



GFO'S RESPONSE TO THE TSVCM PUBLIC CONSULTATION

Brussels, 14 June 2021

General remarks

In January 2021, The Green Finance Observatory published an open letter signed by a number of economists and experts highlighting the serious questions and concerns that we had with the Taskforce on Scaling Voluntary Carbon Markets. Subsequently we had a meeting with the Taskforce where we raised many crucial questions related to curbing speculation, linking with cap-and-trade markets, double-counting / corresponding adjustments, excluding forestry offsets or adding credible measures to prioritize curbing emissions over offsetting. Unfortunately, we did not feel that we got clear straightforward answers, and we therefore welcome this consultation as another opportunity to answer these points of crucial public interest.

Before answering the individual questions that are relevant to GFO, we would like to make 5 general remarks that summarize our assessment:

1. Carbon offsets are not about climate change mitigation

Before delving into the design details, it is worth re-emphasizing this point in order to contextualize the questions and our answers. As discussed in our open letter,¹ carbon offset markets have been a spectacular failure over the past 13 years, have been riddled with frauds and human rights abuses, rely on debunked assumptions, suffer from intractable conceptual issues and at scale create serious risks of food prices skyrocketing. By itself, ***this should already seriously question the idea of creating new offset markets, if the objective is to mitigate climate change.***

In addition, carbon offsetting ***does not accelerate but on the contrary delays climate action***, by most often taking place instead of curbing emissions. Also, as offsetting is not about sequestering past emissions but about enabling current and future emissions, ***by definition emissions are at best displaced and not reduced: the whole point of an offset is that one entity gets to keep emitting.***

¹ Green Finance Observatory, Is scaling up voluntary carbon markets really what the climate needs? January 2021 <https://greenfinanceobservatory.org/wp-content/uploads/2021/01/Scaling-up-GFO-analysis-final4.pdf>

For this reason, offsetting is not about mitigating climate change, but about ***providing the social license for economic growth maximization to continue, and about minimizing the cost of compliance for private corporations.***

Lastly, ***there is no “need” to grow carbon markets 15 times by 2030.*** While the report claims that *“to support the investment required to deliver the 1.5-degree pathway, the TSVCM estimates that voluntary carbon credit volume would need to grow by up to 15 times by 2030,”* there is no objective scientific facts evidencing a need to grow carbon markets. Rather, this figure is based on a number of assumptions about political and societal choices.

As long as the case is not made that voluntary carbon offset markets can contribute significantly to climate change mitigation, such initiatives should not be given too much importance in our opinion, as they are at best a dangerous distraction from the need to curb emissions.

2. A design with weak environmental integrity

a. Emission reductions are still not being credibly prioritized in our opinion

The taskforce report states that *“companies’ internal decarbonization and emissions reporting remain the priority with offsetting playing an important but complementary role.”* It also states that *“corporates must follow a clear mitigation hierarchy: they must first reduce emissions in their own operations and value chain, followed by regular and transparent reporting of emissions reductions, only then does effective use of carbon credits have a role to play.”* Unfortunately, such statements are not backed by credible binding measures, and we therefore find it hard to take them at face value. History shows no shortage of well-meaning mitigation hierarchies that were ignored in practice.

b. Forestry offsets are not excluded

Despite the well-known issues of forestry offsets, including much harder to calculate additionality, documented cases of human rights abuses, conflicts over land-use and risks of green land grabbing, forestry offsets are not excluded from the market.

The recent study² evidencing the fact that the Amazon rainforest now appears to release more CO₂ than it is storing is a case in point in the inherently temporary and uncertain nature of CO₂ storage in trees – and the related risks for investors of including forestry offsets.

Given the importance of building investors’ trust and a positive public perception for this new market, one might have expected forestry offsets to be excluded as a whole, in order to remove any potential perception of greenwashing and carbon colonialism, that might in turn lead to sharp reversals in investors’ appetite and in the value of the credits.

Incidentally, the report reference to ***“nature-based” offset credits*** –financial instruments linked to reforestation and soil, mangrove and peatland restoration with often *“high co-benefits for nature and society”*³ - provides yet another implicit confirmation that the terms nature-based solutions are now fully captured by the proponents of the financialization of climate change and biodiversity loss.

