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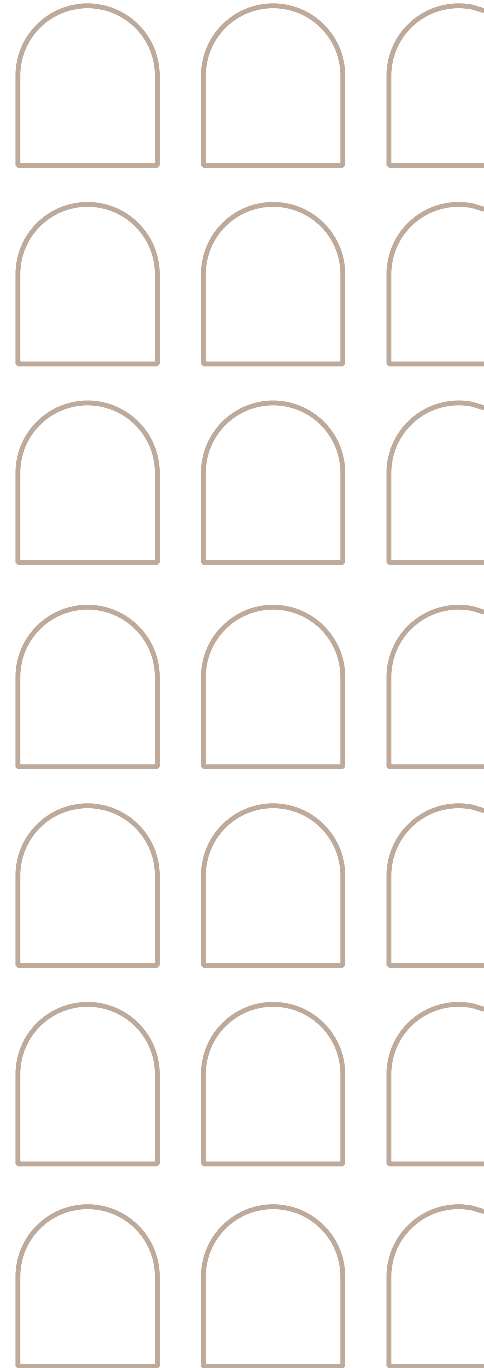
POLICY BRIEF



INTERNATIONAL AND EUROPEAN ACTION ON INTERNATIONAL CARBON CREDITS

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EXECUTIVE SUMMARY

The regulatory landscape related to carbon credits is dynamically evolving. Even though the global market for carbon credits remains relatively limited compared to the ones created by emission trading systems, it can still play an important and complementary role in fostering positive climate actions through economic incentives. A variety of recent policy developments aim at strengthening good governance and environmental integrity of carbon credits. Policy efforts take place at different governance levels, given the variety of actors involved in the value chain of the international market for credits: from the UNFCCC, to individual states and regional groupings, including the European Union, to Voluntary Carbon Markets' stakeholders. This policy brief sheds light on the intricate international and European regulatory infrastructure that is being forged to support the trade of carbon credits and the claims associated to their use and outlines ways forward to enhance the soundness of the policy framework.

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1. INTRODUCTION

The regulatory landscape related to carbon credits is dynamically evolving. Recently many useful initiatives have been taken to improve the trust in Voluntary Carbon Markets (VCM), but these are not (yet) bearing fruit[1]. Policies seem to be required to strengthen the good governance and environmental integrity of carbon credits. This policy brief sheds some light on the emerging international and European regulatory infrastructure related to carbon credits and the claims associated with their use.

2. THE PARIS AGREEMENT AND INTERNATIONAL CARBON CREDITS

International aspects related to carbon credits continue being discussed within Article 6 of the Paris Agreement. Many Parties indicated their intention to engage in market-based approaches potentially using the two avenues offered by this article to export and import carbon credits.

