

Policy Brief

Preventing Carbon Market Abuse Through Effective Governance¹

Carbon markets are artificially created by policy. For this reason, regulators have an additional responsibility for making sure that these markets work as intended and are not abused for personal gain.

Main Challenges:

Regulatory loopholes: Carbon markets often link different administrative jurisdictions. Under these circumstances, complex governance arrangements between multiple regulators and authorities and across jurisdictions are required, which has at times led to regulatory loopholes that have been exploited in unexpected ways leading to VAT fraud, money laundering, etc.

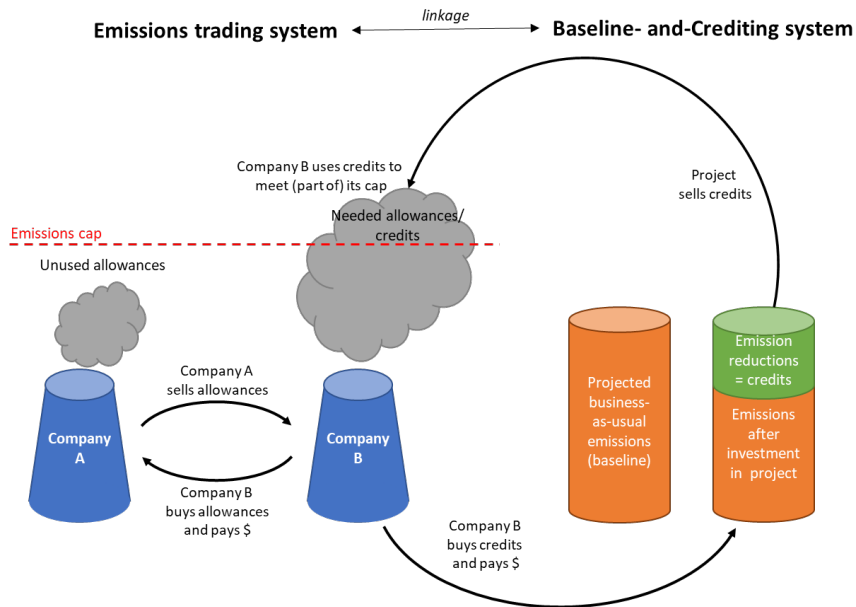
Regulatory loophole example: Credits from the Kyoto Protocol's Clean Development Mechanisms were allowed for compliance under the European Emissions Trading System (EU ETS) in 2005-2020. In 2010 it was reported that Hungarian businesses had surrendered 2 million CERs to the government to compensate for their emissions under the EU ETS and the Hungarian government decided to (legally) re-sell them. The credits were re-sold by various companies and ended up in a European carbon exchange, where the final buyers were unaware that they had already been used in Europe, which could have resulted in double-counting under the EU ETS (INTERPOL, 2013). This specific issue has been solved now, but the example illustrates that linked systems can lead to unexpected regulatory loopholes.

Recommendations to avoid regulatory loopholes and abuses during trading:

- ➔ Preventing double counting of allowances and credits requires **robust registries** (ideally common registries) and **transaction logs** that allow the monitoring of transactions across the different participating markets.
- ➔ Preventing criminal activities such as VAT fraud, money laundering, and theft of allowances requires **securing registries against hacking, rigorous account opening processes**, and establishing **know-your-customer checks**.
- ➔ **Robust accounting system**, with common emissions metrics and with corresponding adjustments is important to avoid double counting.
- ➔ Regulators of linked markets need to be prepared to share information in real time, to define **who is responsible for oversight**, and to ensure that there is **adequate staffing** for analysing the data to detect abuses.
- ➔ **Transparency** is vital for the appropriate functioning of all types of carbon markets, and to avoid cases of corruption, as well as fraud and abuse during the trading phase.

¹ This policy brief by the Center for Energy and the Environment of the Zurich University of Applied Sciences summarizes the main findings of the project "Designing Effective Regulation for Carbon Markets at the International, National, and Subnational Levels", which was financed by the Swiss Network for International Studies (SNIS). More details, including a forthcoming open-access volume, can be found on <https://www.zhaw.ch/en/sml/institutes-centres/cee/research-consulting/snis-effective-carbon-market-regulation/>

There are **two different types of carbon markets** which entail different risks for abuses: emissions trading systems and baseline-and-crediting systems (see Figure below). Both types can be combined by linking the markets as the Figure illustrates.



Major risks of abuse for baseline-and-credit systems and suggestions:

Be aware of conflicts of interest: Most stakeholders directly involved in the market (project developers, credit buyers, host country governments, validators) have an **incentive** to set the baseline in a way that the generated emission reduction **credits are maximized**.

- **Missing additionality:** Ensure careful scrutiny of values that may bias additionality, such as prices, load factors, IRR, etc.
- **Overstated baselines:** Establish liability for the seller to 'make good' on any already issued excess credits.
- **Poor validation and verification (v/v):** Introduce accreditation processes for v/v, spot checks by authorities, rotation of v/v assignments, and payment by the regulator to v/v instead of by the project developer to avoid conflict of interest.

Major risks of abuse for emissions trading systems and suggestions:

Be aware of lobbying by potential losers from the cap-and-trade system, as they will try to lower the sectoral coverage of the system, reduce the cap stringency, and/or water down specific design elements through generous banking and borrowing rules, linking with offset markets, free allocation, weak sanctioning rules, etc.

- **Risk of overallocation and surplus:** Include market stability mechanisms to protect environmental integrity from lobbying influences.
- **Risk of overshooting the cap:** Penalties for non-compliance should include make-good provisions. In case of insolvencies, ensure that insolvency administrators fulfil duty to surrender required allowances.
- **Perverse incentives in allocation:** Apply auctioning instead of free allocation to reduce most perverse incentives.