Cleantech Edge

Cleantech Investor Insight

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Article 6 agreement is the most significant outcome of COP26

Key implications:

- The deal struck on Article 6 of the Paris Agreement at COP26 is a catalyzing event for carbon offset markets. The bilateral focus and the inclusion of potentially underperforming legacy offsets into the Article 6 agreement reflected a realpolitik approach that succeeds through tactical disappointment.
- While the headlines coming out of the conference have been more focused on the importance of agreements on future emissions goalsetting and the Article 6 agreement has been more of a sidenote, the passage of time will likely prove the reverse to be true: The broad-strokes agreement on carbon offset trading could prove transformational by allowing the market to assign a net benefit to assets that are currently underpriced for their climate risk reduction benefits.
- As a result, carbon offset trading is poised to surge through the coming decade as companies, financial firms, and national governments begin to align their emissions strategies with an increasingly actionable universe of price signals.
- EU ETS prices surged after the close of COP26, pushing to a record €66/ton on the first day of trading after the close of the summit, and have since crossed the €70/ton threshold. Price strength cannot be attributed solely to the outcomes of COP26 – weather and energy supply issues are also components – but improved likelihood that emissions will be more broadly tradable, and thus have value beyond EU borders, is also a factor in the liquidity and attractiveness of this market.

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Article 6 agreement is the most significant outcome of COP26

A large, overarching agreement on climate was the desired headline outcome of COP26. The value of what the summit delivered in that regard is the subject of much debate, and many were not pleased with the level of ambition of the many agreements struck, but the solutions found for resolving Article 6 and the carbon emissions trading conundrum are very significant.

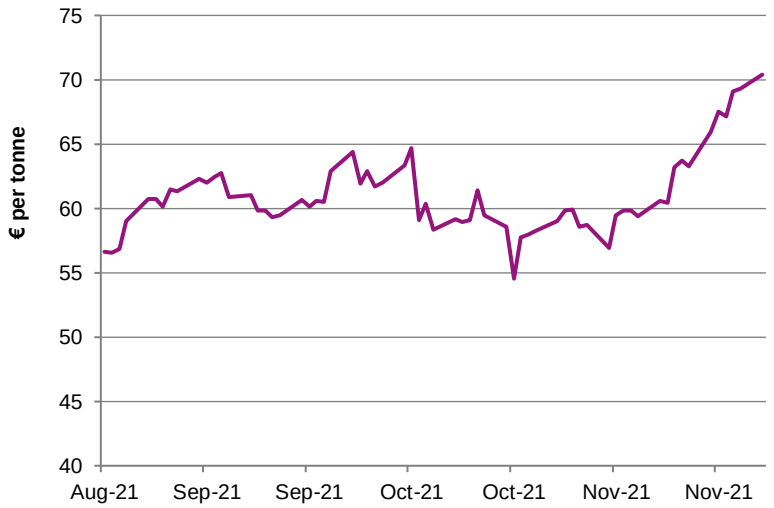
The deal struck on Article 6 in Glasgow has attracted its fair share of criticism, due in part to the inclusion of a class of emissions credits whose quality is questionable at best, and that stands to keep supply loose enough to depress prices for years. Imperfect though it may be, this deal removed a structural barrier to what is widely viewed as one of the most promising tools in the emissions-reduction toolkit – a price on carbon.

On Article 6, the parties opted not to let the perfect be the enemy of the good. And they now have a structure in place for emissions trading that allows them to assign an immediate monetary value both to costs avoided and assets held or amassed. More succinctly, preserving a hectare of rainforest can yield financial returns now, rather than societal returns 30 years in the future. The price will be too low for some time, but at least now it has somewhere to go – most likely up.

Article 6 is one of the concrete, technocratic (possibly even dull) successes of COP that will establish a key part of the financial foundation on which transition will be built. Like mandatory climate risk disclosure, it fundamentally alters corporate accounting by assigning a value to a ton of carbon at a level other than zero. It establishes the framework for letting demand and supply for a new globally tradable commodity align on prices and product standards, creating the potential for a wider range of economies to enter the "resource-rich" category and to earn actual income for actions – like protecting forests – whose value has been largely unquantifiable.

A ton of carbon can now properly be classified as a commodity and treated as such by the marketplace. And while that has limited appeal for many environmentalists hoping for more sweeping action, the potential for financial returns from that new commodity ultimately can redirect capital flows in a manner that properly accounts for a very material risk. A small window of that outcome can be seen in EU ETS pricing. EU carbon prices have surged after the close of COP26, pushing to a record €70/ton since the summit ended. Price strength cannot be attributed solely to the outcomes of COP26 – weather and energy supply issues are also components – but improved likelihood that emissions will be more broadly tradable, and thus have value beyond EU borders, is now a factor in the liquidity and attractiveness of this market.

