

SM58 | 2.26.2022

Demystifying the Carbon Markets | Episode 4

Peter Zaman, Partner HFW, Singapore

Peter Zaman, Partner at HFW, Singapore, sits down with David Greely for a deep dive into Article 6 of the Paris Agreement, how it allowed for more ambitious NDCs and the role of carbon markets in helping nations achieve those increased targets.

Announcer (17s):

Welcome to Smarter Markets, a weekly podcast featuring the icons and entrepreneurs of technology, commodities and finance, ranting on the inadequacies of our systems and riffing on ideas for how to solve them. Together, we examine the questions are we facing a crisis of information or a crisis of trust and will building Smarter Markets be the antidote?

David Greely (44s):

Welcome back to demystifying the carbon markets on Smarter Markets. I'm Dave Greely, Chief Economist at Abaxx Technologies. Article 6 of the Paris Agreement provides a framework for international cooperation in reaching climate targets, including the international transfer and trading of carbon credits between two or more countries. To understand the framework agreed to at COP26 last year in Glasgow, we figured it was time to call a lawyer, and I'm glad that lawyer is our guest today. Peter Zaman. Peter is a partner at HFW in Singapore and has been practicing law in climate finance and the environmental markets since 2004. Hello, Peter, welcome to Smarter Markets.

Peter Zaman (01m 24s):

Thanks David and thank you very much for inviting me onto the podcast.

David Greely (01m 27s):

We're very glad you could be here. Well, let's get started maybe a little bit of table setting. So under the Paris Agreement countries make commitments to reduce their emissions. These are called nationally determined contributions or NDCs. I think it'll be important for later to note that NDCs are more than just a numerical target. They're also a plan of action with specific steps to be taken and the Paris Agreement and Article 6 envision countries meeting their NDC targets not only through their own efforts, but through bilateral agreements and even a multilateral mechanism. So what is Article 6 specifically and can you walk us through each of these pathways?

Peter Zaman (02:12):

So just one point on your question about NDCs. I mean, yes, NDCs are more than just targets and they do, if you will take on non-GHG based targets, you know, for example, increasing a certain level of renewable energy generation in a country that's not a GHG target, but it's one that nonetheless sits within the NBC of a country, but the detailed plan, that's actually not in the NDC. So it's down to each individual country to determine how it's going to meet its NDC And that's kind of where Article 6 becomes relevant because until we had an Article 6, if you will, alternative being of offered in the Paris Agreement, I think people were in doubt as to whether or not carbon markets was a pathway available to them And that requires you to understand that despite the fact that the Paris Agreement came into force in 2016 after it was agreed in 2015 the reality is not all parts of the Paris Agreement were operational at the same time and Article 6, which is the market's provision Didn't become operational until COP26 in Glasgow.

Peter Zaman (03m 24s):

So as you say, it finally did become operational at the last COP and as a result of which we now have a market mechanism to enable countries to if they wish buy carbon offsets or other equivalent carbon credits or similar carbon credits from another country and by essentially buying those credits from another country, the theory is that they should be able to enhance their ambition under their NDC. So you take, you know, Singapore where I live as an example, it's a country that is quite developed. It basically has a limited number of options when it comes to increasing its renewable capability. It can't do nuclear because essentially if you imagine a little island like Singapore, if they have a nuclear disaster that would wipe out the country in one sweep. So they have limited options on what they can do to enhance their ambitions under their NDC.

Peter Zaman (04m 18s):

So you can see a country like Singapore over the course of time as it is obliged under the Paris Agreement to increase its NDC obligations being forced to find other ways to meet those ambitions and therefore it should over time be a net buyer of credits under Article 6 from other countries. So the market mechanism under Article 6 enables a country like Singapore to do that. So it can both meet its increased ambition obligations under the Paris Agreement, but at the same time, find an alternative to what would otherwise be a very, very difficult position for it if it had to do it all domestically. So Article 6 does that and there are two mechanisms in Article 6, Article 6.2, which is a bilateral or multilateral option that countries can negotiate amongst themselves. There are some guidelines published and agreed in COP 26, which those countries have to agree within but generally speaking the countries can decide what they want to do. Article 6.4 is a more centralized mechanism. It's a bit like the clean development mechanism that was developed under Article 12 of the Kyoto protocol. It's centrally managed by the United Nations Framework Conventional Climate Change and that secretariat will essentially develop and help create a centralized market where countries can bring projects or abatement opportunities to them and then that platform can issue credits and people come and buy from that platform. So that's essentially 6.4.

