

# Commodity Futures Trading Commission's Request for Comment: Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts

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Consultation response from the

## Centre for Competition Policy

University of East Anglia, Norwich Research Park, Norwich NR4 7TJ

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**Authors:**

- Andrea Calef
- Geraldo Costa Junior

This consultation response has been drafted by named academic members of the Centre, who retain responsibility for its content.

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The two authors welcome the opportunity to respond to this request for comment. This response is structured as follows:

- Responses to questions 1, 3, 9, 11 and 16.
- Please note that responses partly address a few of other questions we have not directly provided a response too.

## General

1. In addition to the VCC commodity characteristics identified in this proposed guidance, are there other characteristics informing the integrity of carbon credits that are relevant to the listing of VCC derivative contracts? Are there VCC commodity characteristics identified in this proposed guidance that are not relevant to the listing of VCC derivative contracts, and if so, why not?

*As defined by the Commission, the voluntary carbon credit market will be mainly composed by three types of participants: (i) the developer of a mitigation project or activity that is intended to remove or reduce GHG emissions from the atmosphere; (ii) a crediting program that, among other things, issues VCCs; and (iii) an independent third party that verifies and validates the mitigation project or activity.*

*In addition to the three VCC derivative contracts' intended characteristics cited by the Commission, namely (i) quality standards, (ii) delivery points and facilities, and (iii) inspection provisions, we would like to suggest a closer attention to two particular points that may increase or decrease the levels of liquidity in these markets. The first concerns the size of VCC derivative contracts and the margins required for operations of such contracts (futures, options). In this sense, if the margins or the size of contracts are too large, they may repel potential entrants seeking to buy or sell VCC derivative contracts for the purpose of mitigating GHG emissions (or mitigating their exposure to GHG emissions), but also speculators, and market makers. This could negatively affect the arbitrage process, lower the levels of liquidity and increase the chance of price manipulation (Security and Exchange Commission (SEC) Staff Report, 2003; Choi et al., 2009). The worsening of the VCC derivatives market quality could have further consequences to the physical market, discouraging the entrance of new project developers or amplifying price fluctuations (Deutsche Bundesbank Monthly Report, 2006).*

*Therefore, promoting and maintaining the atomization of voluntary carbon credit derivative markets is key for its well-functioning. One possible manner it could be achieved is by keeping contract sizes and operating margins at levels that encourages the entrance of new market participants, including arbitrageurs. In addition, ensuring a good interaction between developers, crediting programs and independent third-party agents when the market is open to foreign participants may result in long lasting good levels of liquidity and its associated benefits, such as smaller spreads, lower liquidity costs and lower probability of market manipulation.*

3. In addition to the criteria and factors discussed in this proposed guidance, are there particular criteria or factors that a DCM should consider in connection with monitoring the continual appropriateness of the terms and conditions of a VCC derivative contract?

*One point we would like to highlight regards the origin of the participants in the VCC market. The interaction between developers, crediting programs and independent third-party agents seems to work well if all these participants are US based. However, potential problems may arise when non-US based participants enter the market. For instance, consider one developer of a project intended to remove/reduce GHG from the atmosphere in another continent. One particular question is: how will crediting programs verify whether projects developed in other countries fulfil the requirements? There is a wide range of factors that should be taken into consideration for monitoring and inspection of such projects: access to all needed information, a good knowledge of the local environment, good transit with the government, institutions, and bureaucracy, among other factors. Incorporating the solution for these bottlenecks has positive implications for the quality of VCCs and to the conceptualization of a standardized methodology, which, in turn, will support the development of the nascent VCC derivative market.*

*In addition, we would like to extend monitoring concerns to incorporate potential negative indirect effects of some projects, that may eventually appear. For instance, it has been documented that wind turbines may negatively impact local populations and wildlife (Schuster et al, 2015; Krekel and Zerrahnn, 2017). Similarly, negative externalities have been documented for hydroelectric power dams (Ezcurra et al., 2019; Peluso et al., 2022). It may well be the case that some populations and the local wildlife are negatively affected by some project linked to a VCC contract. In this case the problem with local populations may negatively affect the contract's performance in the market and even trigger systemic risk fears regarding similar projects.*

## **Risk of Reversal**

9. Are there particular criteria or factors that DCMs should take into account when considering, and/or addressing in a VCC derivative contract's terms and conditions, a crediting program's measures to avoid or mitigate the risk of reversal, particularly where the underlying VCC is sourced from nature-based projects or activities such as agriculture, forestry or other land use initiatives?

