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Carbon Offsets and Voluntary Carbon Markets—Opportunities and Uncertainty

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The voluntary carbon market is rapidly growing to match the increasing focus by corporate leaders on ESG efforts and net-zero goals. In 2021, the voluntary carbon market reached $2 billion, and by some estimates may be worth up to $50 billion by 2030.

This growth, however, does not come without increased risk. The existing market faces a number of barriers to scaling effectively, in particular challenges in marketing, difficulties identifying projects or credits to fit corporate goal, challenges determining the quality and marketability of projects and carbon offsets/credits, transparency concerns, and fraud. Detractors accuse buyers of carbon credits of greenwashing and relying on purchasing credit offsets rather than reducing their greenhouse gas ("GHG") emissions directly through investing in more efficient and sustainable practices and technologies. At the same time, carbon credit producers face accusations of false emissions reduction claims that open the industry and market to growing regulatory scrutiny and calls for reform.

The Carbon Markets

There are two types of carbon markets, voluntary and regulatory compliance markets. The compliance markets involve state actors imposing limits on carbon output. For example, the EU and UK Emissions Trading Schemes and the California Compliance Carbon Offset Market require certain industries to limit their carbon output and establish carbon markets to help those industries manage their carbon risks and satisfy their regulatory commitments. In particular, the California Cap-and-Trade program establishes limits on major sources of GHG emissions for certain industries and creates allowances that decline annually, creating an economic incentive for investment in cleaner more efficient technologies. Similarly, the Regional Greenhouse Gas Initiative (RGGI) is a cooperative effort among 12 states to reduce CO2 emissions from power plants within the participating states, utilizing a market-based cap-and-invest initiative.

Voluntary carbon markets are independent, are not mandatory, and allow companies to purchase carbon credits or offsets issued by independent projects claiming removal or reduction of certain amounts of GHG emissions from the atmosphere. A carbon credit typically represents one metric ton of carbon dioxide removed from the atmosphere. Carbon credits are issued through a series of steps. First, projects aimed at avoiding, reducing, sequestering, or eliminating emission are developed. Examples include:

- land use change and forestry projects;

- renewable energy or energy efficiency improvements;
- carbon capture and storage; and
- waste handling and disposal.

Projects are then certified by standards-setting organizations—third-party (typically nonprofit) organizations, also known as registries, that audit and verify the legitimacy of the project and the credits issued. These third-parties certify that the carbon credit meet certain stated goals as well as the volume of emissions. While there are a dizzying number of carbon credit standards, the "high integrity" credit issued consistent with The Core Carbon Principles, established by The Integrity Council for the Voluntary Carbon Market, is recognized by many as the global benchmark. The Core Carbon Principles ensure that the project has a meaningful emissions impact demonstrated by measuring certain metrics including:

- Additionality—the GHG reduction or removal would not have occurred without the incentive created by carbon credit revenues;
- Permanence—the GHG reduction or removal is permanent, or there are measures in place to address the risks of reversal including compensation;
- Robust quantification of reduction and removals; and
- Exclusivity—emission reduction and removal is not double counted.

Once a carbon credit is certified and registered for sale, it is available for purchase by end-users, typically corporations who have committed to reducing their carbon/GHG emissions. Other entities in the voluntary carbon markets are brokers and retail traders. Carbon credit brokers help companies to purchase carbon credits by connecting projects with purchasers. These brokers are not regulated and some have at times been accused of disproportionate margins and diverting value away from the carbon offset projects.

Increased Regulatory Focus

Commensurate with this growth of the carbon markets, regulatory interest also increased. In April 2022, the SEC proposed for public comment a series of rules that registrants include information about climate-related risks in their disclosures, as well as disclosure of a registrant's GHG emissions. The proposed rule would require a registrant to disclose "the role that carbon offsets or [renewable energy credits or certificates] play in the registrant's climate-related business strategy." In its proposal, the SEC noted that detailed disclosures about the carbon offsets purchased by a registrant may "also help to mitigate instances of greenwashing." While the final rule is still under consideration—and the SEC has faced push-back for what has been viewed by some as onerous reporting requirements—the proposed rule does demonstrate the Commission's awareness of and commitment to combatting greenwashing in carbon offset programs.[1]

Similarly, the CFTC recently indicated concerns about representations related to carbon offsets and greenwashing, with Commissioner Christy Goldsmith Romero stating in Marchthat "[v]oluntary carbon credit markets are particularly vulnerable to greenwashing, fraud and manipulation." The CFTC will likely play a key role in any forthcoming regulation of both the underlying voluntary carbon markets as well as related derivatives. Carbon credit brokers who purchase offsets on behalf of other companies raise

concerns not only of significant mark-ups but also of fraud involving commodities, an activity that is squarely in the jurisdiction of the CFTC.

Greenwashing and Fraud Exposure

One of the greatest challenges for the voluntary carbon markets are the accusations of greenwashing and fraud. Recent studies and reporting have raised questions about the methods and standards employed by some leading standards organizations regarding certain projects. In particular, the analyses question whether certain types of projects truly provide additionality, permanence, and transparency, among other concerns. But those analyses also have been challenged as misleading and misrepresenting the projects at issue, the data, and the methods involved.

In an environment of competing accusations, confusion is often the result, leading to litigation and regulatory scrutiny. On June 20, 2023, the CFTC Whistleblower Office issued an alert seeking tips of alleged misconduct in the carbon markets, further signaling regulators' growing scrutiny of carbon markets and the legitimacy of carbon credits.[2]

The voluntary carbon markets present a real and exciting option for companies seeking to manage their climate risks. But like all new and emerging markets and products, especially global markets, significant risks exist and need to be managed. Public and private efforts to curb emissions and demonstrate commitments to sustainability and net-zero emissions have bolstered the voluntary carbon markets and led to rapid growth in demand. Purchasers of carbon credits, however, face a risky, still developing market struggling to provide consistent and high-integrity carbon credits necessary to meet the increased demand and avoid litigation and regulatory risks. Parties engaged in this evolving market, including purchasers, certifiers, marketers, brokers, and traders, should all be aware of the increased litigation risks as well as the potential for increased oversight and enforcement from federal regulators. Companies should conduct careful due diligence on all parties involved when considering investing in carbon credits, establish effective internal controls and oversight, and seek experienced counsel.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Washington, D.C. lawyers:

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[1] "The proposed rule changes would require a registrant to disclose information about (1) the registrant's governance of climate-related risks and relevant risk management processes; (2) how any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term; (3) how any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook; and (4) the impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a registrant's consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements." https://www.sec.gov/news/press-release/2022-46.

[2] Carbon offsets or credits are commodities under the Commodity Exchange Act. The CFTC has authority to regulate carbon credit derivatives; it also has authority to investigate and take regulatory action against fraud and manipulation occurring in the spot commodity markets underlying the derivatives markets it regulates.

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