David Greely (05m 47s):

And one of the accomplishments at last year's COP was the making the rule book as you said, for the Paris Agreement operational and settling some of the key issues around Article 6, can you go into a little bit of depth of why is Article 6 so important to the Paris Agreement and why is it important to the carbon markets in particular?

Peter Zaman (06m 08s):

So the challenge of any country meeting its NDC and I use the Singapore example just now is always going to be that different countries have different circumstances. The reason why Singapore would want to need or depend on Article 6 is very, very different from why the European Union might want to need or depend on Article 6. So as you probably know, the European Union has said that they wish to be essentially a net to zero continent by 2050, and in the way in which they've envisaged them to getting there, they haven't at the moment said, they're going to rely on Article 6 because they essentially want to create the ability to achieve their net zero commitments on a self-sustained basis. So the EU has basically said, okay, there is an Article 6 markets, but I don't plan to tap into it that much other countries, Japan, Singapore, and a number of other countries are basically not as lucky.

Peter Zaman (07m 05s):

They don't have as much choice. So Article 6 is a lifeline to countries like those to be able to comply with their NDC ambitions and to enhance their ambitions as they're obliged to do under the Paris Agreement every five years, by relying on the Article 6 markets, but more fundamentally there are some countries where clearly the cost of abating a greenhouse gas emission is much higher and there are some countries where the cost of abating a greenhouse gas emission is lower. The idea, the logic behind having a marketplace is that the countries with the higher abatement cost can say to the countries with the lower abatement cost, I'm gonna pay you for that lower abatement cost opportunity. You sell your abatement cost opportunity to me and then use the proceeds from my sale to go and tackle the higher cost abatement opportunities that in your jurisdiction, you are struggling to otherwise fund. So the point of having an Article 6 market is it gives, it creates a framework within countries to have that conversation where countries can say, well, okay, you've got something I want, you know, a cheaper abatement opportunity. I've got something you want carbon financed to enable your higher abatement opportunity be funded. Why don't we come to an agreement on something and that's exactly why the Article 6 markets exist.

David Greely (08m 27s):

And when you allow for countries to begin to transfer the credit for an emission reductions between each other, that of course raises the key issue and what has been a key issue for Article 6, which is how do you avoid double counting those emissions reductions and which is done in Article 6 through the use of what are called corresponding adjustments. Now this would seem to be a rather straightforward accounting issue, but it's taken five years to reach an agreement. Why is it not straightforward in practice?

Peter Zaman (08m 57s):

Let me take you back a little bit to some of the background to how Article 6 came to be, because then that context will help you understand why it took five years. So the Paris Agreement when it was negotiated in 2015 at COP21 was an agreement that pretty much most things the parties agreed on in the end, but it was a tough one. It wasn't an easy one as you could imagine, it was the point at which everybody decided, okay, let's move away from the top down approach of the Kyoto protocols, CDM mechanism and what the Kyoto protocol otherwise was forcing a handful of countries to do and let's replace it with a we are all in it together bottom up

approach and that was great. The only problem in that was that nobody was that interested in a market mechanism and therefore Article 6 was almost an afterthought in those negotiations.

Peter Zaman (09m 53s):

It was literally an 11th hour sort of element that came into the negotiating documentation of the Article 6 text and when it was forced through at the 11th hour a lot of things were put in without necessarily expanding on them or thinking them through or elaborating on them. So we had words in Article 6 that didn't have any definition. So corresponding adjustment was a phrase used without any explanation, double counting was used without any definition. So essentially from COP21 onwards, till the time we get to COP26, what you have are people scratching their head saying, well, what does double counting mean, what does corresponding adjustment mean and of course as you do if you're sort of active in this space, there are political interests. There are think tanks and everybody has an opinion about it and over the course of the last four, five years, what we get is a different set of views given by a different group of academics or different think tanks or differently funded organizations who all come up with their opinion about what do you mean by double counting and what do you mean by corresponding adjustment.

Peter Zaman (11m 04s):

And actually all the multitude of thought processes did in the end was just create a lot of confusion. So I'll give you a couple of examples of how that came about. So if you think about the nature of what an NDC is, as we talked about earlier, it's the idea that a country commits to doing something as part of their contribution towards the overall Paris Agreement goals. Now, do all countries have the same Paris Agreement goals. In one sense yes, because we all want to reach the below two degree target, but actually do all countries have to have the goal reached at the same time and the answer to that is no, because there is a concept called common but differentiated responsibilities. So this is the idea that some countries were responsible for what we call today's climate change problem.

