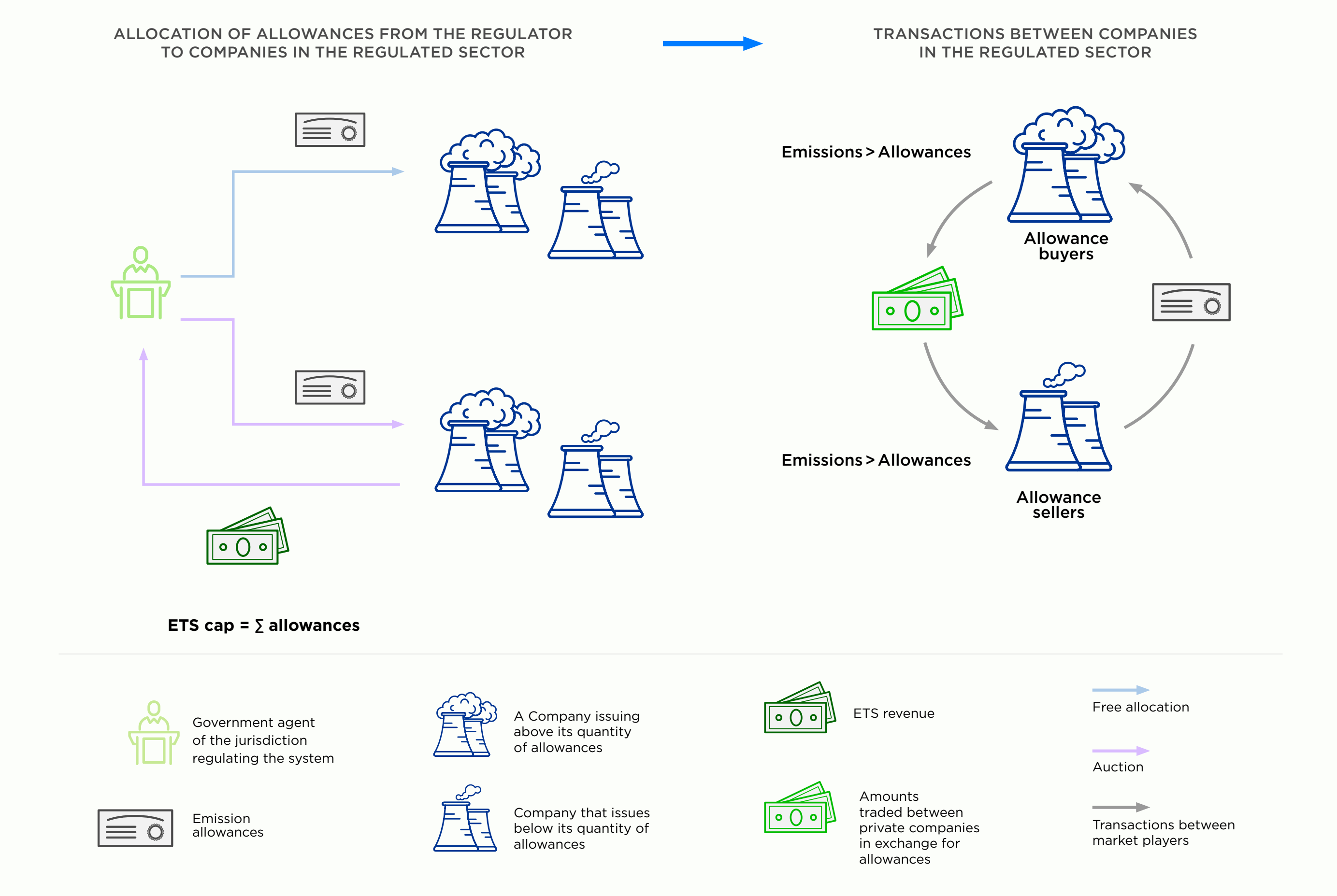
FACT SHEET 2023

OPPORTUNITIES FOR BRAZIL IN CARBON MARKETS

ICC Brasil | WayCarbon

HOW AN ETS WORKS

The new edition of the study "Opportunities for Brazil in carbon markets" continues to focus on raising updates and recommendations for the evolution of the carbon market. However, **while previous editions have mainly explored the opportunities in the Article 6 mechanisms of the Paris Agreement and the Voluntary Carbon Market, this study focuses on analyzing the potential impacts of the Brazilian Regulated Market**. In