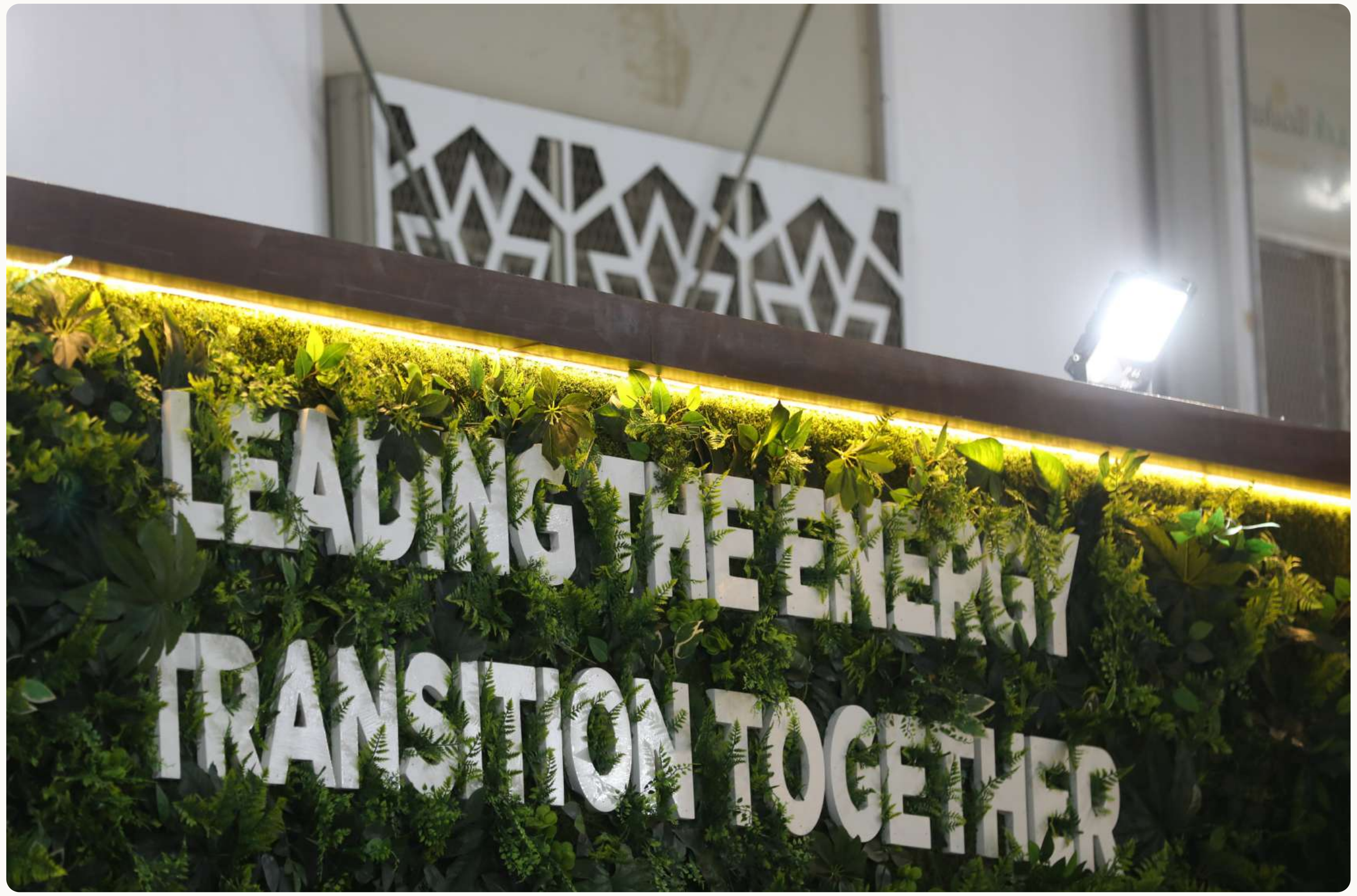
Singapore, for example, is increasing its ambitions under Article 6 and establishing itself as Asia's 'carbon hub', using carbon markets to encourage faster decarbonization through a carbon tax. In allowing carbon credits to be used towards carbon taxes, Singapore is leading the way in integrating voluntary and compliance markets.

