October 7, 2022

Via CFTC.gov
Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Dear Mr. Kirkpatrick:

The Natural Resources Defense Council (NRDC) is pleased to submit comments in response to the Request for Information from the Commodities Futures Trading Commission (CFTC) regarding climate-related financial risk.[1] We agree with the CFTC that climate change presents emerging risks to the financial industry and that "[c]limate-related financial risk may directly or indirectly impact Commission registered entities, registrants, and other market participants as well as the derivatives markets and the underlying commodities markets themselves."[2] We appreciate the CFTC's efforts to study these emerging risks and how the CFTC might use its authority to address them, including its 2020 report, Managing Climate Risk in the U.S. Financial System, and its convening on voluntary carbon markets earlier this year.

Our comments will address the voluntary carbon markets, which are topics 22-24 of the CFTC's request for information. The voluntary carbon markets are important to meeting net-zero commitments and they are a valuable source of funding for projects that can mitigate climate change. But voluntary carbon markets must address a set of common problems: double-counting, additionality, permanence, and leakage. We explain these concepts in further detail below. Briefly summarized, carbon offsets can vary in quality; some reduce emissions in the way that they promise, others have little or no real-world impact. A valuable offset is one that funds activity that would not

[1] 87 Fed. Reg. 34,856 (June 8, 2022).
[2] *Id*. at 34,857.

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otherwise occur, ensures that the associated emissions reductions are permanent or occur for a specific time, and does not result in emissions increases elsewhere. To enhance the efficiency of these markets, we recommend that the CFTC use its existing legal authority to promote best practices in voluntary carbon markets and use its enforcement authority over spot markets to address instances of fraud and manipulation.

NRDC is an international nonprofit environmental organization. Since 1970, our lawyers, scientists, and other environmental specialists have worked to protect the world's natural resources, public health, and environment. Through its finance and legal experts, NRDC advocates for regulation to mitigate the financial effects of climate change.

Voluntary carbon markets are distinct from compliance carbon markets, in which a regulated entity purchases credits to make up for emissions exceedances. Voluntary markets typically sell offsets for emissions of carbon dioxide or other greenhouse gases in which the buyer pays the seller to undertake an emissions-reducing or emissions-sequestering activity to compensate for emissions that the buyer is unable to eliminate. Many companies and organizations use voluntary carbon offsets to meet net-zero commitments. The voluntary carbon markets will likely grow substantially in the next two decades: "demand for carbon credits could increase by a factor of 15 or more by 2030 and by a factor of up to 100 by 2050. Overall, the market for carbon credits could be worth upward of $50 billion in 2030."[3]

The CFTC has authority to regulate these markets. Carbon offsets are commodities under the Commodities Exchange Act: they have a market value and there is an existing futures market in them that is likely to grow

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[3] Christopher Blaufelder, Cindy Levy, Peter Mannion, & Dickon Pinner, *A blueprint for scaling voluntary carbon markets to meet the climate challenge*, https://www.mckinsey.com/capabilities/sustainability/our-insights/a-blueprint-for-scaling-voluntary-carbon-markets-to-meet-the-climate-challenge (Jan. 29, 2021).

substantially in the coming years.[4] And because the voluntary carbon markets are subject to CFTC regulation, the agency also has the authority to address fraud or manipulation in the spot markets for carbon offsets.[5]

Below, we address some issues regarding voluntary carbon markets raised in questions 22-24 of the CFTC's request for information.

22. Are there way in which the Commission could enhance the integrity of voluntary carbon markets and foster transparency, fairness, and liquidity in those markets?

23. Are there aspects of the voluntary carbon markets that are susceptible to fraud and manipulation and/or merit enhanced Commission oversight?

24. Should the Commission consider creating some form of registration framework for any market participants within the voluntary carbon markets to enhance the integrity of the voluntary carbon markets? If so, what would a registration framework entail?

We recommend that the CFTC use its regulatory authority to investigate the degree to which offset sales are accompanied by disclosures about the project's likely impact, including how emissions reductions are calculated and

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[4] *See* 7 U.S.C. § 1(a)(9) (defining commodity as "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.") (emphasis added); *see also Inv. Co. Inst. v. Commodity Futures Trading Comm'n*, 720 F.3d 370, 372 (D.C. Cir. 2013) ("the Commission has regulatory jurisdiction over a wide variety of markets in futures and derivatives, that is, contracts deriving their value from underlying assets.").

