Volunteers step forward

The voluntary carbon market held up better than its bigger mandatory brother in 2011 but, say the top ranked firms in \textit{Environmental Finance}'s market survey, innovation and differentiation will be key to success in what is still a tough environment. Mark Nicholls reports

"With the economy getting better, people are starting to purchase offsets again"  
Kathy Benini, Market

Voluntary carbon markets

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I"t's the very definition of the voluntary carbon market that – unlike in compliance environmental markets – no-one is ever obliged to buy a voluntary carbon offset. This makes the market uniquely vulnerable to macro-economic headwinds, but it also encourages levels of innovation and creativity that are often lacking in mandatory markets.

The winners of this year's \textit{Environmental Finance} voluntary carbon market survey are demonstrating that innovation in spades. Developers in the voluntary market are working to bring donor finance alongside carbon finance, they are trailblazing project types at the frontiers of carbon markets and they are developing ever-closer relationships with their corporate clients in a bid to stay relevant in what remains a difficult market.

"The market is still nowhere as active as it was before the financial crisis, but it's picked up from the depths," says Lenny Hochschild, San Francisco-based managing director at brokerage firm Evolution Markets, which was the top placed broker in the survey.

"We've definitely seen interest increase over the past year – no doubt," says John Davis, voluntary and compliance carbon emissions trader at London-based CF Partners, which took second place in the Best Trading Company category. Indeed the company is so bullish on the market it plans to hire four or five traders to focus on voluntary carbon – more than doubling its existing capacity.

The effects of the financial crisis and recession hit the voluntary carbon markets early, with a collapse in prices in 2009 as the economic downturn saw discretionary spending evaporate. And without doubt, say participants, the gloomy economic mood and the not unrelated fall in concern about climate change have seen some erstwhile corporate offsetters step back.

"Due to the lack of national action on climate change in the US, a number of our clients have been revisiting what they're doing on a voluntary basis, why they're doing it, and whether they should continue," says Craig Ebert, a California-based managing director at consultancy ICF International, voted Best Advisory Firm in the survey, referring to Fortune 500 companies as well as "mid-sized" firms.

"We've had clients backing off specific strategic goals because they aren't convinced that the business climate is supporting that level of investment – and it's hard to argue with them." Ebert stresses that "the climate issue isn't going away", but the lack of regulatory momentum from the US Congress "takes away any sense of urgency".

And economic uncertainty and the lower political profile of climate change has had an impact on the market for offsets. Luca Bertali, London-based emissions broker at second-placed broker TFS Green, notes that the transactions of 250,000–300,000 tonnes of carbon dioxide equivalent (CO2e) of years gone by have dried up. "The market didn't see any last year – it's 10,000–15,000- or 20,000-tonne deals," he says.

Nonetheless, there are indications that the market is holding its own. According to Markit, which runs the leading registry for voluntary carbon offsets – and which, for the third year in a row, was voted Best Registry Provider – issuance activity in 2011 was up slightly, year on year. Some 27.8 million Verified Carbon Standard (VCS) credits were issued across all VCS's registries, up from 27.3 million in 2010. However, 9.8 million VCS credits were retired – that is, consumed – in 2011, up from 3.6 million in 2010. Markit alone saw an increase in VCS retirements from 2.7 million to 5.2 million and similar increases across the other standards it supports.

Prices in the over-the-counter market have held up for voluntary carbon credits, with top-end credits certified to the Gold Standard holding steady at...
markets by last December’s Durban climate talks.
And buying carbon credits to offset some or all of a company’s environmental impacts remains appealing, says Renat Heuberger, CEO of South Pole Carbon Asset Management, voted Best Project Developer, and in third place in the Best Advisory category. “Carbon offsetting is still a very interesting tool from a [corporate social responsibility] perspective – it’s very cheap, it’s concrete and tangible, and the companies get nice pictures.”

There is a constant trickle of companies coming to carbon offsetting for the first time – many of which are spurred by regulatory developments. “Traditionally, when a compliance market is introduced, the voluntary market has increased in size,” Heuberger says.

Indeed, Heuberger was visiting Australia when he was interviewed by Environmental Finance, with one eye on business opportunities following the passage of that country’s Clean Energy Future legislation last year, which puts a price on carbon from this July, with a €7–10 ($9.30–13.30)/t CO₂e, depending on the volume bought, says Davis at CF Partners, while Hochschild at Evolution Markets says that prices for the more run-of-the-mill VCS project-specific verified emission reductions (VERs) remain in the $1.50–3/tonne range.