WHAT TO DO

What to do? How corporates can take advantage of carbon market convergence.

Regulators and standard-setters are driving the convergence of voluntary and compliance markets, which means that the way organizations invest in and participate in the carbon markets will change radically in the next several years.

While some of these shifts may feel far off, participants will need to grapple with the implications much sooner than they may expect. Whether they've been investing in carbon credits for years or haven't yet, market convergence will affect all companies. To prepare, companies should take three key actions.



Why does it matter?

01 Understand the regulations and prepare for compliance

A transition such as this gives rise to new concerns for corporates, who should understand the complex issues at play in order to plan accordingly. Firstly, businesses need to understand the regulations that apply to them and focus on compliance. For example, most U.S.-based carbon credit buyers will need to disclose detailed purchase information under California Assembly Bill 1305.

01 Line up partners and service providers to simplify compliance

In this shifting, complex landscape, deep knowledge and expertise are not always easy to find. Corporates need to find a range of partners, from legal counsel with deep expertise in carbon market law across multiple jurisdictions, to carbon credit suppliers compliant with the CCPs or CORSIA, for example. Corporates should seek out secure partners and service providers that can help them navigate the changes and implications for carbon markets, reduce their risk exposure, and capitalize on the opportunities of an evolving market.

Thankfully, Sylvera can help guide organizations through their carbon market journey end-to-end, from building a strategy that meets their goals to monitoring ongoing regulatory changes as convergence evolves. Sylvera's carbon data and deep expertise can streamline companies' participation and compliance in the voluntary carbon market as it becomes increasingly less voluntary.

03 Act early on the opportunities

In anticipation of potential demand hikes in the future, corporates with long-term climate targets should be thinking seriously about how to secure the volume and type of credits they need before more competition comes online.

For more sophisticated, larger corporations, this security may come in the form of moving earlier into the project lifecycle and investing in pre-issuance credits. However, many companies may not have the capacity or interest in investing earlier. For those, investing in projects that have already issued credits will become more costly, due to the compliance measures that will push companies to buy credits of a certain quality marker. These players can't afford to delay their action. Instead, they should look to secure investments now at the head of this wave.

Until recently, net-zero target-setting was a 'nice to have.' As climate change grows more pressing, there is increasing pressure on corporates to shift business models and prioritize action. Companies that manage to transition to a more sustainable business well will reap benefits that go well beyond having just done their part. However, for those that fail to act, there will be real costs associated.

CONCLUSION

What's next for corporate carbon credit buyers

At the same time as voluntary and compliance markets are converging, carbon credits are playing a larger and more visible role as the 'net' in 'net zero.' From the VCMI's new Scope 3 claim to the ISO's clarification of the role of carbon credits in carbon neutrality, the voluntary carbon market's role in the net zero economic transition is becoming even more important.

> We cannot afford the net zero transition without high-integrity carbon projects.

The expansion of compliance markets means that in time, companies will no longer be able to delay or forgo participation in the carbon markets – it will be mandatory. In all industries and all countries, the cost of greenhouse gas emissions will only increase.

Corporations that are serious about their net zero transition will invest in carbon credits now and choose them wisely to secure the best quality at the best prices for maximum impact. For carbon traders, this convergence between voluntary and compliance markets may create some turbulence because of evolving standards and regulations. Meanwhile, the long-term opportunity remains strong and will help bolster the carbon markets to new heights.

The convergence of voluntary and compliance markets will accelerate innovation and demand as both sides learn from and contribute to each other's progress. Stronger regulation and oversight will mean the VCM becomes a tool for mandatory climate action, thereby strengthening the incentives the planet desperately needs to regain climatic balance.