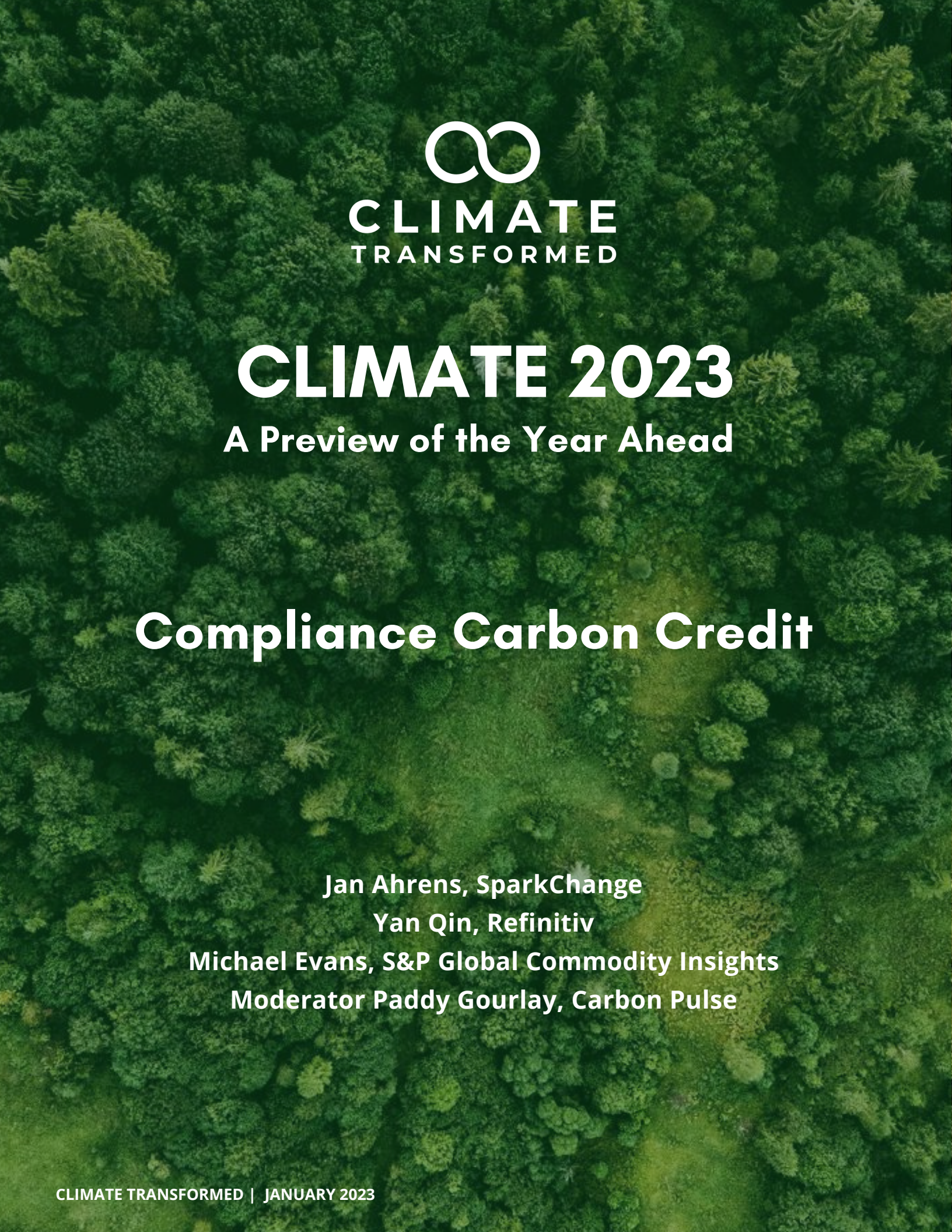

CLIMATE 2023

A Preview of the Year Ahead

Compliance Carbon Credit

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Michael Evans, S&P Global Commodity Insights
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Compliance Carbon Credit

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Summary

This session dives deeply into the outlook for compliance markets in 2023 and focuses on the challenges facing compliance carbon pricing, such as European energy dislocations, climate policy changes in the United States and the effectiveness of a spluttering Chinese compliance market. **Watch the full session here.**

