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Can the CFTC Tame Carbon Fraud and Create Trust in a Broken System?

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Voluntary Carbon Credits (VCCs) have become a notorious tool for greenwashing rather than a legitimate means of addressing climate change. Marketed as a critical solution to combat climate change under agreements like the Paris Agreement, their fraudulent use and abuse have undermined their purpose, overshadowing the potential for progress. Instead of fostering genuine emission reductions, these markets allow corporations to purchase the illusion of sustainability while continuing their environmentally harmful practices.

Allegations of corruption and false claims plague the voluntary carbon market, with some projects even linked to criminal activities, as highlighted by Brazil's environment minister. Money from carbon credits has allegedly funded illegal land grabs in the Amazon, further damaging the credibility of such markets. Shell's recent scandal, where it sold millions of carbon credits tied to greenhouse gas reductions that never took place, only deepens the sense of fraud permeating the system. Shell's Quest carbon capture facility, hailed as a major player in greenhouse gas removal, registered credits equivalent to twice the volume of emissions it actually avoided. These "phantom credits" were sold to major oil producers such as Chevron, ConocoPhillips, and Suncor Energy, creating a picture of a system riddled with deceit.

Adding to this mounting crisis is the recent federal indictment and civil charges against Kenneth Newcombe, former CEO of C-Quest Capital (CQC), and Tridip Goswami, its carbon and sustainability accounting lead, for manipulating data tied to cookstove projects in Africa and Asia. The U.S. Commodity Futures Trading Commission (CFTC) filed its first-ever enforcement action for fraud in the voluntary carbon credit market, accusing Newcombe of misleading reporting to inflate carbon credits far beyond what his company was entitled to. Jason Steele, CQC's former COO, also admitted to participating in this deceptive scheme. These fraudulent activities generated millions of dollars worth of credits.

This deep-rooted deception makes it clear why many companies are now hesitant to buy credits, fearing that their investments are propping up fraudulent projects rather than contributing to real climate solutions. Even worse, such fraudulent practices undermine global climate goals, and as Greenpeace's senior energy strategist Keith Stewart put it, selling credits for reductions that never happened "literally makes climate change worse."

Many projects tied to VCCs, especially those focused on renewable energy or forest conservation, have been exposed for exaggerating their impacts or trampling on the rights of local communities. For instance, the Integrity Council for the Voluntary Carbon Market (ICVCM) recently refused to approve methodologies linked to renewable energy projects, which account for 32% of the market's credits, citing insufficient evidence of their claimed environmental benefits.

Despite attempts by oversight bodies to impose stricter standards, such as the ICVCM's Core Carbon Principles, the damage to the market's reputation has already taken its toll. Annual transaction values, which once seemed poised for explosive growth, have plummeted from $2.1 billion in 2021 to just $723 million last year. The promise of a $50 billion market by 2030 now seems far-fetched.

Ultimately, these voluntary carbon markets must undergo a fundamental transformation if they are to be credible and have any meaningful impact. Recent scandals demonstrate that merely tweaking the system won't suffice. Nevertheless, the CFTC has taken important first steps toward improving these markets, starting with the approval of its Guidance Regarding the Listing of Voluntary Carbon Credit Derivative ("CFTC Guidance"). This guidance aims to bring much-needed transparency and accountability to carbon trading by setting clear standards for derivatives linked to VCCs. Following this, the groundbreaking enforcement action against Newcombe suggests that the CFTC is also committed to tackling fraud in the voluntary carbon credit marketplace.

Greater transparency, clear standards, strict enforcement, and much more accountability for project outcomes are essential steps in addressing the widespread fraud that has destroyed confidence in this sector. Only then can VCCs transform from a tool of deception to a legitimate part of the fight against climate change.

The CFTC Guidelines for the Listing of Voluntary Carbon Credit Derivative Contracts

The CFTC has long played a role in overseeing derivative contracts on environmental commodities, including VCCs. These derivative contracts have been traded on CFTC-regulated exchanges for decades, and since 2007, instruments tied to greenhouse gas (GHG) emissions have also been listed. As of August 2024, 29 derivative contracts on voluntary carbon market products are listed for trading on Designated Contract Markets (DCMs), three of which currently have open interest.

The CFTC Guidance was issued to enhance transparency and standardization in the voluntary carbon market. This guidance focuses on the listing of physically-settled VCC derivatives. Physically-settled VCC derivative contracts are structured to reflect the market price of VCCs. If a position remains open when a contract expires, the holder must either deliver or take delivery of VCCs, in line with the contract's specific delivery rules. The CFTC believes that establishing clear standards for the delivery of VCCs helps ensure that the underlying credits meet expectations of quality, fostering confidence in accurate pricing and reducing the risk of market manipulation.

The CFTC Guidance also outlines considerations for DCMs to support accurate pricing and enhance liquidity, helping to address concerns over the susceptibility of these contracts to manipulation. These considerations include rules on the essential economic characteristics of the underlying

VCCs, which would also apply to any future cash-settled derivative contracts or physically-settled VCC swaps that might be introduced.

Key Elements of the CFTC's Guidelines

Under the CFTC's Guidance, DCMs must list only derivative contracts that are not readily susceptible to manipulation. Physically-settled VCC derivative contracts must specify all economically significant characteristics of the underlying commodity. Failure to do so could lead to market confusion, price distortion, and manipulation. As VCC markets continue to develop their own standardization and accountability mechanisms, these individual characteristics must be accounted for in contract structure to ensure that the underlying commodity's quality and attributes are clearly defined.