Article 6.4 discussions focus on the operations of a centralised baseline and credit mechanism managed by a Supervisory Body[2] of regionally appointed experts. Article 6.2 allows for a more flexible approach between interested Parties without a centralised governing body and to date the focus was on bilaterally agreed crediting approaches that would enable transfers of emission reductions (accounted as ITMOs – Internationally Transferred Mitigation Outcomes). It must be noted that some Parties have in mind a different avenue of cooperation through Article 6.2 that would allow international linkages between more encompassing schemes, most notably ETS.

Parties left COP 28 without a complete ruleset to govern credits under Article 6 of the Paris Agreement. The lack of a solution on detailed provisions to operationalise the centralised mechanism under Article 6.4 is seen as undermining the ambition of this UN-based scheme to become the threshold that standards catering to VCM should match. At the base of the Parties' disagreement on Article 6.2 lie some fundamental differences in how Parties view the role of international carbon markets in achieving their National Determined Contributions (NDCs). While some ask for a model with maximum flexibility and relatively light oversight, others seek additional stringency, including in governance approaches.

Engaging in international markets under the Paris Agreement represents a change compared to the Kyoto Protocol's flexible mechanisms. It includes new responsibilities for the host Parties, ultimately determining how Article 6 should be 'Paris aligned'. A universally agreed definition for what 'Paris alignment' stands for in the scope of the generation of international credits has not yet been agreed. But it indicates that carbon credits should do their fair share in delivering the goals of the Paris Agreement and that the Paris pathway needs some reflection in crediting approaches. A very important lesson learned through the experience with Kyoto Protocol's flexible mechanisms is that a central register was keeping track of all international exchanges of carbon credits thereby creating a most helpful transparency. Parties will continue their talks in the formal UNFCCC negotiations, including at COP 29 in Baku,

[1] Ecosystem Marketplace 2024, State of the Voluntary Carbon Market', https://www.ecosystemmarketplace.com/publications/2024-state-of-the-voluntary-carbon-markets-sovcm/.
[2] UNFCCC: https://unfccc.int/process-and-meetings/bodies/constituted-bodies/article-64-supervisory-body.

and hopefully settle on resolutions on the use of international credits.

3. CORE ELEMENTS FOR PARIS ALIGNMENT IN VCM

A plethora of initiatives have recently been undertaken in the VCM showing the appetite to homogenise approaches and sending strong signals that alignment with the Paris Agreement is possible. Key principles and objectives of such an alignment are integrity in methodological approaches, enhancing ambition over time, fostering sustainable development, and securing appropriate levels of transparency. These principles and objectives are the subject of intensive negotiations under Article 6 of the Paris Agreement and the VCM can already incorporate them. Whether and to what extent these initiatives will ultimately lead the VCM to converge and ultimately fall under Article 6 of the Paris Agreement remains to be seen.

Methodological approaches and enhancing ambition

Paris alignment in VCM necessitates a focus on environmental integrity, ensuring that activities lead to real, additional, and permanent emissions reductions. This would require adherence to robust standards and methodologies that uphold the highest environmental standards and contribute to global efforts to limit global warming to well below 2 degrees Celsius. Paris alignment should also require VCM to support ambitious climate action by driving increased investment in emissions reduction projects and encouraging the adoption of innovative and transformative technologies and practices. Activities should contribute to raising ambition over time, helping countries and businesses exceed their climate targets and commitments.

In its methodological recommendations to Parties the Article 6.4 Supervisory Body envisaged last year an element of the so-called downward adjustment for baselines in the mechanism, which was meant to implement the principle of enhancing ambition over time. Potential practical implications and solutions to implement this principle are being discussed.[3] This could also be undertaken in the context of VCM if standards were to align with Article 6 methodology requirements. One key element under consideration is deriving and applying a specific factor (sometimes referred to as a coefficient), which would, over time, progressively reduce the total amount of emission reductions eligible for crediting.[4] Deriving such a factor would be linked to Parties' climate objectives and to envisaged pathways needed to deliver on the long-term goals of the Paris Agreement. In effect, this should align the baseline of a given activity with these broader goals and avoid over-crediting.