Key takeaways

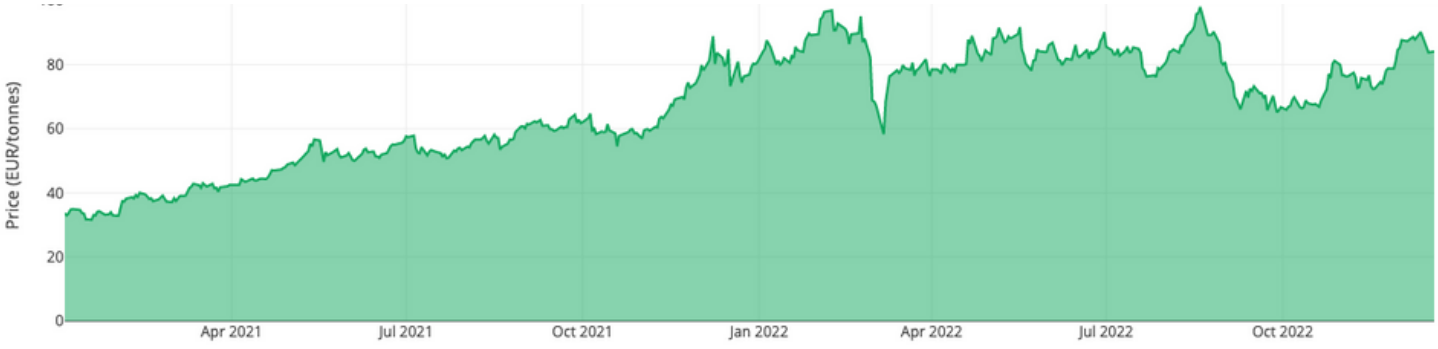
- The Carbon Border Adjustment Mechanism (CBAM) will be the most discussed global carbon initiative in 2023. This is effectively a global carbon tax that ensures that importers into the EU have paid the equivalent carbon price based on the EU Emissions Trading System (ETS). Viewed by many as a protectionist measure, it will be vigorously debated and challenged. That said, the implementation transition will last until 2032 at the earliest, so there are no near-term market implications.
- China and Turkey will be significantly affected.
- China's ETS market continues to evolve and expand. Its coverage of the 4.5 gigatonnes of utility emissions makes it the world's largest market, but it has a long way to go.
- The quest for a common carbon price remains elusive. Voluntary offsets remain the cheapest way to express a tonne of carbon, but this market remains illiquid and controversial. Compliance markets continue to dwarf voluntary markets in terms of liquidity and scale.
- The fragmentation of the Voluntary Carbon Markets (VCM) and the difficulty in assessing the environmental integrity of those projects are problematic. However, this is where compliance markets have the most significant advantage in that they are standardized, regulated, and much more significant in scope. The path towards a merger of compliance and voluntary looks inevitable in the next 5 years.

Paul's observations

We often hear from activists that we are not moving quickly enough regarding the economic transition toward a decarbonized global economy. I am no activist, but it is obvious that policy measures such as the CBAM will not help us reach the 2050 Paris goals if implementation periods are a decade. I am not passing judgment on the efficacy of the CBAM as a tool for decarbonizing global supply chains, but it will not influence production methods if the punitive costs of the CBAM don't come into full effect until the mid-2030s. Also, even if it works, the benefits of decarbonizing supply chains only have 15-20 years to take effect, which is negligible in the scheme of things. Either we implement change, or we don't, and the EU is proving yet again that it wants economic sustainability but is not prepared to disrupt its economy. It doesn't work that way, and hence EU climate policy will fail if it continues with strategies for hedging all negative consequences of this economic transition. The debacle that is EU energy policy exemplifies this. Compliance market credits need to play a role in global investment portfolios. Given the regulatory tailwinds such as the CBAM and the desire for higher carbon prices, passive exposure to liquid compliance credits such as California or the EU ETS is essential. It not only gives you the benefit from rising prices but also a hedge against rising carbon costs for portfolio companies. Between 1% to 2% of your portfolio in compliance credits is prudent. Exposure to VCM credits is much more speculative, but voluntary markets are the cheapest expression of a tonne of carbon.

"Either we implement change, or we don't, and the EU is proving yet again that it wants economic sustainability, but is not prepared to disrupt its economy."

EU ETS futures prices Jan. 2021 – Dec. 2022



Source: Ember

Questions & Answers

What is the Carbon Border Adjustment Mechanism (CBAM)?