*Regarding measures to avoid or mitigate the risk of reversal, we would like to propose two potential forms of attenuation of the risk of reversal. The first one involves the requirement of some sort of insurance linked to projects. In this case, the insurance should be provided by an independent third-party company specialized in the field of the project being developed. The insurance premium quantifies the risk and introduces this information in the market, leading both demand and supply sides to better decisions and the market as a whole to higher levels of efficiency.*

*In this same direction, another possibility is the introduction of credit default swaps (CDSs) associated to VCCs as an alternative to mitigate the risk of reversal. The buyer of a VCC contract linked to a certain project buys a credit default swap (CDS) from a certified swap seller. In the case the project defaults, the swap seller promises to pay the swap buyer a previously agreed amount. In return for this promise, the CDS buyer pays the seller a periodic (quarter, monthly, etc) amount.*

## Robust Quantification

11. Are there particular criteria or factors that a DCM should take into account when considering, and/or addressing in a contract's terms and conditions, whether a crediting program applies a quantification methodology or protocol for calculating the level of GHG reductions or removals associated with credited projects or activities that is robust, conservative and transparent?

*One point we would like to highlight involves the clarity about how GHG emissions are calculated and its publicity to market participants. Understanding exactly how GHG are quantified by the crediting program is a non-trivial matter. Consider, for the sake of illustration, the case involving the project of a hydroelectric powerplant. In theory, hydropower generation emits less greenhouse gases than its counterparts fuelled by natural gas or coal. However, GHG emission must also consider the natural area flooded for the construction of the reservoir, which has a different dynamics of carbon transportation from open system freshwater networks (Raadal et al., 2011).*

*Consider another example from a project proposed by a pulp mill involving planted forests. Depending on what species of trees are planted, the projected forest may expose the soil to water and nutrients depletion, and in some cases reduced biodiversity. When the project is over and the planted forest is harvested, the depleted soil will not be able to fully regenerate the natural forest cover (Jeffries et al., 2010; Xu et al., 2022). As an ultimate consequence, the process of GHG sequestration carried out by a natural forest will likely be reduced.*

*Considering the volatile nature of the VCC underlying projects, which are subject to a number of exogenous factors that may determine their success or failure, we would like to advocate for a pricing framework in the VCC derivatives market that is not based solely on point estimations. We believe that a more suitable pricing framework would encompass point estimations associated with a bandwidth, which, in turn, includes multiple scenarios for the underlying projects and associated probabilities.*

*Having a clear and sound methodology, understandable by any market participant, and furthermore, having it fully publicized, is crucial for leading market participants both at the demand and supply sides to make rational choices in the market. In addition, it makes the occurrence of frauds and greenwashing less viable.*

## Sustainable Development Benefits and Safeguards

16. Certain private sector and multilateral initiatives recognize the implementation by a crediting program of measures to help ensure that credited mitigation projects or activities meet or exceed best practices on social and environmental safeguards, as a characteristic that helps to inform the integrity of VCCs issued by the crediting program. When designing a VCC derivative contract, should a DCM consider whether a crediting program has implemented such measures?

*We believe that the VCC projects should not mandatorily meet practices on social and environmental safeguards, such as those pointed out by ESG programs. On one hand, the adoption of ESG practices is not yet consensual all over the world, and such practices are considered excessive by some important players. Further, meeting ESG requirements is not trivial for many market participants, above*

*all the smaller ones and those capital constrained. The absence of such players could negatively impact liquidity and volume in the VCC market, increase concentration and ultimately worsen market quality.*

*On the other hand, a growing number of market participants are indeed concerned about meeting the best social and environmental practices. Therefore, we believe that VCC contracts could include an addendum to the adoption of ESG practices as a way to differentiate those who adopt ESG practices from those who do not. Ultimately, the market itself would price the adoption of such practices. Attaching the nascent VCC market to a concept that is not yet consensual could not be prudent.*

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