

# Business Opportunities (And Risks) In The Voluntary Carbon Market

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## Introduction

The voluntary carbon market is booming. Volumes and values tripled last year alone, from a total worth of about \$97 million in 2006 to \$331 million in 2007.<sup>1</sup> Although demand is being driven primarily by corporate sustainability and green marketing initiatives, many companies are also participating in the market as a "trial run" in anticipation of a national cap-and-trade mandate.

These forces have created significant new business opportunities. For example, the ability to generate "carbon offsets" from voluntary carbon reduction and sequestration projects has created a new type of asset – a new stick in the bundle of property rights – that is only beginning to be understood. The voluntary market has helped to launch a new industry devoted to developing and marketing such carbon assets.

On the other side of the equation, businesses interested in acquiring carbon offsets in the voluntary market, for whatever reason, now have the benefit of new standards and protocols that promise to bring a measure of standardization and quality control to a market that is still in its infancy. Furthermore, the existence of the voluntary market in the EU – even along side the mandatory, compliance-driven market – suggests that the voluntary market within the United States can sustain itself even in the absence of a national mandate.

For those participating in the market for investment purposes, the most significant risks and opportunities stem from the uncertain regulatory climate. Because eligibility standards vary among the existing cap-and-trade systems, it is difficult or impossible to predict the future value, in a mandatory system that has not yet been developed, of credits developed for the voluntary market.

The remainder of this article provides an overview of the legal landscape that has given rise to the voluntary carbon market and identifies a few of the many legal issues that should be considered by companies seeking to take advantage of these new opportunities.

## What Are "Carbon Offsets"?

"Carbon offsets" are one of the two basic units of trade within a cap-and-trade system. The other unit is an "allowance," which is a credit generated by an entity subject to the emissions cap that has reduced emissions beyond the required amount. "Offsets," on the other hand, are generated by entities outside the cap that have implemented voluntary projects that either reduce emissions or sequester carbon. Offsets and allowances can both be used to meet compliance obligations, though the use of offsets is generally limited in some fashion.

The most common carbon offset projects are renewable energy projects and energy efficiency projects. Other popular projects include landfill methane reduction

and afforestation projects. The dominant exchange within the voluntary market, the Chicago Climate Exchange, has developed specific protocols for the following types of offset projects:

- Methane capture and destruction at landfills and farms;
- New renewable energy systems, such as wind, solar and renewable fuels;
- Carbon sequestration in newly planted trees, in North America farmlands managed with continuous conservation tillage and newly established grasslands;
- Fuel switching and end-use energy efficiency;
- Methane capture and destruction at coal mines;
- Soil carbon capture through grazing land best management practices;
- Destruction of ozone-depleting gases that also contribute to global warming;
- Energy efficiency at best-in-class new and retrofitted warehouses.

## The Legal Landscape: Existing And Emerging "Compliance Markets"

The voluntary market for carbon offsets exists in the shadow of the "compliance market" created by mandatory cap-and-trade systems, such as the European Union's Emissions Trading Scheme (EU ETS). The EU ETS is a national system designed to meet emissions reduction commitments contained in the Kyoto Protocol. It is the largest carbon market by far, with over \$50 billion traded in 2007 (a 100 percent increase over 2006).<sup>2</sup> Similar markets are or will soon be operating in New Zealand and Australia.

Within the United States, seven western states and 4 Canadian provinces – Arizona, California, Montana, New Mexico, Oregon, Washington and Utah and British Columbia, Manitoba, Ontario and Quebec – have formed the Western Climate Initiative. The WCI Partners set an overall regional goal for emissions reductions in 2007 and are scheduled to complete the design of a cap-and-trade system by August 2008.

Meanwhile, the California Air Resources Board issued Draft Scoping Plan on June 22, 2008 that calls for the State of California to adopt a broad-based cap-and-trade program that links to other Western Climate Initiative Partner programs to create a regional carbon market. If this element of the Draft Scoping Plan is adopted as final, regulations to implement this system would need to be developed by January 1, 2011, with the program beginning in 2012.

A separate market-based system is also being developed in the East, through a partnership of nine northeastern and mid-Atlantic states (Connecticut, Delaware, Maine, New Hampshire, Massachusetts, New Jersey, New York, Rhode Island, and Vermont) known as the Regional Greenhouse Gas Initiative (RGGI). The goal of RGGI is to develop a regional cap-and-trade system initially targeted at power plants. The RGGI states issued a Model Rule for the carbon trading program on August 15, 2006. The initial three-year compliance period will begin on January 1, 2009.

Each of these systems imposes geographical restrictions on the location of offset projects. For example, offset projects



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within the United States are not eligible for credits for purposes of Kyoto (or EU ETS) compliance. Similarly, the RGGI Model Rule limits credit for offsets to projects undertaken within RGGI states or within States that have entered a memorandum of understanding with the RGGI states (none have done so to date). Although the Draft Scoping Report issued by CARB is not specific on this issue, it too suggests that offset credits might be limited to projects undertaken within California. As a result of these limitations, the voluntary market is currently the only source of demand for credits generated by offset projects within much of the United States.