Michael Evans:

The CBAM is an EU initiative designed to address carbon leakage in which a business might decide to relocate operations outside of a jurisdiction that does not run a carbon pricing mechanism to avoid paying related costs while gaining the benefit of accessing that market. The CBAM will do this by issuing free allowances to sectors most at risk of doing that in the EU market.
The CBAM is outward-looking in that it will take the EU carbon price as a reference, and an equivalent price adjustment will be made for anyone seeking to import particular goods into the EU market. Whether a carbon price has already been paid for producing that good will be considered under certain conditions deemed by the European legislatures. They will then require importers to pay for a CBAM certificate to meet the difference between the two carbon jurisdictions. The concept already exists in California, but the EU proposed in their Fit for 55 reforms to include CBAM, which will be of a different magnitude to what we have already seen in California.
It is a controversial measure that is still the subject of negotiation between the European Parliament, the EU Commission, and the European Council. While it is intended to be designed as an environmental initiative, it could also be seen as a protectionist trade measure, so it potentially comes up against World Trade Organization (WTO) compatibility. It has significant implications for some of the largest exporting countries to the EU. Before the Russian invasion of Ukraine, Russia would have been significantly influenced by this. China and Turkey will be most at risk of being affected by those higher CBAM costs.

"The CBAM is outward-looking in that it will take the EU carbon price as a reference, and an equivalent price adjustment will be made for anyone seeking to import particular goods into the EU market." – Michael Evans

What is the timescale for us to see the CBAM introduced?

Michael Evans:

There is the process of agreement, and then the process to implement it. The hope is that the negotiation process will conclude before the end of 2022*. CBAM costs will be incrementally increased, and at the same time, EU ETS allocations will be decreased so that a carbon price is then paid by the participants in the EU market as well as by anybody selling into the EU market from outside. The European Council has proposed a 10-year timeline for that transition from 2026-2035. The European Parliament, through its

**The EU Council released a statement regarding the agreement on December 13. Learn more here.*

internal negotiations proposed 2027-2032 implementation. While negotiation continues regarding this contentious point, businesses that will be significantly affected are thinking about their long-term hedging needs and opportunities, which we are starting to see translate into the EU carbon price at the moment.

How will the rest of the world react to the CBAM?

Yan Qin:

Market experts in China oversee the CBAM process, as a sudden implementation would have a massive impact on China's export economy. The Chinese government is opposed to CBAM, seeing it as a barrier to trade, and China considers action on climate change as a multi-lateral process.
Enterprises have asked me how carbon tonnage will be calculated to calculate CBAM and whether their use of renewable energy could be deducted from CBAM cost. There is some concern, but the EU is the biggest market for most of them. In preparation for CBAM, some companies have progressed their carbon accounting.

Is this contra to the Paris Agreement in that Europe is exerting an influence that no longer leaves it to individual countries to manage their emissions reductions?

Jan Ahrens:

In theory, every country has its way of decarbonizing its economy, and only some go for carbon markets. As a result, close to 80% of global emissions still need to be priced. In some countries, companies may be forced to reduce emissions by meeting fuel standards, such as the US, which does that on the federal level. But, those countries are then in a difficult situation when there are cross-border initiatives such as CBAM. If the EU continues with a carbon price of $80 or more, the risk of leakage is higher with companies in regions outside of Europe with lower carbon prices.
The idea of CBAM is to create a level playing field, but as companies can deduct the domestic carbon price from the EU price, there is a strong incentive for the 80% of emissions that are not priced to then think about carbon pricing.
Other countries are considering similar initiatives, albeit moving more slowly than the EU, including Canada, the UK, Japan, and China. As carbon markets pop up, governments want to protect their domestic industries. In the end, there is a tension between protecting your industry by creating a level playing field and, on the other hand, leaving every country to make their decarbonization measures, which might not include a carbon price.

"If the EU continues with a carbon price of $80 or more, the risk of leakage is higher with companies in regions outside of Europe with lower carbon prices." – Jan Ahrens

Is there an alternative to CBAM?

Michael Evans:

The idea of a global harmonized carbon price gets mentioned a fair bit. However, we do not see that developing. It might not be appropriate for a single carbon price because abatement is moving at different paces in different economies, targeting other sectors and putting that investment into very different technologies. The political challenges of putting together carbon markets in the regulatory space are particularly complicated. However, some linked markets have managed to cooperate, which has helped harmonize carbon prices across jurisdictions. Still, to take the EU and Switzerland as an example, it was a 7-year negotiation to get that in place.
Policymakers want to move to action now. CBAM is a long-term opportunity because free allocation over the last 15 years has often worked out against the principle of incentivizing industries to reduce emissions. Within the EU, there is concern about the reduced free allocations, and manufacturers are already asking for the export rebate, so if they export to a country with a lower carbon price than the EU, they would claim a discount or benefit back. It may seem beneficial to EU exporters, but it would weaken the concept of CBAM, creating a level playing field.

