

## Guest Commentary

### Carbon markets need urgent oversight

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As carbon markets mature they are increasingly characterised by crime, corruption, institutional malfeasance and incompetence. These problems increasingly appear to be systemic. Since the conclusion of the first phase of the world's largest formal carbon market (the EU-ETS) in 2007, carbon market crime has cost the market no less than €5 billion. Since the last quarter of 2009, our preliminary analysis reveals 17 unique incidences of fraud that together represent almost 90% of publicly-known incidences of fraud since the end of phase one. Contrary to predictions and proclamations: as the formal carbon market matures, without proper oversight, criminal activity, corruption and ethical malfeasance are on the rise.

Rising carbon market crime presents law enforcement, regulatory and analytical challenges for existing and emerging carbon trading initiatives, in Europe, the US and other countries considering market-based climate solutions.

Carbon market corruption and crime has involved manipulating project additionality; forging certifications; falsifying documentation; misrepresenting the extent of public participation; bribing public officials; obfuscating methodological protocols; and producing greenhouse gases for the purpose of generating lucrative offset credits. Whereas market malfeasance has seen abuse of power at the project level, through questionable land grabs for example; and unethically (yet permissible) carbon credit double-counting. These practices are not just limited to countries across Africa, Asia and Latin America, where transparency and corruption indices are worrisome and carbon market institutional infrastructure is weak or non-existent. Disturbingly, the biggest frauds and scams seem to be systematic to the core of the EU cap-and-trade system. This is cause for grave concern, and may multiply the problems for regulation, as architects of the 'next largest carbon market' – in the US – borrow ideas and practices, from a system suffering from deep, intractable crimes, corruption, unethical practices and malfeasance.

Most worrisome are allegations that some polluters have increased their greenhouse gas emissions solely to cash in on extremely lucrative offsets. Industrial gases are the most notorious, but new research in Indonesia raises serious questions about that country's recent high profile commitment to curtailing deforestation.

As markets mature and malfeasance and fraud grow, corresponding regulatory infrastructure has not emerged—despite clear and urgent calls from many sectors. Accordingly new market scams are flourishing. Most recently market phishing scams, value-added tax (VAT) evasion, and carbon credit recycling (which was technically permitted) have cost markets and taxpayers billions of dollars—even by conservative estimates.

The most damaging cases of fraud are those with direct environmental consequences, even though the highest profile arrests have involved fraud with little environmental consequences. Project-level environmental fraud must receive explicit regulatory attention. The rapid increase of fraudulent practices indicates that these issues must be addressed in policy design and not be left for later, and it is questionable whether the task can be left to the UN process.

Risk in carbon markets has parallels with that faced by the financial system during the subprime mortgage crisis. Subprime lending based on derivatives exacerbated bad faith lending practices, jeopardising the whole American financial system by hiding questionable loans. Carbon reduction projects must in good faith actually achieve real and additional reductions, yet even now some market proponents lobby for weakened additionality procedures, and the evidence already exists that markets sometimes produce perverse incentives at the project level. Since an offset is used to justify emissions elsewhere, the crime of every fudge, cheat and dirty trick is double.

Climate change is a diffuse long-term public interest problem which is especially worrisome for the world's most vulnerable groups. Yet carbon markets propose to confront the problem through short-term private gain for quite a small group of elite market participants. The risk of pervasive fraud in carbon markets is the continued and even accelerated accumulation of emissions in the atmosphere. Interpol's September environmental crime conference may offer spaces to address problems in carbon markets. Such efforts must achieve real emissions reductions. The inability to bring robust governance structures will exacerbate injustice, facilitate new problems of wealth disparity and may ultimately cause increases in emissions.

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