

New Regs Will Strengthen Voluntary Carbon Offset Market

By **David Smith** (December 1, 2023)

Net-zero is not the same as zero. An array of solar panels or a wind farm produces electricity with zero greenhouse gas emissions generated as a byproduct. A business venture, however, is highly unlikely to get to true zero in terms of GHG emissions relative to its operations or production.

Nonetheless, companies worldwide have long pledged and undertaken accomplishing net-zero relative to their operations and output. So what's the difference? Easy: math.

After a company does all it can to reduce its emissions, it calculates the emissions that remain, and eliminates or pays to eliminate an amount of emissions by another entity that is equal to or greater than its ongoing emissions. Thus, the net output of global emissions attributable to that company is zero or less — i.e., net-zero.

With California's adoption of GHG disclosure mandates for specified companies in October, the pressure to pledge net-zero is likely to increase exponentially. But relatively few companies have the means, expertise and resources to invest in and generate these emissions-offsetting projects. So a robust, voluntary carbon emissions credit market has developed.

In this market, project operators demonstrate either that their project results in the avoidance of a quantifiable amount of emissions that otherwise would have been released into the atmosphere, or that the project removes carbon — newly produced or legacy emissions — from the atmosphere, and more or less permanently prevents their reintroduction, resulting in credits to be purchased and used for offsetting the purchaser's ongoing emissions.

While the demand for voluntary carbon offset credits has grown exponentially in recent years, exposure of speculative if not outright fraudulent claims regarding the sale of or reliance on carbon offsets has been devastating to the market, at least in the short term. Reporting, monitoring and verification efforts must be predictable and reliable for a market to function — so many entities are stepping in to try to ensure that security.

As discussed below, numerous federal agencies are establishing fraud enforcement efforts, California is mandating verifiable disclosures, nongovernmental organizations and journalists are exposing fraud, and uniform standards and protocols are being forged in both the public and private sectors. Such regulatory efforts, and the increasing demand for offsets, portend a growing, robust and hopefully reliable voluntary carbon offset market.

The Present Plight of the Voluntary Carbon Credit Offset Market

Reportedly, the global market for carbon offsets quadrupled in 2021 to a value of over \$2 billion, and that figure is predicted to spike to over \$10 billion in 2030.

Types of projects avoiding or removing carbon emissions include forest preservation, select agricultural practices, and mechanical carbon removal, either from industrial emission streams or directly from the atmosphere. The term "voluntary" is contrasted with the term



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"compliance" — measures taken to avoid or eliminate carbon emissions in compliance with a regulatory or legal mandate do not qualify as voluntary.

But private sector confidence in the voluntary market has been rocked. Perhaps most notable was an exposé published in *The New Yorker* in October, documenting the meteoric rise of South Pole, a Zurich-based global provider of carbon credits whose flagship project was a massive forest preservation effort in Zimbabwe.[1]

The problem is that South Pole's own internal analyses eventually showed that the project generated and sold far more credits than it should have. At the heart of the problem was faulty modeling regarding the amount of forest preserved for which South Pole could take exclusive credit.

Many notable multinational megacorporations are said to have significantly overstated their own climate benefits in reliance on their purchases from South Pole. Bloomberg reported in March that the reputational hit to South Pole has had devastating implications for private sector confidence in the voluntary market at large.[2]

Feds Seeking to Root Out Fraud and Deception in the Voluntary Market

To crack down on fraudulent practices in the voluntary carbon credit market, the U.S. Commodity Futures Trading Commission is exerting jurisdiction over manipulation and deceptive practices in voluntary carbon markets. The CFTC established its Environmental Fraud Task Force on June 29.

As for all domestic physical commodity trading markets, the CFTC has authority to exert enforcement and otherwise regulate fraud or misleading practices. The task force will target fraud related to claimed environmental benefits of purchased carbon emissions offset credits.

According to the CFTC, the task force's enforcement efforts will focus on, among other things, material misrepresentations of securing sustainability objectives, including environmental, social and governance goals. Among other tools it has deployed, the task force has authorized whistleblower bounties for insiders reporting misconduct in and through the voluntary market.

Additionally, the Federal Trade Commission is updating its Use of Environmental Marketing Claims advertising directives, often referred to as the "Green Guides." The proposed changes seek to clarify to marketers that claiming a given product is environmentally beneficial will come under the FTC's purview of regulatory scrutiny.

This includes claims related to carbon offset credits sold on the voluntary market. Examples of potential red-flag claims include that operations or products are "carbon neutral" or "net-zero."

The practice being targeted by these efforts — claiming overinflated or purposefully deceptive environmental benefits of products or operations — is referred to as "greenwashing." Generally, greenwashing is claiming that products, services or practices are more environmentally friendly than they actually are.

The charge of greenwashing may apply both to the original marketing of the credits for sale, based on flaws in the project from which they are derived, and the reliance by the purchaser of the credit offsets on the benefits to its underlying operations, as a result of the

purchased offsets.

Critical to a legitimate claim for creation of a valid credit is the concept of additionality. Additionality means that an offset being offered for sale on the voluntary market represents emissions that have been avoided or removed as the result of a project that would not otherwise have been realized under a business-as-usual scenario. In other words, but for the credit-producing project, the emissions benefit would not have happened.

California Out Front Again With an Unprecedented Regulatory Mandate

California received much attention in October when Gov. Gavin Newsom signed into law two unprecedented legal mandates relating to climate disclosures. S.B. 253 requires large business entities, public or private, to disclose all GHG emissions, including Scope 1, Scope 2 and Scope 3 emissions under the Greenhouse Gas Protocol.

