The interaction of public money & private finance in carbon markets

An interview with Dr Andrew Moxey, Economist at Pareto Consulting

What is the policy view and direction of travel in Scotland and in the UK on carbon markets and agriculture?

Both UK government and Scottish Government have stated that they think private funding is necessary, in fact essential, for dealing with carbon emissions, but also with biodiversity and land use. For example, the current agriculture bill consultation in Scotland actually quotes the estimated figure for how much money is needed from private finance. So they've acknowledged that public money isn't sufficient here, but are more ambiguous about where they think private funding will come from.

Voluntary carbon markets are one of the sources and they seem quite keen on it, except for concerns about widespread afforestation on agricultural land, and ensuring a say for stakeholders other than the buyers and the sellers of that land. Whenever you get large flows of capital coming in from another sector it distorts things, and government has perhaps been remiss in not articulating the trade-offs between the forestation and agriculture when forestry targets have been in place for years now, even if the targets weren't explained then in terms of climate mitigation.

More people are now calling explicitly for land use planning to include agriculture and rural land use, and that large-scale changes to tree coverage may not be in the public interest and should therefore become a planning issue which forces ministers to make a decision on where trees should be, rather than leave it to private markets.

Overall, government's principles seem clear, but the details less so at this stage.

One of the big questions is what should government fund and what should be left to the private sector? What will be the likely interaction between public and private funding, and what might that mean for land managers choosing between finance options?

There are two main things that need funding: 1) up front capital investment, and 2) ongoing management, maintenance and monitoring. Currently we have a public system that pays for most/all of capital costs for woodland and peatland, but there is still the question of who is then covering ongoing costs of monitoring and managing. In peatland restoration it's assumed that this is what the carbon market is paying for, as you can't generate enough through carbon revenue for the upfront restoration.

What is needed is long term funding commitments, such as woodland establishment factoring in costs up to year 12; the public sector tends to be less generous about the ongoing management,

particularly where there is no future income (unlike forestry) so this could potentially be a space that VCMs fill, e.g. costs for 30 year management of the site to fulfil permanence criteria.

The picture gets more confused, however, when you factor in where the funding comes from and what it's motivations and goals are; e.g. payment for carbon credit creation and trading, or investment for ESG. The latter is a kind of sponsorship rather than investment looking for an explicit return, e.g. because it gives kudos with my customers, shareholders etc., and then they may be less concerned about what the market price of carbon is.

For those looking at commercial investment for carbon trading, you have to look at the returns from such projects. Peatland restoration projects indicate little or no return, with lots of uncertainty and few track records. Generally, commercial investors such as pension funds want 20% return not 2%. This suggests that commercial investment into reducing emissions in agriculture would form more of a sponsorship model, like ESG and insetting. The value of doing this then links quickly to the wider social, biodiversity and other environmental credentials of projects, and the interaction of formal additionality of these outcomes is less of an issue within ESG frameworks versus in carbon credit trading.

What is the role of policy in carbon price guarantees and other similar market structures to remove barriers to entry and increase uptake at early market stage?

A carbon price guarantee, like used in England for the woodland carbon, is intended to create a floor price in the market and de-risk investment. Alternatively, Contracts for Difference (as used in renewable energy) could be used - It's quite a neat way of doing it.

Basically, government is saying to the private sector that they will guarantee a minimum future price or return for carbon, and if the project runs at a loss, government will take the first hit. But if you actually get more than that, we get some share of the extra, so there is potentially an upside for government too. It's also possible that government could itself take like an equity stake in investments and there are some arguments around if government was seen to be committing on a long-term basis to some of these activities, it might attract some of the big private finance houses.

There is the argument that why doesn't the government just fund all of it and take all the profits, especially if they genuinely believe this is the right thing to do, why do we need to be enticing the private sector? The main reason there is down to the scale of investment needed, which is far more than the public purse has available. The other is around incentivising the private sector to help meet country-based and government-set legally-binding reductions targets, and avoiding fines for countries not meeting targets.

