

Legal Update - September 2023

Financial Services Authority Regulation No. 14 of 2023

Mechanism of Carbon Trading through Carbon Exchange Established

Following Financial Services Authority Regulation Issuance on Carbon Trading through Carbon Exchange

Mechanism of Carbon Trading through Carbon Exchange Established by New POJK

1 Overview

Previously, Law No. 4 of 2023 on the Development and Strengthening of the Financial Sector (**UUP2SK**) had mandated the Indonesian Financial Services Authority (*Otoritas Jasa Keuangan - OJK*) to regulate and supervise carbon trading through carbon exchange. Hence, instruments related to carbon pricing or *Nilai Ekonomi Karbon (NEK)* will be tradable through the secondary market or exchange.

With the enactment of Law 4/2023, carbon units are categorized as securities (*efek*)¹, and it is further highlighted that the mechanism of carbon trading through the carbon exchange is categorized as transaction activities in the financial sector, specifically in the capital market. The implementation as a whole is carried out through the development of the carbon trading infrastructure, regulation on the utilization of state revenue from carbon trading, and/or the administration of carbon transactions.

To build the infrastructure of carbon exchange, the OJK has issued the Financial Services Authority Regulation Number 14 of 2023 on Carbon Trade through Carbon Exchange (*Peraturan Otoritas Jasa Keuangan No. 14 Tahun 2023 - POJK 14/2023*). In this regulation, OJK highlights the object of trading, as well as framework on carbon exchange, including the stakeholders involved and trading requirements. Following the enactment of POJK 14/2023, OJK issued the OJK Circular Letter No. 12/SEOJK.04/2023 on the Procedures for Implementing Carbon Trading through the Carbon Exchange (**OJK Circular Letter 12/2023**) - a step further into developing and strengthening the carbon trading ecosystem.

2 Carbon Units as Object of Trade

a. Carbon Units as Securities vs Non Securities

Fundamentally, the Presidential Regulation and Minister of Environment and Forestry Regulation on NEK² have stipulated that carbon trading may be conducted directly (business-to-business purchase) or through a carbon exchange. When traded through direct trading, some would say that carbon units are considered as commodities. Whereas, when traded through an exchange, carbon units are financial instruments that can be bought and sold among various market participants. However, it has been clearly established by the Indonesian government that in the context of the financial sector, carbon units are categorized as financial instruments, particularly as securities or *efek*.

Principally, in terms of securities, there are securities markets and securities companies. A securities market is a place for buying and selling securities (exchange), while a securities company is a party that conducts business activities and holds a license from the OJK. Securities companies act as intermediaries between investors and the financial markets. However, in contrast to the traditional securities market, carbon exchange is organized by

¹ UUP2SK defines "securities" or "efek" as tradable financial instruments, whether physical or digital, granting owners economic benefits based on agreements, including derivatives, traded in the capital market.

² Presidential Regulation 98 of 2021 on the Implementation of Carbon Pricing to Achieve the Nationally Determined Contribution Target and Control Over Greenhouse Gas Emissions in the National Development (PR 98/2021) and Minister of Environment and Forestry Regulation No. 21 of 2022 on the Procedures for Carbon Pricing Implementation (MOEF Reg 21/2022).

Carbon Exchange Organizers that have obtained permission from the OJK. Users that have registered themselves in the carbon exchange platform may utilize the carbon exchange to conduct carbon trading through various mechanisms available within it.

As comparison, Australia also treats carbon units as securities, while the United States treats them both as commodities and securities. Some carbon allowances or offsets are traded in the form of commodity derivatives and fall under the US Commodity Futures Trading Commission (CFTC) regulation. On the other hand, there are also some carbon-based financial products in the form of securities and are subject to the US Securities and Exchange Commission (SEC) jurisdiction. More comparison about the variety of arrangements of carbon units can be found on the table below.