Peter Zaman (11m 53s):

And other countries traditionally considered to be more developing countries are being asked to not take the same path those other countries took in their own progression towards becoming a more successful economy. So, you know, we are asking countries don't burn coal, okay. I burnt coal for 40 years and I became a rich country, but no, you can't do that. So that's essentially what the Paris Agreement NDCs are all about and their concept of common, but differentiated responsibilities says that some countries are entitled to therefore burn more emissions today than other countries who are not entitled to burn more emissions today. So therefore the pathway taken by the countries who are allowed to burn more emissions is a different pathway from a timing perspective and an ambition perspective from other countries. So if you take the EU example, the reason why the EU is saying, no I will set myself a 2050 net zero target is because they are one of the people who got successful or one of the group of countries got successful burning coal and actually their chance or their window for burning coal should be over now, right. Now is the chance for the other countries to burn their own coal for a longer period of time. So the NDCs therefore recognize that different countries have different pathways and over different part time periods, which means that for the countries who are not taking the same pathway as the EU, there will be some aspects of their economy and some sectors or gases within their NDC that will not be included every time there is a new NDC. So there will be some things that are inside the NDC and some things that are outside the NDC.

Peter Zaman (13m 30s):

So the problem is that when you now talk about corresponding adjustments, first of all, nobody knows what the meaning of that term is and then they say well, corresponding adjustments should apply to only stuff that is inside my NDC. Other people say, no, no, no, no, no. If I let you apply corresponding adjustments to only inside your NDC, then you're never gonna expand the ambition levels of your NDC but you're gonna be flogging stuff that sits outside your NDC in the way Article 6 allows you to do and it creates a perverse incentive for you never to expand your NDC despite the fact that you have a legal obligation every five years to ratchet up the scope of your NDC under the Paris Agreement. So I'll tell you what we are gonna do. We're gonna insist that you apply a corresponding adjustment for things that are inside NDC as well as outside your NDC. Now, if you think about that logically, it doesn't make a lot of sense to say, you have to apply to a corresponding adjustment for something that is outside your NDC, because you're concerned of double counting. Why am I double counting, it doesn't fall within my NDC. So why would I be double counting it, but the principle as to why you do therefore apply corresponding adjustment is lost because you are leaving that logic and applying a different policy idea, which is to avoid the perverse incentive, to justify why you should overcome the logical gap over here. Anyway, where you get to eventually is different countries have different views about therefore what a corresponding adjustment is when it should apply and why it should apply.

Peter Zaman (14m 58s):

And because the context in which Article 6 sits is about ultimately economic growth and how many carbon, how much greenhouse gases you can burn in order to achieve that economic growth. Ultimately it becomes political and because it's essentially a political question that impacts trade, it becomes a very, very heated subject for most countries. So hence you get to the point where for four or about four or five years, we have multiple negotiations at the COP where we don't reach a conclusion on it mainly because there was no gun being pressed to the proverbial heads of any of the countries, because everybody could kick it down the road for another year. Then we arrive at COP26, where we are told that this is the defining moment. It's now never. If you don't do it now it's never gonna happen. You know, that we are running out of time, all of which is true, but people now feel the pressure to finally reach an agreement of some sort.

Peter Zaman (15m 55s):

And therefore they reach a compromise under Article 6 now, as with all political compromises, it's imperfect and it's imperfect especially because the two entrenched positions in the negotiating debate never, ever reached an agreement on whether or not each one of them was wrong or right. They all went into there and came out of COP26 thinking that they were both ultimately right and they were both ultimately wrong looking at the other side's position, but they all walked away with something that they could live with and that means logic didn't win the way a compromised deal won the way and in that compromised deal, essentially logic was a sacrificial lamb. So you landed up with something that if you thought about it, logically doesn't make any sense, but it is what it is and that is today's Article 6 and hence why so many people find understanding Article 6 so confusing.

David Greely (16m 47s):

I'm certainly counting myself among those, so very glad that you're here to straighten that out because you're right. When you first read through Article 6 and you say, well, you have to make a corresponding adjustment so that you don't double count something that you didn't count in the first place. It is a bit of a head scratcher, but as you said, it's not just accounting, it's politics and compromise, and that's a whole different thing. I'd like to take one more wrinkle at my own risk, which is the other twisted added to this Article 6 compromise was that whether it's designated under Article 6.2 or Article 6.4, a carbon project can be differentiated as being for use against one zone NDC international use, which is typically read to be like CORSIA or for the airlines, international airlines or some other use, which is often interpreted as corporate under Article 6.2, all three of those uses require a corresponding adjustment. However, at COP26, there was what's called the Japanese solution that allows a post country to issue Article 6.4 emissions reductions without a use authorization. And if they do it that way without a use authorization, they don't need to make a corresponding adjustment. Hopefully I said all that correctly now why was this done and why is it important?