In the wake of the 2009 financial crisis, “voluntary carbon offsetting went from being a public good to a luxury good,” says Kathy Benini, Markit’s New York-based head of environmental markets. “But we’ve seen growth in 2011. With the economy getting better, people are starting to purchase again.”

That sentiment is echoed – at least so far – by Nevena Pingarova, the Munich-based head of climate change projects at TÜV SÜD, voted second Best Verification Company. “From the project proponent side, it’s been quite stable. But there is a time lag,” she notes, between changes in demand from buyers and project development. “And the voluntary market follows the compliance market.” However, weighing against that is what Pingarova describes as the “green light” given to the carbon trading programme in place from 2015. “It’s an ongoing debate as to whether, if you have a compliance regime, the voluntary market dies,” says Martijn Wilder, Sydney-based partner and head of Baker & McKenzie’s global environmental markets and climate change practice – winner, once again, in the Best Law Firm category. “But the carbon scheme [in Australia] may actually increase interest in offsetting among, for example, the professional services firms that don’t have obligations.”

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“I wouldn’t be surprised if you see a groundswell of activity in the corporate market” in Australia among retailers and manufacturers, agrees Anthony Hobley, a London-based partner at law firm Norton Rose, which tied as runner-up, Best Law Firm.

And survey winners report emerging interest from the developing world. “Our Rio and Delhi offices have been working with a number of relatively heavy-industry clients … who are figuring out what climate change and sustainability mean for their business,” says Ebert at ICF. “Offsetting is definitely being considered,” he adds.

As well as the neophytes, there is a growing number of companies that have been running offsetting programmes for some years, and are developing both their approach to offsetting, and the sort of projects from which they are looking to buy offsets.

“Probably around 20% of our clients have been with us for five years or more,” says Jonathan Shopley, managing director at the London-based CarbonNeutral Company, a veteran of the voluntary carbon space, and winner of the Best Offset Retailer category – although, with just 1% of its revenues from retail customers, it is best described as a wholesale supplier to companies offering offsets to their retail customers.

“The early impetus [to offset emissions] is evolving into deeper and more embedded programmes,” Shopley says. One trend that his company is watching closely is “the concept of companies moving from offsetting carbon in their operations to carbon in their products and services … and in their supply chains.”

Such a move would see carbon offsetting “escape the boundaries of companies … and when we find ways of getting into the supply chains in Africa and Asia, that may improve the penetration of carbon offsetting,” he says.

Heuberger at South Pole, meanwhile, says that his company is developing projects in closer partnership with clients, citing a project with WWF and the Swiss Coop supermarket chain. That project is helping the farmers in Kenya from which the Coop sources its cut flowers reduce their emissions. “It’s about involving its supply chain in offsetting,” he explains.

Such novel projects can be risky, Heuberger says, but South Pole is now offering a type of insurance, where around 20% of the client’s investment in offsets is used to buy Gold Standard VERS to make good any shortfall in the project’s emission reductions. If the project delivers, the VERS can be sold or recycled for use in the next project.

Meanwhile, some leading developers in the voluntary carbon markets are looking beyond emissions reductions to get projects financed. UK-based ClimateCare, which was last year spun out of JP Morgan just three years after the US investment bank bought the firm, has been in discussions with leading donor agencies “for six or seven months” about monetising some of the co-benefits of its projects in Africa, says director Edward Hanrahan.

Such donors could help fund projects which, for example, deliver measurable reductions in water-borne diseases or respiratory illnesses. The projects would continue to generate and sell carbon credits, but also earn payments from donors for their health benefits.

“For example, cookstoves reduce incidences of pneumonia … if you could finance these deliverables on a results basis, and overlay that on the carbon revenue, these projects may become some of the more financially attractive projects,” says Hanrahan, whose company was voted second place in both Best Project Developer and Best Offset Retailer. “The scale could be transformative.”

