COP28

The clock is ticking: Climate change and voluntary carbon markets

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In January 2023, the Science and Security Board of the Bulletin of Atomic Scientists moved the arms of the Doomsday Clock to 90 seconds to midnight, the closest to Doomsday since the clock was started in 1947. The main reason for resetting the clock was the threat of nuclear catastrophe related to the Russian invasion of Ukraine, but climate change and the multilateral failure to prevent its worsening consequences also figured into their decision. According to the Bulletin's digital magazine's November issue, one impediment to effective climate action is to limit the framework for action to the current facts, rather than to expand the framework in terms of what the future requires.

Government and intergovernmental regulatory help for Voluntary Carbon Markets

The Doomsday Clock is a device for drawing public attention to an emergency whose imminence is difficult to imagine. Government action on climate change, however urgent, operates over a longer time scale. The U.S. Commodity Futures Trading Commission's (CFTC) guidance on Voluntary Carbon Markets (VCM), released on December 3, and the VCM consultation document of the International Organization of Securities Commissions (IOSCO), published on December 4, are well anchored in their current legal and diplomatic authorities. Notwithstanding this anchorage, the market for Voluntary Carbon Credits (VCCs) is restricted. For example, according to United Nations Secretary General's High-level Expert Group's standards, businesses are prohibited from using VCCs to achieve their net-zero emissions commitments. Despite governments' support for VCMs, promised growth in VCC sales has been inhibited by litigation and reputational risk concerns due to numerous reports about VCCs that fail to deliver promised climate benefits.

Comment deadlines are February 16 for the CFTC guidance and March 3 for the IOSCO consultation paper. (IATP commented on both an IOSCO consultation on VCMs and on the CFTC Request for Information on climate change and derivatives trading.)

The IOSCO paper was presented at COP28 in Dubai on a panel discussion on how to improve the credibility of VCM markets in the jurisdictions of IOSCO's dozens of government regulators. One challenge for both organizations is to ensure that trading on VCMs "support[s] emissions reduction efforts," per the CFTC draft guidance. (p.8) If trading derivatives contracts, for which the underlying assets are VCCs, fail to support emissions reductions (and more long-lasting

Institute for Agriculture & Trade Policy

Written by Dr. Steve Suppan, December 2023

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emissions removals), then we are one tick closer to Doomsday.

The efforts to align VCMs with the Paris Agreement may make it difficult to hear that tick. If the negotiators of the Article 6.4 "market mechanism" manage to resolve many disagreements about rules to authorize credits for sale from governments to the private sector, one analyst has argued, "voluntary offsets without a corresponding adjustment [to prevent double counting of climate benefits by buyer and seller] could actually threaten the credibility of the VCM and undermine the Paris Agreement." (p. 19)

U.S. political context of the CFTC guidance

One telltale hint that the CFTC guidance is limited by fear of U.S. congressional reaction is the following comment on the guidance by Chairman Rostin Behnam: "These markets [VCMs] present an opportunity for the agricultural economy that historically underpins the need for derivatives markets for risk management and price discovery, but they also provide a useful tool throughout the financial markets and the real economy." This comment makes little sense in relation to the content of the guidance, except that the CFTC is overseen by the U.S. congressional agriculture committees, which have not reauthorized the CFTC since 2008 to undertake new regulation and studies concerning hundreds of new contracts that trade on vastly greater and more complex markets than those of 2008. (IATP wrote to the Senate agriculture committee in 2013, the last time re-authorization was attempted as a title (chapter) in the Farm Bill.)

If the agriculture committee majorities read the CFTC guidance as operating outside of the Commodity Exchange Act (CEA) and CFTC rules, exposing the CFTC to the allegation that it has become a "climate regulator," then reauthorization and the larger CFTC budget to implement CEA amendments with additional personnel and computer infrastructure will be endangered. The Chairman's sales pitch that VCMs might benefit "the agricultural economy" is based neither on the content of the guidance nor on the exchange trading of current VCCs derived from agricultural soil carbon sequestration projects, which is non-existent in CFTC regulated markets. Instead, the Chairman is appealing to a speculative future, in which soil carbon dioxide sequestration will overcome its low VCC integrity to become a reliable underlying asset of CFTC-regulated futures contracts.

Exchanges are to ensure the compliance of emissions offset futures contracts with CFTC rules

The 42-page guidance assigns to the Designated Contract Markets (DCMs, or the exchanges on which derivatives contracts based are traded) the responsibility for ensuring that the carbon derivatives contracts transactions comply with the CEA and the CFTC's Core Principles, such as ensuring that contracts offered for DCM trading are not susceptible to fraud or to market manipulation. DCMs are self-regulatory organizations that self-certify that their contracts comply with the CEA and all Core Principles. (Only very exceptionally do Commissioners formally review a proposed new contract and disapprove it, as they did in September with the Kalshi exchange contract on the political party control of each chamber of Congress.)

