TAKING THE PULSE OF THE VOLUNTARY MARKET

Mark Nicholls reports on the results of *Environmental Finance* and *Carbon Finance*'s latest Voluntary Carbon Market Rankings – and finds growth and innovation, but some anxiety about oversupply

In many regards, participants in the voluntary carbon market are the envy of their peers in the compliance markets. The right offset projects can still command top dollar in the voluntary markets, while the Clean Development Mechanism (CDM) market has collapsed. And, despite the ongoing economic heavy weather, the winners of this year's Voluntary Carbon Market Rankings report continued growth and persistent corporate commitment to offsetting.

"The market's been surprisingly stable," says Renat Heuberger, CEO of South Pole Carbon, voted overall Best Project Developer, and best developer of renewable energy and energy efficiency projects, among other placings. "I continue to find it remarkable, given that we're still in a financial crisis, and given the environment has faded a little among the public."

"Climate change seems to have developed a certain resistance" among the company's corporate clients, he says. "CEOs have agreed that the topic is here to stay, and they need to take action to address their emissions."

Not so vulnerable

A few years ago, the assumption was that the voluntary carbon market – defined as the creation, trading and retirement of carbon offsets outside the bounds of a regulated mandatory emissions trading programme – would always be much more vulnerable to economic downturns than compliance environmental markets. After all, voluntary carbon purchases are, by definition, discretionary.

But the reality has been just the opposite. The price of CDM credits – certified emission reductions (CERs) – has fallen by some 90% in the last year or so, while prices for voluntary emission reductions (VERs) have, by and large, held up.

Moreover, issuance and retirement volumes have both grown strongly. In 2012, carbon credits equivalent to 36 million tonnes of carbon dioxide reductions were issued to the Verified Carbon Standard (VCS) – up 31% on 2011. VCS retirements, which track 'consumption' of the voluntary credits, were up 60%, to nearly 16 million tonnes.

"What we identified quite early on is that the voluntary market is not as tied to political tensions as the regulated market is," says Gareth Turner, head of carbon and renewables at Armajaro Securities, a London-based subsidiary of commodity trader Armajaro Trading, and voted Best Broker – up from a third-place ranking last year.

He cites the hugely bureaucratic and cumbersome CDM project approval process, which was unblocked just as mandatory demand for carbon credits began to dry up, contributing to the CDM price crash. And the EU Emissions Trading System (ETS), of course, has become what one analyst described as "a politicised mess".

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Zubair Zakir,
the CarbonNeutral Company

In contrast, purchases in the voluntary market take on "a wider importance than simply fulfilling a voluntary requirement", with clients needing to see "a tangible benefit" from the offsets they buy, Turner says. "It's a highly specialised market," with clients requiring structured, customised transactions, which play to the strengths of an intermediary such as Armajaro, he says. "Plus, we've been focused on the voluntary market for a long time," Turner adds.

Boost from co-benefits

"There has been downward pressure on prices," says Zubair Zakir, director of carbon sourcing at the London-based CarbonNeutral Company, which describes itself as a "carbon reduction solutions provider", and was voted Best Offset Retailer in the annual *Environmental Finance* and *Carbon Finance* Voluntary Carbon Market Rankings. "In the voluntary market, by its nature, there is always a significant amount of volume that can be accessed."

"But the key thing to remember is that, from a buyer's perspective, there are certain drivers" that make many CERs unattractive, Zakir continues. "They want to address these drivers, and achieve co-benefits and features that are relevant to their business … if a seller can hit those demand drivers, then a deal is possible."

Such co-benefits include accompanying social or environmental benefits that the projects deliver – on water availability, or health benefits – that give the buyer a more compelling story to communicate with its stakeholders.

"Our advice has always been to go after these co-benefits," says Craig Ebert, a Los Angeles-based senior vice-president at ICF International, the consultancy voted Best Advisory Firm in the rankings. "The voluntary market is more boutique than the compliance markets – companies want to be able to tell a compelling story that resonates with their stakeholders."

However, while prices have held up, relatively speaking, the excess of supply in carbon markets generally is making its presence felt. "You can't have a huge overhang of supply and firms exiting the market, and not expect to see downward pressure on prices," Ebert adds.

DNV – the leading verification company both in the CDM market and now, according to the rankings, also in the voluntary market – has seen a huge flood of CDM business as developers scrambled to get projects registered last year, to beat a deadline for selling credits into the EU ETS.

Supply is building

Given this huge volume of CDM work, Stein Bjornar Jensen, head of the DNV's climate change unit, says his firm hasn't been particularly focused on the voluntary market, with it representing perhaps 5% of its carbon business last year. He suggests the success in the rankings – in which DNV was placed third last year – is likely a "reflection of improvements we've put in place in terms of our CDM work", especially in terms of the time it takes to process projects.

Jensen says that, "given the problems with the CDM, the voluntary market is likely to become more important to us," noting that DNV is an accredited verified for Verified Carbon Standard and Gold Standard projects, and is accredited to the American National Standards Institute's ISO Standards 14065 and 14064-3. "Success in the rankings is an additional incentive," he says.