Peter Zaman (18m 13s):

So one of the things that came up because of corresponding adjustment as a debate was whether or not you understand double counting to include a double claiming. Now let me explain what double counting is and let me explain what double claiming is before we get into that. So double counting is essentially where, for example, the same credit is being used twice in two different systems. So the same carbon offset is registered as a project under the Article 6 mechanism while also being registered under the voluntary markets as a Vera unit, for example, that's clearly the same thing being used twice and there's no debate that that is double counting. It gets a bit harder when you start saying, well, if I'm not registering the project twice and the unit isn't being registered twice, but in fact, it's being claimed twice, is that double counting now, because there was no generally accepted definition of double counting provided in the Paris Agreement and people therefore came up with their own ideas of what double counting means.

Peter Zaman (19m 23s):

If you look back at the definitions used by the voluntary markets, the gold standard and Vera as example, there was a time when they defined double counting to include what we today call double claiming and at some point there was a divide in the viewpoint between people who were following the Vera methodologies and people who were following the gold standard methodology. Gold standard said nope, we've said that this double claiming is always double counting and that's our position and Vera said, actually, I think we can make a distinction between Paris Agreement level accounting, which is what happens when countries have to report their GHG emissions and GHG abatements as part of their reporting obligations and the Paris Agreement and what we are saying is the use of these carbon units for corporate purposes under net zero claims made by corporates under various standards, like SBTi or under the Oxford Net Zero Principles.

Peter Zaman (20m 24s):

So from our perspective, I do think there is a difference between double claiming and double counting and we will amend our definition of double counting to now exclude double claiming. So Vera can therefore say that according to our standards, double claiming is not double counting, which according to the way they define, is currently true, but that doesn't change the fact that five minutes ago, you thought it was double counting and now you do think it's not double counting. So how did we get there and that requires you to sort of have recognize this shift then that is created between the negotiators who negotiated the Paris Agreement and the people who are five years later negotiating at Glasgow. Now very often what you find, particularly when you're dealing with government negotiating groups, is that rarely does anybody at the senior level, in an organization stay in one post for five years.

Peter Zaman (21m 19s):

Very often these negotiators are moved around between different organizations and different parts of government and if you're lucky, they'll be on post for three years before they're required to move on. So actually the people negotiating at COP26 for the large part were not the people who were negotiating at COP21. So they don't have historical awareness or historical memory to call upon what do we mean by double counting and what do we mean by corresponding adjustments. As we thought about it, back in Paris they're looking at it and says, well, I read this text and then it doesn't mean anything to me. It can mean whatever I want it to be. So again, if you are a government representative preparing for COP 26, and your minister says to you get me a briefing note ready on how to negotiate this when I turn up at COP26, they're gonna be looking at the same research papers that I've been referring to earlier on that have caused as much confusion as anything else between these different views.

Peter Zaman (22m 17s):

And then you come across Vera and gold standards debate about what do you mean by double counting and double claiming and that then if you will, has another impact in terms of how these negotiators go into these negotiations. So you go into these negotiations essentially with some historic memory, but not a lot of historic memory of COP21 and then you get into the negotiations with these informed views of what is double counting and therefore, you know, corresponding adjustment must apply to it and what is not double counting and it's only double claiming and that's okay and therefore you don't need to apply corresponding adjustment to it. So you get these two entrenched positions as you go into the negotiations. So everybody has their own view and nobody wants to accept that the other person's view is right, or there is merit to the other person's view.

Peter Zaman (23m 06s):

And it's again unfortunate part of where we are in history that we are actually in the context of the global politics no longer moving towards a unified view of the world, where everybody has entrenched views. You see that in domestic politics, in many countries, including in the United States. So you come into a room, a cauldron, if you will, of negotiators who are similarly likeminded, you know, they're just a reflection of what happens back at home and they're also similarly saying, well, I don't see why I should accept your view. There is no willingness, if you will, to understand the other person's position. So you did have a stale mate going into these negotiations and that stale mate lasted for the best part of 10 or 12 of the 14 days of negotiation and then you got to the point where somebody said, well, hang on, we've gotta find a way to break through this.