Fostering sustainable development

For VCM to be Paris-aligned, positive social and environmental impacts alongside emissions reductions should be delivered. Projects within VCM should contribute to sustainable development, poverty alleviation, biodiversity conservation, and other social and environmental objectives, in line with the Sustainable Development Goals. Many standards prioritise exemplifying such positive contributions of their activities and elaborate methods of demonstrating those. It is worth noting that a mandatory tool for demonstrating impact on sustainable development (both positive and negative) is still under development by

[3] Lessons Learned from the Kyoto Mechanisms for the Article 6.4 Mechanism, CLIMATE CHANGE 02/2024, ISSN 1862-4359 - http://www.umweltbundesamt.de/publikationen.

[4] Adapting CDM methodologies for use under Article 6 of the Paris Agreement CLIMATE CHANGE 01/2024, ISSN 1862-4359.

the Supervisory Body and may serve as the UN standard, which could also be replicated in VCM.

Transparency and collaboration

Paris alignment also entails improved transparency and accountability, with precise reporting requirements and verification processes. Stakeholders must have access to comprehensive and reliable information about the emission reductions achieved and the co-benefits delivered by VCM projects. Collaboration and partnership among the main actors, including governments, businesses, civil society organisations, and international institutions, will also be vital. Collaborative initiatives in VCM were launched recently and aim at standardising approaches.[5]

Additionally, there are several international initiatives aiming at scrutinising the largely unregulated VCM. Activities undertaken by the Integrity Council for VCM (IC VCM) envisage fostering the creation of high integrity credits. The issuance of the first credits with the attached Core Carbon Principles label is imminent. Some of the IC VCM assessment framework principles relate to the element of alignment with the Paris Agreement. Notably, the principle of 'Contribution toward net zero transition' requires that mitigation activities *"(…) avoid locking in levels of GHG emissions, technologies or carbon-intensive practices that are incompatible with the objective of achieving net zero GHG emissions by mid-century"*[6]. This principle is also at the heart of a recent policy statement by the US government announcing principles for high-integrity VCM.[7]

Share of proceeds

VCM could further establish its alignment with the Paris Agreement by applying the so-called Share of Proceeds for Adaptation modality which is a mandatory element for the Article 6.4 mechanism and can be voluntarily applied also to Article 6.2 approaches. The basis is setting aside a portion of issued credits and monetising them directly to undertake adaptation measures in developing countries. Article 6.4 also introduced another form of levy on the issued credits, known as Overall Mitigation in Global Emissions. This 'tax for the atmosphere' would mean that a small portion of credits issued are entirely cancelled and, therefore, cannot be used by anyone to make climate-related claims.

Corresponding adjustments

In view of Paris alignment, some in the VCM advocate the application of the so-called Corresponding Adjustment to authorised credits, namely ITMOs.[8] Debate on this modality has been lively, since COP 27 adopted a definition of a Mitigation Contribution Unit (MCU).[9] In the context of Article 6.4, it meant to describe those credited emission reductions, which would not be authorised for use by Parties against NDCs (nor obligations such as ICAO's CORSIA), thus could be considered as units not used to compensate emissions directly, but rather to contribute to the host Parties' NDCs. Therefore, a contribution type of claim was established. Some early movers in VCM have already secured the promise of

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[5] IETA 2024: https://www.ieta.org/resources/cop28/cop28-independent-crediting-programme-joint-statement/.

[6] https://icvcm.org/core-carbon-principles/

[7] The White House 2024: https://www.whitehouse.gov/briefing-room/statements-releases/2024/05/28/fact-sheet-biden-harris-administration-announces-new-principles-for-high-integrity-voluntary-carbon-markets/

[8] Under Article 6 of the PA, as a means to avoid double counting, a form of double-entry bookkeeping called "corresponding adjustments" was introduced. It would mean that host countries should adjust their reported emission levels by the number of credits transferred to buyer countries or other entities.

