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Carbon Offset Market — Buyers and Sellers Beware

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Special to the Legal

A few weeks ago, as I was completing my travel arrangements on a national airline's Web site, I was given the option to pay a few extra dollars to "offset" the carbon dioxide emissions attributable to my flight. As an attorney practicing in the area of air quality and climate change, I was intrigued by this latest manifestation of the growth and proliferation of the carbon offset market. But at the same time, my attorney-wired brain began to pose a number of questions about what exactly I would be purchasing and whether I could be confident that my payment did, in fact, go toward offsetting the carbon footprint left by my plane ride.

Apparently, I'm not the only person asking these questions. The Federal Trade Commission held a hearing on carbon offsets and renewable energy certificates, or RECs, as part of a broader review of its enforcement policies concerning "green marketing" claims. In addition, recent news articles have reported that offset providers are beginning to receive increased scrutiny from regulators and purchasers. This article will briefly describe the characteristics of the carbon offset market, some of the key issues surrounding carbon offsets and some of the existing legal constructs that could shape the carbon offset market as it continues to mature.

THE CARBON OFFSET MARKET

A carbon offset is an instrument designed to represent the amount of greenhouse gas reductions attributable to an emission reduc-

tion activity. This instrument has value based upon the concept that it may be more economically efficient for persons who desire to reduce their net carbon footprint to pay another entity to engage in an activity that reduces carbon emissions. Entities that wish to offset their carbon emissions "purchase" the offset, which really means retiring the ability to use the offset in other circumstances. Thus, a purchaser's carbon emissions are "offset" by the more economically efficient actions of the entity engaging in the emission reduction activity.

With respect to carbon offsets, there are two major markets: the compliance market and the voluntary market. The compliance market is driven by laws and regulations that require emitters to comply with some type of cap on greenhouse gas emissions and allow those emitters to achieve that cap in part by purchasing offsets. The prime example of compliance markets are those associated with the Kyoto Protocol, which allows participating countries subject to emission caps to meet those caps by purchasing offsets generated by emission reduction projects in participating countries not subject to emission caps. The value of carbon offsets traded in compliance markets has been variously estimated at between \$30 billion and \$70 billion, representing almost two billion tons of carbon emission reductions.

The voluntary market, by contrast, is much smaller and takes place outside the auspices of a compliance regime. Entities that purchase carbon offsets in the voluntary market are motivated by a variety of reasons, ranging from a desire to be "green" to hoping that such offsets will ultimately become usable in whatever mandatory



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greenhouse gas programs emerge in the United States. The value of offsets traded in voluntary carbon markets has been estimated at \$100 million, representing less than 50 million tons of carbon emission reductions.

Another important distinction in the carbon markets is the difference between the wholesale and consumer markets. The wholesale market typically involves corporations purchasing and selling bulk amounts of offsets either directly via contract or over an exchange such as the Chicago Climate Exchange. It has been estimated that the voluntary wholesale offset market comprises 80 percent of voluntary offset transactions.

The consumer market, by contrast, involves offsets sold to persons who wish to offset the carbon emissions that result from their individual activities such as driving or flying. Many of these sellers provide carbon calculators on their websites that purport to estimate the carbon footprint of commuting, energy use and even events like weddings. Like any commodity, these market makers generate net revenue by selling the carbon

offsets to consumers at a price greater than what the market maker purchases them from the offset generator. TerraPass, one of the more successful retail offset providers, which began as a challenge of a Wharton School professor to his students to create a retail carbon offset provider, claims it has sold over 350,000 tons of offsets to the public, while boasting of corporate partnerships with heavy-hitters such as Ford, Expedia and Sam's Club.

KEY CHARACTERISTICS OF OFFSETS

The types of projects that can generate offsets encompass a wide variety of projects, including wind farms, landfill gas reduction, reforestation or the use of methane digesters in agricultural operations. Regardless of the specific project, most agree that quality carbon offsets should exhibit certain fundamental characteristics. While these characteristics have been ascribed various names, the characteristics are supposed to ensure that the carbon reductions in question are real, verifiable, permanent, unique and additional.

The first four characteristics are relatively straightforward. For an offset to have any value, it must be generated by a real project that has occurred, and one must be able to verify the amount of carbon reduction actually achieved through the project. In addition, the carbon reductions should be permanent and not be subject to reversal in ensuing years. For example, any offset based upon reforestation should contain some assurance that the carbon sequestering plants will not be harvested so as to release the stored carbon into the atmosphere. Also, an offset should be unique, meaning that two persons should not be able to lay claim to the same offset.