	Australia	USA	Indonesia
Carbon Market	Voluntary and Compliance Carbon Market	Voluntary and Compliance Market	Voluntary and Compliance Market
Instruments	Voluntary: Australian Carbon Credit Unit	Voluntary: Certified Emission Reduction	Voluntary: SPE-GRK
	Compliance: Allowance, carbon cap	Compliance: Allowance, Carbon cap	Compliance: PTBAE-PU and SPE-GRK (Offset)
Jurisdiction	Primary Market: Clean Energy Regulator	Primary Market: Up to States government	Primary Market: Minister of Environment and Forestry and Relevant Ministers ³
	Secondary Market: Australian Securities and Investments Commission	Secondary Market: Securities and Exchange Commission (SEC) for stocks Commodity Futures Trading Commission (CFTC) for derivatives	Secondary Market: Indonesian Financial Services Authority (OJK)

In the US, as result of the differentiation of SEC and CFTC, the SEC could impose regulation and policy regarding the registration process, financial statements and reporting, disclosures, investigating procedures, and trading restrictions. Meanwhile, CFTC only focused on building transparent and liquid markets, therefore, they formed an Environmental Fraud Task Force to address process irregularities in derivative trading mechanisms.

³ The minister who is the coordinator of the sector or the person in charge of the sub-sector in the NEK implementation procedure.

In Indonesia, carbon units traded at the carbon exchange consist of PTBAE-PU and SPE-GRK⁴. PTBAE-PU is for trade between other PTBAE-PU holders, under the same sectors and within the domestic levels. Meanwhile, SPE-GRK is a cross-sector trade and can be traded overseas.

Previously, Indonesia already had a stock exchange operated by the Indonesian Stock Exchange (IDX). Just like the stock exchange, the carbon exchange will function as a place for buying and selling carbon units. The presence of the carbon exchange functions as a supervisor and facilitator of securities trading. With the existence of a carbon exchange, carbon unit transactions can be more secure and open so that they can be more accountable, maintain market integrity and support the achievement of NDC targets.

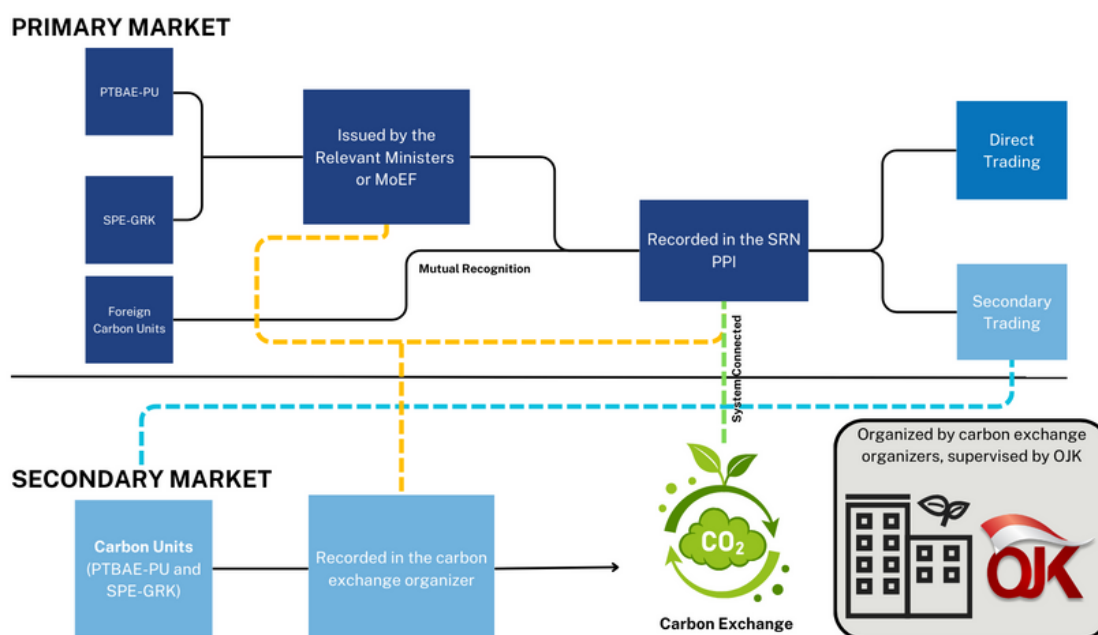
As per 18 September 2023, the IDX has obtained the carbon exchange organizer license from OJK.