How will this affect companies that import into the EU?

Jan Ahrens:

Our modeling shows that corporates within the EU are far more affected by CBAM than companies outside the EU because most of their emissions are in Europe. They are generally selling into the European market, so they are more affected by European carbon pricing than a company that exports a tiny share of their products into the EU. EU companies will no longer have spare allowances to trade or sit on. The free allocation has shown that some EU companies are much more carbon efficient than others. As free allocation is reduced, some will feel more pain than others.

What sectors in China will be most affected by CBAM?

Yan Qin:

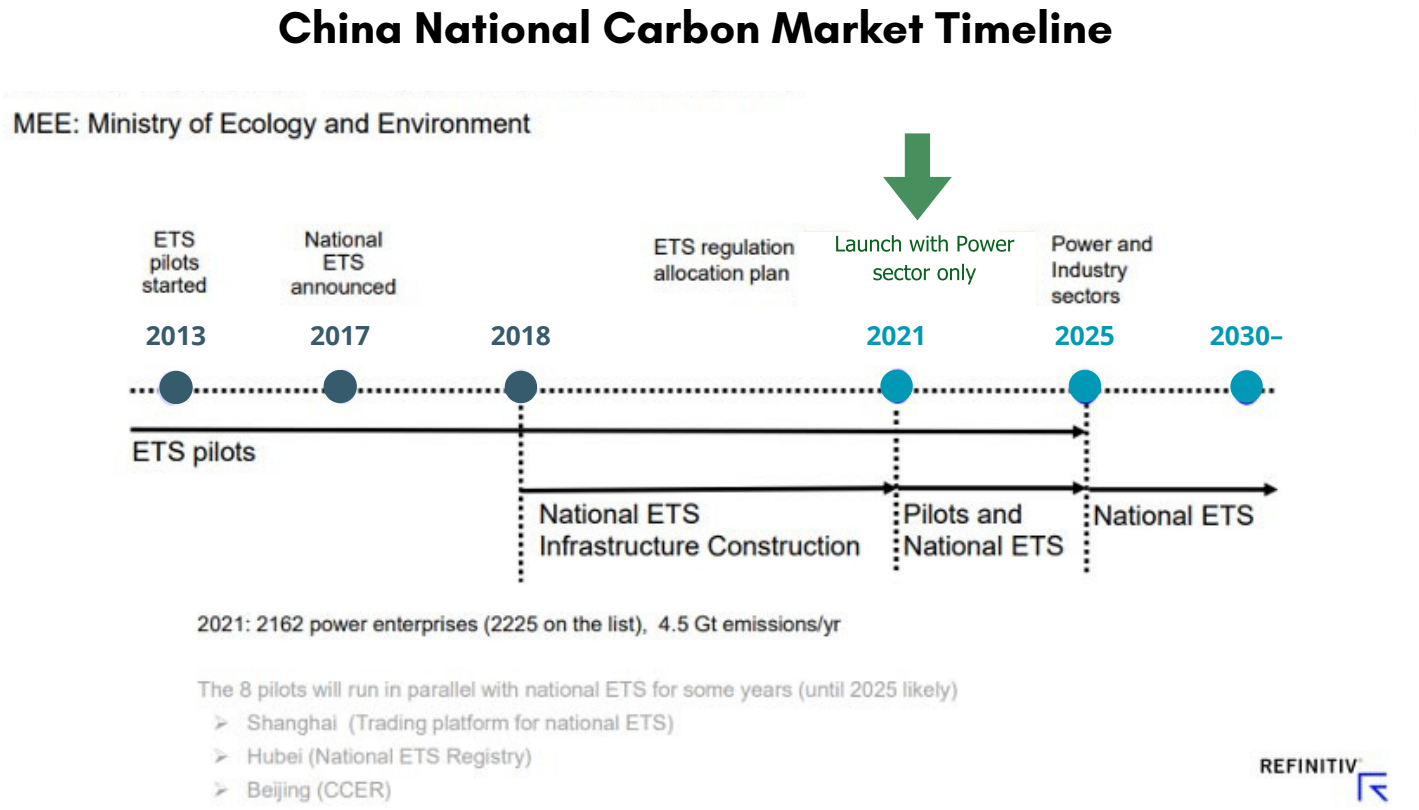
The electronics sector is watching CBAM closely. Raw products and manufactured products will all be affected.

