

Let the seller beware

The voluntary carbon market offers a potentially large source of financing outside the Kyoto system for emissions reduction projects. But, to sell into the market, developers must look at risk from the buyer's point of view, say **Sascha Lafeld** and **Jutta Rothe**

The voluntary carbon market – otherwise known as the carbon offset or carbon-neutral market – is growing to become an increasingly significant source of funding for sustainable projects that reduce greenhouse gas (GHG) emissions. This dynamic market is made up of corporate buyers and private customers that have voluntarily committed to compensate for their GHG emissions by acquiring emission reduction certificates from GHG reduction projects.

While this type of 'carbon neutrality' is not likely to provide a solution to global warming on its own, it can complement in-house and private emission reduction measures by offsetting those GHG emissions that are unavoidable. On the corporate side, this is being demonstrated by, for example, UK retailers Marks & Spencer and Tesco, both of which recently announced plans to implement extensive internal GHG reduction measures in combination with offsetting the remainder of their emissions.

From financial sector pioneers Credit Suisse, Swiss Re and HSBC to web giant Yahoo, numerous large companies are committing to offset GHG emissions from their corporate activities. And a growing number of companies, including BP, Virgin Atlantic and Expedia, are offering premium products whereby consumers can opt to offset the emissions associated with their purchases.

All this is building demand for emissions reductions. According to the World Bank's *State and Trends of the Carbon Markets*, traded volumes in the voluntary market reached the equivalent of 6.05 million tonnes (Mt) of carbon dioxide (CO₂e) in 2005. In 2006, traded volumes are estimated to have risen to 12–20Mt CO₂e, and a recent report prepared by consultancy ICF International sees voluntary demand rising to 400Mt CO₂e by 2010. ICF's study forecasts three-quarters of this demand to come from



Blue-chip names want blue-chip emission reductions

organisations and corporate buyers, with individual buyers accounting for the remainder.

The crucial difference between the voluntary and regulated carbon markets is, by definition, the lack of regulation for voluntary carbon projects. However, there are numerous standards that developers can apply, and that buyers can demand. And there is a lively debate about how best to ensure the environmental credibility of the voluntary offset market.

One approach, as proposed by the UK government in its Carbon Offsetting Standard proposal, is to set a high quality bar for companies seeking to claim carbon neutrality or carbon neutral products – requiring them to buy credits from regulated markets, namely from Kyoto Protocol Clean Development Mechanism (CDM) or Joint Implementation (JI) projects, or the EU Emissions Trading Scheme.

The UK government's approach is understandable in principle – the still young and fragile carbon offset market is not homogeneous in terms of quality, and rigorous standards are needed to ensure its credibility and further growth. However, this approach

neglects the potential of high-quality projects that, for various reasons, have not sought or achieved official registration to supply credible, environmentally and socially beneficial verified emission reductions (VERs).

There are a number of VER standards in the market, such as the VER Gold Standard, the Voluntary Carbon Standard under development by The Climate Group and the International Emissions Trading Association, the Climate Trust Standard and the Australian GHG Friendly Programme standard. In cooperation with CDM-accredited verifier TÜV SÜD, 3C has developed the VER+ Standard, including independent validation and verification as well as project additionality.

Not all standards employed by carbon-neutral service providers are immune from criticism by environmental NGOs, especially with regard to project additionality (whether the project delivers reductions that are 'additional' to the business-as-usual case) or quantification methodologies. For example, the proposed international Voluntary Carbon Standard is still lacking crucial elements, notably a clear and transparent commitment to project additionality and, in our view, does not sufficiently ensure the credibility of offsets, exposing buyers to related risks.

Also, there are huge differences among carbon offset service providers (those acting as intermediaries between the project developer and the offset buyer) in terms of carrying out effective due diligence of VER purchases and managing portfolios large enough to control delivery risk, thus enhancing both delivery security for the buyer, and investment security for the seller.