Peter Zaman (23m 57s):

And the Japanese came out with the idea that says, look, let's supply a corresponding adjustment to both inside and outside NDC. I know it's not logical and one of the consequences of applying a corresponding adjustment outside an NDC is that if you are a country hosting a project, even though your project sits outside your NDC and doesn't interfere with your NDC, you now have to apply a corresponding adjustment, even though it has no impact on your NDC. So you are giving something up that you don't have to give up logically or rationally, but you're being forced to give it up by the entrenched views of the other camp. So then the question is, well, why should I give it up without getting something else in return and what they got in return was the Japanese solution, which is to say, okay, you can use the Article 6.4 mechanism to have a project that is registered as a UN project and you can then have a third win bite, the cherry, where you don't have to authorize the unit for purposes that are expressly for the Paris agreement. You can use them if you will, for non-Paris agreement purposes, even though it's a project that is registered under 6.4 and if you do that, you don't have to apply a corresponding adjustment. Now one would say, well, why would they bother doing that, why not just go to the voluntary markets because that's the position Vera has adopted. So we just do it under Vera and actually, if you think about it from that selling country's perspective, that country has to think about where the market's gonna be in five years' time, we don't have a 6.4 or 6.2 market today. We might have one in about two years' time, but until we get that, we don't know what kind of price we are gonna get for credits under 6.2 and 6.4.

Peter Zaman (25m 46s):

What we do have a sense for what kind of price we might get in the volume markets today. So I need to hedge my bets, so one of the ways to hedge my bet is to basically have a UN mechanism, which has it on switch and an off switch and then if I turn the switch on, I'm authorizing it and therefore I get to tap into the Paris agreement markets. I have an off switch in which case I don't have to apply a corresponding adjustment and I get the same benefits that I would be if I was selling it in the voluntary markets. So from a country's perspective, the Japanese solution created optionality that it was losing with its inside NDC outside NDC commitment that it was making, even though it wasn't logical for them to do so,

David Greely (26m 23s):

That's fascinating and so we end up with multiple different ways that you can get a, a project into the market. So at the end of the day, what then are the implications of Article 6 as it stands for a country and its NDC, how does Article 6 affect a country's use of carbon financing and how do you think it affects what a country ultimately accomplishes in terms of reducing its emissions?

Peter Zaman (26m 49s):

If you think about it from the perspective of a particular country, it doesn't matter which country it is. Those particular circumstances of that country will be different by definition from the circumstances of its neighbor. Just to give you an example, Singapore has two immediate neighbors, Indonesia, and Malaysia. They have so much more natural resources than Singapore does that they can do things that Singapore has, can only dream of, right. If Malaysia decided that they wanted to invest in renewables, lots of solar with some offshore wind, theoretically, they could Singapore doesn't have that option. So ultimately what you have to realize for each country is that every country, when they look at their own economic circumstances, the stage of economic development they're in and the natural resources that are available to them, they have strengths and they have weaknesses and those strengths and those weaknesses translate into essentially the commitments that they're willing to make in as a country, under the Paris agreement in their NDC.

Peter Zaman (27m 50s):

So low abatement cost opportunities are easy to put inside your NDC because, you know, you can achieve those results without having to worry about how I'm gonna finance those results. We can do that. We can afford to do it as simple as that and there are things that sit outside their NDC, particularly if you're a country benefiting from the common, but differentiated responsibility principle, I mentioned earlier, where you can choose to keep things outside your NDC for now, for at least maybe 5 years or 10 years more, but those are your higher abatement cost items. So if you are smart about this as a country, what you do is you take the fact that you have under your circumstances, certain opportunities of lower cost abatement, for which you don't need international funding, but you can achieve that relatively easily and you over perform and theoretically could over perform on that.

Peter Zaman (28m 53s):

So if I take my inside NDC example, and let's say I'm a country that has adopted a 10% avoided deforestation target, right? I'm gonna reduce deforestation by 10%, but in fact, it's within my capability of achieving 15%, I can essentially afford to sell 5% abatement from my forestry sector because I can over perform by 5%, without too much effort. So that means that 5% of my forestry credits, even though it's inside my NDC can be sold because I can compensate for the shortcoming of that 5% from elsewhere. So if Article 6, then forces me to do a corresponding adjustment as the rules now do, if I ignore my Japanese solution, then the question is, well, okay, so I will have a 5% shortfall, but because I've sold 5% of my credits, how do I make up that 5% and your choices are over perform from inside your NDC or take stuff from outside your NDC and use that to compensate for the 5%.

