PRI RESPONSE

IOSCO CONSULTATIONS ON COMPLIANCE CARBON MARKETS (CCMS) AND VOLUNTARY CARBON MARKETS (VCMS).

14th February 2023

ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI Executive welcomes the opportunity to respond to the Board of the International Organization of Securities Commission (IOSCO)'s call for feedback on developing fair and functional carbon markets.

ABOUT THIS CONSULTATION

On November 9, 2022, coinciding with COP27, the International Organization of Securities Commission (IOSCO) launched a 90-day public consultation and two papers on Compliance Carbon Market (CCM) regulation and Voluntary Carbon Market (VCM) design. Carbon markets are an important mechanism to facilitate the transition to net zero, that have proliferated in recent years but have not yet been scaled to their full potential to combat climate change.

Responses to this consultation will inform IOSCO as it aims to support the successful development of carbon markets and facilitate society's transition towards net zero through engaging with private actors. PRI Association has consulted with some of its signatories, but the view and opinions expressed in this document do not necessarily represent the views of the contributors to the briefing or any signatories to the Principles for Responsible Investment (individually or as a whole).

For more information, contact:

Edward Baker

Head of Climate & Environment Policy

edward.baker@unpri.org

Elise Attal

Head of EU Policy

elise.attal@unpri.org

Ashmeet Siali

Associate, Net Zero & Climate

ashmeet.siali@unpri.org

Rafael Silvestre

Specialist, Financing Net Zero Transition

rafael.silvestre@unpri.org

KEY RECOMMENDATIONS

The PRI Executive welcomes IOSCO's work to develop sound carbon markets that are well-equipped to achieve their core environmental objectives. Carbon markets are a necessary tool to achieve net zero and IOSCO's work in this area signals their growing relevance. Although carbon markets have proliferated in recent years, there is still work to be done to unlock their full potential.

The two primary types of carbon markets, compliance and voluntary, come with their own challenges and possibilities. In Compliance Carbon Markets (CCMs), governmental bodies issue carbon emissions allowances which indicate the maximum amount holders are permitted to emit. Conversely, Voluntary Carbon Markets (VCMs) are largely unregulated currently. In VCMs, entities buy carbon offset credits form emissions-reductions projects to offset their own carbon emissions. As the conditions underlying these markets differ, PRI Executive has two sets of key recommendations to capture this nuance.

The PRI's Executive key recommendations regarding CCMs are:

- **PRI Executive broadly agrees with the principles and recommendations in the consultation.** Regulations are important and encouraged to ensure CCMs behave more like established commodities markets and operate with the principles of accountability, standardization, predictability, oversight, and trust. However, regulations alone are not wholly sufficient for scaling these markets and delivering on climate policy goals; appropriate and effective design of carbon pricing policy instruments are also essential.
- **Improving the design of CCMs.** CCMs are an important mechanism to reduce emissions by putting an absolute cap on emissions and a price on real assets and by being directly linked to a nation's real emissions. To ensure maximum efficacy and minimal drawbacks, PRI recommends carbon markets follow the design principles put forward by the UN-convened Net Zero Asset Owners Alliance (NZAOA)[1]: coverage and ambition, delivering a just transition, providing a predictable price signal, minimizing competitive distortions and international cooperation.
- **The linking of compliance carbon markets has potential benefits, such as increased liquidity and price stability, but it should not be rushed.** Care is needed to ensure that the linking of schemes between countries does not undermine the integrity of the emissions cap and market design. As per the EU approach, there should be criteria for assessing the feasibility of linking schemes, which should be evaluated in a public impact report.
- **The linking with voluntary carbon markets is not recommended at this stage** until there is evidence that the underlying issues of these commodities, referred to below, can be addressed.
- **PRI Executive encourages and supports the close collaboration of IOSCO and its members with national climate and environment ministries** to design and scale

[1] https://www.unepfi.org/wordpress/wp-content/uploads/2022/06/NZAOA_Governmental-Carbon-Pricing.pdf

mandatory carbon pricing schemes consistent with the goals of the Paris Agreement. The end goal would be to achieve market standardization between CCMs and VCMs, and ensuring that they are transparent, verifiable, and robust.