addition, it seeks to understand how the competitiveness of Brazilian products in the international market can be affected by the border adjustment rates of foreign regulated markets, investigating whether the adoption of a regulated market in Brazil could mitigate these impacts. In this way, some concepts are revisited, such as the functioning of Emissions Trading Systems (ETS) and the possibilities of these systems interacting with other markets. The following figure 1 illustrates how ETSs work.

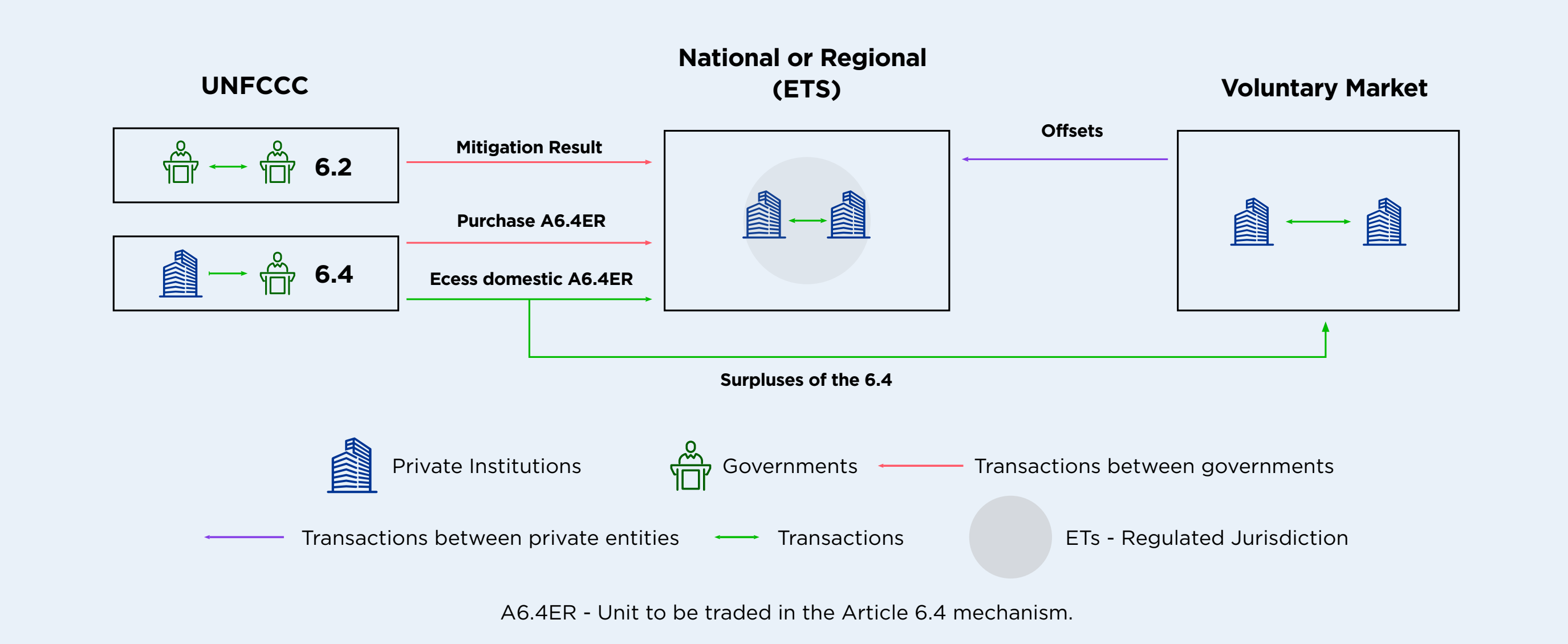


Source: Own elaboration.