[5] *Commodity Futures Trading Comm'n v. McDonnell*, 287 F. Supp. 3d 213, 217 (E.D.N.Y.), r*econsideration denied*, 321 F. Supp. 3d 366 (E.D.N.Y. 2018) ("CFTC's broad authority extends to fraud or manipulation in derivatives markets and underlying spot markets.")

verified. This would include examining disclosures on issues of double-counting, additionality, permanence, and leakage. Based on the results of this work, the CFTC should then consider whether standardized disclosures and verification processes, as well as registration requirements, could further support the development of the voluntary carbon markets.

Carbon offsets fund two types of activities, "those for reducing emissions and those for capturing carbon already in the atmosphere and either storing it underground or embedding it in other products (such as concrete)."[6] Voluntary carbon markets face a set of common problems in designing carbon offsets that meet the goal of reducing emissions: double counting, additionality, permanence, and leakage. Markets have also confronted issues around monitoring and quantifying carbon reductions.

- Double counting is the problem in which one or more parties are claiming emissions reductions from the same offset. This can occur, for example, if a seller claims the emissions reductions from a project for which offsets are sold, or if a buyer fails to "retire" a carbon offset and re-sells it after claiming the associated emissions reductions.

- Additionality is the concern that a carbon offset is funding activity that would have occurred anyway, even without the carbon offset. Additionality is judged against a baseline – an emissions scenario in which. Problems of additionality often reduce to problems of identifying the correct baseline. If the baseline is not properly calibrated, then carbon offsets will fund activity that does not reduce emissions to the degree promised.

- Permanence is the concern that the offsetting activity may be reversed at some point in the future. This can occur when, for

[6] Robert O. Mendelsohn, Robert E. Litan, and John Fleming, *A framework to ensure that voluntary carbon markets will truly help combat climate change*, https://www.brookings.edu/research/a-framework-to-ensure-that-voluntary-carbon-markets-will-truly-help-combat-climate-change/ (Sept. 16, 2021).

example, a preserved forest burns down, or when the seller of an offset stops using an emissions-reducing process or technology.

- Leakage is the concern that the offset will result in activity being moved elsewhere. For example, leakage would occur if an offset created a forest preserve that resulted in logging activity moving to the acres immediately surrounding the reserve.

Many voluntary carbon markets have protocols to address these problems. Article 6.4 of the Paris Convention concerns the Sustainable Development Mechanism, which allows trading of emissions reduction credits for specific activities. The Sustainable Development Mechanism released a set of "rules modalities, and procedures" after COP 26 in 2021.[7] Those rules require that "public or private entities" registering an activity with the Sustainable Development Mechanism design those activities so that they are "additional," "[m]inimize the risk of non-permanence of emissions reductions" "[m]inimize the risk of leakage," and "[m]inimize, and, where possible, avoid negative environmental and social impacts."[8] The Article 6.4 rules also require that anyone registering an activity use a baseline with a "performance-based approach" taking into account emissions-reduction technology, and demonstrate additionality "using a robust assessment that shows the activity would not have occurred in the absence of the incentives from the mechanism, taking into account relevant national policies, including legislation, and representing mitigation that exceeds any mitigation that is required by law or regulation."[9] The rules also require monitoring of emissions reductions, and verification by a "designated operational entity."[10] The Sustainable Development Mechanism is not yet supervising the trading of credits pursuant to Article 6.4 of the Paris Agreement, and will implement these requirements over the coming years.[11]

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[7] Article 6.4: Decision 3/CMA.3,
https://unfccc.int/sites/default/files/resource/cma2021_10_add1_adv.pdf#page=41
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Samuel L. Brown, *Carbon Markets and Carbon Offsets*, Nat. Resources & Env't, Spring 2022, at 56, 58

To take another example, the Climate Action Reserve, a California-based voluntary carbon offset registry, has developed a set of protocols on problems like additionality, leakage, and verification.[12] On additionality, "[t]he Reserve applies a standardized approach to determining additionality, where performance standards and other conditions or criteria that projects must meet in order to be considered additional are determined by the Reserve."[13] This contrasts with an approach "where additionality is assessed using information and analysis specific to each project." The Reserve screens out projects where emissions reductions are legally required, or are driven by performance standards that are "attractive investments irrespective of carbon offset revenue."