[9] Paragraph 29 b) of annex I to decision 6/CMA.4 refers to 'mitigation contribution A6.4 ERs'

applying compensating adjustments to credits. Obviously, the choice for the contribution model should not be the reason for any concessions regarding the integrity of credits generated.

4. THE EMERGING EU REGULATORY FRAMEWORK FOR USING CARBON CREDITS

The EU is undertaking regulatory action on claims made by different stakeholders when using carbon credits. This will arguably have a bearing on the overall outlook and future of carbon credits. The EU's regulatory action could also play a role in improving the integrity of carbon credits and bringing clarity to what sort of claims are appropriate in relation to their use.

Given that climate claims based on offsetting are particularly prone to being unclear and are often not backed by scientific evidence, the EU aims to bring more transparency and regulatory soundness to a space which continues to be tainted by greenwashing.[10] However, the interplay and partial overlap of the different policies create a complex policy framework, whose coherence and interoperability need further clarification.

On the use of credits, the Empowering Consumers for the Green Transition Directive[11] complements existing consumer protection rules by integrating green considerations and banning misleading claims if they are not accompanied by scientific evidence. The Directive regulates the demand side of credits, as it bans claims that a product has a neutral, reduced, or positive impact on the environment based solely on the use of carbon offsetting schemes. However, while the Directive bans climate claims on goods and services based on greenhouse gas emissions offsetting, it leaves the door open for organisation-level claims.

To bridge this gap and regulate the substantiation of green claims not prohibited by the Empowering Consumers Directive, the proposed Green Claims Directive[12], aims to counter greenwashing by mandating that companies substantiate explicit environmental claims with verified scientific evidence. In its current shape the draft Directive stipulates that organisations including private firms, can still use offsetting schemes to make climate-related compensation claims but only to balance their residual fossil fuel emissions with permanent carbon removal credits certified by the Carbon Removal Certification Framework (CRCF) or other schemes recognised by the Commission. This is in line with the like-for-like principle, which forbids companies to claim that short-term removals offset their fossil fuel emissions.[13] However, while the Empowering Consumers for the Green Transition Directive has already been adopted, the Green Claims Directive is still being negotiated and hence open to modifications.

[10] Financial Times 2024: https://www.ft.com/content/93938a1b-dc36-4ea6-9308-170189be0cb0?accessToken=zwAGF_F92SF4kdOTk4ob3DZOptOTCBcBib4MsA.MEYCIQCRSJJG6cMcq1fO_be_H4xuhal1yEm_gZ7x9P72j9Q2nglhANQri5T1rnrO4T4avb8dH9kN7C9vb6_GgYD12OVijdNY&sharetype=gift&token=a24b154c-4852-4656-b894-60754961451f.

[11] Directive (EU) 2024/825 of the European Parliament and of the Council of 28 February 2024 amending Directives 2005/29/EC and 2011/83/EU as regards empowering consumers for the green transition through better protection against unfair practices and through.

[12] Proposal for a Directive of the European Parliament and of the Council of 22.03.2023 on substantiation and communication of explicit environmental claims (Green Claims Directive).

[13] Carbon Gap 2024: https://carbongap.org/carbon-credits-and-compensation-claims/.

Adding to these legislations is the Corporate Sustainability Reporting Directive (CSRD), which regulates transparency around the use of credits. The CSRD establishes mandatory reporting obligations on the extent and quality of purchased credits and demands companies to disclose the use of credits separately from emission reductions. However, the CSRD is not directly linked with the Green Claims Directive, as it has not yet been clarified whether corporate reporting can be used to substantiate green claims. Moreover, while the related climate change disclosure standard (ESRS E1) aims to set robust annual reporting requirements for transition plans, net zero plans, emissions, removals, and accounting methodologies, it does not set specific guardrails to prevent companies from making faulty net-zero claims.