² Welch C, National Geographic, first study of all Amazon greenhouse gases suggests the damaged forest is now worsening climate change, 11 March 2021

<https://www.nationalgeographic.com/environment/article/amazon-rainforest-now-appears-to-be-contributing-to-climate-change>

³ Taskforce on Scaling Voluntary Carbon Markets, Final report, January 2021

https://www.iif.com/Portals/1/Files/TSVCM_Report.pdf

c. Links to compliance markets are foreseen

The Taskforce report foresees links to and convergence with compliance markets, including the forthcoming Sustainable Development Mechanism that is expected to be finalized at the COP26.

We strongly hope that this voluntary market will **not be linked directly or indirectly to any ETS**, as allowing the use of offset credits in cap-and-trade markets would once again remove the cap, thereby significantly weakening climate change mitigation. This is a crucial point in our opinion and a real risk.

As an example of indirect linkage, linkages between voluntary offsets and compliance offset schemes such as CORSIA, combined with an allowance to use compliance offset credits in the EU ETS could mean that voluntary offset credits get to weaken climate action in Europe once more. We therefore strongly hope that policy makers will reject any linkage between the EU ETS and voluntary /compliance offset markets, and also with other ETS that allow the use of offset credits.

d. Water credits?

The technical appendix to the consultation raises the following interesting question: “*Should credit / payment stacking be allowed? (i.e., where one activity receives additional credits for other ecosystem benefits it generates such as water credits).*” The term “water credits” suggests either a market scheme for water quality (also known as nutrient trading), or water rights (such as the CME future contract on water⁴). Unfortunately, no additional information is provided.

Financialising water, that many consider to be a human right, might be both a debatable ethical decision and a poor business one, given the risk of public opinion to turn against contracts including such a feature. Past examples of speculation on agricultural commodities suggest that this is a real risk⁵ and we hope that carbon offsets will stay clear of attempting to financialize water and water quality.

3. A number of design features clearly favour speculators and gambling over climate

While spot contracts (contracts to buy and sell credits now) are necessary for offsetting purposes, **futures and options contracts** are not: they enable to bet on the future prices of credits, either for speculative purposes or for hedging purposes.

About the first purpose, financial speculation on the future price of carbon is not necessary from an environmental perspective, and the market should arguably favour end users with an interest in offsetting over gamblers. In addition, it has been shown that in most markets, the existence of futures contracts tends to distort prices away from supply and demand for the underlying asset and towards the mood swings of speculators.

More importantly, **speculation leads to increased price volatility that makes any price signal unobservable**. Yet the price signal – the ability to observe an upward trend in carbon prices that is

⁴ CME Group, Nasdaq Veles California Water Index futures

<https://www.cmegroup.com/trading/equity-index/us-index/nasdaq-veles-california-water-futures.html>

⁵ Financial Times, Food speculation taken off the menu, March 2013

<https://www.ft.com/content/c4813446-7f5e-11e2-97f6-00144feabdc0>

Oxfam, Key Eurozone banks step back from food speculation, February 2013

<https://www.oxfam.org/en/press-releases/key-eurozone-banks-step-back-food-speculation>

deemed to incentive corporations to curb their emissions and switch to greener technologies – is the *raison d'être* of carbon market schemes. If there is no price signal, then markets do not provide any incentives, and are therefore useless and to be abandoned.

As for hedging, the other potential purpose of futures and options contracts, it is equally bad if not worse. Hedging means insuring against a future rise in the price of carbon, through either purchasing credits to be delivered at a future date but at a price agreed today (futures contract) or buying tailor-made insurance contracts against a future rise in the price of carbon (option contract). Hedging is good for corporate profits, as it insulates them from potential future price fluctuations, but **hedging is bad for the climate**, as by removing corporates' exposure to higher prices, it removes the incentive mechanism for corporates to curb their emissions - the famous price signal. Corporates are no longer exposed to higher carbon prices, and no longer care financially about curbing their emissions.

Since both potential uses and purposes of options and futures contracts are detrimental from a climate perspective, we believe that such contracts should be not allowed in the market, and only spot contracts should be.