INTERACTION BETWEEN CARBON MARKETS

It is also expected that there will be interaction between the ETS and the global carbon markets regulated by the UNFCCC and with the voluntary market. Obviously, these negotiations must undergo the necessary corresponding adjustments to avoid carbon credits being double-counted in the decarbonization targets of regulated agents or countries.

The use of credits for offsetting purposes could take various paths, mainly depending on whether the project´s host country accepts the sale of credits and the appropriate adjustment. **Governments, for their part, will have to decide how to use the voluntary market and be selective in approving credits that contribute or not to the NDCs.** The figure bellow illustrates the possible forms of interaction between carbon market environments.

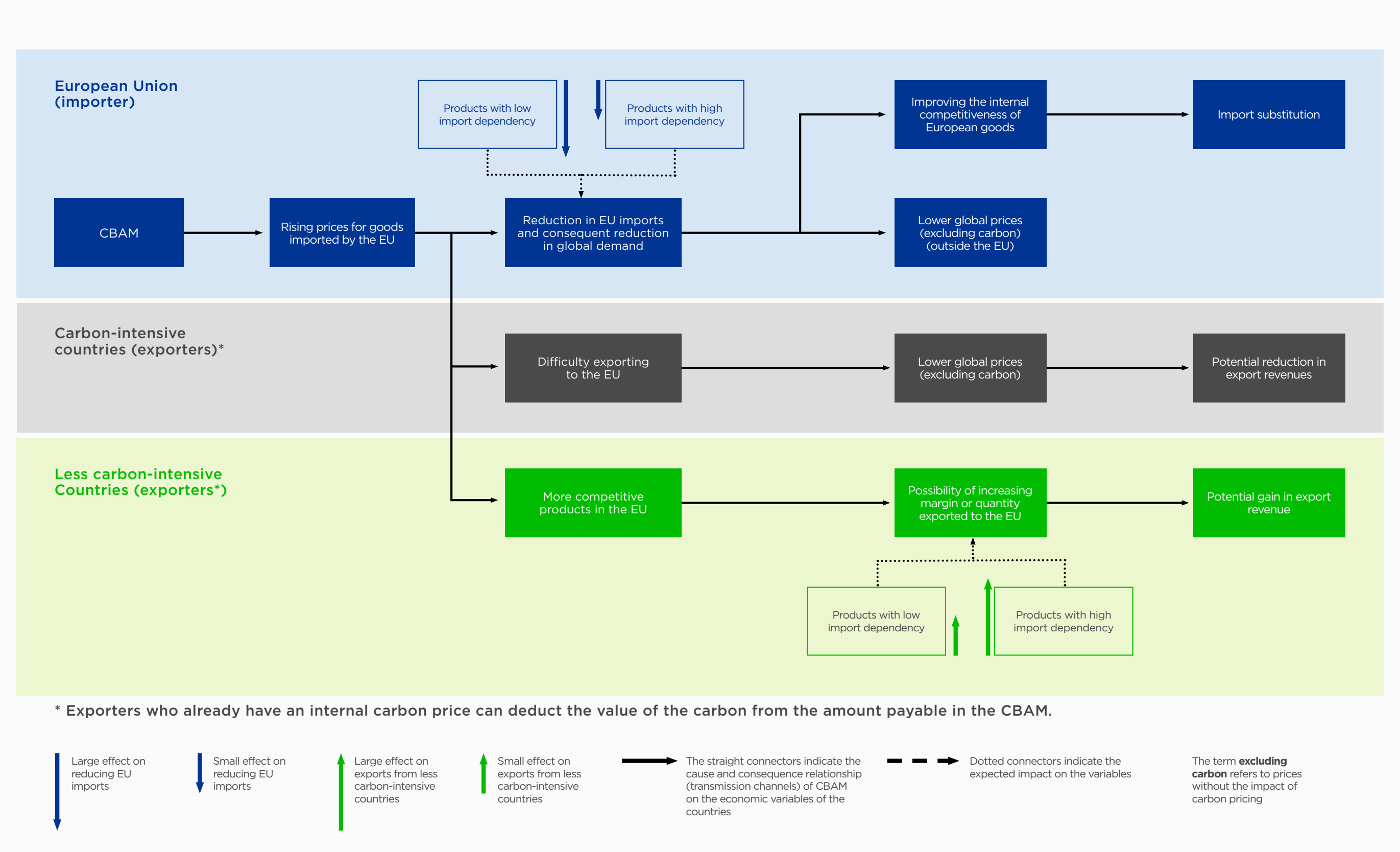


A6.4ER - Unit to be traded in the Article 6.4 mechanism.

Source: Own elaboration

IMPACTS OF EU CBAM

Carbon markets become even more interdependent as countries adopt border adjustment mechanisms for carbon pricing. **This year's study analyzes the expected impacts of the Carbon Border Adjustment Mechanism (CBAM) on the competitiveness of Brazilian industry**, comparing the carbon footprint of national products with European products and with other countries exporting these products to the European Union (EU).



* Exporters who already have an internal carbon price can deduct the value of the carbon from the amount payable in the CBAM.

Source: Own elaboration.

It can be seen that the selected national products are less carbon intensive than the "rest of the world" profile, but this does not always occur regarding EU. One of the advantages of products produced in Brazil compared to their international competitors is the greater presence of renewable sources in the electrical matrix, so that this advantage is more apparent in procedures with high energy consumption. However, emissions from industrial processes themselves can play a major role in the carbon footprint of products, and can reduce the country's competitiveness in less energy-intensive processes.

Calculation of carbon footprint in the production of 1 ton of selected products for Brazil, Europe and the rest of the world

Sectors (ISIC Class)	Product	Brazil (tCO_2e)	EU (tCO_2e)	World (tCO_2e)
Manufacture of basic iron and steel	Steel production, converter, low alloy	2.14	2.08	2.18
Manufacture of vegetable and animal oils and fats	Soybean meal and crude oil production	3.04	7.60	7.82
Extraction of crude oil	Oil and gas production	0.34	0.18	0.39

* It should be noted that the CP calculation considers the average emissions for the production of the selected products, so certain companies may have higher or lower CPs than those presented.
Source: Own preparation based on data from Ecoinvent (2023).

