Response to CFTC guidance regarding the listing of Voluntary Carbon Credit Derivatives

February 2024

BeZero

Contents

Executive summary

- **BeZero Carbon welcomes efforts to bring greater regulatory safeguards to the Voluntary Carbon Market** (VCM). We believe this is vital to help the market scale.
- **The CFTC's guidance rightly highlights the importance of carbon credit quality**. However, "quality" is a complex and contestable concept which requires a judgement to be made at a project level across risk factors like leakage, over-crediting and additionality (comprising of financial, activity, policy and legal considerations). BeZero Carbon's independent ratings simplify this for market participants by condensing this multi-dimensional risk analysis into a single 8-point scale which is applicable to all credit types.
- **We therefore believe that carbon credit derivative contracts should include independently assigned ratings as a key requirement** in order to account for the quality of credits in a robust but proportionate fashion, as in the financial market.
- **We also believe that the CFTC's guidance is incorrect in treating carbon credits, and their associated derivatives, as binary commodities**. Our ratings show that carbon credit quality is a spectrum, even across specific sectors and project methodologies, and therefore standardising "quality" risks creating a race to the bottom.
- **We welcome the CFTC's ongoing engagement on the VCM**, and were particularly grateful for the opportunity to speak at a CFTC conference this summer.

Background to BeZero Carbon

BeZero Carbon is the ratings agency for the voluntary carbon market (VCM). We use our technology, ratings, and research to help participants in the market channel capital into the solutions that will have the greatest impact on the path to net zero.

We have rated and provided detailed risk analysis for more than half of the world's carbon credit projects, and that list is constantly expanding. Our team uses advanced technology to produce comprehensive and high-quality ratings, giving our clients the tools they need to make better decisions in the VCM. Our technology and insight is trusted by a global client base spanning the environmental, energy, finance, and commodities sectors, and our ratings are hosted on a wide range of international platforms. We employ internationally renowned remote sensing scientists, machine learning engineers, field ecologists, and financial analysts who constantly monitor carbon credit projects to determine their efficacy

Since founding in 2020 we have grown rapidly. Our Series B funding round in 2022 raised $50 million, the largest such climate tech funding round in the UK that year, and we now employ more than 150 people on almost every continent.

Comments on CFTC guidance and consultation questions

We note that the CFTC welcomes comments on its guidance as a whole, in addition to welcoming further insight on some more specific questions. Here, we start by offering some general comments on the guidance document as a whole before selecting key relevant questions to respond to.

Guidance as a whole

Quote from the guidance: Challenges with respect to accurately ascertaining VCC quality, and associated pricing challenges, can erode confidence in voluntary carbon markets. Furthermore, opaque or inadequate calculation methodologies or protocols, which can obscure or mischaracterize the carbon impact of a mitigation project or activity, can undermine both the integrity and purpose of those markets.

BeZero Carbon response: The ability to assess quality and therefore, in time, develop crucial links between quality and price is crucial to allow the VCM to mature. The CFTC is right to draw attention to the issue of quality - and the challenges with methodologies and protocols which lead to errors such as over-crediting and double counting. Participants in the VCM must take every precaution to ensure that the credits they produce are of the highest integrity.

However, the CFTC does not acknowledge some of the effective market mechanisms that are already in place to assess quality - including carbon ratings, like those we provide at BeZero Carbon. Determining the quality of a carbon credit requires an assessment to be made at a project level across risk factors like leakage, over-crediting and additionality (comprising of financial, activity, policy and legal factors). BeZero Carbon's independent ratings simplify this for market participants by condensing this multi-dimensional risk analysis into a single 8-point scale which is applicable to all project types.

We are the only ratings agency to publish our headline ratings publicly, free of charge - contributing to increasing transparency and boosting integrity across the market. As a consequence, our ratings are already having an impact on price - for example, the average price premium for credits in the highest BeZero rating categories of 'A' or above has risen rapidly to 200% over the last year.

Ratings exist alongside standards put forward by initiatives like the Integrity Council for Voluntary Carbon Markets (the importance of which the CFTC has acknowledged). Ratings are complementary to standards which help raise the bar for quality. Quality in the VCM is not binary - no two carbon credits are the same, and our ratings show that quality varies even within specific sectors and project methodologies.

In order to tackle the challenges of integrity and transparency which the CTFC rightly identifies, we believe that carbon credit derivative contracts should include independently assigned ratings as a key requirement. This would support parties to manage their risk in a way which accounts for all relevant risk factors, but does not require a bespoke analytical assessment for each individual derivative contract. This would mirror the infrastructure which exists in financial markets, where ratings from agencies like S&P enable investors to make informed decisions by providing a reliable assessment of default risk.

Quote from the guidance: The Commission recognizes that, while standardization and accountability mechanisms for VCCs are currently still being developed, there are certain characteristics that have been identified broadly—across both mandatory and voluntary carbon markets—as helping to inform the integrity of carbon credits. The Commission preliminarily believes that a DCM should take these characteristics—referred to in this proposed guidance as "VCC commodity characteristics," and discussed more fully below—into consideration when designing a VCC derivative contract, and addressing in the contract's terms and conditions the underlying VCC.

BeZero Carbon response: We welcome and support regulation of the Voluntary Carbon Market - but the Guidance from the CFTC is based on a flawed assumption that Voluntary Carbon Credits are a commodity.