A number of other features also favour speculators:

- **Financial delivery.** Contracts can be settled in 3 ways: physical or deemed delivery, whereby at maturity the buyer receives the carbon credits purchased and retires them, or financial delivery, whereby the buyer and seller merely exchange a cash sum corresponding to a price differential. Allowing for financial delivery is well-known to attract gamblers with no interest in receiving any credits and only wishing to make a quick speculative profit. Financial delivery should thus not be allowed in our view.
- **No max price fluctuation:** the absence of limits to price fluctuations clearly favours speculators, as the higher the price volatility the higher the trading profits, but is bad for everyone else.
- **Carbon index fund:** the report also foresees investments in “carbon index funds” as a way for private corporations to fulfil their carbon neutral pledges. The way it is supposed to work according to the report is that corporates purchase a stake in the index fund, then at the time of their choosing sell the stakes and use the cash to purchase credits with physical delivery. Such a fund would seem to only play a role for hedging, which would be bad for the reasons described above.
- **Securitisation of offsets:** The technical appendix describes the possibility to have pooled portfolios of offset projects, whose tranches could be traded OTC or through exchanges. This seems to suggest the securitisation of carbon offset projects, the technique that was at the heart of the 2008 financial crisis and led to the originate-to-distribute model of subprime mortgages. The potential issues associated with carbon securitisations have been amply documented.⁶
- **No consideration of position limits:** also noteworthy is the fact that nothing is foreseen to limit the proportion of speculators in the market, whereas this could have been a design feature of the scheme.

To be clear, ***speculators can be useful, insofar as their proportion is limited and there is no implicit political cap on prices, but it is unlikely to be the case:*** speculators in very limited proportions are useful, as end users (polluters) often want to buy or sell credits all at the same time, and speculators are willing to take the other side of the trade. As, however, the presence of speculators

⁶ Hache F, 50 shades part I: carbon, Green Finance Observatory, March 2019
<https://greenfinanceobservatory.org/wp-content/uploads/2019/03/50-shades-carbon-final.pdf>

leads to increased price volatility, the more speculators there is, the more inexistent the price signal, which is why the proportion of speculators should be limited.

The other hypothetical benefit of speculators in the case of carbon is that it may in theory lead to higher carbon prices, at least initially, as new players enter the market. In turn, one might expect these higher carbon prices to incentive a real reduction in emissions and switch in technologies. However, in practice this is unlikely to be the case due to the aforementioned hedging and most importantly due to the implicit political cap on prices: it is indeed widely accepted among market participants that should carbon prices rise quickly to significantly higher levels, a number of policy makers would claim that it is too disruptive economically, and measures would be put in place to limit or reverse some of this rise, by flooding the market with additional credits for example.

Unlimited speculation will thus most likely lead to higher price volatility – thereby removing the price signal – but not to a steep rise in carbon prices. We therefore believe that market blueprints should include features to curb the proportion of speculators and price volatility.

High regulatory and public opinion uncertainty: it is interesting to note, from an investors' perspective that voluntary carbon markets are significantly riskier than compliance ones, as they are exposed not only to regulatory risk – the risk that the rules regulating compliance markets will change, in turn impacting demand for voluntary markets – but also to public opinion. Since voluntary markets do not respond to any regulation, demand is driven by the branding and reputational benefits associated with buying the credits, as well as the perceived effectiveness of the market to pre-empt tougher environmental regulations. Should public opinion start to question their environmental integrity and contribution to climate change mitigation, the value of the credits could suffer abrupt shocks. Public opinion is arguably harder to manage than regulatory risk, which can be mitigated via lobbying; it also means that there needs to be an important price differential between compliance and voluntary markets for investors to justify taking this additional risk.

4. A governance design with some potential conflicts of interests

“Voluntary, stakeholder-led and self-regulating:” the report foresees a new umbrella governance body that *“is an independent, voluntary, stakeholder-led and self-regulating body.”* For those who remember pre-crisis so-called “light touch” financial regulation, voluntary, stakeholder-led and self-regulating are words that should ring some alarm bells, the last one in particular. The last financial crisis has indeed evidenced the spectacular inability of the financial sector to self-regulate, and suggests extreme caution with such claims.

We also find that some of the governance proposals raise some concerns:

The board of directors of the new governance body will have 9-11 directors, consisting of 3-4 founding sponsors (NGOs, investor alliances and industry associations) and 6-7 independent board members (experts, academics, former market participants, representatives from multilateral and international organizations). The TSVCM Advisory Board will recommend organizations to become Founding Sponsors and the initial Independent Board Members in September 2021.

We believe that board directors should not belong to investor alliances or industry associations, as this could create conflicts of interests. The nomination of the initial independent board members

by the advisory board does not provide much reassurance, given the composition of the advisory board⁷ that exhibits a strong pro-market and pro-business bias in our opinion.