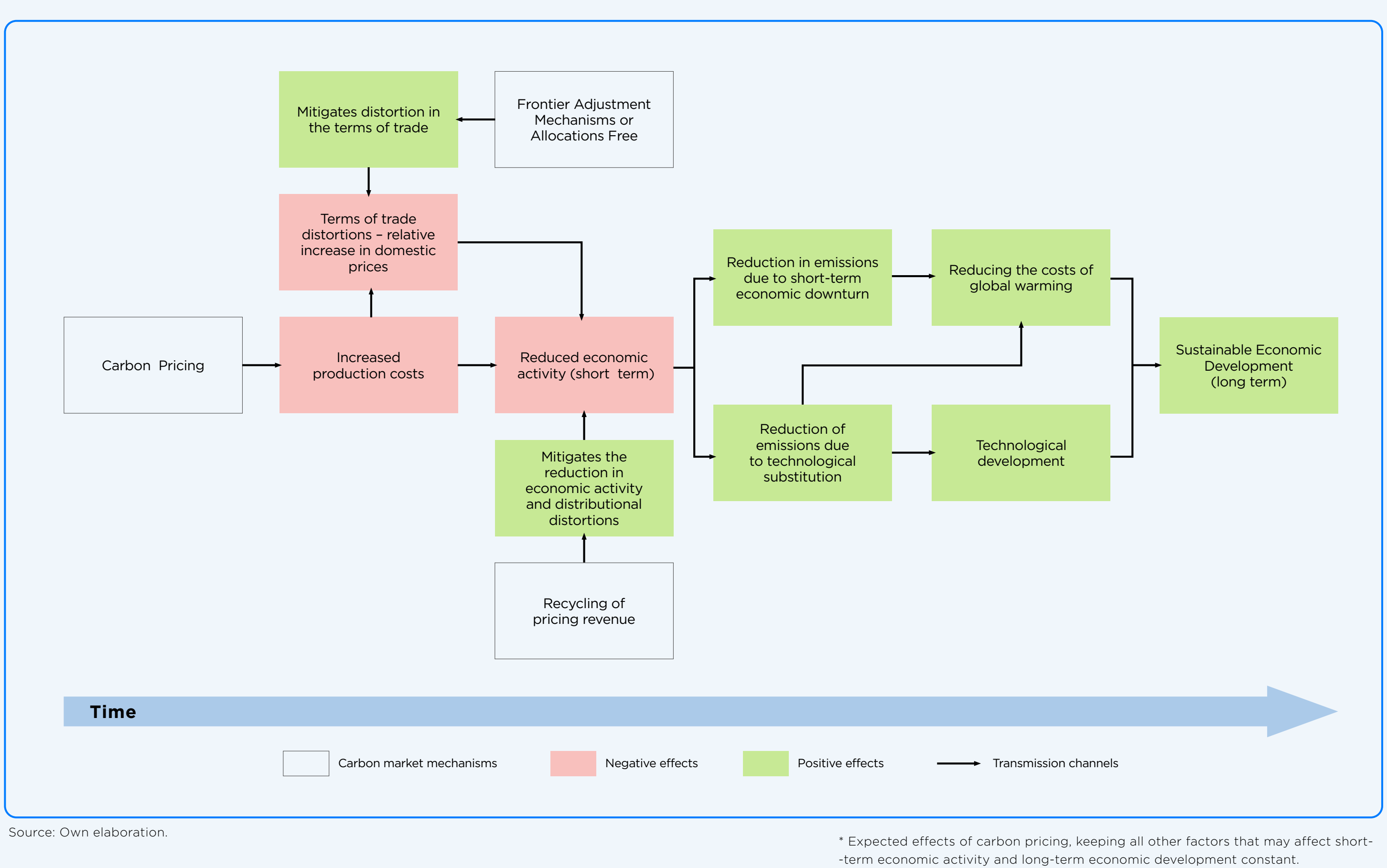
IMPACTS OF CARBON PRICING

Moving on to the regulatory elements for a Brazilian carbon market, the study also delves into the arrangements needed to create an efficient market, which guarantees the security of emissions allowance transactions, providing confidence in the contracts.

As a crucial aspect concerning the effectiveness of the carbon pricing system, this study also examines the costs and potential for emission reduction in Brazilian industrial sectors. Brazil stands out for offering numerous investment opportunities with low marginal abatement costs, enhancing the appeal of emission reduction for potentially regulated sectors. Consequently, the anticipated impacts of carbon pricing in Brazil are expected to be mitigated.

In addition, the study seeks to substantiate the socio-economic expected impacts from a regulated carbon market. In this sense, besides conceptualizing the transmission mechanisms between pricing, emission reductions and economic impacts, the study provides a survey of the impacts on economies that already have an established carbon pricing mechanism.

In addition to carbon pricing, you also need to establish an efficient recycling of the revenues obtained on the market, which can be achieved mainly through the auctioning of allowances. Revenue recycling aims to compensate for possible distortions created by carbon pricing, whether through the direct transfer of income, tax reductions or investments in clean technologies among other alternatives.



Source: Own elaboration.

* Expected effects of carbon pricing, keeping all other factors that may affect short-term economic activity and long-term economic development constant.

RECOMMENDATIONS

TO THE GOVERNMENT

The recommendations to the government are aimed at increasing the country's climate ambition, avoiding possible regressive effects on the most vulnerable populations and enabling a just transition to a low-carbon economy.

