

CLIFFORD CHANCE COLLABORATES WITH TASKFORCE ON SCALING VOLUNTARY CARBON MARKETS – FINAL REPORT PUBLISHED

Clifford Chance is one of the collaborators on the Taskforce on Scaling Voluntary Carbon Markets ("TSVCM"). The TSVCM is working to overcome challenges the voluntary carbon market is currently facing, such as being highly fragmented or having difficulties with the quality of certain carbon credits. We are supporting the TSVCM in achieving its goal(s) in addressing these issues around fragmentation and carbon credit quality by sharing our deep experience and insights into the voluntary carbon market.

On 8 July 2021, the TSVCM published its final report summarising its findings (to date) of how to best scale up voluntary carbon markets. As part of this process, the TSVCM recently concluded a public consultation (between 21 May to 21 June 2021) focusing on the establishment of a voluntary carbon market governance body, progressing the standardisation of legal principles and contracts within the market and further consolidating carbon credit requirements (in this regard, please refer to our previous briefing available here: <http://ow.ly/MvZH50FkGV4>).

Based on TSVCM's final report, we want to highlight the TSVCM's proposed solutions for some of the most crucial issues the voluntary carbon market needs to overcome in the coming years:

Linking of compliance markets with international credits

In the past, compliance markets like the EU-ETS were linked with international credits under the Clean Development Mechanism ("CDM") (exchanging carbon credits acquired in developing countries for additional EU emission allowances) and Joint Implementation ("JI") (meeting required cuts in emissions levels by paying for projects that reduce emissions in other industrialised countries). Starting from the beginning of the fourth trading period of the EU-ETS (1

Key facts:

- TSVCM published its final report on 8 July 2021 summarising its findings of how to best scale up voluntary carbon markets
- Public consultation concluded between 21 May to 21 June 2021 focusing on the establishment of a voluntary carbon governance body, progressing the standardisation of legal principles and contracts and further consolidating carbon credit requirements
- In its final report, TSVCM proposed solutions for some of the most crucial issues the voluntary market needs to overcome in the coming years (including double counting, additionality, permanence and leakage)

January 2021), the EU removed the ability to use CDM/JI credits for satisfying EU-ETS obligations due to a potential lack of transparency in operation of the CDM/JI mechanisms.

Linking compliance markets with international credits (again) will strongly depend on the outcomes of the discussion about implementation of Article 6 of the Paris Agreement (especially against the background of the upcoming COP26). Article 6 of the Paris Agreement highlights the importance of voluntary carbon markets to promote higher ambitions in decarbonisation and to reduce the climate effects of GHG emissions. One core element of Article 6 (in conjunction with Article 4) of the Paris Agreement is the issuance of nationally determined contributions ("**NDCs**") in which countries outline their efforts to reduce national emissions and adapt to the impacts of climate change. Further, Article 6 of the Paris Agreement aims to facilitate a market mechanism to allow part of a country's mitigation effort to be satisfied by mitigations in another country (the transferred effort known as internationally transferred mitigation outcomes ("**ITMOs**"), a form of carbon reduction unit). A similar approach was taken under the Kyoto Protocol with the CDM. Under the CDM, carbon credits were earned from emission-reduction projects in developing countries which can be traded and sold and used by industrialised countries to meet a part of their emission reduction targets under the Kyoto Protocol.

However, the Paris Agreement does not define the scope of ITMOs, nor does it specify their operationalisation or provide for an accounting framework. It is also not clear if there will be a transition between the CDM and the Article 6 provisions (e.g. if carbon credits issued under the CDM can be used towards meeting NDCs) or if the CDM will be phased out. The details around the ITMOs and the transition from the CDM are still subject to ongoing discussions/negotiations between the Parties to the Paris Agreement, especially in preparation for COP26.

Nonetheless, in its final report, the TSVCM makes important recommendations for how to prepare for different (anticipated) outcomes of negotiations on Article 6 of the Paris Agreement (e.g. details around the ITMOs and the transition from the CDM). First, voluntary carbon standards should provide registry data infrastructure and general trading language anticipating different possible outcomes for negotiations on Article 6 of the Paris Agreement. Secondly, carbon credits with specific Article 6 attributes may receive respective tags in order to make those Article 6 attributes visible for potential buyers (comparable to, inter alia, the CCB label of the VCS). Finally, liabilities will need to be allocated in the event that governments fail to perform necessary actions under Article 6 of the Paris Agreement.

Double Counting/Claiming/Use

The reputation of carbon markets suffers where carbon credits are subject to double counting/claiming/use. This happens where one carbon credit is either sold multiple times by the same entity, is registered in more than one carbon standard or is claimed by multiple parties. In order to effectively address this problem at a contract level, the TSVCM aims to ensure that carbon credits are uniquely retired on behalf of one entity by proposing general contract language for warranties and representations in carbon trading transactions. In these proposed warranties and representations, the seller warrants that the carbon credits are not registered in more than one carbon standard or are claimed by multiple parties whereas the buyer warrants that the carbon credits are not sold multiple times.