## The Voluntary Market

The voluntary market exists to accommodate entities who wish to reduce their emissions voluntarily. According to a survey conducted by Ecosystem Marketplace and New Carbon Finance, the majority of participants were private businesses (79 percent), while NGOs comprised 13 percent of the buyers.<sup>3</sup> Buyers from the EU represented approximately half of this demand, while North American buyers purchased 37 percent of credits.<sup>4</sup> Although most buyers reported their primary motivation as being corporate sustainability/branding initiatives, buyers also reported that approximately one-third of the offsets purchased in 2007 were purchased for investment purposes.<sup>5</sup>

The voluntary market can be divided into two basic components – the Chicago Climate Exchange and the Over the Counter ("OTC") market. The Chicago Climate Exchange (CCX) is a voluntary but legally binding cap-and-trade system. It is the world's only voluntary exchange. Members join the exchange by executing a contract with CCX. Emissions allowances are allocated in accordance with each member's Baseline and with the CCX Emissions Reduction Schedule. Trading on the CCX accounts for about one-third of the volume of the voluntary market. Within the United States, pre-compliance buyers and those solely interested in carbon neutrality tend to gravitate toward CCX.

The unit of trade on the CCX is known as a Carbon Financial Instrument (CFI). As of August 15, 2008, one CFI was trading at about \$4. The price reached a high of about \$7 earlier this year after bottoming out at \$2 in 2007. By way of contrast, carbon is currently trading on the EU ETS at approximately \$25 per ton. This discrepancy accounts for a large part of the speculative activity within the existing voluntary market.

In contrast to CCX, the OTC market consists of bilateral trades apart from any exchange. The OTC market is much less standardized in terms of quality control and it is also much less commoditized. On one end of the spectrum, some OTC buyers seek to avoid the expenses associated with certification and verification requirements for CCX. On the other end, many OTC buyers seek to leverage their investment in carbon neutrality in projects that generate social and environmental "co-benefits." On the supply side, the OTC may provide a market for innovative projects that are not currently eligible for credit within CCX. This flexibility is both a strength and a weakness of the OTC market.

## Contractual Provisions To Ensure Quality Control

The use of offsets within cap-and-trade regime has generated substantial contro-

versy. Opponents have raised both technical and philosophical / political objections to these types of projects. The primary technical concern is to ensure that offset projects result in GHG reductions that are "real, additional and permanent." These concerns have given rise to certification and verification procedures within both the compliance and voluntary markets. Specific protocols have also been developed to quantify the benefits resulting from different types of projects.

New standards are being introduced at a rapid pace. The Voluntary Carbon Standard (VCS) – introduced by the Climate Group, the International Emissions Trading Association and the World Business Council for Sustainable Development in November 2007 – seems poised to become the dominant standard, but many other standards exist. The Gold Standard, for example, is designed to emphasize social and environmental co-benefits in addition to GHG reductions.

The concern about "additionality" is somewhat more difficult to address. The idea is that credits should not be awarded for "business as usual" – for example, for projects that must be undertaken for other purposes that also happen to reduce GHG emissions. "Additionality" standards vary from program to program and can be somewhat arbitrary. Buyers within the voluntary market should be aware of this issue. Depending on the particular type of project involved, there is a risk that credits generated for the voluntary market may not be accepted within any future cap-and-trade system.

CCX has developed verification and certification standards, as well as eligibility requirements for the types of offset projects that will be accepted. Buyers within the OTC market, however, must use due diligence and appropriate contractual provisions to protect their investment.

Depending on the buyer's objectives, contractual provisions for offset credits should include the following:

- certification of credits to be achieved under a specific standards;
- third-party verification;
- measures to ensure permanence, such as deed restrictions;
- allocation of risk in the event of project failure.

## Conclusion

In conclusion, the voluntary carbon market has arrived, together with substantial new business opportunities. New participants should assess their motives for participating in the market to determine whether to join CCX or to tailor an OTC contract to their particular needs. For those seeking to participate in the market for investment purposes, the present window of opportunity may begin to close as prices adjust to the expectation of a mandatory cap-and-trade system and as the most cost-effective offset projects are developed.

<sup>1</sup> See Ecosystem Marketplace & New Carbon Finance, Forging a Frontier: State of the Voluntary Carbon Market 2008 at 6-7 ([http://ecosystemmarketplace.com/documents/cms\\_documents/2008\\_StateofVoluntaryCarbonMarket.4.pdf](http://ecosystemmarketplace.com/documents/cms_documents/2008_StateofVoluntaryCarbonMarket.4.pdf))

<sup>2</sup> The World Bank, State and Trends of the Carbon Market 2008 (May 2008) (<http://siteresources.worldbank.org/NEWS/Resources/State&Trendsformatted06May10pm.pdf>)

<sup>3</sup> See Ecosystem Marketplace & New Carbon Finance, Forging a Frontier: State of the Voluntary Carbon Market 2008 at 65.

<sup>4</sup> See id.

<sup>5</sup> See id.

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