Peter Zaman (29m 54s):

But if you look at what's outside your NDC, it was probably outside your NDC. It was a more expensive abatement anyway, then you've got to say, well, actually think about it. The corresponding adjustment is now costing me the more expensive abatement, because I have to bring that inside my NDC and because of that doing a corresponding adjustment is costly to me. If I don't have a corresponding adjustment, I save the benefit of that cost and by the way, if the voluntary market therefore pays for me to do that without a corresponding adjustment, I'll just sell it there. Of course, then the buyers in the voluntary market have to accept that they're comfortable with this double claiming versus double counting debate, but that's a view for them. So ultimately where you get to from an Article 6 perspective is if I'm going to have to do a corresponding adjustment and I'm therefore going to compensate for it by using things that are more expensive for me from outside my NDC, then by definition, a correspondingly adjusted credit has to be more valuable to me. So it boils down to is the Article 6 market paying enough for a corresponding adjusted unit for me to want to be able to

sell, if it isn't, I'm just not gonna sell it in the Article 6 markets, if it is great, I'll sell it there, but the price I'm gonna be expecting is gonna be much greater than the price I would expect in the voluntary markets.

David Greely (31m 15s):

And that's one important price difference that the legal structure of Article 6 introduces, but there are others so there'll be a legal distinction between an Article 6.4 emission reduction that has a user authorization and requires a corresponding adjustment in Article 6.4 emissions reductions without a user authorization that doesn't require a corresponding adjustment and a strictly voluntary market offset. I imagine we should expect all of these to have a price difference reflected in markets eventually relative to one another. Do you have thoughts on how they should price relative to each other?

Peter Zaman (31m 58s):

Look, the reality is going back to the point I was making about the cost of a corresponding adjustment. A correspondingly adjusted credit has to be more expensive than a non-correspondingly adjusted credit for the reasons I outlined. The question is, is the market willing to pay for that cost of corresponding adjustment. Now, if I think about the nature of a lot of the demand that we see in today's voluntary markets, these demands are based on an assumption that you would abide by your voluntary net zero commitment or your commitments under let's say the Oxford Net Zero Principles. The reality is their voluntary commitments and a company or a corporate wishing to make these commitments will have to recognize that that commitment comes at a cost. Different companies, depending on how good a year they're having or how bad a year they're having, or what circumstances they're in will find themselves saying, this is maybe not a good year for us to be buying these credits at \$25 a pop.

Peter Zaman (33m 01s):

Maybe I'll wait next year. Hopefully they'll be \$10 a pop and that makes more sense for me to buy at that point, because these are voluntary commitments. They're not forced to buy at the peak of the market. So actually, when you think about the demand side of these things, if the demand side is driven by pure cost considerations, people will say, well, I don't need a correspondingly adjusted credit. Why am I gonna pay more for a correspondingly adjusted credit just because somebody says that there's, you know, a country having to pay the price for it and what do I care about that as a corporate. If the debate however, is determined not purely on cost, but on overall questions, like do we want to be aligned with the way that the negotiators of the Paris Agreement view the idea of a double counting and corresponding adjustment and therefore we should pay for correspondingly adjusted credits then absolutely the cost of corresponding adjustments should be just the same for a voluntary market credit as it would be for Article 6 market because the buyers should be insisting in their credits being subject to a corresponding adjustment.

Peter Zaman (34m 06s):

Now at the moment, three months after the end of COP, we haven't yet got a uniform view from the market as to whether or not they believe that all voluntary market credits should be subject to a corresponding adjustment. You will be familiar with the fact that Mark Carney led a task force about scaling the voluntary carbon markets, which then became the ICVCM, which is essentially a body that is now established to consider what should be the principles and qualitative criteria applied to voluntary carbon credits. So the voluntary carbon credits issued by the various standards will have to meet certain core principles or core carbon principles as they call them. I'm very interested to know how the ICVCM views this question on corresponding adjustment, because if they take the view that corresponding adjustment is necessary in order for these credits to meet our stamp of approval, then low and behold, there should be less price differential between an Article 6 correspondingly adjusted unit and a voluntary market correspondingly adjusted unit.

Peter Zaman (35m 16s):

But the challenge for a voluntary market standard is that the voluntary standard cannot guarantee a corresponding adjustment themselves because it's not their gift, is the gift of the host country hosting the project. So the country isn't going to give up its corresponding adjustment just because Vera asks them to, there has to be a formal bilateral agreement between Vera or goal standard in those countries in order for that corresponding adjustment commitment to be taken on by the host country and I don't see that much progress being made by either of those two organizations to try and achieve that result. So perhaps they're waiting for the ICVCM to determine the outcome of the core carbon principles on this point and then maybe they're going to do something about it, but that's a wait and see issue and actually a very, very big question mark for the ICVCM. So let's see how they resolve that one.