5. NAVIGATING COMPLEXITY AND SEEKING CLARITY

Adding to the complexity of the EU regulation architecture is an under-defined terminology. Ensuring a common understanding of the subject regulated is critical as minimal nuances in terminology can imply substantive differences in climate impacts. The complementary directives on Empowering Consumers for the Green Transition and Green Claims fail to clearly define several essential terms, often postponing and passing over the task to Delegated Acts. Given that such concepts are transversal across the legislative pieces, their clarification is urgent to avoid propagating confusion and conflicting interpretations across directives.

Carbon credits and offsets

'Carbon credits' and 'offsets' are often used interchangeably, particularly in the Green Claims Directive. This equivalence between the terms may be the legacy of the Kyoto world, wherein the use of credits was almost automatically matched with offsetting practices. However, with the shift to the Paris era, the end-use of credits and the claims buyers can make are not limited to offsetting but rather multi-faceted. Moreover, a negative connotation is often attached to the term 'offsets', with public discussions increasingly favouring the term 'carbon credits'. Therefore, carbon credits and offsets are not fungible anymore, with the former identifying the market's currency and the latter referring to a specific use of carbon credits.

Compensation and contributions claims

Compensation and contribution claims are not yet clearly defined in the Green Claims Directive. In general terms, compensation claims are associated with classic offsetting practices, whereas contribution claims refer to branding voluntary climate action as helping achieve a country's target. The newly adopted Council position on the Green Claims Directive brings some clarity on the distinction between the two types of claims: a contribution claim refers to an explicit claim to 'have contributed to climate action by purchasing carbon credits, but without using those carbon credits for balancing out a share of its emissions' (art 2 19(d), whereas an offset claims refers to a claim made by a company 'to have balanced out a share of its emissions by purchasing carbon credits (art 2 19e).[14] Offset claims must be accompanied by a net-zero target and demonstrate progress emissions reduction, as well as the percentage of total greenhouse gas emissions that have been offset.[15]

[14] Council of the European Union 2024: https://data.consilium.europa.eu/doc/document/ST-10940-2024-INIT/EN/pdf.
[15] Council of the European Union 2024: https://www.consilium.europa.eu/en/press/press-releases/2024/06/17/green-claims-directive-council-ready-to-start-talks-with-the-european-parliament/

While there seems to be a certain degree of consensus on the necessity to move towards contribution claims, the definition of this umbrella category will need to be further refined. Crafting the methodologies underpinning it will be an important step to make these claims attractive for companies and sound for consumers. The ton-per-ton approach behind offsetting allowed for a clear, concrete, and homogeneous understanding of what was lying behind it. An equally understandable and robust framework for contribution claims is needed to ensure that the climate finance behind them will be as valuable as the one behind compensation. The framework should provide corporates with clear indications on how to use contribution claims to maximise reputational benefits, given that contribution claims do not raise corresponding adjustment questions. At present, these claims are not yet perceived by corporates as offering the same reputational benefits as compensation claims.

Residual emissions

The meaning of 'residual' emissions is yet to be determined. The European Parliament position on the Green Claims Directive strongly called for allowing compensation claims only when based on companies' residual emissions. Consequently, understanding their definition is crucial to comprehend the role of certified removals in decarbonisation pathways of companies. It is also key to understand when companies will be able to make compensation claims, as it appears they can only make such claims once they have exhausted all other avenues for direct emissions reductions, which is unlikely to happen before 2040 or 2050. While further clarification on the definition of residual emissions should come with a Delegated Act, it is worth noticing that ESRS 1 - Climate Change has a definition of residual emissions (Disclosure Requirement E1-7). These are the emissions that remain *"after approximately 90-95% of GHG emission reduction with the possibility for justified sectoral variations in line with a recognised sectoral decarbonisation pathway"*.[16] While the negotiations on the Green Claims Directive are still ongoing, the Council omitted the explicit reference to compensation claims for companies' residual emissions.

