



The incentives in the IRA pave a path for corporate buyers to step up action and advance climate-related commitments.

The IRA also opens new pathways to transfer private capital into renewable projects. For example, the IRA includes updates to a tax credit located in Section 45Q of the Internal Revenue Code. This credit incentivizes the use of carbon capture, utilization and storage (CCUS) technology. The updates increase the credit values for qualifying technologies, thus increasing the incentive to use these technologies. Further, the updates allow 45Q credit recipients to transfer all or any portion of the credit value to any third-party tax-paying entity in exchange for a cash payment during the credit window. Beyond monetization of 45Q credits, these updates also have the potential to advance the VCMs. Projects utilizing CCUS technology may have the opportunity to sell carbon credits into the market representing their carbon abatement. Thus, if more businesses adopt CCUS technology due to the favorable tax treatment under 45Q, this may also lead to an increased supply of carbon credits, and therefore increase trading, in the VCMs.

The IRA introduces new tax credits and clean energy financing for a range of clean energy technologies, including clean hydrogen, nuclear, storage, carbon capture and sequestration, and electric vehicles. These incentives not only drive investment into the development and deployment of new, emerging technologies needed to drive grid decarbonization, but also provide voluntary buyers with more options to meet their own climate and sustainability goals.

As the voluntary markets are expected to serve a growing role in fulfilling carbon emissions commitments, it is likely that regulation in this space will also increase. Boards of directors and executives, as well as other participants in these markets should keep a close eye on legal and regulatory developments as they consider their use of carbon credits and offsets as part of overall emissions reductions targets and strategy ■

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(Source: Cleary Gottlieb)

The global carbon markets need to be more strictly regulated

Governments around the globe have made commitments to limit global warming and reach net zero carbon emissions by 2050 in order to deliver against the targets of the Paris Agreement. Carbon markets have a significant role to play in helping to achieve these commitments by enabling governments and organizations to more effectively manage emissions and emissions reductions limits.

Financial sector regulation of carbon emissions, trading and disclosure will develop given the fundamental need to reduce gross carbon emissions to manage the financial risks of climate change. In the short to medium term, carbon markets will become more highly regulated, in order to introduce greater consistency, reinforce the integrity of sustainability disclosures, and respond to stakeholders' expectations that sustainability information should be transparent and comparable.

Mandatory and voluntary markets

Carbon markets exist as mandatory (compliance) schemes or voluntary programs. Emissions trading schemes (ETS) usually fall into the first category, with participants identified by governments based on carbon intensity, sector or size. The EU ETS is the world's largest cap and trade scheme, covering just over a third of the EU's GHG emissions.

Under these schemes, a limit (cap) is set on the total amount of certain GHGs that can be emitted by the companies covered by the scheme. The cap is reduced over time so that the total permitted emissions fall. Within the cap, companies buy or receive emissions permits (or allowances) which they can trade with one another as needed. At the end of each year, companies must surrender enough allowances to fully cover their emissions or incur heavy fines.

Conversely, baseline-and-credit mechanisms (also known as carbon credit schemes) are largely voluntary and have typically grown organically to meet the demand from organizations which seek to manage their carbon footprint. These schemes allow the purchase or sale of "carbon credits", which represent a standardized unit of carbon (1 ton CO_{2e}) being either removed from the atmosphere or not produced. While ETSs cap the amount of carbon that can be emitted by an organization, carbon credit markets allow companies to manage the impact of their emissions more proactively.

Voluntary markets function independently of compliance markets, and the credits traded cannot be used to meet the legal and regulatory obligations placed on organizations by compliance markets.

Increasing the legal and regulatory for carbon markets

The global landscape for carbon markets has developed rapidly leading to a patchwork of regulations and standards. Standards are heavily influenced by organizations operating in the voluntary markets. Mandatory frameworks are also being reviewed. Therefore, Carbon Border Adjustment Mechanism



(CBAM) would address the risks of so-called “carbon leakage”, where firms take advantage of less stringent and more favorable carbon credit rules to move emissions outside the domestic market, potentially undermining climate efforts. The CBAM would equalize the price of carbon between domestic and imported products.

