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Explainer: The difference between Compliance and Voluntary Carbon Markets

Government-regulated **compliance carbon markets** (CCMs) are created and regulated by mandatory national, regional, or jurisdictional carbon reduction regimes. Facilities or companies covered are obliged to take part – hence the term compliance. These markets are normally in the form of a cap-and-trade system where installations or bodies need to hold or purchase enough permits to cover their emissions. Over time, total emissions are reduced by imposing a gradually declining 'cap'. An example is the EU ETS.

The **voluntary carbon market** functions separately from compliance markets and enables companies and individuals to purchase carbon credits on a voluntary basis. The VCM process is different to the CCMs' process: the basis here is that one entity (e.g. a company) pay another one (e.g. a carbon project) for the removal or avoidance of emissions. The activities by a project, for example, generate carbon credits, each representing one metric tonne of removed or avoided CO2e. These independently verified credits are purchased by companies (and other entities such as individuals or governments) who voluntarily choose to counterbalance their emissions footprint in this way.

While the compliance market and the voluntary market evolved separately and serve different purposes, there are overlaps and **blurred boundaries**. Historically, some compliance markets had VCM credits, but overtime concerns over the integrity of some of the Clean Development Mechanism (CDM) credits as well as the need to focus on domestic mitigation action drove several CCMs away from voluntary credits, which leads some experts to predict that the two will never merge. However, experts are divided with some believing that the two types of markets can inform each other towards higher standards and integrity, and over time they may come closer together.

Today a few **compliance markets** currently accept a set and small percentage of voluntary carbon credits. In California, for example, the Climate Action Reserve (CAR) developed a series of voluntary carbon project protocols that were subsequently adopted (with some modification) in the California Compliance Offsets Program. Voluntary credits issued under these protocols by CAR prior to the start of California's cap-and-trade program were able to transition over and become eligible for compliance. Countries like Mexico and South Africa have also recognised a certain proportion of carbon credits issued by voluntary programmes as a means of complying with carbon tax obligations.

Developments on **Article 6** at COP26 in Glasgow gave rise to the possibility of more carbon markets and trading activities globally, with more countries looking at establishing different types of carbon markets as a tool to help them meet their NDCs.

Article 6 relates to the establishment of rules under the Paris Agreement where countries can employ market-based mechanisms or cross-border collaboration to achieve their Nationally Determined Contributions (NDCs). Article 6 proposed two market mechanisms: 6.2 governs country-to-country trading rules, and 6.4 establishes a global carbon credit mechanisms where countries, international bodies, companies, and individuals can take part. In both mechanisms, double counting is avoided by applying a corresponding adjustment. **Double counting** is when an emissions reduction or removal is claimed twice by different bodies, undermining global climate ambition. A **corresponding adjustment** is a carbon accounting procedure where a credit that is 'exported' from the host country (country of origin for the credit) is only counted once by a buyer of that credit. This is done through 'authorisation' of credits ready for export by host countries.

How companies will engage with Article 6 and these **accounting rules** is still an open question. A company is not obliged to buy 'authorised' credits, but they may very well choose to do so. It will be up to individual countries and companies on the rules of the markets and how they will engage with them. For example, the market-based mechanism for airlines -- the International Civil Aviation Organization's Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) – is expected to require corresponding adjustment for traded credits.

Major **registries** such as Verra and Gold Standard are looking at offering Article 6-compliance credits to market. The VCM has been in operation for decades and many proponents would argue that checks and balances are in place to ensure market integrity. However, it remains unregulated with some reputational issues, and so efforts for greater oversight from the private sector are underway. The Integrity Council for the Voluntary Carbon Market (ICVCM) is addressing the supply-side quality, while the Voluntary Carbon Market Integrity Initiative (VCMI) is establishing a common code of practice for company claims – when it comes to counterbalancing emissions and **beyond value chain mitigation** – that will drive the demand side.

This is still a way off: the VCM has huge **potential to scale** and more linkages to CCMs are possible; but assurances of integrity are key for its success. The VCM is still tiny compared to CCMs, trading nearly 300mt in 2021 while CCMs covered 12Gt globally. But the VCM has grown massively in recent years and a high-integrity voluntary carbon market (separate from the compliance markets) has the potential to mobilise, at speed and scale, billions of dollars a year in additional climate finance that removes carbon or cuts emissions that help the world stay within the 1.5 degrees limit of the Paris Agreement, and that benefits communities and ecosystems more broadly, helping us reach not only our climate targets, but our nature and sustainable development goals as well.

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