THE FUTURE OF OFFSETS

THERE IS NO QUESTION THAT THE PARIS AGREEMENT IS A GAME-CHANGER FOR CARBON MARKETS. FOR THE PAST TWO YEARS, IETA AND ICROA HAVE BEEN DISCUSSING THE FUTURE OF OFFSETTING. STEFANO DE CLARA, ANTOINE DIEMERT AND SOPHY GREENHALGH SUMMARISE THE LATEST THINKING

THE RECENT RELEASE of IPCC's latest climate change report notes that only rapid and far-reaching changes to the world economy will stop global warming exceeding 1.5°C by 2040. However, while the Paris Agreement unites countries in their national efforts towards a universally agreed goal to limit global warming to below 2°C, current targets fall far short of this.

A global carbon price is deemed as one of the most powerful ways to shift the world towards cleaner greener outcomes and deliver the action that is required to avoid catastrophic climate change impacts. Indeed, it was core to all scenarios laid out by the IPCC.

Carbon markets are steadily growing worldwide; they are increasingly seen as an essential policy tool to achieve emissions reductions at lower cost than other regulations acting on their own. A recent economic analysis from Environmental Defense Fund found that these cost savings from international trading of emissions could produce nearly double the climate ambition at the same overall cost as countries' complying with their Paris Agreement targets without international carbon markets.In addition to the volume and scale of emissions reductions that carbon markets can unleash, further sustainable development outcomes can also be delivered through various activities, projects and climate financing channelled through market avenues. Such co-benefits are increasingly being measured and plotted against global sustainable development goals. While the use of international credits in compliance schemes is often for cost containment rather than enhancing ambition, it can act as a powerful source of private sector finance for climate change mitigation. Most of the crediting mechanisms which exist today are built around the peculiar structure of the Kyoto Protocol and some, like the CDM and JI, were actually created by the Protocol. As the global framework of reference for climate action shifts from the Kyoto Protocol to the Paris Agreement questions emerge as to what the future of international credits will look like.

The Paris Agreement does not specifically reference carbon markets; rather, it allows parties to pursue "cooperative approaches" and use "internationally transferred mitigation outcomes" to help meet their reduction targets, while ensuring that transparency and the environmental integrity of the regime is maintained. Article 6 of the agreement also establishes a new mechanism to "contribute to the mitigation of greenhouse gas emissions and support sustainable development". The mechanism allows for the participation of both the public and private sectors, and can be a driver for the uptake of market-based measures worldwide.

IETA has consistently argued the new mechanism should become a broad framework mechanism, within which many types of mitigation approaches can be executed, rather than a single purpose mechanism such as the Kyoto Protocol's CDM. Nevertheless, similarly to the CDM and other existing mechanisms, its core purpose could be defined so as to deliver an emissions reduction against some reference level, while also delivering an overall reduction in global emissions and sustainable development benefits. Because such a mechanism can connect with the emission mitigation objectives of another party, it can act to facilitate cooperative approaches.

The future of this mechanism is still currently uncertain. At COP22 in Marrakech, parties committed to prepare all of the elements needed for the implementation of the Paris Agreement for adoption this year at COP24. Commonly called the "Paris Rulebook", it will contain a chapter with the necessary guidance, rules and procedures for operationalising the market provisions in Article 6, including the new mechanism.

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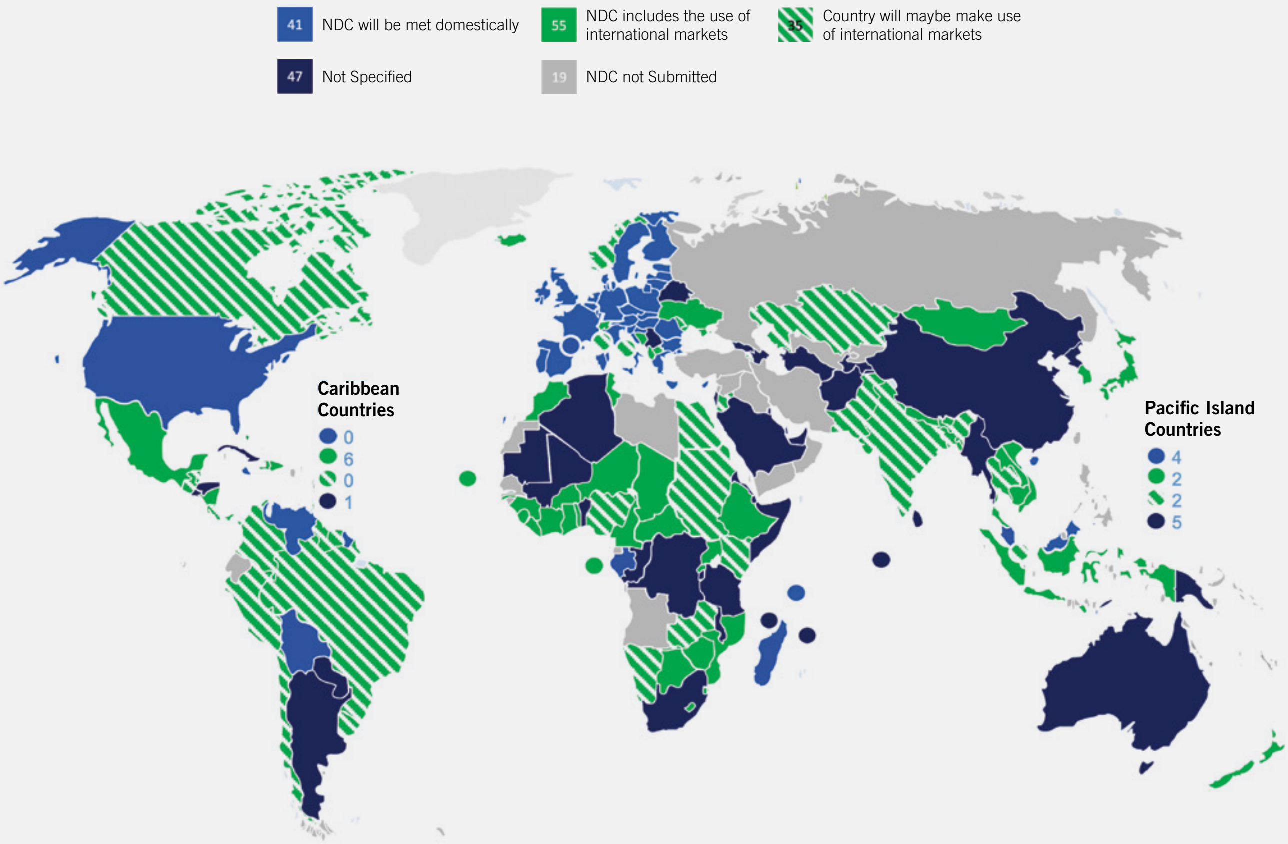