The PRI's key recommendations for VCMs are:

- **Distinguish between market integrity and climate policy integrity.** The regulation of commodity markets, including secondary carbon markets, is needed to ensure transparency and deter market abuse. Yet, these markets are intended not only to meet financing objectives, but also to reduce GHG emissions. Thus, the regulation of how VCMs operate would not address the underlying issues of the commodity for investors, namely: the variable nature of credit quality, the need for exclusive rights to an asset (additionality), and the permanency of emission reductions. Other important factors to consider include ensuring against carbon leakage and having strong social as well as environmental safeguards.
- **Companies and financial institutions should be focused on reducing their own and their supply chain emissions directly.** To meet net zero ambitions and limit global average temperature rise to 1.5C, carbon offsets should not be used to meet near to mid-term achievement of net zero targets, as set out in the UN-convened Net Zero Asset Owner Alliance 3rd Target Setting Protocol[2] and related position paper[3]. PRI Executive recommends aligning with the Oxford Offsetting Principles, which state that an organisation should 1) first seek to reduce emissions; 2) where offsets are used, purchase high quality credits; 3) disclose accounting practices where offsets are use; and 4) revise offsetting strategy as practices improve.
- **IOSCO to continue to raise awareness and build capacities among its members to create transparency and help ensure integrity of the carbon market.** PRI Executive recognizes and supports the role of IOSCO and its members in promoting greater transparency and transaction integrity of voluntary carbon markets. This may include setting clear markers to identify low-quality credits, increase market oversight, and point out greenwashing efforts.

---

[2] NZAOA 3rd Target Setting Protocol 2023 https://www.unepfi.org/wordpress/wp-content/uploads/2023/01/AOA-Target-Setting-Protocol-Third-edition.pdf

[3] NZAOA "The net in net-zero" paper, September 2021 https://www.unepfi.org/wordpress/wp-content/uploads/2021/09/AOA_Negative-Emissions.pdf..

The Science Based Targets Initiative also do not allow for the use of carbon credits to count towards net-zero targets, see page 7 of their criteria available here https://sciencebasedtargets.org/resources/files/SBTi-criteria.pdf

RESPONSES TO RELEVANT QUESTIONS

REPORT ON COMPLIANCE CARBON MARKETS

Question 1: What are the benefits and risks of linking frameworks? How can these benefits be enhanced, and these risks be mitigated?

PRI Executive broadly agrees with the benefits of linking emission trading schemes (ETSs) referenced in the consultation report, notably the potential for improved cost effectiveness, liquidity and price stability as well as a means of raising policy ambition between countries internationally. Yet, care is needed to ensure linking schemes do not undermine the integrity of the scheme's emission cap, due to difference in market design, the risk of sudden oversupply of permits, and/or differences in emissions baseline, verification and enforcement (penalties for non-compliance). As such, the drive to link ETSs should not be rushed. There should be clear and robust criteria for linking compliance schemes, as the EU has set out,[4] followed by a public feasibility and policy impact study. This would help to ensure that the integrity of climate policy is supported and not undermined.

However, this approach should not apply to linking CCMs and VCMs. VCMs have traditionally been characterized with concerns related to permit quality, additionality, and permanence. Until there is evidence that such issues can be addressed, linking voluntary and compliance markets risks adding complexity and is not recommended.

Question 2: What should be the conditions underpinning a decision to link frameworks?

PRI Executive supports the approach taken in the EU, referenced in the consultation, to have clear criteria for considering the suitability of linking two countries' schemes. Namely:

- system compatibility (i.e., the systems have the same basic environmental integrity, and a tonne of CO_2 in one system is equivalent to a tonne in the other system – CO_2e);
- the mandatory nature of the system; and
- the existence of an absolute cap on emissions.

A public feasibility and policy impact report should be published to evaluate the suitability of schemes against the above criteria. Frameworks should only be linked when all of the above are met.