Earlier in the CFTC Guidance, it is acknowledged that VCCs are "tradable, intangible instruments". Carbon is not a commodity - it is impossible to accurately quantify whether a carbon credit project has delivered on removing a tonne of carbon from the atmosphere as one might assess, for example, the delivery of a tonne of steel.

However, it is possible to assess the likelihood that a carbon credit project has, or will, deliver on its claim. Carbon credit projects exist across a spectrum of quality - instead of treating them as binary commodities, we should treat them akin to instruments of financial risk, which require project-level assessments and ratings to understand their efficacy.

Of course, there are broad characteristics of good quality carbon credits that are common to all projects. For example a project must be additional, and it must have permanence. But these should always be assessed on a project-level and in relation to other factors, rather than implementing binary market conditions.

Responses to specific questions

Question 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?

BeZero Carbon response: We disagree with the characterisation of VCCs as a "commodity" as outlined in our responses to the guidance above.

We are in agreement with the characteristics identified in the proposed guidance of transparency, additionality, permanence and risk of reversal. Indeed, we wholeheartedly welcome the focus on disclosure and transparency - which is vital across the whole VCM supply chain if the market is to be a success. We therefore support the CFTC's call for underlying VCC projects to make information about their policies and procedures publicly available in a searchable and comparable manner - this is something we have advocated for at BeZero Carbon.

The assessment of additionality and permanence is also vital to understand the quality of a carbon credit project, and we welcome the CFTC's guidance that buyers should assess these qualities in relation to the underlying VCC when purchasing derivatives. As set out above, we believe that independent carbon credit ratings offer a solution for market participants to account for the quality of credits in a robust but proportionate fashion. We would therefore advocate that carbon credit derivative contracts should include independently awarded ratings as a key requirement.

Furthermore, at BeZero Carbon, we also assess a number of other factors in addition to additionality and permanence when assessing the quality of voluntary carbon credit projects, which may be of value for the CFTC to consider. We consider leakage (which assesses the risk that emissions avoided or removed by a project are pushed outside of a project boundary), overcrediting (assessing the risk that more credits are issued than tonnes of carbon avoided due to unrealistic baseline assumptions) and policy (the risk that a policy environment could undermine the efficacy of a project.)

Question 2: Are there standards for VCCs recognized by private sector or multilateral initiatives that a DCM should incorporate into the terms and conditions of a VCC derivative contract, to ensure the underlying VCCs meet or exceed certain attributes expected for a high-integrity carbon credit?

BeZero Carbon response: We believe that carbon credit ratings are an integral part of understanding the integrity of underlying VCCs. As per our previous responses, we believe that carbon credit derivative contracts should include independently awarded ratings as a key requirement in order to account for the quality of credits in a robust but proportionate fashion, as in the bond market

The BeZero Carbon Rating assesses the efficacy of carbon credit projects on an eight-point scale to determine the likelihood that they will remove or avoid a tonne of carbon. Our ratings are already used by some of the world's biggest businesses, banks and commodity traders to understand the risk behind their carbon credit investment, and enable them to make better financial decisions. Carbon ratings can work in tandem with broader industry standards initiatives, such as the Core Carbon Principles put forward by the IC-VCM, and provide the project-level analysis needed to give market participants the confidence to make effective environmental investments.

We have found that there is a statistically significant and growing relationship between BeZero rating and carbon credit price. This is evidence of the adoption of BeZero ratings as a key decision-making tool for market participants. On average, over the period since the launch of BeZero ratings in April 2022, there has been a 25% price difference between credits separated by one BeZero rating notch (e.g. 'C' and 'B' or 'BBB' and 'A'). Furthermore, as set out above, the average price premium for credits in the higher BeZero rating categories of 'A' or above has risen rapidly to 200% over the last year.

Question 8: In this proposed guidance, the Commission recognizes VCCs as additional where they are credited for projects or activities that would not have been developed and implemented in the absence of the added monetary incentive created by the revenue from carbon credits. Is this the appropriate way to characterize additionality for purposes of this guidance, or would another characterization be more appropriate? For example, should additionality be recognized as the reduction or removal of GHG emissions resulting from projects or activities that are not already required by law, regulation, or any other legally binding mandate applicable in the project's or activity's jurisdiction?

BeZero Carbon Response: We agree that an assessment of additionality is core to determining the quality of a VCC. We believe that the additionality of a carbon project cannot and should not be assessed through a single lens - e.g. carbon accounting, financial or legal. Rather, a holistic analysis considering a range of factors is necessary.

Additionality is a key element of BeZero's rating methodology. BeZero's assessment of additionality analyses four aspects: financial, activity, policy and legal. Financial analysis considers why the project is not economically feasible without carbon credits. Activity analysis considers the pervasiveness of the methodology or technology within the region and sectors. Policy analysis covers the extent to which the national or regional policy environment relevant to a project undermines its carbon effectiveness. Legal analysis assesses specific regulatory requirements for a project which may impact its additionality.

Accreditation bodies test across some or all of these factors, but do so on a binary (pass or fail) basis. In reality, additionality is a continuous range and there are varying degrees of relevance across each additionality factor, depending on the project. This is why project-level ratings are a critical tool to provide deeper risk-based insight for market participants.

We welcome further engagement on this topic. Should you wish to discuss further please email:
marketsandpolicy@bezerocarbon.com