# View from the inside - markets for carbon credits to fight climate change: addressing corruption risks proactively

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A general scientific consensus has established a relationship between the accumulation of greenhouse gases in the atmosphere and global warming. In response, more than 180 countries have ratified the Kyoto Protocol, which caps greenhouse gas emissions in industrialised countries at around 5 per cent below their 1990 levels.

Kyoto contains several important market mechanisms that are intended to ensure that the required cuts can be made most effectively and efficiently. One of them is the Clean Development Mechanism (CDM), whereby the private and public sectors can invest in emission reduction projects in developing countries and receive related emission reduction credits, which are tradable in so-called 'compliance markets' and can be bought by emitters to offset their own emissions. Similarly, under Kyoto's Joint Implementation (JI) scheme,

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investors from one industrialised country can engage in an emission reduction project in another industrialised country and use the credits they obtain through this to meet their own compliance targets.

Some doubt the general viability of these mechanisms and fear that they distract from the more fundamental structural policy changes that are needed to tackle climate change. Carbon trading is here to stay, however, and is expected to grow considerably in the near future. It is certainly not the only answer to climate change, but an integral element of the overall solution.

International carbon markets have grown almost exponentially since their inception in the late 1990s. By 2007 2.7 billion tonnes of carbon-dioxide-equivalent emissions with a total value of €40 billion had been traded globally, of which about one-third were CDM- and JI-related offsets.[3] The future size of these markets depends on whether policy-makers agree on further reductions after the Kyoto Protocol expires in 2012, as well the level of US participation. Even in a low-growth scenario, the market will probably be several times larger than it is today. In a high-growth scenario, it may grow by a factor of almost thirty by 2020.[4]

## New markets – new risks of corruption?

Theoretically, the nature of carbon markets might present a number of corruption risks, but most of them have been addressed by the regulatory design of the compliance markets under Kyoto.[5] One potential challenge is that carbon markets deal with intangible assets (carbon offsets). Compared to markets for tangible objects with apparent physical characteristics – apples, for example – the quality and veracity of carbon intangibles are potentially difficult to verify 'on the spot' by the purchaser in markets in which certificates and not products with physical characteristics change hands. The tracking of certificates through registries, as well as the independent verification of emission reductions that give rise to certificates, are therefore key elements in regulated carbon credit markets, and have been fully implemented in the Kyoto Protocol compliance market.

The only open flank of the compliance markets is the check of the general eligibility of a project under the project-based mechanisms CDM and JI. Offsets are valid and make an effective contribution to reducing carbon emissions only if they are awarded for projects that would not otherwise have taken place. This *additionality* criterion is difficult to ascertain and can provide scope for manipulation. Here there is an ongoing 'cat and mouse' game between project developers, who try to get projects that would have happened anyway approved as *additional*, and the regulators, who have developed detailed rules to prevent such projects from qualifying under the mechanisms. In broader perspective, this underlines the fact that carbon markets are political constructs in which products, values

3 K. Røine, E. Tvinnereim and H. Hasselknippe (eds.), *Carbon 2008: Post-2012 Is Now* (Oslo: Point Carbon, 2008).
4 *Carbon Market Analyst* (Norway), 21 May 2008.
5 Some of these conceptual ideas have been presented by J. Werksman, of the World Resources Institute, at the thirteenth International Anti-Corruption Conference (IACC), Athens, 30 October 2008.

and their distribution are critically shaped by rules and regulations, which as a consequence become the focus of intense lobbying, some of which might degenerate into corruption. Against this backdrop, it is quite striking that published allegations and evidence about corruption in the carbon market are still very rare.[6] The following sections discuss some of the key challenges in more detail.

## Additionality in practice

Carbon credits are awarded to CDM and JI projects if they can prove that they face prohibitive barriers, or that another way of producing the same service or product would be more profitable and thus would have been chosen instead of the less carbon-emitting method. In most cases, the cited obstacles are real, and the claim that the low-carbon alternative is not profitable *enough* to go forward without revenues from carbon offsets is correct. It is very difficult to be absolutely sure, however. As a result, a number of commentators claim that CDM and JI projects are not always leading to real emission reductions,[7] and some even link this directly to corruption.[8]

Project developers seeking carbon credits need to make detailed documentation publicly available for stakeholder comments, resulting in a high degree of transparency that is likely to deter corruption. One of the authors personally witnessed a corruption attempt in India, however, where a project developer on whose project the author had submitted a critical public comment proposed a 'fee' to write a positive report.

The need to prove additionality has probably tempted some project developers to forge documents in order to qualify for the CDM. Indeed, the CDM executive board has recently referred to 'incidents of attempts of falsification of documents by project participants'.[9]

Market players in India say that CDM project developers frequently backdate documents in order to show that they considered the CDM before they started the project. Another tactic is manipulating rate of return calculations to make it appear that CDM revenue would push the project above a certain profitability level that determines execution. Moreover, CDM consultants in India have on at least a couple of occasions copied and pasted stakeholder consultations carried out for one project into documentation for other projects.[10] To prevent such behaviour, British CDM authorities require project developers

6 See K. Holliday, 'Clean and transparent', Energy Risk; available at www.energyrisk.com/public/showPage.html?page=834295.

