

Voluntary Offsetting

With its lack of regulation, the voluntary carbon market can be a risky place for the unwary buyer. Dominic FitzPatrick considers the pitfalls to watch out for.

Last year, the voluntary offset market saw rapid growth, driven by demand from both businesses and individuals. However, at the same time, concerns about the lack of regulation and conformity in the market gave rise to considerable media attention and controversy, with buyers raising some fundamental questions about the market.

The voluntary market is defined by a lack of regulation. The carbon markets created by the Kyoto Protocol, or national or regional emissions trading schemes (**ETS**) such as the EU ETS, involve strict rules on what qualifies as an emission reduction. But, in the voluntary market, anyone can offer to sell a so-called verified (or voluntary) emissions reduction (**VER**). As a result,

the onus is on the carbon offsetter to manage the risk involved in carbon purchases.

So, how should a buyer approach the market? The offsetter needs to be confident that the emission reduction represented by the carbon credit that it is paying for will stand up to scrutiny from stakeholders, particularly in terms of its environmental credentials. These include, for example, whether the reductions would not have occurred in any event (i.e. are additional to the “business as usual” scenario), and have not been ‘double counted’ – that is, that the same VER is being claimed by or sold to more than one person.

The degree of certainty with which these objectives have been met varies between compliance credits (e.g. certified emission units (**CERs**) created via the Clean Development Mechanism, and emission reduction units (**ERUs**), under Joint Implementation) and VERs. It also varies according to different types of VERs.

The Kyoto Protocol flexible mechanisms and the EU ETS provide transparent frameworks for verifying, transferring and cancelling CERs and ERUs produced by emission reductions projects in accordance with approved methodologies and processes. However, the demands of voluntary offsetters are often different from those of compliance buyers, with the type of project activity, social factors and sustainability being important considerations.

Voluntary offsetters will often specify that carbon credits from certain activities which are approved for the purposes of the Kyoto Protocol (such as destruction of industrial greenhouse gas (**GHG**) emissions) are excluded from their offset programme. As CERs and ERUs are readily identifiable with a specific project, the emissions reduction activity and type of project are ascertainable.

VERs are less transparent. While CERs and ERUs are the product of international treaties, the legal standing of a VER is less certain. The legal agreement under which the VER is sourced is likely to refer to *“any right, interest, credit, entitlement, benefit or allowance to emit (present or future) arising from or in connection with the removal, limitation, reduction, avoidance, sequestration or mitigation of emissions of GHGs”*, which will be defined in units of one metric tonne of carbon dioxide equivalent (**MtCO₂e**).

The existence or otherwise of any legal right arising out of such an activity needs to be considered in the light of local law, as well as the governing law of the contract. This is particularly the case for so long as VERs are not represented by a unit registered in a central registry. Such registries track the ownership and trade of emissions and,

while at least one has been developed for voluntary offsets, no widely accepted registry has yet emerged.

An overlap between the voluntary and compliance markets exists for emission reductions generated by projects that apply for CDM registration but have not yet been registered. These “pre-registration” credits are often seen as one of the more valuable type of VERs, as – assuming they are registered – they retrospectively satisfy the Kyoto test of additionality.

The key component of a VER is independent verification, which is the process by which it is confirmed that the emissions reduction has occurred and has been generated and measured in accordance with agreed standards and protocols. It is this act of independent verification that enables the emission reduction unit to be traded with greater certainty that the emission reduction underlying the VER has occurred. However, there is no single standard by which the emission reductions are verified and so the character of a VER will vary according to the standard against which it is measured.

Several organisations have developed standards and methodologies for VERs. Examples include the Gold Standard for Voluntary Offsets (**Gold Standard VER**) developed by the Gold Standard Foundation, the Voluntary Carbon Standard (**VCS**) developed by the International Emissions Trading Association, the World Economic Forum and the Climate Change Group and the Voluntary Offset Standard (**VOS**) developed by European Carbon Investors & Services (now INCIS) to name but a few.

The aim of these standards is to create a benchmark for measuring emission reduction offsets to be utilised in a designated sector and to seek to ensure that market participants can obtain VERs that represent real, measurable, permanent and additional benefits to the environment. However, several standards and methodologies exist that are not as stringent as those noted above and the plethora of standards is confusing to the consumer.