As an example, ClimateCare is helping to market the carbon credits generated by the LifeStraw water filters project, with Swiss disease control company Vestergaard Frandsen. In addition to its climate benefits, the company is monitoring its health benefits, specifically its impact on diarrhoea. Adrian Rimmer, CEO of the Switzerland-based Gold Standard Foundation, which sets standards for emission reduction projects that offer social benefits, and which was voted runner-up in both Best Project Developer and Best Offset Retailer. “The scale could be transformative.”

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Andrew Hedges, Norton Rose

Voluntary project developers have always operated at the frontiers of carbon markets, and they have often helped define the methodologies and processes that are adopted by mandatory regimes. Nowhere is this clearer than in efforts to develop markets to credit projects that reduce emissions from deforestation or forest degradation (REDD).

Many carbon market proponents are confident that an enormous market in REDD credits will develop to help raise the billions of dollars of finance needed to protect the world’s remaining tropical forests – and, ahead of regulation, developers are looking to register their reductions using leading voluntary market standards to give buyers confidence that their credits are credible.

The VCS – voted Best Voluntary Standard – has been at the forefront of developing REDD methodologies. And early last year, the first VCS REDD credits were issued to Wildlife Works Carbon’s flagship Kasigau Corridor project in eastern Kenya.

The strength of the VCS is in what David Antonioli, VCS president, describes as “an open and transparent process” involving “regulatory-grade drafting requirements … It gives the end-market credence and credibility, and it reduces risk.”

However, the assistance of bodies such as the VCS notwithstanding, the supply of credits from REDD projects has been limited so far. “People thought REDD credits would come flooding out and hit the market hard,” says Antonioli. “The fact is, they’re hard to pull off.”

Robert O’Sullivan, executive director North America at Climate Focus – which was voted runner-up, Best Advisory – says that work within the VCS on a jurisdictional-level REDD methodology could prove to be “potentially very significant” for the REDD market. The methodology would set out how individual projects fit into wider state-

How the survey was conducted

Companies were e-mailed in March and asked to nominate the leading service providers active in the voluntary carbon markets, via an online survey.

Voters were asked to make their judgments on the basis of: efficiency and speed of transaction; reliability; innovation; quality of service provided and influence on the market; not just the volume of transactions handled. More than 600 completed responses were received.
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David Antonioli, VCS: “People thought REDD credits would come flooding out and hit the market hard”

Although standards such as the VCS are helping to define the terms under which developers can issue credits, projects using them risk finding themselves incompatible with mandatory REDD regimes as they emerge in places such as California and Australia and, ultimately, under a global UN regime. Wilder at Baker & McKenzie notes that while credits generated by activities that offer immediate abatement are generally highly fungible, “there are more significant differences” in the treatment of credits from land-based projects, such as REDD.

He notes that programmes are likely to take different approaches to the issue of permanence – ie, how to handle the risk that a forestry project may release its carbon through, for example, fire or pestilence. Some programmes use credit buffers, or insurance. “One issue will be the ability to transfer the rights from one scheme to the next,” he adds.

And the work that is going on in the voluntary market will inform markets for REDD credits, as they continue to emerge. For example, they pose unique challenges in how REDD credits are tracked through registry systems, notes Benini at Markit.

“The regulatory set-up [in the carbon markets] is based on projects – but the infrastructure needs to change,” she explains. Because individual projects will sit within wider geographical areas, and will potentially contribute to deforestation targets at the project, sub-national, national and even regional level, existing approaches to tracking carbon will no longer be adequate, she says.

Registries such as that operated by Markit have gone a long way towards driving from the voluntary market the so-called ‘carbon cowboys’ who, by selling suspect or downright fraudulent carbon offsets to unsuspecting buyers, did so much damage to the reputation of carbon markets a few years ago.

But the REDD market seems to have encouraged a new breed of sharp operators. “We’re dealing with a recurrence of carbon cowboys in the REDD space,” says Andrew Hedges, a London-based partner at Norton Rose. He praises a programme in the Democratic Republic of Congo to license project operators.

“We would like to see the voluntary market become regulated,” says Bertali at TFS Green, who warns of “misrepresentation and false selling … Voluntary credits shouldn’t be sold as an investment vehicle.”

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or province-level REDD baselines, which “should make it simpler for REDD projects to get off the ground. It should remove some of the uncertainty.”

However, he notes that “the million-dollar question” remains the extent of demand that exists in the market for REDD credits in the absence of compliance demand. “What’s out there at the moment isn’t adequate.”

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