Further, the TSVCM recommends that potential technology solutions be explored and considered which can help avoid double counting/claiming/use (e.g. blockchain-based logs or reference number systems).

Overcoming the hurdles associated with double counting/claiming/use will be the centrepiece of a functioning voluntary carbon market, from a legal, but also technical perspective.

Additionality

Another pressing issue in the voluntary carbon market is additionality. Projects to reduce GHG emissions should ensure that their reduction, avoidance or storage of emissions is *additional*. This means that the project's climate protection measure would not have taken place without the expected revenue from the sale of carbon credits. Measures that are already economic in themselves and would have been implemented anyway are therefore not eligible. Furthermore, the carbon credits cannot be legally required (e.g. they must be voluntary), meaning that the project is not implemented because of legal or regulatory obligations under existing or prospective laws and regulations in a jurisdiction.

The TSVCM points out that it is crucial that all activities and projects must demonstrate additionality before any credits are issued. The carbon standards issuing credits should implement additionality test(s) (such as negative profitability without credit revenue) appropriate for the scale and nature of the offset to demonstrate financial and regulatory additionality. Additionality tests at regular intervals (minimum frequency being at crediting period renewal) are required to account for market and technological developments and ongoing financial need. Such additionality tests must be reviewed and approved by accredited third party validation/verification bodies.

Another important point is to consider whether it is necessary for projects to demonstrate additionality to the host country's NDCs and appropriate instruments to implement such a requirement (this also depends strongly on the outcomes of the discussion about implementation of Article 6 of the Paris Agreement, please see above under "Linking of compliance markets with international credits").

Permanence

Long term permanence of emissions reduction or removals is key for a high-integrity voluntary carbon market and must be a requirement for carbon standards. Reductions / removals should endure for a minimum time period ('minimum permanence timeframe') for the carbon stored to be considered permanent. In order to achieve this, carbon standards should have the obligation to maintain a buffer pool, insurance or equivalent mechanism to respond and compensate for any reversal events (intentional and unintentional) that occur during a credit's minimum permanence period. Further, carbon standards should include the requirement for project or activity owners to notify any likely reversals within a specified number of days of their discovery.

One of the key points which will be discussed (and decided) by the newly created governance body of the TSVCM is how long the minimum permanence timeframe should be for carbon credits, e.g. a lower and more flexible period (10, 20 or 30 years) or a higher and more stringent period (at least 100 years). Defining a minimum permanence timeframe will be crucial for a well-functioning voluntary carbon market.

Leakage

Another major issue in the voluntary carbon market is so called 'leakage'. Leakage refers to the relocation of emissions, meaning that the implementation of a project in one location increases GHG emissions elsewhere and thus the emissions that should have been avoided (partially) occur in any event (e.g. activities that cause emissions are relocated to an area not monitored by a project). The TSVCVM proposes that carbon standards must require leakage assessments for any activity or project where leakage is a risk. The assessment should identify material sources of leakage and quantify existing leakage risks in order to have sufficient information to address the problem properly. It is also necessary that carbon standards require that the amount of issued carbon credits is adjusted to mitigate for any increases in emissions outside the boundary of the project or activity (e.g. by halting the issuance of carbon credits until leakage is resolved). Further, continuous monitoring of any leakage risks throughout the crediting period is required and carbon standards should require the publication of leakage estimates and any material leakage monitoring results for the benefit of transparency.

The importance of dealing with carbon leakage is also acknowledged by the European Commission which recently published a proposal for a Regulation on a Carbon Border Adjustment Mechanism ("**CBAM**") (for further information, please refer to our briefing on the CBAM available here: <http://ow.ly/dlOp50FwqzD>).

NEXT STEPS/LOOKING FORWARD

Following the publication of its final report, the TSVCVM aims to implement its findings. It will establish a governance body with an oversight function which will host and update the necessary infrastructure for a scaled and high-integrity voluntary carbon market such as key general trading terms and the TSVCVM's Core Carbon Principles. External bodies (e.g. IETA, ISDA, EFET etc.) will then be able to integrate (inter alia) the key general trading terms recommended by the TSVCVM into their contract templates. The TSVCVM recommends that such bodies regularly update the terms of these templates, accounting for relevant developments in the market.

We view the work of the TSVCVM to be crucial in improving liquidity in the voluntary carbon markets. As such, we have been involved as a Member of the Consultative Group of the TSVCVM (focusing on the standardisation of legal principles) and will continue to consult with the TSVCVM going forward. We will closely monitor the next steps the TSVCVM is taking and its progress. If you have legal queries which you would like to raise in respect of the TSVCVM's work, the development of your carbon (offset) projects or carbon trading more generally, please reach out to a Clifford Chance team member below.

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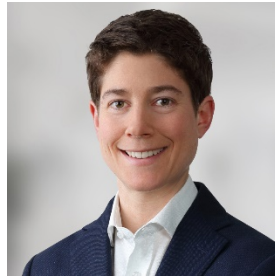
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