FOR THE IMPLEMENTATION OF THE BRAZILIAN ETS:

1. Ensure transparent and open consultation with the entities to be regulated and institutions with technical knowledge of carbon markets to design the rules of the Brazilian carbon market during the government's drafting process.
2. Implement a regulated carbon pricing system (ETS) to ensure the setting of prices and that there is an exemption from or reduction in the fees imposed by EU CBAM for exported products.
3. Define the institution that will be responsible for operationalizing the ETS, as well as other institutions that could be involved.
4. Define the legal nature of the emissions allowances to be traded in the ETS.
5. Establish phases for the implementation of the ETS to: begin implementation by regulating the fuel and industry sectors and expand the number of regulated sectors; gradually reduce the ETS cap; initially include domestic offsets in the Brazilian ETS for eligible project types; and periodically reassess the impacts of the ETS to guarantee the effectiveness of the carbon pricing policy.
6. Reconcile free allocations and allocations through auctions, considering the adoption of the grandfathering criterion, for 50% free allocation to all sectors with a risk of competitiveness, and a percentage of allocation through auctions designed to raise revenue.
7. Recycle any revenues effectively and fairly to offset the negative distributive effect on the population's income and in sectors that will have their competitiveness affected by the pricing mechanism and for investments in decarbonization or R&D projects.
8. Establish a system of strong penalties to discourage possible fraud.
9. Regarding the inclusion of offsets, the following should be studied: the types of carbon projects that will be eligible for the inclusion of credits and the criteria for the inclusion of offsets should be projects that benefit and have the active participation of local communities.

OTHER RECOMMENDATIONS TO THE GOVERNMENT:

1. Simultaneously with the adoption of carbon pricing, implement a robust MRV system to record and monitor mitigation results to meet NDCs and integrate with other systems.
2. Support and direct the private sector in its decarbonization so that Brazilian companies do not lose competitiveness internationally.
3. Commit to zero illegal deforestation and reduce legal deforestation in the country.
4. Take a stand for the World Trade Organization (WTO) to guarantee clear rules regarding the equal measurement of the carbon intensity of products and their production processes, so that different production routes and the reality of each country are taken into account, as well as the electricity matrix.
5. When discussing the methodology to calculate emissions according to the European Union's CBAM guidelines, it is essential to broaden the approach to include not only direct emissions, but also to consider carbon removals from the sustainable implementation of forests.
6. Support the debureaucratization and simplification of transaction processes, as well as implement digital technology for the MRV and carbon credit certification processes.
7. Enable a series of important institutional measures for the voluntary carbon market.
    - **7.1.** Define the legal nature of carbon credits and the roles of financial institutions and the carbon credit asset regulator. In addition, creating a trading infrastructure, as well as bookkeeping and creating identification codes for the credits.
    - **7.2.** Foster the development potential of the voluntary carbon market.
    - **7.3.** Strengthen the government's technical bodies on carbon projects, local community participation in these projects, for example.
8. Given the planning for compliance with the NDC, establish the strategy for selling credits through Article 6 mechanisms.

TO THE PRIVATE SECTOR

To strengthen national carbon markets and support companies exporting products potentially affected by border adjustment mechanisms and sectors to be regulated under the Brazilian ETS, the following recommendations have been drawn.

1. Prioritize decarbonization as an urgent strategy to be implemented independently of and in parallel with the process of creating a regulated market in Brazil.
2. Draw up a GHG inventory and calculate the carbon footprint of the products produced.
3. Expand the effort to reduce and remove GHG emissions by investing in technological development and innovation.
4. Strengthen the involvement of the financial sector to increase market liquidity and the possibilities of financing and financial mechanisms for decarbonization projects. Other financial mechanisms can be developed to reduce the cost of capital for regulated entities.
5. Advocate for a decrease in legal deforestation and the elimination of illegal deforestation in the country, while promoting the expansion of reforestation efforts.
6. For those involved in the supply of carbon credits, with a view to including offsets in the regulated Brazilian market, invest in carbon projects that include the participation of and generate income for indigenous and traditional populations.

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