EU ETS carbon price



Source: IHS Markit, Intercontinental Exchange (ICE) © 2021 IHS Markit

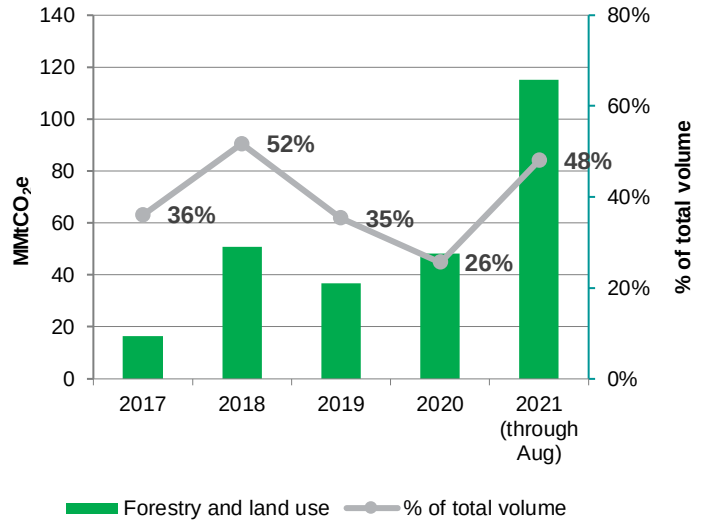
Starting low, but getting to destination

One of the primary critiques of Article 6 as agreed by the parties is the inclusion of Certified Emissions Reductions (CERs) from 2013 to 2020. Legacy CERs traded under the Kyoto Protocol have been widely criticized for a lack of proven emissions reductions, double-counting of emissions reductions and unanticipated negative externalities. After an initial spike in trade a decade ago, many firms have moved to more verified emissions offset programs, even when administered by private entities outside the United Nations process. Flooding the market with low-quality credits is likely to keep emissions prices too low, at least at the outset, to trigger meaningful emissions reductions.

This was also the case at the outset of the EU Emissions Trading System (ETS), which only recently – on the back of

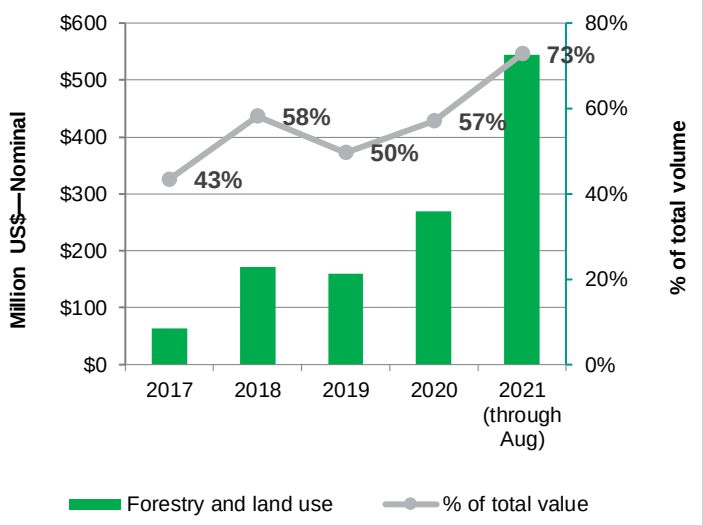
meaningful regulatory action in Europe and broader acceptance of the necessity and utility of incentivizing emissions cuts – produced a price high enough to prompt corporate behavioral change. Unlike the EU ETS, which came into being before a critical mass within the public and private sectors was actively seeking opportunities to invest in the transition to less emissive energy, infrastructure, and industrial systems, a market for international trade in emissions credits will be meeting unmet demand rather than endeavoring to create it through policy. Trade in offsets had already accelerated dramatically in the first eight months of 2021, well ahead of COP26.

Transacted volume of forestry and land-use offsets, 2017–Aug 2021



Note: "Transacted" denotes volume or value of offsets that have been traded—bought and sold—in a given year. Ecosystem Marketplace data compiled by global annual surveys.
Source: Ecosystem Marketplace © 2021 IHS Markit

Transacted value of forestry and land-use offsets, 2017–Aug 2021



Note: "Transacted" denotes volume or value of offsets that have been traded—bought and sold—in a given year. Values assumed to be in nominal terms. Ecosystem Marketplace data
Source: Ecosystem Marketplace © 2021 IHS Markit

Energy companies facing transition pressures have already begun to adopt trade in offsets as a way to handle both anticipated and unexpected emissions overshoots. Partners in the **Chevron**-led Gorgon LNG project in Australia have agreed to purchase carbon offsets potentially valued at more than A$250 million to compensate for failure to meet targets for carbon capture and storage. US oil producer **Occidental** bought offsets it said were sufficient to cover scope 1, 2, and 3 emissions from a 2 million-barrel cargo of "carbon-neutral" crude delivered to India's **Reliance** in January. Reporting from Reuters estimated the cost of the offsets at $0.65/bl – or around $1.3 million – when the crude price was more than $60/bl. Colorado oil producer **Civitas** this month announced that it had purchased enough offsets to cover its 1 million tons/year of scope 1 and 2 emissions from its operations

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