The project activities that are recognised by the different standards vary from one standard to the next. For example, carbon reduction projects in agriculture, forestry and land use may be eligible for VCS accreditation, whereas only renewable energy and end-use energy efficiency projects are eligible project activities for Gold Standard accreditation. Different project activities bring their own sets of risks, particularly in the area of land use and forestry, where difficult questions surrounding additionality, measuring and the permanence of carbon reductions are the subject of ongoing debate.

Without standardised criteria, purchasers of VERs therefore face the following issues:

- The absence of a central register or system of linked registries to record the origin and ownership of VERs leaves open the possibility of double counting;
- Different validation and verification processes exist for different types of VER. Furthermore, the fact that certain activities that are ineligible as CDM or JI projects may nevertheless generate VERs means that there are not necessarily equivalent methodologies that can be applied to verification of VERs. Even if (as is often the case) verification is carried out by a CDM accredited Designated Operational Entity, the verification will be carried out in accordance with the requirements and protocols of the applicable standard which is selected by the project developer, and not the CDM protocols;
- The absence of standardised documentation may lead to a lack of clarity as to the nature of the rights that the offsetter obtains;
- The VERs being sold could be generated by projects that would have taken place regardless of the sale of the VERs, such that the carbon emissions reductions are not additional to those that would have otherwise occurred under a business-as-usual scenario;
- The sustainable development benefits of many projects relating to the creation of VERs may be difficult for a purchaser to ascertain or verify, although certain standards may provide some comfort in this regard; and

- There may not be adequate recourse in the event of double counting or inaccurate verification.

Despite the issues facing purchasers of VERs, the VERs may offer some advantages over compliance credits for the voluntary offsetter:

- Transaction costs are typically lower and the bureaucratic requirements are less. This enables smaller scale projects that are not viable under CDM to proceed;
- Many of these projects have particular community or ecological benefits and they are often well suited to the requirements of voluntary offsetters, who often have increased focus on sustainability and social responsibility over and above the climate benefits of carbon offsetting;
- Voluntary offset projects offer the opportunity for new technologies and methodologies to develop that may not be included in regulatory regimes; and
- Projects may be more quickly and easily implemented outside the CDM approval processes.

For self regulation to be effective, participants need to be able to demonstrate coherent standards in project eligibility, verification and monitoring and provide clear information and a system for assuring purchasers that carbon credits are not at risk of double counting.

Ideally, there would be a robust registry system enabling the origin and ownership of VERs to be recorded. Such a registry system should have sufficient protections to ensure that VERs that are recorded in the registry(ies) are real and have been properly verified. However, given the difficulties encountered in getting the Kyoto and EU ETS transaction logs operational, this may be some way off. In the interim, there is an enhanced role for the verifiers and/or the standards authorities to provide such a registration and transfer system, as in the case of VCS and TÜV SÜD's Blue Registry. Where the verifier provides such a registration system, an unbroken chain of the same verifier being involved in each transfer may provide buyers with comfort.

The challenge for the market is to find the correct balance between robust procedures and costs, as there is a risk that the costs and complexity of compliance could increase to a level that makes small-scale projects unviable.

Until such procedures and mechanisms are put in place, one has to consider what steps can be taken to reduce the risks of contracting for VERs. These might include the following:

- Properly specify what you are buying. Specify a standard that matches the requirements of the offsetter and any additional requirements of the offsetter concerning project activities that are eligible or ineligible.
- Information. The contract should provide the buyer with rights to information to demonstrate the existence of the VERs and confirmation of cancellation. Depending on the nature of the contract, audit rights may be appropriate.
- Provide for what happens if credits are unavailable or are not delivered. In an offsetting programme, obtaining the carbon credits is likely to be more important than simply marking the contract to market and obtaining financial recourse. It may also be difficult to find suitable pricing information for, or supplies of, VERs, meaning that an alternative benchmark and/or substitution of a different type of emission reduction may be required. Dispute resolution procedures must be enforceable.
- Representations and warranties as to ownership of VERs and the absence of prior transfers may be available in some circumstances, but it is unrealistic to expect a party to give a greater assurance than the assurances that they have themselves.
- Registration. Unregistered VERs may be more susceptible to double counting than registered VERs. However, until a central registration system develops, one needs to understand how the registration and transfer procedures operate and carry out due diligence on the chain of ownership.
- Select a reputable counterparty. It is an obvious point, but a reputable organisation is likely to put in place checks and balances to monitor its activities and its supply chain for VERs and other forms of emission reductions.

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