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WHO WILL NEED INTERNATIONAL CREDITS GOING FORWARD?

PARTIES AND COMPLIANCE-DRIVEN DEMAND FOR CARBON CREDITS

While certain parties have already indicated they do not envisage using international credits to meet their Paris pledges, such as the EU, many others will need Article 6 compliant units to do so. In fact, about half of the signatories to the Paris Agreement plan to have a contribution from market mechanisms.

Demand for eligible credits will also continue in regional, national and sub-national emissions trading systems around the world where they usually play an important role in helping entities to meet their compliance obligations, subject to qualitative and quantitative restrictions. In addition, some countries are now looking to implement hybrid systems allowing regulated entities to meet their compliance obligations with carbon credits. That is already the case in Colombia where fuel importers and producers can cover their carbon tax obligations by retiring domestically produced offset credits, thereby adding flexibility in the system and supporting voluntary GHG certification programmes[1]. Other countries such as South Africa and Chile are contemplating a similar approach, adding further compliance-driven demand for carbon credits.

(1) Similarly, an open architecture approach to Article 6.4 could allow recognised independent standards to be accredited under the future emissions mitigation mechanism. As such, these standards could issue and verify Article 6 compliance units if requested, in addition to their own verified units when not issuing for a Party.

SECTORAL INITIATIVES

Responsible for about 2% of human-induced GHG emissions annually, the global civil aviation industry is currently designing its CORSIA programme to address emissions from international flights, which are not covered under the Paris Agreement. ICAO will determine which certification programmes, project types and credit vintages will be eligible for use under the scheme to address all increase in emissions above 2020 levels. Around 3 billion offset credits may be needed under CORSIA over its proposed lifetime (2021-35). Credit supply could range from as little as a few million units to as much several billion, depending on the final guidance to be adopted in the coming months.

Going forward, the demand for credits will very much depend on the supply available for voluntary offsetting

International shipping - also not covered under the Paris Agreement and a significant contributor to global warming, accounting for over 2% of global GHG emissions annually - will have its own long-term strategy. IMO is set to adopt guidelines in the near future to help meet its objective to cut emissions by 50% by 2050, compared with 2008 levels. Among the set of tools to meet this target, the launch of a market-based measure in 2023 could add significant demand for international credits.

VOLUNTARY DEMAND FOR INTERNATIONAL CARBON CREDITS

The Paris Agreement presents an opportunity for the private sector to step up and take a leadership role by helping to bridge the existing ambition gap. While the voluntary carbon market provides the tools to enable this climate leadership, sufficient progress on Article 6 will be needed to ensure the future Paris rulebook enables, incentivises and rewards voluntary action by the private sector. Voluntary carbon market issuances and retirements levels in 2017 set record highs and this growth looks set to continue in 2018. This shows the pivotal role of carbon credits as part of global corporate carbon management strategies.

Going forward, the demand for credits will very much depend on the supply available for voluntary offsetting, bearing in mind the need to address double-counting risks to ensure environmental integrity. The ambition gap is a call to action for many non-state actors and there is a growing momentum through voluntary initiatives, such as TCFD and Science Based Targets. Other initiatives, such as Nature for Climate involving WBCSD and the World Economic Forum's Gigatonne Initiative, are looking to create a strong commitment from the private sector to support investments in natural climate solutions, which has the potential to add substantial demand for carbon credits.

CLEAR SIGNALS TO UNLOCK POTENTIAL AND MAXIMISE AMBITION

Long term signals are needed for project developers to continue to fund the much-needed emission reductions that will make it possible to meet the objectives of the Paris Agreement. The current lack of visibility and incentives poses high risks and makes it difficult for developers to look to the future and invest at scale when the prospects are not clear. Among other issues, how the CDM's 7,000+ projects and billions of carbon credits will be treated under Article 6 is still a key question. Only strong demand signals can unlock this potential.

Likewise, voluntary market buyers are beginning to ask questions about future options available to source and retire credible carbon credits in order to continue to make strong claims, as part of their long-term carbon management strategies to bring down their environmental impact. Several pathways are being considered, and the rulebook expected at COP24 should provide elements of response.

Public finance alone will not enable the transition of developing countries away from fossil fuels. The mobilisation of private sector finance through robust carbon markets, underpinned by clear and transparent rules, needs to play an essential role in scaling up low emission practices. Business is eagerly waiting for the rules so it can get to work.