Environmental, Social and Governance Alert

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The London Stock Exchange's New Voluntary Carbon Market Solution

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On November 5, 2021, the London Stock Exchange (LSE) announced that it is developing a new Voluntary Carbon Market (VCM) solution to "accelerate the availability of financing for projects that will support a just transition to a low-carbon economy".[1] As explained in the press release announcing the VCM, the LSE's initiative is intended to address two major challenges related to carbon mitigation projects: facilitating scalable capital formation for the development of new climate projects worldwide and establishing primary market access to a sustainable supply of high-quality carbon credits (CCs) for companies and investors. Per the announcement, the LSE believes that the VCM will enable stakeholders to "augment credible net zero transition strategies, by financing additional projects to offset unavoidable carbon emissions during their path to net zero".[2]

Specifically, the LSE envisages that the VCM will: (i) facilitate a liquid market for listing and trading interests in carbon funds with opportunities for investors in secondary markets; (ii) provide a wide range of investment opportunities generating CCs from a diverse range of underlying carbon reduction projects offering investors the chance to gain exposure to a variety of initiatives whilst at the same time hedging their risk; (iii) provide an additional and transparent benchmark to generate a "clear price signal" for carbon; and (iv) help generate investor confidence in the carbon credit market by facilitating investment opportunities in high-quality CC-generating projects via a reputable institution within an existing regulatory framework, including well-known disclosure and governance requirements.

The LSE believes that the VCM will serve as a natural extension of its previously announced Climate Transition Offering, an initiative that "provides data and tools to listed companies to support them to make their [low carbon] transition".[3] Additionally, the LSE believes the VCM is another example demonstrating its commitment to innovating markets generally and particularly with respect to driving action on climate change initiatives on a global scale. The LSE's CEO, Julia Hoggett, has stated that by "raising the profile of the public listed fund market, we can enhance the disclosures and the visibility of that market and also direct capital into it."[4]

The establishment of the LSE's VCM follows in the footsteps of climate change efforts by other countries in the carbon market field, including, most recently, Singapore's

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announcement of the creation of Climate Impact X, a VCM backed by the Singapore Exchange. Please see our related blog post here.

How will the LSE's VCM work?

The LSE envisages a potential five-step process for how its VCM will operate, as follows: [5]

- Step 1: The project developer identifies one or multiple projects that will generate voluntary CCs.
- Step 2: The fund is listed onto the LSE with a new designation for carbon markets.
- Step 3: Investors invest into the fund.
- Step 4: The fund issues CCs as a dividend *in specie* to investors and any economic interests associated with underlying assets are paid in the form of a dividend.
- Step 5: Investors can continue to buy and sell shares in the fund and use CCs for their own purposes or trade CCs.

Accordingly, funds will be listed using the LSE's existing market infrastructure which already includes extensive governance and disclosure requirements, with the expectation that such requirements will be complemented by specific requirements relative to the generation of CCs, thereby combining "the governance and rigour of public markets with the best practice in carbon markets today".[6] It is recognised that standards in the carbon markets are evolving and, on that basis, the LSE envisages that "the process of generating carbon credits will use the current ecosystem of credible standards and verification bodies that is being strengthened by the efforts of the Taskforce on Scaling Voluntary Carbon Markets and other governance initiatives". As the market develops further, the LSE will presumably implement new standards and frameworks as they emerge.

As set out above, investors will receive investment returns *in specie* in the form of CCs, and/or cash dividends and other distributions, where applicable. That said, the issuance of CCs as a form of financing only works if the CCs are generated from projects that would not otherwise be undertaken in the normal or ordinary course of business.[7] As a result, it is believed that utilising a framework undergirded by Voluntary Carbon Credits will be readily accepted by the markets because they are a proven financing mechanism, with each credit representing "one tonne of CO2 (or equivalent greenhouse gas) reduced or removed that has been independently verified against robust accounting methodologies".[8] Investors will then be able to use CCs received in the following ways: retire the CCs to mitigate their own activities or investments, or sell them, through traditional methods or through approved markets/schemes. It is anticipated that the impact of this increased financing will ultimately give rise to an increased supply of CCs.

The LSE recognizes that whilst a VCM ecosystem has already been in place for over 20 years, its key obstacle to scale has been its small, fragmented nature and lack of market infrastructure resulting in poor access to institutional investment. The LSE anticipates that the core participants in its VCM will be corporations and institutional or retail investors with long term needs for CCs. As a result, the VCM will allow investors to credibly implement their own net zero transition strategies by financing these additional projects to offset their remaining and unavoidable carbon emissions on their path to net zero. The development of the LSE's VCM comes at a pertinent time where the growth in companies committed to meeting net zero targets, through off-setting strategies and innovation, is being “stifled by the combination of a largely OTC [over-the-counter] procurement model from small entities and rapidly rising secondary market prices for a limited pool of high-quality carbon credits”.[9] On the other side, the LSE expects that the VCM will encourage project developers to focus on climate mitigation projects, serving to help reduce greenhouse gas emissions or remove carbon from the atmosphere, by facilitating receipt of new flows of investment capital, which have previously been insufficient and inconsistent. It is anticipated that the VCM will particularly benefit climate mitigation projects in the Global South.[10] Further, as the Global South is a significant source of high-quality CCs, the VCM is expected to provide a “key financing tool for those countries in a just transition”.[11]

Conclusion

With suggestion that we may reach 1.5 degrees of warming as soon as 2034,[12] the LSE is looking to enhance its status as the leading global venue for sustainable finance and the role that it can play in combatting the climate crisis through successfully developing market solutions such as its VCM within its existing regulatory framework. The LSE maintains that this will incentivise higher carbon market standards, facilitate transparent pricing and improve investor confidence resulting in an increased overall carbon market engagement, and additional capital that can contribute to global efforts for climate change reduction.

[1] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[2] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[3] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[4] https://www.cnbc.com/2021/11/09/london-stock-exchange-aims-to-bring-firms-carbon-claims-out-into-daylight.html.

[5] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[6] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[7] According to the press release, these projects represent the “concept known as ‘additionality’ i.e., the activity is genuinely additive to the sum total of existing global efforts to reduce CO2”.

[8] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[9] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[10] Less developed countries below the Brandt Line; Africa, South America and developing countries in Asia.

[11] https://www.londonstockexchange.com/discover/news-and-insights/voluntary-carbon-markets.

[12] https://climate.copernicus.eu/how-close-are-we-reaching-global-warming-15degc

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