

## **An Investor's Perspective on the Voluntary Carbon Market**

### **By David Brand and Marisa Meizlish**

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Long before there was a Kyoto Protocol or an EU ETS, carbon transactions were occurring. The earliest deals (related to forest conservation and reforestation) began in the late 1980's. Through the 1990's the retail and voluntary markets<sup>1</sup> grew slowly, but certain key developments began to emerge. Companies whose entire business focused on carbon markets were born, including EcoSecurities, Future Forests (now CarbonNeutral), Natsource, CO2e.com and Evolution Markets. The concept of green power, linked with renewable energy and tree planting programs as an offset for automobile and air travel emissions began to develop.

While the overall carbon market shuddered for two or three years after the withdrawal of the United States from the Kyoto Protocol, the retail and voluntary markets continued to diversify. The Chicago Climate Exchange (CCX) was established in 2003 as the first voluntary carbon credit market. Retail carbon companies proliferated, and there are now more than 30 worldwide. On the demand side, the concept of businesses offsetting some or all of their emissions has become mainstream (e.g. HSBC, Swiss Re, Blackwell Publishing and the World Cup have all offset their emissions). The market is also seeing the emergence of investment funds focused on retail offsets as the focus for some or all their investment program, such as Cheyne Capital, RNK Capital and Climate Change Capital.

The voluntary market remains somewhat difficult to categorize, and its boundaries are difficult to define, but estimates of the size of this market range from 2 million tonnes (for specific retail-style carbon offsets) to up to 20 million tonnes, including a whole range of voluntary offsets, retail offsets, green power programs, etc. There is no

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<sup>1</sup> The voluntary market refers to all purchases of carbon offsets that are undertaken on a voluntary (eg not required by law) basis. The retail market is a segment of the voluntary market related to direct purchase by consumers, or purchase of offsets linked with other products such as energy or air travel.

question the market has matured dramatically in the past two years, and most participants feel that the market is growing by 100% or more per annum at this point. Again, there is no formal tracking of the market, but a few studies have been done, and the Ecosystem Marketplace ([www.ecosystemmarketplace.com](http://www.ecosystemmarketplace.com)) is increasingly providing centralized information on the sector.

### **At the Tipping Point**

Organizations ranging in size and character from small NGO's to events organizers to major multinational corporations are determining that climate change is an important issue to their customers or stakeholders, and they are taking action to reduce the greenhouse gas emissions associated with their business, event or product. While this may have seemed a quirky thing to do ten years ago, its recent embrace by major mainstream businesses has pushed the voluntary carbon market to a tipping point.

The focus is shifting from the innovators to the laggards, and the question is being asked, "Why haven't you offset your emissions?" Companies that have a corporate social responsibility policy or have made statements supporting action on climate change are moving from vague emission reduction commitments to quantifiable reduction targets and how offsets can help achieve them.

The retail side is also growing, although uptake of green or branded carbon products such as green energy, green airline flights and even green automobile loans remain a tiny niche in overall consumer markets. (Often we hear of uptake rates of only 1-4% for products where there is any kind of cost imposed.) However, recent discussions with companies indicate there is some very stretch thinking, with one Australian company recently stating that they would like to see their entire business and all the products they sell becoming carbon neutral by 2015. This kind of thinking would indicate that continued substantial growth is on the horizon in the retail and voluntary market.

### **A Weird and Wonderful World**

Voluntary and retail carbon offset products include a host of offset types originating from tree planting, forest conservation, industrial gas destruction, energy efficiency programs, renewable energy credits, changes in animal husbandry or waste management, changes in vehicle fleets and many others.

The retail and voluntary markets are certainly not 'commoditized' at this point, but with the entry into the market of large and reputable buyers, the writing is on the wall for poorly defined or managed offset programs. Buyers now want standardized offsets with real evidence of additionality and truly independent verification of the offsets. There is also a growing expectation that projects have other social and environmental benefits, such as local employment or biodiversity protection. Many buyers do not necessarily want to buy Kyoto units or other regulated carbon products largely because they generally are more expensive. Carbon offset suppliers, particularly small projects or types of offsets not well accepted under Kyoto (e.g. forest conservation and reforestation), also find the lower transaction costs and lack of

bureaucratic accreditation processes makes the route to market easier with voluntary buyers.