7 A. Michaelowa and K. Umamaheswaran, *Additionality and Sustainable Development Issues Regarding CDM Projects in Energy Efficiency Sector*, Discussion Paper no. 346 (Hamburg: Hamburg Institute of International Economics, 2006); L. Schneider, *Is the CDM Fulfilling Its Environmental and Sustainable Development Objectives?* (Berlin: Öko-Institut, 2007); M. W. Wara and D. G. Victor, *A Realistic Policy on International Carbon Offsets*, Working Paper no. 74 (Stanford, CA: Program on Energy and Sustainable Development, Stanford University, 2008).

8 *Guardian* (UK), 21 May 2008.

9 CDM Accreditation Panel, *Twenty-sixth Progress Report of the CDM Accreditation Panel* (New York: CDM Accreditation Panel, 2008).

10 Point Carbon, *Consulting Firms Deny Wrongdoing in Drafting Indian PDDs* (Oslo: Point Carbon, 2005); A. Michaelowa, 'Experiences in Evaluation of PDDs, Validation and Verification Reports', paper presented at Austrian JI/CDM workshop, Vienna, 26 January 2007.

to sign a declaration certifying that their information is correct, and hold them criminally liable if fraud is discovered.

## Corruption risks for certifying agencies

In order to obtain carbon credits, project buyers need host- and investor-country approval, validation of the project documentation by an accredited third party, international UN approval and third-party verification of project operations compared to the plan. The 'street-level' staff in some of these organisations are not paid particularly well, and can be inexperienced, due to the rapid development of the market.

Project approval by host countries is, arguably, the stage most vulnerable to corruption. Although kickbacks to officials have not been reported, a Russian agency reportedly asked for direct monetary payments.[11] In South-east Asian countries, it is fairly common for developers to invite the authorities to workshops (with attractive *per diems*) before submitting projects for approval. In China, it is not uncommon for project developers to invite experts reviewing their projects to dinner. On the other hand, the Indonesian Designated National Authority has an elaborate ethics code that aims at preventing corruption.[12]

## Ambivalent incentives and revolving doors for expert consultants

Ensuring the integrity of the expert consultants involved can also be a challenge. In China, consultant fees are capped, and these experts cannot take a share of carbon credits as payment. The unintended consequence seems to be that consultants charge separate, undisclosed fees to both the seller and the buyer of the same project. In the United Kingdom, buyers are barred from making such payments.[13]

Assessing CDM projects requires detailed technical competence and an intimate understanding of the CDM. Because very few people fulfil these criteria, potential conflicts of interest have been very difficult to avoid. Several project consultants also conduct expert project reviews for the CDM's executive board. In addition, consultants assess project baseline and monitoring methodologies, and theoretically could block methodologies submitted by their competitors. To our knowledge, there are no quarantine rules preventing executive board members from entering the private sector as lobbyists, and at least two members were hired by companies submitting projects after their terms on the board had expired.

11 A. Korppoo, 'JI Projects in Russian Energy Sector', paper presented at St Petersburg, 30 September 2005.
12 Government of Indonesia, 'Code of Conducts (2007)', available at dna-cdm.menlh.go.id/en/about/?pg=ethic.
13 L. Mortimer, 'Overly Protective?', in Environmental Finance, *Global Carbon 2008* (London: Environmental Finance, 2008).

## Strengthening governance for improving the markets for carbon credits

Corruption risks in markets for carbon credits could be reduced by making procedures more standardised and transparent. More specifically, this could include:

- not awarding carbon credits to projects if they are not submitted for UN approval within a limited time period after investment decisions are made;
- selecting members for the UN bodies approving carbon projects based on professional competence rather than geographical representation, granting them legal immunity and requiring them to state their current and previous roles and potential conflicts of interest in detail in a publicly available document;
- where feasible, making summaries of the contents of discussions relating to the approval of CDM (as well as relevant JI) projects publicly available; and
- restricting situations in which former regulators work for private companies, and perhaps vice versa.

## A host of additional corruption risks

Discussions, both under the auspices of the UN and in many individual countries, are under way on how to design the post-Kyoto carbon market, after the protocol expires in 2012. One lesson to draw from the experience with carbon markets so far is that particular attention should be paid to new market segments for which data are limited or additionality criteria are particularly difficult to prove. These could include credits for avoided deforestation, carbon capture and storage, aviation and marine transport.

The sale of governments' Kyoto units presents another accountability challenge. Since former Soviet bloc countries were allocated Kyoto allowances based on their economic activity before the 1990 collapse, they have many surplus allowances to sell. If these countries fulfil a number of (relatively strict) criteria they can implement JI[14] projects, for which no international third-party checking or UN approval is needed. In principle, they can thereby transfer some of their surplus allowances to buyers via JI. Revenues from such sales could be significant – in the billions of euros in the cases of Russia and Ukraine. It is not clear which government organisations in these countries have the authority to sell the surplus and how transparently and accountably such transfers of public wealth will be carried out.

A final area of concern is the voluntary carbon credit market, in which companies and individuals without formal compliance obligations can buy offsets to compensate for their carbon footprint. While standards have been developed for such markets and most players act responsibly, a lack of regulation poses the risk of fraud – for example, the selling of one and the same emissions reduction to several customers.

14 So-called 'Track 1' JI projects.