Also noteworthy is the mandate of the governance body, that includes establishing guidelines and frameworks, providing oversight and fostering the (responsible) growth of the market. Experience suggests that overseeing a market and fostering its growth are two potentially conflicting objectives often leading to lax oversight, and it would be best to separate them.

5. A risk for indigenous rights and a potential wealth transfer to developed countries?

The Taskforce report states that on the topic of land use, *“weak or unclear land titles, statutory and customary rights relating to land ownership, and indigenous rights can create an uncertain and risky ground for the allocation of clear rights over mitigation outcomes.”* While it is certainly true that statutory and customary land ownership rights and indigenous rights are not ideally suited to fluid private commercial transactions, framing them as a “risk” for the allocation of carbon credits might be a very limited perspective. More importantly, it implicitly asks the question of whether these statutory and customary rights should be legally formalized for the sole benefit of a handful of speculators and polluters and to the detriment of indigenous communities. We believe that they should not.

According to the Taskforce, voluntary carbon offset markets *“can drive billions of dollars from those emitting carbon to those removing carbon or preventing its emission over the next 30 years. For finance to flow to the right projects, a well-functioning voluntary carbon market with high integrity quality standards and robust governance is needed.”* At first glance, some might see these alleged billions of dollars flowing from developed to developing countries as a positive development. What is left unmentioned, however, is the huge potential implicit wealth transfer from society to private corporations embedded in offset markets compared to alternative binding environmental regulations (e.g. less curbing of private profits in exchange less effective mitigation of climate change and related higher future public health costs) and also the potential wealth transfer from developing countries to developed countries, via land acquisition at bargain prices, and through pushing developing countries to open new markets for private green foreign investors. A rigorous assessment of the net result of these dynamics is required in our opinion before hinting at any positive wealth transfer claims.

Overall, the report confirms our view that the Taskforce on Scaling Voluntary Carbon Markets is primarily a private lobbying effort aimed at both diverting the conversation away from phasing out fossil fuels and a rebranding the city of London as a “green” financial hub, or as an event puts it, *“harnessing the power of London for global climate action.”*⁸

Only the questions that are relevant to GFO are reproduced below.

⁷ IIF, Advisory board members, <https://www.iif.com/tsvcm>

⁸ London Climate Action Week 2021 <https://www.londonclimateactionweek.org/>

B.2) Do you agree that the mandate of the body is suited to address the governance needs of the VCM?

Experience suggests that overseeing a market and fostering its (responsible) growth are two potentially conflicting objectives, often leading to weak oversight. We therefore believe that the mandate is not suited to address the governance needs of the VCM.

B.4) Which specific linkages should the governance body have to financial regulators, expert bodies, standard setters for corporate claims, legal and accounting firms, governments and regulators of compliance markets, and other bodies?

The governance body does not need to have any particular linkages to financial regulators, governments and regulators of compliance markets, since it is in charge of a voluntary market. Potential linkages could be seen as an attempt to give a perception of higher democratic legitimacy to the voluntary market and at influencing the regulation of compliance markets.

B.8) How should the governance body balance the need to avoid conflicts of interest with the need to represent interests of market participants on the Board of Directors?

We believe that no entity should be both represented in the board of directors and participating in the market, as it could give it an unfair advantage and create potential conflicts of interests undermining oversight.

C.1 Do the use cases reflect how you would like to trade CCPs in the future?

The use cases do not reflect how we would like to trade CCPs in the future. Trades should only be based on spot contracts with physical delivery, not futures, options or index funds with financial delivery.

This would prevent hedging, but that would be a deliberate and good thing from a climate perspective, not an unintended consequence, as it would avoid further weakening the price signal.

This would also limit the attractiveness of the market for pure speculators, thereby curbing excessive price volatility.

C.6 Do you agree on the specific elements and language proposed (including for compliance linkages)? Why / why not?

C.7 Would you like to give comments on any specific general trading terms?

We do not agree with a number of specific trading elements. For the reasons highlighted above, we believe that the market should:

- be limited to exchange-traded spot contracts with physical delivery and exclude futures and options contracts and financial delivery. We also see no need from a climate perspective for OTC instruments;
- include maximum price fluctuations and position limits, in order to limit price volatility and weed out excess speculators;

- exclude entirely forestry offsets in order to strengthen environmental integrity and investors' trust, and to reduce public opinion risk.