S.B. 261 requires an even larger universe of businesses to disclose climate risks, as defined by and in accordance with the Task Force on Climate-related Financial Disclosures. Both disclosure mandates generally kick in beginning in 2026.

But a lesser-noted bill, A.B. 1305, applies to virtually any company of any size, public or private, operating in or through California, that sells or buys carbon offset credits or otherwise makes any public claims of having accomplished major climate goals, such as carbon neutrality or net-zero status, or made major strides toward such goals. A.B. 1305 was signed on the same day as the other two bills, but becomes effective earlier, on Jan. 1, 2024.

A.B. 1305 mandates disclosures by three types of business entities. First, any business entity that is marketing or selling voluntary carbon offset credits in California must disclose on its website specified information underlying the specific carbon offset project from which the marketed credits are derived. Additionally, the entity must provide accountability measures should a project fail to be completed or fall short of projected emissions benefits.

The second type of business entity subject to A.B. 1305 is any entity that purchases or uses voluntary carbon offset credits to make claims of achievement of net-zero emissions or other similar claims.

Information that must be disclosed on the entity's website includes the name of the business entity from which the credits were purchased; the specific project from which the credits are derived, including the project identification number if available; whether the offset type was carbon removal, avoided emissions or a combination of both; and the protocol used to estimate emission reductions or removal benefits.

The third and final type of entity subject to the disclosure mandate of A.B. 1305 is the broadest of all. Namely, any entity that makes any claims of the achievement of net-zero emissions or carbon neutrality, not adding net carbon to the atmosphere, or otherwise making significant reductions to its GHG emissions must disclose "[a]ll information documenting how, if at all, [such a] claim was determined to be accurate or actually accomplished, and how interim progress toward that goal is being measured."

Violations of A.B. 1305 are subject to a civil penalty of up to \$2,500 per day, not to exceed a total of \$500,000. The law mandates that disclosures be updated no less than annually.

USDA Seeks to Establish Certainty and Standardization

The vast majority of voluntary carbon offsets presently derive from forestry projects. A much smaller percentage comes from select agricultural practices, most of which involve livestock.

In October, the U.S. Department of Agriculture issued a report to Congress offering an assessment of the role of agriculture and forestry in U.S. carbon markets. The intent of the report is to support the USDA's Greenhouse Gas Technical Assistance Provider and Third-Party Verifier Program.

The report was mandated by Congress to, among other things, "[c]onduct a general and quadrennial assessment of the state of the voluntary environmental credit market, including the supply and demand of credits, state of technology, barriers to participation, and potential roles for USDA." Appropriately, the report places critical focus on both established and proposed protocols under which a given credit-generating project may be certified.

Factors for certification by a given protocol standard include participant eligibility, sources of emissions to be included, and procedures for measurement, monitoring, reporting and verification of carbon credits. According to the report, as of mid-2023, there were 40 active protocols applicable to agriculture, forestry and land use projects in the U.S., but only 18 have been successfully used to generate carbon credits for domestic projects.

The report further states that "[a]n accurate quantification of greenhouse gas emissions and carbon sequestration in a project is critical to the functioning of carbon markets and to achievement of the greenhouse gas reduction goal driving participation in the market," and asserts that protocols can address challenges such as additionality, leakage, permanence and uncertainty through protocol design and risk mitigation.

DOE Juices the Market

The U.S. Department of Energy announced on Sept. 29 that it will invest up to \$35 million in the voluntary market by a commitment to purchase "high quality carbon removal credits from commercial-scale activities."

According to Noah Deich, deputy assistant secretary for the DOE's Office of Carbon Management, aside from the purchase of credits, the lasting and catalytic impact of the investment should be the evaluation of carbon removal alternatives and tools for standard setting and measurement, monitoring, reporting and verification, or MMRV.

Deich said the DOE investment sends a signal to the private sector in search of "bulletproof carbon removal credits" that a DOE model could establish much-needed certainty and reliability.

Under the new program, the DOE can invest in four different types of carbon removal: direct air capture, biomass carbon removal, enhanced weathering and mineralization, and natural carbon sinks. Proponents of carbon removal have praised the effort as having a potential impact that goes beyond the specific dollars spent.

A policy director for the nongovernmental organization Carbon180 told a reporter that "[t]he real impact of this is potentially far beyond a \$35 million pot of money because it is in the federal government stepping in and adopting these high standards for what long-duration verifiable carbon removal looks like."

Conclusion

Very few organizations, if any, can get to zero, but net-zero is frequently within reach — and the planet is the beneficiary of efforts to get there. But authenticity, transparency, verification and accountability are as essential to a global carbon emissions offset market as to any other commodity exchange market.

The efforts recounted above are not an exhaustive list, and testify to the unbounded interest in a robust and flourishing voluntary market. The efforts by the CFTC, the FTC, the USDA and others appear substantive, comprehensive and well-funded.

With the regulatory stick of threatened enforcement and penalties paired with incentive spending by the DOE and others, there is just cause for future optimism for a global, well-functioning, verifiable and enforceable voluntary carbon emissions offset credit market.

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[1] <https://www.newyorker.com/magazine/2023/10/23/the-great-cash-for-carbon-hustle>.

[2] <https://www.bloomberg.com/news/features/2023-03-24/carbon-offset-seller-s-forest-protection-projects-questioned>.