And there are growing fears that the supply of CERs could make its way into the voluntary market – especially given the decision last year to allow the credits to be voluntarily cancelled, in a deliberate bid to make them more attractive to voluntary buyers.

However, the feared tsunami has yet to materialise.

"Companies buying large volumes for offsetting seem to have a preference for high-quality VCUs [verified carbon units] rather than CERs," says Martijn Wilder, the Sydney-based partner who runs law firm Baker & McKenzie's climate change practice – which was voted, for the fifth year in row, Best Law Firm in the voluntary market rankings. "In some circles, there can be issues with the integrity of CERs, even if those concerns aren't justified."

But he notes that "the market is coming off – pricing has got a lot more difficult." He also adds that, while his firm is doing a lot of work with project developers, it is doing relatively less business advising on actual transactions. "It begs the question, where is the supply going? A lot of it is not being sold."

Nonetheless, most winners in this year's rankings report business growth in a tough market. In South Pole Carbon's case, Heuberger cites the firm's business model, which combines both voluntary carbon and compliance-market businesses, "which provide a hedge for each other, and give us room to breathe", and the firm's grounding in engineering.

"Our DNA is our engineers on the ground – we really understand the projects, and know what is a good project and what is not. My feeling is that our customers understand that."

Voluntary Carbon Markets Rankings 2013

CATEGORY	1ST	2ND	3RD
Best Broker	Armajaro Securities	Evolution Markets	TFS Green
Best Trading Company	First Climate	Tricorona	South Pole Carbon
Best Advisory Service	ICF International	South Pole Carbon	EcoAct
Best Law Firm	Baker & McKenzie	Norton Rose	SNR
Best Verification Company	DNV KEMA	SCS	SGS
Best Project Developer – renewable energy	South Pole Carbon	EcoAct	
Best Project Developer – energy efficiency	South Pole Carbon	ClimateCare	
Best Project Developer – forestry	Wildlife Works	Terra Global	
Best Project Developer – health	ClimateCare	Impact Carbon	
Best Project Developer – overall	South Pole Carbon	Wildlife Works	ClimateCare
Offset Retailer	The CarbonNeutral Company	Climate Care	EcoAct
Registry provider	Markit	APX	American Carbon Registry
Best Voluntary Standard	Verified Carbon Standard	Gold Standard	American Carbon Registry

HOW THE SURVEY WAS CONDUCTED

Companies were e-mailed in March and asked to nominate the leading service providers active in the voluntary carbon markets, via an online survey.

Voters were asked to make their judgments on the basis of: efficiency and speed of transaction; reliability; innovation; quality of service provided and influence on the market, not just the volume of transactions handled. More than 700 completed responses were received.

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Gareth Turner, Armajaro

But the company also continues to innovate, and evolve its approach to the voluntary carbon business. And one way its approach is changing, Heuberger says, is in "putting project development right at the centre of the discussion with buyers".

"We go to the corporates and say, 'look, you're buying VERs, why don't you have your own project?' It's much more attractive

GETTING THE FOUNDATIONS RIGHT

Kathy Benini, Markit: "constantly investing" in registry system

Given the lack of regulation that defines the voluntary carbon market, the carbon offsetting industry has had to come up with its own solutions for oversight and market infrastructure.

This makes the Best Voluntary Standard and Best Registry Provider particularly important categories in the Annual Rankings – although the Verified Carbon Standard (VCS) and Markit have had their respective slots locked down since we began polling.

"We're constantly investing – adding functionality, such as more robust reporting and audit logs, enhanced transaction capability, and additional security features – to improve its usability and friendliness," says Kathy Benini, the New York-based head of environmental markets at Markit, the financial information services company which offers credit registry and tracking for a wide range of environmental commodities.

As well as providing a vital service in underpinning the voluntary market's environmental integrity – ensuring that credits are issued in accordance with the protocols set by standards organisations and other certifiers – registries offer more traditional forms of protection, such as a system of serial numbers for credits which helps ensure that registered credits are not sold to more than one buyer.

Benini notes that voluntary offset buyers are increasingly favouring projects which deliver more than one environmental or social benefit either through the project itself or via an additional certification – and Markit stands ready to incorporate them into its registry services. "We see the trend continuing for standards organisations to consider combining carbon plus water quality, carbon plus health impacts, and other related combinations. We already do it for ecosystem services and our infrastructure can support a range of verifiable combinations" for voluntary carbon market participants, she says.

Innovation is one of the reasons the VCS has repeatedly been voted Best Voluntary Standard, believes David Antonioli, the Washington, DC-based head of the not-for-profit association that maintains it. "We put enormous effort into continuing to innovate," he says.

He cites the association's work in developing standardised methodologies – such as performance benchmarks or positive lists of project types. The use of such methodologies makes project development more straightforward, as it makes the test of whether a project qualifies to earn carbon credits much easier.

"You don't have to do a prior assessment of additionality," he says, referring to the test that the project delivers reductions that are 'additional' to a hypothetical base-case. "It lowers transaction costs, and it's very elegant – it will serve the market well."