More clarity is needed on what sectoral pathway variations entail in relation to residual emissions. Do these variations imply that there is no 'one size fits all' approach in the definition of residual emissions? And, if so, what approach would be envisaged to identify sector-specific variations? Should the CSRD definition of residual emissions be embraced, companies would have limited incentive to invest in carbon removal solutions now. The target date wherein these certificates would be needed is seen as further pushed in time as residual emissions represent only a minimal fraction of their emissions, which is difficult to materialise in the first place. However, scaling carbon removals and curbing their cost curve need to happen in the near term to ensure their available supply for the foreseen demand.

Net-zero and carbon neutrality claims

'Net-zero' and 'carbon/GHG neutrality' claims are not legally defined. Although commonly used interchangeably, the two claims imply a different timeline for climate action and the typology of carbon credits companies can use. The ISO 14068 on Carbon Neutrality explains the difference between these two related concepts at the organisational level: while net-zero claims are associated with (usually) long-term

[16] Commission Delegated Regulation (EU) 2023/2772: Delegated regulation - EU - 2023/2772 - EN - EUR-Lex (europa.eu)

target dates and residual emissions are to be balanced out only with permanent carbon removals, carbon neutrality refers to near-term target dates that spell out the path towards the net-zero target along which it is possible to compensate unabated emissions with reductions and removal credits.[17] The ISO document uses carbon neutrality as a synonym for GHG neutrality following common practice. As the entity proceeds towards its net-zero goals, the reliance on carbon credits for unabated emissions decreases, given that the international reduction efforts increase until only residual emissions remain. The two concepts imply different procurement levels of different carbon credit typologies at different points in time.

Even though in a less explicit manner, the ESRS 1 disclosure requirement E1-7 seems to point in a similar direction, making net-zero targets proceed in tandem with removals while leaving aside the larger category of carbon credits associated with GHG neutrality claims. However, it is unclear if the EU considers the two claims mutually exclusive or progressive stages in the transition to a decarbonised economy. It would be helpful to clarify this issue.

Relationship between corresponding adjustments and compensation claims

In addition to this terminology ambiguity, it is unclear what the EU's position is on applying Compensating Adjustments to claims made by EU companies. The European Parliament Resolution on the Green Claims Directive[18] calls for compensation claims to be based on credits certified by the CRCF. According to the political agreement reached by the Parliament and the Council on the CRCF[19], all certified removals should contribute to the EU NDC and EU climate goals. The amended Regulation mentions that to prevent double counting, 'a certified unit should not be used or claimed by more than one natural or legal person', making examples of public authorities but not referring to private entities.[20] Some have considered this as double counting[21] while this feature is in fact the usual way of accounting emissions under the EU's NDC and reporting towards the UN[22]. Indeed, EU companies make compensation claims based on certified removals, while the EU authorities counts the same certified removals against its NDC or climate goals.

6. CONCLUSION

Policy efforts at multiple governance levels are underway to ensure good governance and high environmental integrity of carbon credits. While the Paris Agreement architecture permeates national and private activities, the EU is moving to regulate the demand side of carbon credits, placing particular emphasis on providing a foundation for eligible claims. Across the board, companies must align to new practices and standards of quality, but the rules of the game are not yet clearly defined. While the foundations have been laid, policy alignment is yet to emerge.
At the international level, Paris alignment for international carbon credits is still very much

[17] ISO 14068-1:2023 - ISO 14068-1:2023 (iteh.ai)

[18] European Parliament 2024: https://www.europarl.europa.eu/news/en/press-room/20240308IPR19001/parliament-wants-to-improve-consumer-protection-against-misleading-claims.

[19] Climate action: Council and Parliament agree to establish an EU carbon removals certification framework - Consilium (europa.eu)

[20] Amendment 20a.