Question 3: Do you agree these IOSCO principles are appropriate for carbon markets? Explain your response.

PRI Executive agrees that the IOSCO principles are relevant for financially traded commodities, including carbon markets. However, while greater market transparency is necessary and important, it is insufficient to grow and scale CCMs. For this, appropriate and effective design of carbon pricing policy instruments are essential. PRI and the UN-convened Net Zero Asset Owner Alliance identify

[4] https://climate.ec.europa.eu/eu-action/eu-emissions-trading-system-eu-ets/international-carbon-market_en

five key market design principles for scaling carbon pricing that we recommend are incorporated into CCM design. They are as follows:[5]

1. **Ensuring appropriate coverage and ambition**: Carbon pricing instruments should be implemented across more countries and expanded to cover more sectors, entities, and GHG emissions where feasible. As of 2021, less than 5% of global GHG emissions were covered by a carbon price that is consistent with reaching a 1.5 C target. More policymakers should consider implementing carbon prices that are legally binding and set in line with science-based evidence. Jurisdictions with existing systems should consider expanding coverage and ramping up ambition to provide a sufficiently high long-term price signal.
2. **Delivering a just transition**: Carbon pricing will impact a wide range of sectors, markets, and businesses. In some cases, the shifts in economic activities driven by carbon pricing may be concentrated in disadvantaged communities. Policymakers should design carbon pricing instruments to reduce or compensate for these impacts. For instance, revenues raised from carbon pricing can be used to support communities and households disproportionately impacted by these instruments through retraining, lump-sum transfers, or broader policy changes like reducing income taxes.
3. **Providing a predictable price signal**: Certainty over the broad trajectory of carbon prices allows for a planned and orderly transition to a low-carbon world. Both types of carbon pricing instruments can be designed to provide this type of certainty. Carbon taxes can have a steadily increasing rate that is announced well in advance. Similarly, ETSs can be designed to include market stability measures including price floors, ceilings, or corridors, to avoid excessive price volatility and provide a predictable increase in price signal over time. Cross-party commitments and corresponding legislation can help increase long-term reliability so the private sector can be assured that the schemes will be followed through.
4. **Minimizing competitive distortions**: Carbon leakage results in a failure to achieve desired environmental outcomes and a loss in domestic competitiveness. Carbon pricing policies should be designed to avoid leakage by implementing appropriate and targeted protective measures for trade-exposed emissions-intensive firms. These measures, however, must still maintain the incentive to abate. Existing systems have used output-based free allocations for targeted sectors, or Carbon Border Adjustment Mechanisms (CBAMs) to minimize competitive distortions.
5. **Promoting international cooperation**: International cooperation on carbon pricing is needed to raise ambition and meet the Paris Agreement goals. Governments can cooperate in several ways, including through linking of ETSs, knowledge transfers, or setting up international 'climate clubs' where members work together to encourage robust carbon pricing.

Question 5: Do you agree the rules currently in place across key jurisdictions are helpful for the scaling of carbon markets?

- *5.1.1. Rules of general good conduct, such as the prevention of conflicts of interest*
- *5.1.2. Rules to promote transparency, oversight, and monitoring of trades*

[5] https://www.unepfi.org/wordpress/wp-content/uploads/2022/06/NZAOA_Governmental-Carbon-Pricing.pdf

- *5.1.3. Rules to prevent fraud, insider trading and price manipulation.*

These three categories of rules put in place across key jurisdictions are helpful for scaling carbon markets, as evidenced by their success in non-carbon markets. Comparable categories of rules for non-carbon securities markets have resulted in greater oversight, transparency, and predictability and will have similar applicability to carbon markets. Beyond improving the functionality of these markets, these rules play a valuable role in increasing public trust, encouraging investor adoption, and providing regulators with greater recourse.

However, while the key jurisdictions' rules overall can be classified into the same three categories, there is significant variation among the actual rules themselves. PRI Executive encourages fostering some level of consistency between various national CCMs to create interoperability between markets and to reduce vulnerabilities, such as carbon leakage.