David Greely (36m 10s):

Yeah, it certainly seems like a big unsettled issue and as we said COP26 made the Paris rule book operational, but it certainly sounds like it didn't finalize it and it's, you know, not the final word. Are there other big issues that you're looking at that remain unsettled in the legal framework regarding the carbon markets and Article 6?

Peter Zaman (36m 31s):

When I think about the conversations I have with my clients on a day to day basis, it's really about which direction do we go. You commit for a lot of these carbon abatement opportunities and projects for a five plus year period. So you've got to look five years forward to work out where you're going to be in five years' time and whether or not you're gonna be able to recoup your investment from the efforts that you're putting in today. So nobody wants to enter into a contract that is gonna fail in five years' time. So everybody needs to know what the world is gonna look like in five years' time and that's very hard to do today because as you say, Article 6 is theoretically alive, but not really functioning because we don't have the bilateral frameworks for Article 6.2 cooperative approaches in place. We don't have the Article 6.4 centralized market up and running, and that's gonna take two years to put in place.

Peter Zaman (37m 28s):

So how do we envisage the world in five years' time when we don't have anything to compare the voluntary markets to today. So essentially the voluntary markets by default are the only game in town, but that equation changes in two years' time or three years' time and when that changes, how do these deals look in five years' time, that's basically the conversation I'm having with most of my clients. So the answer is flexibility. You've got to keep available the choice and the alternative for you to redefine or reregister your activity from the voluntary standard into the Article 6 standard or vice versa if you believe one or the other is going to be better and that building in that flexibility is important because if you don't build it in now, when you turn around in three years' time and try to speak to your counterparty and the counterparty is sitting on a sweet deal at that point, you basically won't have any leverage to have a conversation about it.

Peter Zaman (38m 24s):

They're gonna hold you to your contractual obligation and either you're gonna perform or you're gonna breach and if you perform great, but you'll be unhappy about it and if you're breaching, then of course, you know, we lawyers get more to do off the back of that. The point really is, is that you want to create optionality because we are probably in a transition period over the next five years, we're gonna see the ramping up of the Article 6 markets with a parallel growth and progression in the voluntary markets and at some point potentially these two markets converging and people then next ask me, well, which year is that gonna happen and the best I can guess is probably around 2025. I don't think it will fully converge before then, but there are ways in which the voluntary markets are relevant for Article 6, even today.

Peter Zaman (39m 10s):

So if you think of two countries agreeing some kind of bilateral country framework, where one is the buying country and one is the selling country they have to agree what methodologies they're gonna buy credits for. They're gonna have to agree how the units are gonna be issued. They're gonna have to agree who will verify these units and either they have to agree that completely from scratch bilaterally or they piggyback off an existing standard, like the gold standard or Vera or the VCs standard and the benefit of that is that Vera and gold standard then become plug and place solutions to allow these countries under Article 6.2 to create multilateral or bilateral frameworks much, much more quickly than if they had to create everything of their own from scratch. So there is another role to be played by Vera and gold standard and other standards out there to enable the 6.2 growth to happen separate from the 6.4 growth.

David Greely (40m 06s):

And so bottom line, what is the impact of Article 6 on the voluntary carbon markets. It sounds like there's the impact today and then the potential impact down the road.

Peter Zaman (40m 18s):

Obviously the market has to decide and by the market, I mean the voluntary market has to decide from a demand perspective, how important corresponding adjustment is to them. If they decide one way, then the market goes in a direction of everybody having to do correspondingly adjusted transactions and that if you will really strengthens the call for the Paris agreement markets if the market decides that actually we don't want, or don't feel the need for corresponding adjustment, then the solution that says we'll do this without a corresponding adjustment means the voluntary market has a completely different offering to the Article 6 market. So for me

the division point between voluntary markets and Article 6 markets becomes from a voluntary market consumer perspective this question about corresponding adjustment. If I care as a consumer about corresponding adjustment, I don't really have much choice in the voluntary market today because as I was saying, it's not the gift of the voluntary standards to provide corresponding adjustment that's the gift of the countries and the countries in their negotiations under the Paris Agreement have said, that's what I have Article 6 for why do I need Vera, right.