That said, we believe that – given clear and transparent quality criteria that guarantee the credibility of the offsetting mechanism – the voluntary market has significant potential to beneficially complement the CDM and JI mechanisms. The VER path represents an alternative for projects which, for example:

□ are too small to go through the CDM process. Certification of VERs can lead to reduced transaction costs in comparison to a CDM project. For example, the cost of validation and verification of emissions by an accredited entity can be around 30% lower

than for a CDM project. Development time and cost can be reduced as there is no need for approval by host or investor country governments, the validation and verification can be conducted by the same independent entity and the project avoids having to pay administration and registration costs to the CDM Executive Board;

□ are reducing emissions in an area where there is not yet an approved CDM baseline and monitoring methodology. It may also be possible to deliver VERs from a project that deviates from a CDM methodology in a way that is accepted by the project validator as conservative, eg, by applying adequate safety discounts in cases where data availability is restricted; or

□ are located in a country that has not ratified the Kyoto Protocol, and therefore cannot pursue the CDM or JI paths.

A recent example that demonstrates the benefits of high-quality VERs is the Qingdao QHW Windpower Project in China. This European–Chinese co-funded project was prevented from participating in the CDM by national Chinese CDM rules requiring that projects must be at least 50% Chinese-owned. VER verification therefore proved to be a genuine alternative for this environmentally beneficial project, from which 3C purchased the emission reduction credits as VERs on behalf of an institutional client.

So how should project developers and potential VER sellers look to tap the voluntary carbon market? The key to successful development of VER projects is an awareness of the buyer's perspective.

For the VER buyer, the environmental integrity of the VERs, and therefore their credibility, is crucial. Buyers want the money they invest to make a difference – thus supporting only such projects that would not have gone ahead in the absence of the carbon finance they provide. They want the projects to be environmentally and socially beneficial. In short, they do not want to be associated with any bad press about the project or project owner.

In addition, buyers are also looking for reliable delivery of emission reduction credits. They want the agreed amount of offsets delivered at the agreed point in time from the agreed portfolio of projects. Controlling delivery risk requires a thorough and time-consuming due diligence of the offset project management and partners, especially in developing countries.

Experience with the CDM shows that, in some cases, up to 60% of credits expected at the validation stage aren't ultimately delivered. In most



cases, corporate buyers that intend to go climate neutral do not therefore purchase carbon credits directly from the seller, but rely on offset service providers to manage a portfolio of projects on their behalf, guaranteeing a specific offset quality standard and delivery.

However, small projects set up by NGOs or local community-based initiatives with, on the face of it, high potential sustainable development benefits encounter particular difficulties in acquiring upfront carbon finance. In many cases, reluctance on the buyer's side is a result of unrealistic or unfeasible project concepts. 3C has encountered many project ideas where the emission reduction potential has been severely overestimated by the seller. Small and medium-sized projects often rely on concepts that are not feasible from an organisational point of view (eg, biomass projects that don't include crucial long-term feedstock supply contracts) and, hence, face high delivery risks. Sellers need to understand that buyers are required to have evidence that they can keep their carbon offset promises.

To prove the credibility of the carbon-neutral process, carbon offset buyers need to rely on independent external verification of all steps of the carbon neutral process, from certification of project quality to robust procedures for a once-only and permanent retirement of offsets. The need to ensure credibility thus leads to a certain minimum transaction cost for certification of offset projects, and thus usually requires a minimum project size in terms of annual GHG reduction volume of about 7,000 tonnes. However, the VER path offers a chance to reduce transaction costs in comparison to the CDM.

The Qingdao QHW wind project – the CDM by any other name

Buyers want the agreed amount of offsets delivered at the agreed point in time from the agreed portfolio of offset projects

A good intention is only as good as its project management. Walking the walk in terms of climate protection must not only be expected from the buyer. It is also the responsibility of each seller to transform its plans into a map of realistic and conservatively planned project development steps.

In our experience in the market, VER sellers needed to be supported in a number of ways: by assessing the feasibility of their project idea; identifying and controlling delivery risks, if necessary in the project development process; and by translating the specific requirements of the buyer, in terms of their reputational perspective, into project development and documentation. Such support can help catalyse projects.

The growing demand from corporate carbon offset programmes for high-quality VERs offers a huge potential for funding new environmental and socially beneficial projects. However, understanding the risk-related requirements of the buyer is the key to professional VER project development.

Fighting global warming with all the instruments available is not only a responsibility – it can and must also be profitable: by establishing a sustainable business as a corporate citizen; through implementing cost-saving internal energy efficiency measures; and also through offsetting unavoidable emissions through funding of high-quality VER projects.

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