Do you see increased government compliance for emissions reduction as a threat to carbon markets?

Absolutely, since requirement of carbon reductions by actors from governments will undermine the criteria of additionality in VCMs. Apparently in Germany government policy has indicated that there won't be any voluntary markets beyond 2030, as a result of legislation from government requiring carbon action across industries.

This being the case, it only leaves e.g. 7 years of additionality for farmers. This raises various questions including what can be done in that time to maximise income from carbon credits while these are still an opportunity, whether doing this will undermine ability to meet regulations when enforced (which is likely, as carbon credits sold will be used in that year to offset emissions elsewhere, e.g. airline emissions), and who will fund ongoing management of mitigation options.

This also links to the discussion of paying to incentivise actions, or paying for a higher state of carbon management, whether or not these actions are already in place or they are just being enacted. Scottish Government have already indicated that they do not wish to economically exclude land managers who are already performing well with regards to carbon.

What will be the overlap between carbon credits and biodiversity credits, and is there a double counting and additionality risk, or will payments for some preclude others?

There are still a lot of big unanswered questions around this. It is quite possible that stacking of benefits and payments for actions is the only way that creating tradable credits will be economically viable, to generate enough income to offset both costs of implementation and of MRV. There may be other economic benefits also through indirect benefits to the production system e.g. improved soil health and therefore productivity. As a producer, you might be able to get charge a premium on your products if you say it's come from a pristine environment, and create a new revenue stream from these credentials, whether carbon, biodiversity, or several together.

Part of this discussion relates to what buyers of these credits are willing to pay for the carbon and other benefits. While some markets have more credible standards and higher quality carbon credits that people will pay a premium, globally, the world is awash with carbon credits for £3/tonne, so who is going to buy our £20 ones in the volumes that we are talking about now? The Taskforce on Scaling Voluntary Carbon Markets is working on a global scale to create more trustworthy carbon markets, but there's a sense that in the process it has been watered down and yet some people are pulling out from it because it's too complicated.

Some companies are moving away from buying carbon credits on the global market as they don't believe in it anymore, and would rather invest directly in environmental good deeds, and explore insetting, which is a trend that we're seeing an increasing interest in, supply chains focusing on what they can control themselves. You're starting to see that already with contracts which are now being issued from retailers or from processors, particularly in dairy, where they're now obliging the primary producer to do a whole range of things that then the downstream buyer is going to claim credit for.

For the supermarket or processor trying to move to net zero, scope 3 emissions are going to dominate their total operational emissions; they have no direct control over those so they will lean on suppliers by incorporating environmental compliance into the contract. For the farmers in this, it's a difficult situation because they might feel that they should get the credit for environmental actions, but compliance is likely to become just another cost of doing business. It might seem more lucrative for a farmer sell a carbon credits based on the actions into the open market, but then what happens if in 10 or 20 years' time they can't meet the supply-chain requirements of the buyer because they're so far different from others.

Are there areas that you feel policy could be developing or supporting more, or where there could be greater collaboration between industry and policymakers?

Yes; this is broader than carbon markets, but the current approach is based on standardised costs and a bureaucratic approach based which is not trusting people to deliver. Policy could benefit from talking to land managers as if they're trusted partners. The reality of projects is that often things don't happen as you think they would, which is not necessarily anyone's fault and shouldn't necessarily be penalised. Policy should also accept that costs of implementation of carbon projects are likely to rise partly due to inflation, and partly as low hanging fruit have already been picked. Things will get harder from now on.

It would also be helpful to align the application processes, criteria, windows, requirements etc. aligned between public and private funding. Likewise, to streamline on transaction costs, e.g. if a project has already been inspected by either bodies, there could be equivalence in inspection processes to minimise burden.

There's also not enough conversation and mutual understanding between government officials and financial investors on what both are looking for (e.g. length of commitments, returns expected etc.), which is understandable due to caution around conflicts of interest. But this is necessary if the public sector wishes to work with the private sector for joint delivery, and ensure initiatives that work for both parties.

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