How is China's National ETS doing, and what is the timescale to get off the ground?

Yan Qin:

China's national ETS started trading last year and is trading now at around 7 or 8 euros per tonne. It covers the power sector, with yearly emissions of around 4.5 gigatonnes, making it the largest ETS. However, daily trading volumes of ETS allowance are very low. This has improved in recent weeks, but there have been days in which only 10 tonnes are traded. The low liquidity may be due to circumstances in which free allowances are handed out.

The ETS is about to enter its second compliance period, and we are waiting for clarity on what that will look like. It will end in Q4 2023, so there is around one year for companies to achieve compliance.



Source: Refinitiv

Domestic China Certified Energy Reduction (CCER) and ETS

Yan Qin:

For the first compliance period, enterprises can use domestic offsets for 5% of their compliance obligation. That domestic offset is China Certified Energy Reduction (CCER), and the issue is that the scheme was suspended in 2017. Alongside the China ETS, the domestic CCER is being relaunched as the National Voluntary Emissions Trading Exchange (NVETE). However, it has yet to be launched, so no new domestic allowances have been released.
The demand for domestic offset under the national scheme is significant, but there needs to be more supply.

Is it desirable that a national ETS brings foreign credits into its system?

Michael Evans:

It builds on the level of development of the different markets being put in place worldwide. We have some emerging in Asia if we look at where voluntary credits can be used towards compliance with market obligations. Mexico launched a pilot ETS that accepts up to around 10% of domestic credits. There is a

risk that different jurisdictional areas set up different thresholds. But, the VCM is looking to work collaboratively globally to develop credit integrity and initiatives.
They are using offsets to help emerging markets build a price signal and liquidity, promoting confidence in both compliance and voluntary markets. The EU ETS has been clear that the VCM has no place in that market, perhaps because previously, Clean Development Mechanism (CDM) credits were accepted, leading to oversupply and price depression of the EU ETS price. That weakened the carbon price signal in the EU for a few years.

Jan Ahrens:

Carbon markets exist to deliver emission reductions at the lowest cost. So, if the companies in the market have high emissions costs but there is a cheap way of reducing emissions outside of the market, why not give companies the opportunities to reduce costs and feed into the benefits of VCMs? The VCM is not a standardized market, and there is a hot discussion about which credits reduce emissions on an ongoing basis. If the VCM were to merge into an Article 6.4 market, credits would only be allowed where there are emission reduction adjustments in the project host country. If the EU allows this credit, it gets used in a compliance application, and the host country increases its ambition. Overall it is still cost-efficient.
The fragmentation of the VCM and the difficulty in assessing the environmental integrity of those projects are problematic. However, this is where compliance markets have the most significant advantage in that they are standardized, regulated, and much more significant in scope.

Michael Evans:

Removal-based credits such as carbon capture might play a vital role in the future of the European market. The EU has already looked into the possibility of building removals into the design of the EU ETS, as has the UK.

Does it cause a problem if different markets allow different kinds of credits?

Jan Ahrens:

Different regions have different carbon pricing for a whole number of reasons. There is a lot of talk about fairness, which is not productive. There are many good reasons that a market may want to use offsets, but either way, environmental integrity is critical.
Investment decisions are driven by the stability of prices over the next 10 or 15 years. Today's price is less important than the sense of trust and conviction that there will be increasing carbon prices and the ongoing ambition to decarbonize. So, companies will assume higher carbon prices in their investment decisions. Therefore, markets must be predictable and have high ambition.

Could VCM offset play a part in China's ETS?

Yan Qin:

When the China ETS includes all sectors of Chinese industry around 2025, even 1% of compliance via VCM offsets would be an enormous volume for the global VCM.

Are investigators and speculators good or bad for the VCM?