b. How it is Traded in the Carbon Exchange

As stated above, carbon units are the "financial products (*efek*)" traded on carbon exchanges, consisting of PTBAE-PU and SPE-GRK. This is in accordance with previous carbon trading regulations, such as PR 98/2021, which stipulates that PTBAE-PU and SPE-GRK can be traded, either through direct trading or carbon exchanges.

In terms of the capital market, basically, there are 2 (two) types of markets, including the primary market or initial market, and the secondary market. The primary market is a market where investors buy securities for the first time from the issuer (company) through an Initial Public Offering (IPO). Meanwhile, the secondary market is where investors trade securities that have been issued by the company. This secondary market is often named an exchange, where investors can buy and sell through a number of mechanisms.

In terms of carbon trading, before carbon units are traded on the carbon exchange or enter the secondary market, they must first be registered with the SRN PPI and the Carbon Exchange Organizer, as carbon units that are not registered in the SRN PPI cannot be traded. An explanation of this is set out in the illustration below.



⁴ Petunjuk Teknis Batas Atas Emisi Pelaku Usaha or PTBAE-PU is the determination of upper limits on GHG emissions for business actors and/or the determination of emission quotas within certain compliance periods for each business actor, while Sertifikat Pengurangan Emisi Gas Rumah Kaca or SPE-GRK is a letter of proof of emission reduction by a business and/or activity that has gone through measurement, reporting and verification, and is recorded in the PPI SRN in the form of a registry number and/or code.

From the previous figure, we can conclude that the issuance of PTBAE-PU and SPE-GRK (both SPE-GRK which is the result of the performance of PTBAE-PU and SPE-GRK from emission offset) is first recorded on SRN PPI. This can be understood that this stage is included in the primary market, where the authorized party can determine and issue PTBAE-PU and SPE-GRK, and can then be traded on the carbon exchange or secondary market. In other words, all traded in the secondary market must be verified in the primary market first.

In its determination, PTBAE-PU is determined by the Relevant Minister based on PTBAE. Then, based on the verification results of the calculation of emission results carried out by business actors (above or below PTBAE-PU), carbon trading can be carried out. If the actual emission is below PTBAE-PU, an application for SPE-GRK issuance can be made (SPE-GRK performance results from PTBAE-PU). In terms of SPE-GRK issuance, it is issued by the Ministry of Environment and Forestry (MoEF). Following the establishment and issuance of PTBAE-PU and SPE-GRK, as well as being listed in SRN PPI and the Carbon Exchange Organizer, carbon units can be traded on the carbon exchange (secondary market). In the carbon exchange, the trading mechanism is subject to internal policies set by the Carbon Exchange Organizer.

If we refer to the carbon trading plan and initial trading pilot project organized by IDX, there are 4 (four) possible mechanisms, which are: (a) auction; (b) regular trading; (c) negotiated trading; and (d) marketplace.⁵ These mechanisms may apply to the carbon units and its derivatives. From this, we can assume that in the future, there is a possibility that carbon trading in carbon exchanges will be carried out through several mechanisms and in accordance with their internal policy.

The IDX carbon exchange is expected to run its first trading on 26 September 2023, where the focus will be on the power plant sub-sector.

c. Carbon Unit-based Products Expected to Rise

Carbon Exchange Organizers are also able to conduct other activities, including developing carbon unit-based products or derivatives, as well as providing a platform for such product or derivative trading. One of the most common forms of derivatives tied to carbon credits that has emerged is futures contracts. Derivatives typically attract and allow compliance companies to invest and diversify their portfolio in terms of managing their carbon emission-related risks. Through futures contracts, compliance companies can avoid price fluctuations - providing cost-efficiency in the long run. Hence, with the classification of carbon units as securities, we may expect the development of derivatives from PTBAE-PU and SPE-GRK, which can be traded on the carbon exchange, in the future.