Under its July 2021 Fit for 55 initiatives, the EU put forward a comprehensive set of changes to the EU ETS which aim to drive a reduction of 61% in overall emissions from certain sectors by 2030. This would be achieved by strengthening the current provisions (including aligning the EU ETS cap with net zero) and extending the scope of the scheme, for example to the maritime transport sector. The package also introduced an EU CBAM which is more advanced in its development than the UK CBAM, having been approved by the EU Commission in March 2022 for phasing-in from 2023 with charges applied from 2026.

Activity from financial regulators is also picking up. ESMA delivered its final report on the EU carbon markets in March 2022, in response to a request by the European Commission for an analysis of European emission allowances (EUAs) and derivatives on EUAs. ESMA’s policy recommendations include measures to provide more information to market participants, regulators and the public such as: Extending position management controls to EUA derivatives; Amending EUA position reporting; Tracking the chain of transactions in the Markets in Financial Instruments Regulation (MiFIR) regulatory reports; Providing ESMA with access to primary market transactions.

More broadly, the International Organization of Securities Commissions is undertaking a review of the weaknesses of voluntary carbon trading schemes and is developing an assurance framework for sustainability-related information.

Regulators take a greater role in supervising carbon trading frameworks

Increasing requirements to make corporate sustainability disclosures and demonstrate progress towards net zero commitments, including through transition plans, may influence organizations’ participation in carbon credit markets. The International Sustainability Standards Board’s (ISSB) first two draft standards propose that net zero transition plans be published by all firms, although the pace and scale of adoption is as yet unclear. In March 2022, the Taskforce for Nature-related Financial Disclosures (TNFD) published the prototype framework

that encourage firms to understand and disclose the dependencies of their risks and opportunities on nature, including the sequestration (capture and storage) and release of carbon into the atmosphere.

However, carbon credit markets should only form one part of a wider strategy towards decarbonization and transition. The not-for-profit association Carbon Market Watch notes that carbon markets are about national limits and not about the decarbonization of individual firms, and it has called for a better approach to accelerate the transition, rather than simply passing emissions allowances around the system through offsets.

Guidance has been issued on where corporates should and should not be using voluntary credits. For example, the Science Based Targets Initiative (SBTI) makes it clear that carbon credits should not count as a reduction in carbon emissions against science-based carbon targets, but that they could be used to neutralize the impact of residual emissions once those targets have been achieved, or to finance the reduction of GHG emissions outside of the organization’s own value.

Within the patchwork of frameworks and national regulations, the cost of a unit of carbon emissions can vary significantly. Some of the highest prices are seen in Europe, while developing nations tend to charge less. The introduction of CBAMs represents a significant step towards leveling up carbon prices. However, as regulators take a greater role in supervising carbon trading frameworks, it will be important that they set suitably ambitious prices to encourage the transition away from carbon-intensive operations.

There is not yet an accepted, consistent methodology to define and calculate carbon assets and liabilities. The work of the ISSB may help to define these concepts, driving comparability between trading schemes and paving the way for assurance over carbon metrics.

Voluntary carbon trading frameworks raise another important issue - how to be certain of the existence of carbon units being traded, for example, how to confirm that a carbon offsetting project in a remote part of the world actually exists and isn’t being double counted. Assurance of this information is complex, and without it, a firm engaging in carbon trading could suffer reputational damage or become liable for carbon taxes which it believed it had already offset. Formal adoption of voluntary frameworks into national rules could help delineate responsibilities and reduce the opportunities for inaccuracies and fraud.

The scope of formal regulation looks set to increase. The EU ETS remains the largest carbon market in the world and as such could drive standards. Whichever jurisdiction is first to issue rules may set the ton of regulation globally, with other frameworks either aligning with or building on what has come before. Where firms are already participating, or plan to participate in carbon markets, it will be important for them to engage proactively as regulation evolves ■

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(Source: KPMG International)