The DCMs should demonstrate that the VCCs sold by offset crediting programs such as Verra, and which are the underlying assets of DCM emissions offset futures contracts, are of such a categorical quality as to comply with the CEA and Core Principles. Throughout the guidance, the CFTC refers to the VCC quality programs of the Integrity Council for the Voluntary Carbon Markets (ICVCM) and VCC derivatives contract language proposed by the International Swaps and Derivatives Association (ISDA). Although neither ICVCM nor ISDA is proposed as a self-regulatory organization (SRO) to which the CFTC delegates some of its authority, both organizations have a de facto SRO status in the guidance. If the DCMs attest that their contracts for emissions offset futures rely on VCCs that have received the ICVCM "high integrity" label, the CFTC may assume that no further examination of the VCCs is required.

IOSCO Good Practices: a means to globalize VCMs

The 82-page IOSCO paper recommends Good Practices that "are addressed to relevant regulators and other authorities and market participants and look to offer support to/in jurisdictions that have established or may be seeking to establish VCMs." (foreword) The paper takes about 30 pages to introduce carbon market basics to its member government regulators who may not be familiar with VCMs but whose countries may host land-based emissions offset projects from which VCCs are derived. (CFTC Chair Behnam is also the IOSCO Vice Chair.) IOSCO's 131 "ordinary members" are the most likely users of these

Good Practices but dozens of associate and affiliate member regulators might use them, too. In sum, the implementation of these Good Practices is a potential force multiplier for globalizing support for VCMs.

The third chapter outlines VCM "potential vulnerabilities" of the VCCs issued for purchase, how they are traded on secondary markets, how the VCCs are used and how that use is reported. The fourth chapter summarizes feedback received in response to its November 2022 VCM discussion paper. The fifth chapter outlines "other initiatives" in support of VCMs, including the ICVCM standards for improving the environmental and financial integrity of VCCs. Commenters are asked to respond to consultation questions concerning each of the 21 Good Practices.

Good Practices are at a high level of generality to be applicable to the variety of regulatory jurisdictions and capabilities of IOSCO members. IATP believes it is very important for public interest groups to respond to IOSCO's analysis and questions, if only to help prevent the IOSCO-characterized "potential vulnerabilities" of VCMs to be exacerbated if VCMs expand geographically and scale up in volume and value of VCC trading.

Answering CFTC guidance questions about what it does regulate

The CFTC's jurisdictional focus enables the draft guidance to identify issues and ask questions with a higher degree of specificity. However, in a footnote, the CFTC warns, "For the avoidance of doubt, this proposed guidance does not address the regulatory treatment of any underlying VCC or associated offset project or activity." (p. 21) The CFTC guidance will not be directed to the regulatory treatment or lack of treatment of emissions offset projects that have failed to comply with rules or standards concerning the environmental and/or social integrity of the projects or VCCs derived from them.

However, despite that categorical regulatory exclusion, the guidance poses critical questions about the listing by exchanges of VCC derivatives contracts under themes concerning the environmental and sustainable development performance of the underlying assets of those contracts. For example, the CFTC asks, "Are there particular criteria or factors that a DCM should take into account when considering, and/or addressing in a contract's terms and conditions, whether there is sufficient transparency about credited projects or activities?" (p. 39) If a DCM offers a futures contract that cannot clearly explain the underlying credited projects or activities, should such a contract be allowed to enter into trade?

Or consider how to respond to this question: "How should DCMs treat contracts where the underlying VCC relates to a project or activity whose underlying GHG emission reductions or removals are subject to reversal?" (p. 40) Reversal risk is inherent in land-based emissions offset projects, e.g., because of floods or wildfires. DCMs will have to attest in their self-certifications of VCC derivatives contracts that VCC verification program buffer accounts fully and adequately compensate for the reversals. (Emissions offset project developers contribute a certain number of offset credits to a verification program buffer account for the project to compensate for the scale of the emissions reduction reversal estimated in metric tons of carbon dioxide.)

If such attestation is not part of the "terms and conditions" of the DCMs' self-certifications of VCC-based derivatives contracts, the CFTC will have reason to formally review the contract for approval or disapproval. Public interest groups accustomed to a technical discussion of emissions reversals should advise the CFTC on how reversal risk affects the reliability of the VCC as an underlying asset of a VCC-based derivatives contract.

Don't give in to climate fatalism: respond to the CFTC and IOSCO requests for comment

In our October 2022 letter, IATP advised the CFTC not to propose guidance or a rule on VCMs before having published a staff study that would represent the CFTC's state of knowledge about VCMs and how that status report might inform any guidance or other regulatory action the CFTC might propose. Instead, the CFTC chose to hold two VCM roundtables, featuring almost exclusively VCM proponents, to present the state of knowledge. If we are not to become fatalistic about our future under climate change, responding to the IOSCO and CFTC questions may contribute to reversing a bit the clock that is ticking on our ability to prevent the worst of climate catastrophes.