Therefore there is a move afoot to establish standards for voluntary projects, including the Climate, Community and Biodiversity Alliance standard, the Gold Standard and most recently the Voluntary Carbon Standard being promoted by The Climate Group, the International Emissions Trading Association and the World Economic Forum. To be successful, these standards need to be rigorous yet simple to administer and able to register or accredit projects to create a product that can be sold without a 40-page legal agreement. This maturation process will likely lead to a smaller number of larger carbon offset businesses that can aggregate up projects, manage accreditation and registry processes and create the credibility and verifiability that sophisticated corporate buyers will demand. This process will also likely lead to for-profit companies out-competing the not-for-profit offset providers because they can marshal the resources necessary to support the sophisticated systems and business practices necessary to meet more demanding market standards.

### **Forest-based Offsets**

Forestry credits have been a mainstay in the voluntary and retail carbon market from the very earliest deals by AES Corporation and the FACE foundation to protect rainforests in the late 1980's and early 1990's. However, the negotiations around the Kyoto Protocol forestry rules were protracted and strongly influenced by a group of environmental NGO's who sought to minimize the role of forestry in market-based mechanisms. The legacy of this has been a minimal role for forestry under the Kyoto Protocol and its international mechanisms. Nevertheless, other carbon markets are successfully integrating forestry credits, including the NSW Greenhouse Gas Abatement Scheme, the California Climate Action Registry and the CCX.

Forestry credits are very attractive in the retail and voluntary markets. One energy company polled its customers to ask what kind of offsets they would prefer if a green energy product was to be offered to them. Compared against industrial gas destruction, relining pipelines, improving energy efficiency in office buildings and factories and capturing methane from coal mines, forestry was far and away the preferred source of offsets. Companies indicate that using trees and forests for offsets makes sense to consumers, while trying to explain methane destruction or sulfur hexafluoride destruction is confusing and simply does not resonate. As one company executive explained, "We have been using trees as the imagery of environmental conservation forever, and trying to re-educate consumers to understand methane flaring is too hard."

However, despite this demand, many of the current initiatives to standardize offsets are falling into a 'Kyoto mindset' on forestry. There are real concerns about permanence and measurement, and these issues are often used to argue that forestry offsets are simply too hard to regulate effectively. For example, a carbon credit from forestry may require an ability to retain carbon stock in forests for 100 years or more. This kind of inter-generational obligation is as compelling as it is daunting. New and

innovative approaches are needed to address this, including specialized carbon pooling vehicles, re-insurance approaches and risk management systems. However, the efforts to exclude forestry may create a self-fulfilling prophecy with investors shying away from forestry offsets, reducing access to funding and resources dedicated to establishing 'permanence' protocols and measurement standards; the very issues that have been used to keep forestry credits on the sidelines.

Despite this, there is optimism that forestry credits are on a 'comeback'. The COP11 meeting in Montreal in 2005 responded positively to a proposal sponsored by Papua New Guinea and Costa Rica to re-open the discussion on how to accredit avoided deforestation. Recently, the proposal to develop a Voluntary Carbon Standard received substantial resistance when it attempted to marginalize the use of forestry offsets.

Forests provide a natural infrastructure for the planet, regulating the atmosphere, hydrological cycles and much of the biodiversity of life on earth. Forests continue to be lost and degraded, and areas needing re-vegetation or reforestation cannot attract investment. Without price signals for ecosystem services, including carbon sequestration, we are entrenching the status quo of existing economic signals and dooming a significant proportion of our remaining tropical forests in particular to conversion to 'higher uses,' such as palm oil or soybean cultivation.

### **Towards the Future**

It appears clear that the voluntary carbon market is growing rapidly, and moving to a new level of standardization and legitimacy. If we reach the tipping point where business begins to move in a substantial way to integrate carbon offsets into its internal management objectives and product offerings, the market could increase by orders of magnitude.

As the voluntary and retail carbon markets go mainstream, we hope that forests and land management are one part of the overall portfolio of offsets. If these markets do reach a level of billions of dollars per annum in turnover, it could make a substantial contribution to forest conservation and reforestation.