Question 7: Are the recommendations appropriate for the compliance markets?

- *Recommendation 2:* To foster fair, stable and competitive markets, relevant authorities in charge of primary market issuance should place greater reliance on auctions over free allocation

The PRI Executive agrees with this position and has previously suggested public auctions as an important tool to strengthen and expand ETSs[6]. Auctions increase liquidity and facilitate price discovery, both of which can help carbon markets work more efficiently. At the same time, to facilitate greater reliance on auctions, mechanisms should be put in place to reduce the risk of carbon leakage and, consequently, the number of free permits issued.

Beyond benefits for the market, auctions also provide additional revenue for policy makers issuing credits. PRI Executive recommends that these revenues should be invested in renewable energies, energy efficiency, deployment of new clean technology in hard-to-electrify sectors, just transition, international climate finance, and other climate-related measures.

- *Recommendation 7: Relevant authorities should encourage the scrutiny of auction performances*

The PRI Executive supports this recommendation as a measure to increase oversight and transparency of carbon markets.

[6] https://dwtyzx6upklss.cloudfront.net/Uploads/m/i/l/eu_ets_consultation_pri_summary_response_final_64097.pdf

REPORT ON VOLUNTARY CARBON MARKETS

Question 2: Has the consultation identified the relevant vulnerabilities? Are there any others that should be considered? Please explain

The PRI Executive agrees relevant vulnerabilities have been identified. The PRI Executive welcomes the inclusions of vulnerability 3.1.1., carbon credit quality, and its three subpoints of 3.1.1.1 (additionality and lack of standardized methodology to calculate the baseline scenarios), 3.1.1.2 (permanency and risk of reversal), and 3.1.1.3 (risk of carbon leakage of greenhouse gas emissions). These vulnerabilities create market distortions, reduce transparency, and erode trust in the market, and increase the likelihood of greenwashing by carbon market participants.

To reduce the impact of vulnerabilities, PRI Executive recommends investors and companies follow a hierarchy of actions as described in Principle 1 of the Oxford Principles for Net Zero Aligned Carbon Offsetting[7]:

- **Cut emissions:** Firms should not use carbon credits to obtain net zero targets in the short or medium term. Instead, firms' primary priority should be reducing their emissions.
- **Use high quality offsets:** When offsets are used, they should apply an accurate, conservative baseline; ensure additionality; include measures to fully address the risk of reversal; minimize and account for leakage; and consider unintended consequences.
- **Disclose current emissions, accounting practices and targets to reach net zero:** Organizations should disclose all emissions within their sphere of influence, avoid double counting reductions, and convert climate impacts of short-lived gases, such as methane, into their equivalents in terms of carbon dioxide, which is a long-lived gas.
- **Regularly revise offsetting strategy as best practice evolves:** Principle 1 reflects current best practices, but this may change as more information becomes available.

The topic of co-benefits, i.e., protecting or increasing biodiversity, restoring or enhancing ecosystem services, reducing pollution, improving health or labour market impacts, etc., is of growing importance to investors. Further research is needed to better identify, assess, measure, and standardize such additional benefits.

Question 3: What kind of role could IOSCO play in coordinating the actions of industry specific organizations and public authorities?

PRI Executive recognizes and supports the role of IOSCO and its members in promoting greater transparency and transaction integrity of voluntary carbon markets.

Question 11: What other key considerations may be necessary in order to scale up carbon markets?

When regulating voluntary carbon markets, players are aiming to ensure both market integrity and climate policy integrity. PRI Executive recognizes the importance of regulating the carbon commodities markets to ensure transparency, deter abuse, and create accountability. However,

[7] https://www.smithschool.ox.ac.uk/sites/default/files/2022-01/Oxford-Offsetting-Principles-2020.pdf

creating market integrity does not address the underlying issue within VCMs, which concerns the ability of carbon offsets to create permanent, high quality, and tangible emissions reductions.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of IOSCO on supporting the successful development of carbon markets globally.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org