FUELING CLIMATE FINANCE IN COLOMBIA

LESLIE DURSCHINGER PROVIDES EARLY INSIGHTS ON THE CLIMATE FINANCE OPPORTUNITIES DEVELOPING FROM COLOMBIA'S NEW CARBON FUEL TAX LAW

As part of Colombia's tax reform in 2016, the country added a new fuel tax to encourage compliance with their greenhouse gas mitigation goals. The level of the tax is based on the carbon content of fuels, and includes all petroleum products and all types of fossil gas used for energy purposes, provided that they are used for combustion (other than coal). The details of the tax are covered under Decreto 926 de 2017, which went into effect on 1 June 2017. The tax rate is initially COP$15,000 (US$5) per tonne of CO2, and will be adjusted each year on 1 February, based on the previous year's inflation plus one percentage point.

The provisions of the law are clearly intended to stimulate implementation of mitigation activities that generate emissions reductions/removals that can be used in exchange for payment of the tax. The ability to use emission reductions/removals for tax compliance provides taxable entities the opportunity to reduce the costs of compliance and creates demand for emission reductions.

USING CARBON CREDITS FOR TAX COMPLIANCE

The law defines the ability to be "carbon neutral" as neutralising or mitigating the GHG emissions associated with the use of fuel under the national carbon tax. Eligible mitigation activities include programmes, projects, actions or activities carried out at a national, regional or local level aimed at reducing, avoiding, removing or capturing GHGs. This is achieved through the voluntary retirement of qualifying verified emission reductions (VERs) in the name of the taxable entity.

The GHG standards accepted for mitigation under the law are broadly defined and require that they and/or their verification bodies must meet one of the following criteria: be accredited by the National Accreditation Agency of Colombia (ONAC), be a signatory to the International Accreditation Forum (IAF), and/or the programme must be accredited under the requirements of ISO 14065 or the UNFCCC. This covers most internationally recognised GHG standards used today.

VERs issued for reductions since 1 January 2010 may be used, and the law requires that the GHG standard have a registry that generates a serial number for each unit. Until 31 December 2017, VERs for reductions in countries outside of Colombia may be used, but starting in 2018 only Colombian emission reductions are eligible. The law also specifically states that GHG emission reductions/removals generated by projects which reduce emissions from deforestation or forest degradation (REDD) are eligible as long as they meet that requirements set out for all other verified emission reductions.

THE ABILITY TO USE EMISSION REDUCTIONS/REMOVALS FOR TAX COMPLIANCE PROVIDES TAXABLE ENTITIES THE OPPORTUNITY TO REDUCE THE COSTS OF COMPLIANCE AND CREATES DEMAND FOR EMISSION REDUCTIONS

HOW LARGE IS THE CLIMATE FINANCE OPPORTUNITY CREATED BY THE LAW?

It is early in the implementation of the law to estimate the portion of taxable fuel that will be mitigated through use of verified emission reductions. Many newly taxable entities are only now learning about the ability to retire VERs to lower their cost of compliance. Based on the fuel use reported by Colombia's Ministry of Mines and Energy, the magnitude of fuel use subject to the tax is equivalent to over 4 million tonnes of CO2 per month. If taxable entities were willing to pay up to the per tonne amount of the fuel tax, This provides an opportunity for climate finance through carbon purchases of COP$756 billion (US$261 million) per year. To put this in perspective, State of the Voluntary Carbon Markets reported that the total value of voluntary offset transactions in 2016 was US$191 million. By passing this law, Colombia has provided an opportunity to finance climate change mitigation larger than the global voluntary market.

Over time, the actual portion of this tax liability mitigated will depend on a number of factors. These include fuel use, taxable entities' expertise in accessing GHG emission reductions/removals, availability of qualifying emission reductions, and prices. From 2018, only Colombian VERs may be used for tax mitigation. Over the next two to four years, the estimated supply of Colombian VERs, 1-2 million per month, is much lower than the potential demand – indicating that prices for VERs are likely to trade near the cost of the tax.

INFORMAL REVIEW OF EARLY USE OF CREDITS

As the tax obligations only started in mid-2017, there are limited sources of formal data on credit usage for tax compliance. However, through informal non-confidential information shared with Terra Global by market participants (taxable entities, credit providers, standards and registries) and through public information on retirements on Markit and APX, we can provide some initial insights. As with the roll-out of any new market, spreads start out high but over time, as markets become more efficient, they narrow. This was certainly the case in Colombia, where trades in the first few months of compliance reflected large mark-ups. But after less than three months of operation, some of the same trades are being executed for roughly 10% of the initial prices.

For compliance in 2017 when international credits can be used, most buyers have prioritised price over paying more for projects with other social and environmental benefits. Low priced renewable projects in India, China, Thailand and other countries that can be purchased at as little as 10% of the cost of the tax have so far dominated the market. However, some buyers seem interested in including impact in future decision making and are seeking to understand the opportunities to produce dual benefits (compliance and co-benefits) with their purchases.

COMPANIES ARE ALSO VERY INTERESTED IN PRICING FOR 2018 AND BEYOND OF COMPLIANT CREDITS FROM COLOMBIAN MITIGATION ACTIVITIES

Companies are also very interested in pricing for 2018 and beyond of compliant credits from Colombian mitigation activities. Given the limited number of qualifying domestic VERs, companies realise there may be value in trading early for 2018 mitigation. Despite the limited amount of domestic VERs, however, they are still cheaper than the per tonne tax rate, saving taxable entities around 40%. And buyers, through intermediaries, have already been locking up Colombian projects at fixed prices.

EXPECTATIONS IN 2018 AND BEYOND

Colombia has shown amazing global leadership in passing this fuel tax law and allowing for use of VERs for compliance. With this sweeping reform, the government has created sizable domestic demand for Colombian GHG emission reductions/removals. By 2018, it could promote purchases in excess of 51 million tonnes per year. It is expected that many of these purchases will be executed on a "spot" basis for projects that are issuing VERs. But, as supply is limited, it is likely that a larger market for forward purchases will evolve, as well as moves to source credits through funds or other investment vehicles that invest in Colombian projects.

But there are risks introduced by this law and the demand it creates. This could open up projects to being solicited by market participants that may not provide a "fair" deal for the project proponents. This risk is particularly high for projects types that involve rural participants, such as REDD+, rural energy efficient, climate smart agricultural and other land-use projects. In these cases, it is unlikely that project participants understand the opportunities in the marketplace and what are reasonable terms for selling their credits. This shifts the onus on the market players to structure deals that align interests which may not always maximise their profits.

But as the market develops under Colombia's progressive carbon tax law, companies will have an opportunity to reduce their compliance costs which will drive sizable climate finance to a broad spectrum of projects in Colombia that produce verified emission reductions.

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