More generally, Antonioli says that the VCS aims to provide a few key things: "Environmental integrity; what you get when you get a [verified carbon unit] is a real reduction. Our procedures and systems are practical and not too bureaucratic. And the system is broad – it's not too restrictive in terms of types of projects."

for communication purposes, especially if you can link the project to your underlying business," he says.

He gives the example of an insurance company, which might have a micro-insurance business in a developing country, where the local salesforce could offer farmers carbon-reducing water purification systems alongside the insurance products, or buyers of commodities such as bananas or coffee, who could work with their suppliers to develop projects.

"You get a multiplication of the communication benefits," he says. "Voluntary carbon needs to be much more tangible – we're not commodity traders."

Meanwhile ClimateCare, the Oxford, UK-based project developer, has led the charge of broadening the voluntary carbon market into addressing wider social and environmental impacts – and has been recognised in the rankings in the new Public Health product development category. Its trailblazing LifeStraw Carbon for Water project – which ClimateCare has developed with disease control products manufacturer Vestergaard Frandsen and the Gold Standard Foundation – distributes water purifiers in rural Kenya, reducing the burning of firewood to boil water, cutting carbon emissions and the health impacts of smoke inhalation, as well as freeing up time spent collecting fuel.

Sustainability targets

"Large corporates are gearing up to take responsibility for all their impacts – carbon is one impact, but equally important is their whole overall sustainability," says Edward Hanrahan, ClimateCare's CEO. He sees projects that address other issues in addition to emissions – clean water, public health, better educational outcomes – as the future of voluntary corporate offsetting.

The benefits are numerous. Not only do multiple impacts mean there is a wider pool of potential offset buyers, but achieving the other social or environmental outcomes becomes cheaper, and the projects themselves become more resilient – which is especially important given the anaemic carbon price.

"We're looking at how we layer other interventions onto the carbon projects," he says, giving as an example programmes to deliver LifeStraws to schools, or distribute mosquito nets. "We've got the distribution networks on the ground – it potentially halves the cost" of a distribution programme, he says. Also, tapping offset buyers – or, potentially, donors – with other objectives apart from emissions reductions brings more financial stability to the projects.

The "magic word" for First Climate's success – it was voted Best Trading Company this year, up from third place in 2012 – is diversification, says Sascha Lafeld, a founder of the Bad Vilbel, Germany-based carbon asset manager and trader.

"A couple of years ago, it was clear looking at the voluntary market that it was dividing into various national and regional markets," he says. The response at First Climate was to divide its team into national representatives on the ground, with representatives in Scandinavia, France, the UK, Australia and the US, among others. "Having local sales representatives means we are very close to our customers – we're harvesting the fruits of that."

Lafeld says that, while the market is growing, "competition has become increasingly fierce". The growing sophistication of big offset buyers means that they are increasingly running public tenders, which "bring down margins and put us under increasing pressure

"Large corporates are gearing up to take responsibility for all their impacts."
Edward Hanrahan, ClimateCare

to make our services better and better."

"It means our approach has to be much more tailor-made … it's about embedding our service into their processes."

In terms of areas of growth, Jochen Gassner, board member at First Climate, points to the logistics sector, where companies are following the lead set by pioneer DHL in offering a carbon-neutral delivery service. He adds that the car fleet management sector is "on the brink".

REDD growth

The information technology sector is also promising, he suggests. "The first step is figuring out their own footprint – the next is to offer carbon-neutral services," he says.

In terms of supply, one of the big emerging areas for the voluntary market is in providing finance to protect standing forests – known by its acronym of REDD+. In this project development category, veteran developer Wildlife Works – which was founded in 1997 in San Francisco – took the top slot. Its flagship Kasigau Corridor project claims to be the first REDD+ project to receive issuance of carbon credits – and is set to avoid more than 1 million tonnes of carbon dioxide emissions annually for the next 30 years.

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> Sascha Lafeld, First Climate

The secret to successful development, says company founder and president Mike Korchinsky, is to "focus on the ultimate stakeholders, those people living in or near those threatened forests. If you can make REDD+ a desirable economic development pathway for them, they will help you figure out all the complex details of implementation."

It is also vital to work closely with regional and national host forest governments, to ensure they see REDD+ as a competitive economic alternative to traditional destructive use of forests, he adds, as well as "market the heck out of the projects to ensure they receive the financial pay for performance they need to sustain the behavioral changes necessary to save forests".

On that front, Korchinsky says that prices have held up, and that Wildlife Works is able to sell VERs for $8-12, depending on volume. "That price has been consistent over the last 18 months," he says. "Our traditional market of corporate buyers in the voluntary space is developing nicely as more caring corporations see how REDD+ can help them achieve their corporate social responsibility and sustainability goals."

It is an open question as to how long the corporate market can absorb supply without pricing feeling the pressure. Zakir at The CarbonNeutral Company says that his company is tracking some 90 million tonnes of supply, up from around 50 million in 2011. "Supply has certainly increased, and the size of projects has significantly increased," he says, particularly land-based ones, such as forestry.

"It's not possible to buy everyone's carbon – even if you've got a great project. But it is possible to give a great service and work with suppliers with integrity," he concludes. CF