[21] Carbon Market Watch 2024, 'The EU double-counting problem': https://carbonmarketwatch.org/2024/03/22/the-eus-double-counting-problem/.

[22] Eve Tamme 2024, 'Will the Carbon Removal Certification Framework count in the race to climate neutrality?: https://evetamme.com/2024/03/25/will-crcf-count-in-climate-neutrality/.

"work in progress". On the one hand negotiations on Article 6 are not yet finalised while several VCM actors are gradually improving the integrity of the carbon credits along the concepts and methodologies under discussion at UN Level. The aspiration of the Supervisory Body to have the Article 6.4 mechanism as the benchmark for crediting approaches may have been delayed, but solid work is ongoing and delivery of the full implementation of Article 6 is a question of time.

At the EU level, many definitional hurdles surrounding the use of credits and associated claims risk leaving regulated entities uncertain. Given these complexities, the EU should strive to create a coherent and rational policy framework which strikes the right balance between imposing regulatory guardrails and transparency rules on the use of credits on the one hand, and on the other providing flexibility and incentives for companies to invest in carbon credits. Contribution claims can be a way towards a sound model, whereby the risks involved in offsetting are avoided. Such claims should also be understandable to consumers and appealing to companies.

European companies are adopting net-zero targets for the long term, and this implies by definition the need for offsetting their residual emissions. In the medium term the question remains to what extent carbon credits can play a role in corporate decarbonisation pathways other than compensating for residual emissions. The EU has been proactive in creating transparency and rigour to the use and claim of carbon credits. It now needs to go the extra mile in improving the coherence between the different legislative pieces and define a pragmatic scope for the use of carbon credits of high environmental integrity.

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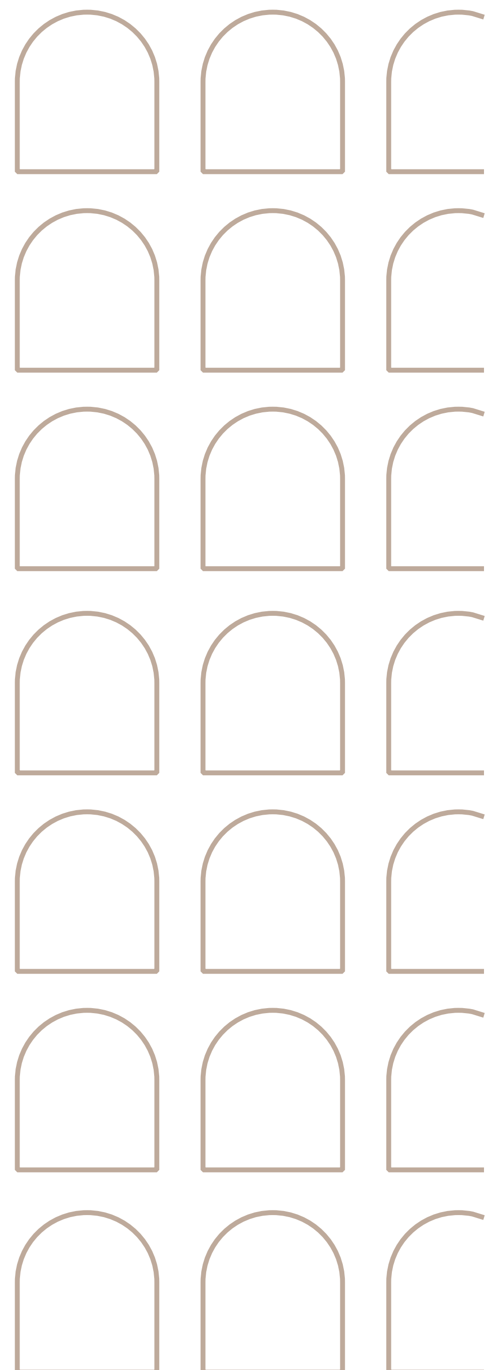

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