Peter Zaman (41m 31s):

So essentially that's where in my mind, the fault lines will be determined and in that sense, that's why the decisions made by an organization like the ICVCM is so important because they are essentially going to become the standard bearers or one of many standard bearers in this market and the corporate buyers are gonna have to take their lead from them not because the corporate buyers are forced to, but every corporate buyer will have to find a justification for why it's done it and it's gonna point towards the direction of a standard body like the ICVCM and say, because they said it was okay.

David Greely (42m 08s):

And that's such an important perspective because I think it's easy to look at Article 6 as a participant in the voluntary carbon markets and say, well, it's not ruling us out. It's not impacting us directly, but it is raising the issue of even if it doesn't impact you directly, do you need to care about things like corresponding adjustments because are the stakeholders that are leading you to make these commitments in the first place, going to care about corresponding adjustments and how, what you're doing fits into the overall framework of what countries are doing under Paris. So, you know, while it can often be difficult and I thank you for walking us through the legal intricacies, they're very important for everyone to understand and before I let you go, I can't help, but try to get one last free piece of legal advice out of you, one more attempt to get you to look into your crystal ball. If I'm a corporation or a large institution, and I'm looking to use carbon markets to help meet my net zero commitments, what's the key risk that I need to be aware of, you know, as it pertains to Article 6 and what should be on my radar screen as I'm looking to move forward.

Peter Zaman (43m 19s):

I think if you look at it from a corporate's perspective, given the voluntary nature of what they're doing, there's going to be what I call a tradeoff between the cost of that commitment and the reputational concerns of being accused of green washing. If you bear in mind, those two equations, the ideal position is something that is robust enough, but also cheap enough. That's the truth. So all corporates are going to aim for, I imagine that middle ground, the challenge for the voluntary markets and organizations like the VCI, and, and ICVCM is can they deliver that middle ground to their audience. If they can deliver that middle ground to the audience, then from a risk perspective, a lot of the voluntary market risk disappears, but the biggest risk for the voluntary market today is actually the same risk that the countries have, which is if you are a country looking to meet your NDC commitments and are dependent on buying Article 6 credits and the voluntary market also decides that they want to be buying Article 6 credits because they want correspondingly adjusted credits then the countries are now competing with their own corporations for essentially the same credits. And they're fighting over the same pricing terms.

Peter Zaman (44:58)

Now the private sector pays more than the government sector. So essentially the private sector wins that the government then starts thinking, actually, I don't want to get into a price war with my voluntary market buyers. So, you know what I'm gonna do, I'm gonna find a way to grab the carbon offsets that they're claiming for net zero purposes and one of the ways for me to do that is to regulate them so that they are obliged to do this and then they give up the credits to me and then I use it towards my NDC and if that happens then as a voluntary entity you are in a slightly more challenging position because now you are essentially from a legal perspective obliged to manage your scope, one scope, two emissions within that jurisdiction and it's only your scope three emissions that sit outside your jurisdiction, that you are now focused on for the purposes of your offset needs and your offset demands, but you're buying it from a country that may be thinking the same thing, which is I'm gonna regulate the corporate in my entity, in my jurisdiction for their scope, one scope to emissions, which basically means you don't really have anywhere to go to get the units that are not subject to a regulated framework.

Peter Zaman (46m 09s):

So the biggest danger for the voluntary market is that essentially the competition that they generate with the countries leads to a position where the country is by default when they realize they're losing that competition from a pricing perspective, say we are gonna regulate it because that's the only way for us to achieve our ability to meet our NDCs and yet get somebody else to fund that for us.

David Greely (46m 29s):

Thanks again, to Peter Zaman from HFW in Singapore, we hope you enjoyed the episode. Join us next week with David Shipman a journalist and the former science editor for the BBC, where he spent 20 years reporting from the climate front lines.

Announcer (46m 53s)

That concludes this week's episode of Smarter Markets by Abaxx. For episode transcripts and additional episode information, including research, editorial, and video content, please visit smartermarkets.media. Smarter Markets is 100% listener-driven so please help more people discover the podcast by leaving a review on Apple podcast, Spotify, YouTube, or your favorite podcast platform. Smarter Markets is presented for informational and entertainment purposes. The information presented on smarter markets should not be construed as investment advice. Always consult a licensed investment professional before making investment decisions. The views and opinions expressed on Smarter Markets are those of the participants and do not necessarily reflect those of the show's hosts or producer. Smarter Markets, its hosts, guests, employees, and producer, Abaxx Technologies, shall not be held liable for losses resulting from investment decisions based on informational viewpoints presented on Smarter Markets. Thank you for listening and please join us again next week.