GAIA
NATURAL CAPITAL

COMPLIANCE & VOLUNTARY CARBON MARKETS

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THERE ARE TWO DISTINCT CARBON MARKETS – THE COMPLIANCE MARKET AND THE VOLUNTARY MARKET.

The compliance market is a regulated market that allows governments, corporates and other organisations to buy carbon credits to meet prescribed limits on their greenhouse gas emissions.

Voluntary markets function outside of compliance markets, are unregulated, and enable companies and individuals to purchase carbon credits on a voluntary basis with no intended use for compliance purposes.

COMPLIANCE MARKET

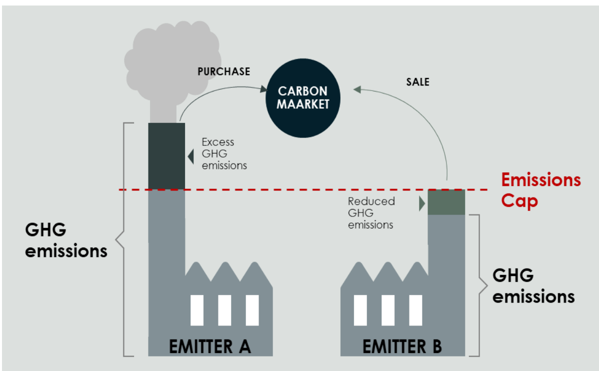
Several countries have established compliance markets to reduce greenhouse gas emissions to meet their commitments to the Paris Agreement. These commitments are formally known as Nationally Determined Contributions (NDCs).

Compliance markets are well established in developed countries - the European Union, the United Kingdom, the United States, New Zealand and Australia.

Most of these countries have schemes in place where companies or industries have a fixed limit of allowable emissions, set by governments, that put in place a ceiling, or a "cap", on their permitted emissions, which all entities that fall under the scheme must comply with. Organisations that exceed those emission limits must offset them using carbon credits or pay a penalty. If an organisation can reduce its emissions below the cap, it is able to generate emissions avoidance credits and sell them to organisations that exceed their emissions cap. This is known as the "cap-and-trade" system, or an Emissions Trading Scheme (ETS). Across global compliance markets, caps on emissions are being reduced over time to meet emission reduction goals.

The most mature market is the European Union ETS, which accounts for ~90% of the global compliance market[1]. Other large regional markets include the California Cap and Trade and the U.S. East Coast Regional Greenhouse Gas Initiative. China launched its national ETS in 2021, and this is expected to become the largest compliance market by a considerable margin, covering one-seventh of global CO2 emissions from fossil fuels[2]. Despite various global compliance market schemes having different names, they typically all operate under the same cap-and-trade structure.

HOW A CAP AND TRADE SYSTEM WORKS



Source: Gaia Natural Capital & Carboncredits.com

[1] Refinitiv
[2] IEA 2021

VOLUNTARY MARKET

The voluntary market encompasses all transactions of carbon credits that are not purchased with the intention to surrender into an active regulated carbon market. The voluntary market is unregulated, with various standards bodies setting the methodologies and verification process for carbon projects.

Voluntary carbon credit markets work in conjunction with compliance markets to reduce global emissions. They provide another means for organisations to reduce their carbon footprint through investment in carbon credits that reduce greenhouse gas emissions or sequester carbon from the atmosphere. As an alternative to buying carbon credits, some organisations are choosing to invest directly into carbon projects – and using the credits generated from the project to count toward that organisation's emissions reductions targets.

While compliance markets are dictated by government regulation, organisations are purchasing voluntary credits because:

- Investors and stakeholders are seeking action from all companies to reduce emissions – not just energy providers. Voluntary carbon credits assist organisations in this process.
- Consumers are demanding sustainability verification from the products and services they purchase. There is a commercial opportunity to create products and services that are carbon neutral.

Despite its relatively small size compared to the compliance market, the voluntary market is playing an important role in channelling capital into climate action projects that might never have occurred without the financial incentive of carbon credits. The voluntary market has developed its own standards and project types that have later been adopted in compliance markets.

There are also significant ancillary benefits from voluntary carbon credit programs. Some of these projects might also bring benefits and help to progress the UN Sustainable Development Goals such as improving poverty, access to clean water and health and wellbeing of local communities. Credits with these characteristics, known as "co-benefits" are generally more desirable for buyers and as a general rule, the more co-benefits "stacked" onto a credit, the higher premium it attracts.

UN SUSTAINABLE DEVELOPMENT GOALS

The voluntary market has grown significantly over recent years. The size of the voluntary carbon credit market neared US$1bn in 2021 in the primary market which compares with a value of US$321m in 2020. Most of the trading occurs over the counter, and there is only a few research groups who publish data, including Trove Intelligence, who in April 2022 forecast the market to grow 100% to 130% to between US$1.9 billion and US$2.2 billion this year.

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