D.3) Do you agree with the proposed requirements for permanence? Are there any additions or changes that we should take into account?

We do not agree with the proposed requirements for permanence.

The report states that *"long term permanence of emissions reduction or removals must be a requirement by standards. Standards must adhere to minimum permanence timeframe set out by the CCPs (number of years to be determined) for carbon stored to be considered permanent."* It also asks the question regarding REDD+ reforestation credits of *"should permanence for nature-based storage be set at a fixed amount of time (e.g., 10, 30, 40, 100 years)? Should it vary by methodology type or should it be left up to the Standards?"*

We believe the only valid criteria for permanence to be the residence time of the relevant greenhouse gases in the atmosphere. Permanence is not an arbitrary amount of time determined by standards, and cannot be approximated to a mere few decades for the purposes of facilitating short term trading and to the detriment of future generations.

D.8) Do you agree with the proposed requirements for "Do No Net Harm"? Are there any additions or changes that we should take into account?

First, we have to admire the taskforce's commitment to offsetting, as it includes in its governance not the fairly standard "do not harm" principle, but instead a more innovative and intriguing "do no net harm."

Yet, we find its definition not sufficiently clear, in particular the "net" aspect, and in need of refinement. The current definition is that *"the independent standard must have requirements to ensure that all projects and programs consider related environmental and social risks and take actions to mitigate associated harm."* Such wording is rather generic and can open the door to a large range of interpretations. It also fails to explain the "Net" element, whether it refers for example to allowing for the offsetting environmental and social harm or means something else entirely. We would find it preferable if "do no net harm" was to be replaced by "do no harm," as this would reassure investors about the environmental and social integrity of the market.

The proposed requirements for "Do No Net Harm" are also not adequate in our view.

Ex ante impact assessments and stakeholder consultations can be notoriously biased and offer little guarantee. As with safeguards and grievance mechanisms, the devil is in the details, and it is therefore hard to assess the adequacy of such generic language. We would find it much more effective instead to exclude the most problematic activities from the market, such as afforestation, reforestation, land management and REDD+.

D.12) What is your perspective on CCP methodologies needing to be financially additional?

We understand financial additionality to mean that an offset project is profitable enough compared to other investments, thanks to the revenue from related offset credits. We don't find such a

requirement to be particularly relevant – unlike environmental additionality - and we hope that it will not be instrumentalized to ask for more public subsidies.

D.16) Do you support the implementation of a Standard taxonomy of Additional Attributes?

D.17) Do you agree with the initial proposal for five Standard Additional Attributes? Are there any additions or changes that we should take into account?

We do not support the implementation of a standard taxonomy of additional attributes, as we believe that the drawbacks outweigh the potential benefits. Specifically, additional attributes may allow buyers to make hard to substantiate and impossible to value claims about allegedly contributing to specific SDG objectives.

As for the initial proposal for five standard additional attributes, we are particularly concerned by the co-benefits attribute. Potential co-benefits foreseen include contributions to biodiversity, water quality, soil quality, poverty alleviation and job creation, as measured by SDGs or some other accredited label, or contributing to technological innovation such as carbon capture and storage or transforming waste into aviation fuel.

First, for the co-benefits to be more than a PR exercise for buyers, they will most likely need to be associated with a price differential compared to credits without these co-benefits. Yet, from an environmental perspective, it is not desirable to financialize either biodiversity, water quality, soil quality or any other SDG. It has also been shown to be impossible to put a meaningful monetary value on biodiversity.

Secondly, considering as a co-benefit technological innovations that are often presented as alternatives to curbing our emissions is environmentally and ethically questionable, as well as politically biased. While exploring such innovations is certainly interesting, there is already no shortage of subsidies and regulatory sandboxes for them, and it is not clear that they always contribute to addressing climate change. While in theory they could complement the need to curb our emissions, in practice they are most often presented as an alternative to it: sustainable aviation fuel is presented to an alternative to curbing flying, and carbon capture and storage is presented as an alternative to curbing dirty activities. Some also view geo-engineering (changing the colour of the sky or the ocean to reflect the sun) as an alternative to curbing our emissions.

Technological innovation can be a good thing, but only insofar as it is not viewed as a magic solution to address climate change without changing our lifestyles and curbing economic growth, as this would be a gigantic and unfair gamble over our future. For these reasons we believe that technological innovation as a whole should not be considered a co-benefit.