3 Carbon Exchange Organizer

A Carbon Exchange Organizer is an entity that organizes and provides the implementation of the carbon exchange. Only organizers holding a license from OJK are eligible to operate. To obtain a business license as a Carbon Exchange Organizer, the applicant must submit the application to the OJK work unit in charge of licensing carbon exchange organizers. To process the application, OJK may conduct further assessment and clarification, before finally accepting or rejecting the application. In addition, licensing requirements may be partially or fully enforced based on OJK's consideration for financial service institutions that have obtained a business license from OJK.

⁵ Indonesia Stock Exchange, "Rencana Perdagangan Karbon dan Pilot Project Perdagangan Perdana", 19 September 2023.

In carrying out its business activities, there are a number of obligations that must be met by Carbon Exchange Organizers, which includes regulating service users, traded carbon units, trading activities, and supervision. In its regulation, there are a number of provisions that need to be contained, one of which is the provision of traded carbon units, which at least contains: (a) criteria for traded carbon units; (b) registration procedure for the carbon unit to be traded; and (c) costs. Detailed mechanisms on the steps to register a carbon unit and how to conduct carbon trading via carbon exchange can be found in OJK Circular Letter 12/2023.

In terms of stakeholders duties, the regulation has set out several responsibilities for Carbon Exchange Organizers and its board members to meet. Failures to meet these obligations, may be subject to administrative sanctions, which are in the form of: a) written warning; b) a fine is an obligation to pay an amount of certain money; c) restrictions on business activities; d) suspension of business; and/or e) revocation of business license.

4 International Carbon Units Tradable in Domestic Carbon Exchange

Aside from carbon units and their derivatives or other financial instruments that are developed nationally, Carbon Exchange Organizers are also able to facilitate trading of foreign carbon units, both that are registered and not registered under SRN PPI. Hence, it can be understood that carbon units generated from carbon projects that were verified outside Indonesia will be able to be traded through the carbon exchange. For the foreign unlisted carbon units, the following provisions apply:

- a. Have been registered, validated, and verified by an institution that has obtained accreditation from an international registration system;
- b. Meet the requirements to be traded on a foreign carbon exchange; and
- c. Meet other requirements determined by OJK.

This is in line with the provisions in MoEF Regulation on NEK, which stipulates that emission reduction certificates issued by other certification bodies can be declared equivalent to SPE-GRK - therefore, tradable in Indonesia - if the MoEF has enacted mutual recognition in overseas carbon trading and has published the certifications in SRN PPI. Though, the MoEF has yet to implement such a mechanism. Furthermore, in order to implement the provision where the Carbon Exchange Organizer can facilitate trading of foreign carbon units, the Carbon Exchange Organizer needs to submit an application for registration of carbon unit listing to OJK.

To support trading operations and supervision of carbon unit trading, the POJK has stipulated that Carbon Exchange Organizers must provide systems and/or facilities, which are further regulated in OJK Circular Letter 12/2023. One of requirements is that the system must be connected to SRN PPI in order to validate carbon units traded at the carbon exchange.

5 Conclusion

The role of a Carbon Exchange Organizer is crucial in ensuring the smooth and secure operation of carbon trading in Indonesia. Through this regulation, the Government of Indonesia aims not only to guarantee the orderliness of these transactions but also the proper recording of each exchange. Through vigilant supervision, they maintain a watchful eye on the proceedings, ensuring transparency and adherence to established rules. Moreover, the organizer plays a paramount role in ensuring fairness to all participants who have an equitable and unbiased experience in the carbon trading market.





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About CarbonEthics

CarbonEthics is an organization that aims to restore the climate balance through natural climate solutions with pioneers in blue carbon conservation.

When you conserve with **CarbonEthics**, you are creating positive environmental change and advancing social impact by directly enhancing the livelihoods of our local community partners.