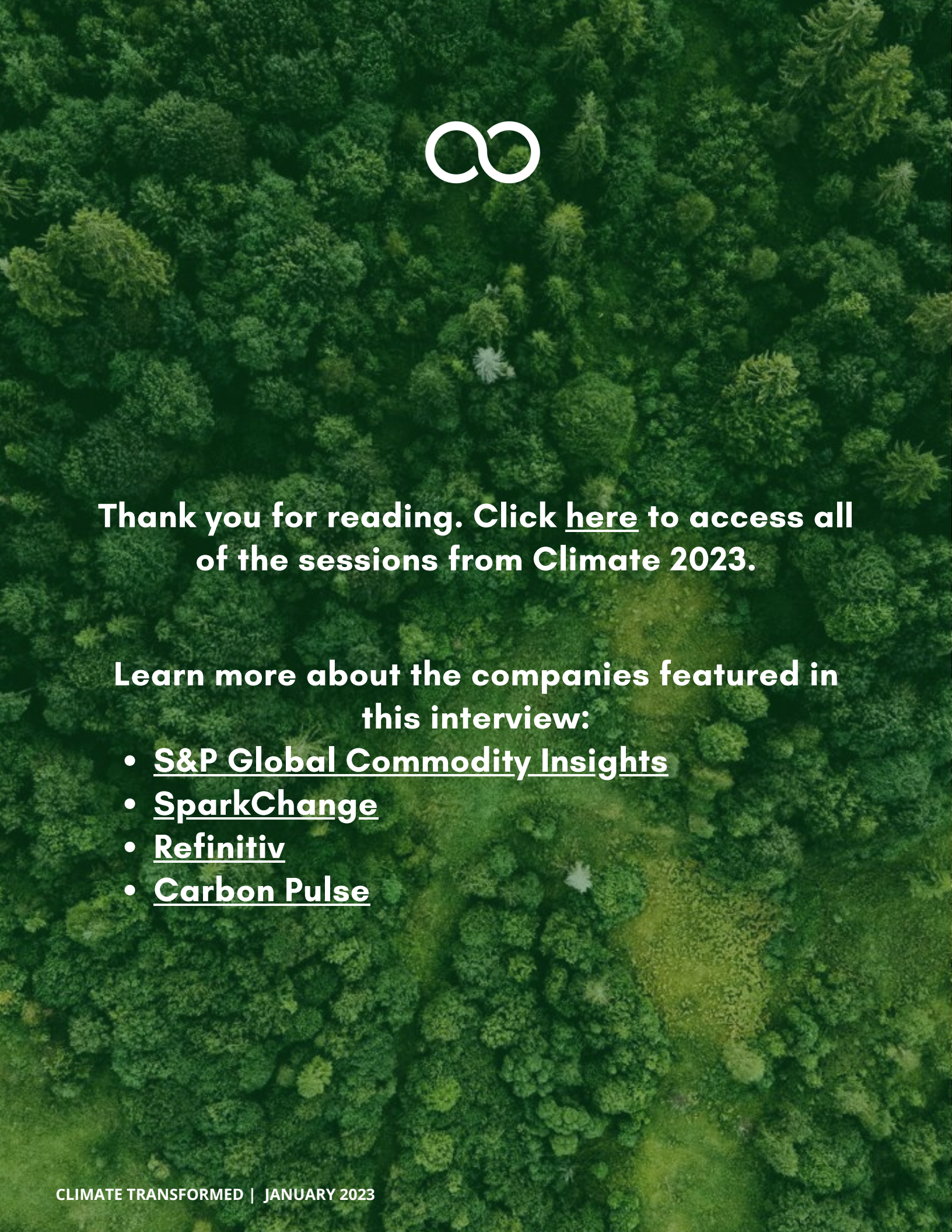
Jan Ahrens:

Predictability and long-term conviction are crucial to market success. Unfortunately, the volatility we have seen this year is not helping the market because investors do not know what figure to consider when making a long-term investment decision.
Short-term speculators expand the volatility, increasing the highs and accentuating the crashes in value, which is not beneficial to the market. On the plus side, they provide liquidity and price discovery, but short-term activity is generally harmful to the market.
The EU ETS is small in volume yet accounts for 90% of global trading. This is because it has a very liquid secondary market, particularly a futures market. That futures market is backed by companies who buy spot allowances and issue futures against them. These are usually not compliance companies but investors. Some long-term institutional investors hold portfolios that include cement companies, steel companies, etc., and therefore may be negatively affected by rising carbon prices. They want to balance their portfolios by adding carbon allowances as an asset class but hold them over a long period.
Credits can be used to balance negative carbon price exposure. In addition, they are an uncorrelated asset with a reasonably attractive return profile that makes sense financially. They buy an asset if they think it is underpriced and sell it if it is overpriced. By holding offsets for an extended period, long-term institutional investors increase the market's overall efficiency by triggering decarbonization efforts and providing stability because they position themselves strategically according to market movements.

How can we bring more institutional investors into the market?

Michael Evans:

The UK launched its scheme with a cost containment mechanism, including publishing a price at which policymakers would release a statement on whether it would be an intervention. In addition, the EU negotiation includes whether or not to have an automatic trigger of allowances released to stabilize the market if prices are deemed to be accelerating too fast.



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