The use of project-specific baselines may exacerbate the additionality problem. "[S]uppliers of projects have an incentive to inflate the project's net effect by claiming emissions would be higher" without the project, and so project-by-project emissions baselines may overstate the impact of carbon offsets.[14] One solution to this problem would be to set broader baselines, such as looking industry-wide emissions projections which take account advances in technology and production that would create emissions reductions without voluntary carbon markets.[15]

Setting a proper baseline is also important to addressing leakage. The Climate Action Reserve, for example, does not require separate accounting for leakages but instead requires that projects submit a comprehensive "GHG Assessment Boundary" that examines "sources, sinks, and reservoirs" of greenhouse gas emissions associated with a project, not just the emissions

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[12] Peter Miller, one of the signatories of this letter, serves on the Board of Directors of the Climate Action Reserve. The views presented in this letter are on behalf of NRDC only.
[13] Climate Action Reserve, *Reserve Offset Program Manual* at 7 (Mar. 2021), https://www.climateactionreserve.org/wp-content/uploads/2021/03/Reserve_Offset_Program_Manual_March_2021.pdf.
[14] Mendelsohn, Litan, & Fleming, *supra* note 6.
[15] *Id.*

reduction or carbon sequestration immediately associated with the project.[16] Other commentators have recommended that voluntary carbon markets set emissions accounting baselines at least at a corporate-wide level rather than at the level of a specific project.[17]

Permanence risks vary by type of project. For emissions reduction projects, voluntary markets can ensure that offsets are tied to the use of emissions-reduction processes or technology so that the offsets represent avoided emissions. The risk is different for carbon storage projects. Carbon markets have dealt with permanence risks through temporary crediting,[18] or through buffer pools, in which some credits are issued but not sold to account for potential reversals of the project.[19]

Avoiding double-counting is a matter of careful project screening – for example, not awarding offsets in a voluntary market for activity that a company is legally required to undertake through a compliance market – as well as operational protocols within a voluntary market. Some markets investigate project applications to ensure that the project sponsor is not registering the project with any other voluntary market for the same time. And markets routinely serialize offsets, identify the project location and time for which the emissions deduction is claimed, and track the retirement of credits, to avoid double counting.[20]

Voluntary markets have developed practices to ensure that offsets result in real emissions reductions, and the CFTC can encourage the standardization of those practices. We recommend that the CFTC proceed in stages.

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[16] Climate Action Reserve, *supra* note 13 at 15.
[17] Mendelsohn, Litan, & Fleming, *supra* note 5.
[18] The Offset Quality Initiative, *Assessing Offset Quality in the Clean Development Mechanism*, 10 Sustainable Dev. L. & Pol'y 25, 30 (2010) ("the [Clean Development Mechanism] addresses permanence concerns by issuing temporary credits that expire at a predetermined time. Once a credit expires, the owner must replace it with another valid credit or emission allowance unit.").
[19] Climate Action Reserve, *supra* note 13 at 20.
[20] *Id.* at 20-21.

- First, we encourage the CFTC to use its investigative authority to evaluate the disclosure practices and verification processes used by voluntary carbon markets. As the Article 6.4 process develops, voluntary markets may converge on processes that comply with Article 6.4's requirements, and so the CFTC should also study how the market evolves over the next few years.
- Second, the CFTC should consider whether to adopt standardized disclosures for voluntary carbon markets so that buyers of carbon offsets can be assured that what they are buying will result in real-world emissions reductions, as well as standardized verification requirements for offsets, such as the use of independent third-party verifiers.
- Third, the CFTC should consider establishing registration requirements for voluntary carbon markets. A registration system would give the CFTC additional authority to enforce disclosure and verification requirements. It would also provide buyers of carbon credits with further assurances about the quality of offsets.
- Fourth, the CFTC should use its authority over the spot markets to investigate potential cases of fraud or manipulation.

Thank you for considering our comments. Please let us know if we can be of any further assistance.

Sincerely,

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