The offset characteristic that has generated the most discussion is the concept of additionality. Additionality is the idea that the carbon reduction project would not have happened absent the funding provided by the sale of the offsets. It has also been described as exceeding "business as usual," meaning that the carbon reduction project is something beyond what would normally be expected in the market. The importance of additionality rests on the idea that an offset does not serve its purpose of reducing greenhouse gas concentrations, and therefore should not have any value in the marketplace, if the project would have happened in the normal course of business.

While additionality is a generally simple characteristic to describe, it has turned out to be difficult to apply in practice. As a result, a number of "tests" have developed in an attempt to establish objective standards of additionality. These tests examine such things as the existing regulatory structure, whether the project exceeds standards of similar industry projects, when the project commenced or the financial metrics of the project absent the funds provided by the sale of offsets.

In an effort to evaluate additionality and other offset attributes on a more objective and consistent basis, a number of protocols and standards have emerged that third parties then use to "certify" carbon offsets. Offset sellers then market their offsets as certified by third parties against various standards with names such as the "Gold Standard," the "Voluntary Carbon Standard" or the "Green-e Climate Standard."

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Despite the proliferation of these standards and third party verifiers, questions continue to be raised about the true value of offsets being offered in the marketplace. For example there is an ongoing debate as to whether RECs can also be considered as carbon offsets, especially in the U.S. Proponents of RECs as carbon offsets argue renewable energy projects are, by their nature, an attempt to go beyond "business as usual" to reduce the greenhouse gas impact from energy production. Detractors argue, however, that the combination of renewable portfolio standards plus generous tax incentives for such projects make any carbon offset revenue inconsequential, meaning that RECs fail the additionality test.

Concerns about the quality of the carbon-offset market have recently affected offset providers. For example, the *Wall Street Journal* recently reported that the United Nations' tightening of standards used to evaluate carbon offset projects under Kyoto Protocol led to a 70 percent stock price decline for EcoSecurities, one of the major players in the worldwide offset markets. Similarly, *BusinessWeek* published last year a number of articles questioning the quality of certain offsets offered in the voluntary retail market, including some offsets offered by TerraPass.

LEGAL PROTECTIONS

Against this backdrop, legal constructs have begun to develop in an attempt to protect the rights of all parties participating in the offset market. As mentioned previously, the wholesale offset market is characterized by transactions between two sophisticated parties either via contract or over an exchange. Offset purchase and sale contracts typically use traditional forms of risk allocation — representations, warranties and indemnities — to allocate risks associated with offset transactions, such as changes in regulation, failure to realize all offsets bargained for or changes in offset market conditions. Few, if any, of these provisions have been tested, however, against the constantly evolving regulatory scheme surrounding greenhouse gases.

On the consumer side, as mentioned at the outset of this article, the FTC has begun to examine whether actions in the current consumer offset market meet the standards of Section 5 of the FTC Act, which declares unlawful "unfair or deceptive acts or practices in or affecting commerce." More specifically, the FTC is currently contemplating revisions to its "Green Guides," which are published in the Code of Federal Regulations and provide guidance as to what environmental claims are unfair or deceptive, to address offset issues.

In addition, many states offer consumer protection statutes that could come into play with respect to the retail offset market, including Pennsylvania's Unfair Trade Practices and Consumer Protection Law or New Jersey's Consumer Fraud Act. These state laws augment the FTC Act by providing private rights of action, treble damages and standards of proof more relaxed than common law fraud. Accordingly, state consumer

protection statutes have been used increasingly in various commercial settings, and there is no reason to think that these statutes could not be extended to the retail offset market. More broadly, given the importance currently placed on “green marketing,” it is not difficult to imagine class action consumer lawsuits against corporations that support green claims in part by purchasing what

turn out to be low quality carbon offsets.

When done correctly, carbon offsets can serve a useful role as part of any regulatory program designed to reduce greenhouse gas emissions. As has been shown recently, however, what can generously be called a lightly regulated market to date has given rise to a number of significant issues related to the value of carbon offsets currently offered in

today’s marketplace. These issues, in turn, could result in additional regulations being imposed upon offset market participants, plus increased risk of litigation involving offset market participants. For now and the immediate future, however, both buyers and sellers of offsets should remain keenly aware of the potential risks associated with offset transactions. •