A. Key Voluntary Carbon Credit Commodity Characteristics

The CFTC has identified certain VCC commodity characteristics that DCMs must consider when structuring derivative contracts, including:

1. Transparency: Publicly Available Data

The CFTC emphasizes that DCMs should ensure transparency by clearly specifying the types of VCCs eligible for delivery under derivative contracts. The contract's terms and conditions should identify the crediting programs and the types of mitigation projects or activities, such as nature-based solutions, to avoid ambiguity and manipulation. Transparent, publicly available data helps market participants understand how GHG emission reductions or removals are calculated, facilitating accurate pricing and informed comparisons of VCC quality.

2. Additionality

The concept of additionality is a critical component of high-quality VCCs, and DCMs should ensure that the crediting programs have robust procedures for assessing whether projects or activities result in emission reductions that would not have occurred without the carbon credit system. Failure to ensure additionality can lead to mispriced contracts and undermine the credibility of the VCCs being traded. While there is variation in how additionality is assessed across different voluntary carbon markets, the CFTC Guidance recommends that DCMs rely on industry-recognized standards for high-integrity VCCs when evaluating additionality.

3. Permanence and Risk of Reversal

Permanence, or the assurance that the carbon removed or reduced will not be released back into the atmosphere, is another critical factor. The CFTC encourages DCMs to consider whether the crediting programs have measures in place to address the risk of reversal, such as "buffer reserves" or other mechanisms to mitigate the risk of previously credited emission reductions being nullified. The quality and reliability of VCCs, and by extension, the derivative contracts based on them, depend on addressing this risk.

4. Robust Quantification

The CFTC stresses the importance of using robust, conservative, and transparent quantification methodologies to calculate the level of GHG emissions reductions or removals. This ensures that the number of VCCs issued for a project accurately reflects the true level of emissions reductions. DCMs should ensure that the crediting programs use reliable quantification methods to support accurate pricing and to set appropriate speculative position limits that reduce the likelihood of price manipulation.

5. Delivery Points and Facilities

The CFTC Guidance also advises DCMs to consider the governance framework and tracking mechanisms of crediting programs, ensuring that the registry system is secure, prevents double-counting of VCCs, and facilitates the physical settlement of VCC derivative contracts. This includes ensuring that a VCC is uniquely identified and associated with a single metric ton of carbon dioxide equivalent to avoid distortions in the contract's pricing.

6. No Double-Counting

To prevent the issuance of multiple credits for the same emissions reduction or removal, the CFTC Guidance requires DCMs to ensure that crediting programs have mechanisms to avoid double-counting. This is crucial for maintaining the integrity of the carbon market and ensuring that market participants can trust the accuracy of the credits they trade.

7. Inspection and Third-Party Validation

Finally, the CFTC Guidance calls for DCMs to require robust inspection and third-party validation and verification of VCC projects. Third-party validation ensures that the credited projects or activities genuinely meet the crediting program's rules and standards. The use of independent, qualified validators, along with regular reviews and updates of these procedures, helps to maintain the integrity of the VCC market and supports confidence in the quality of the underlying credits.

B. Ensuring Alignment with Social, Environmental, and Net Zero Standards

In addition to the core commodity characteristics, DCMs are encouraged to consider whether the crediting programs for underlying VCCs meet high standards for social, environmental, and climate-related safeguards. Specifically, when addressing quality standards in connection with the structure of VCC derivative contracts, DCMs should assess whether the crediting programs have implemented measures to ensure that credited mitigation projects or activities:

a. Meet or Exceed Best Practices on Social and Environmental Safeguards: This includes ensuring that projects do not negatively impact local communities or ecosystems and that they align with ethical standards, protecting both human rights and biodiversity.

b. Avoid Locking in High Levels of GHG Emissions or Carbon-Intensive Practices: DCMs should consider whether the projects underlying the VCCs are aligned with the global goal of reaching net zero GHG emissions by 2050. This means that credited projects should not perpetuate the use of technologies or practices that are incompatible with long-term decarbonization goals.

The CFTC Guidance for VCC derivative contracts aims to enhance the integrity of voluntary carbon markets by setting standards for transparency, additionality, permanence, robust quantification, and governance. These measures reduce the risk of manipulation and help ensure that the carbon credits traded in these markets represent real and verifiable emissions reductions or removals. As the voluntary carbon markets continue to evolve, the CFTC will monitor and update its guidance to reflect industry best practices and market developments.

Developing Green Milestones to Ensure Accountability and Build Public Trust

To ensure that VCC derivatives are genuinely contributing to the fight against climate change, the CFTC must go further than the guidance and establish a series of clear, specific, concrete, and measurable benchmarks and goals – what should be referred to as "green milestones." To ensure accountability, these milestones must be publicly disclosed. These milestones would serve as progress indicators, enabling stakeholders to assess whether the voluntary carbon market is a viable tool for climate action or merely an illusion of progress or, worse, still fraud-filled markets.

A. Proposed Benchmarks and Milestones:

1. Emission Reduction Tracking

    - *Reporting on Reductions:* The CFTC should encourage regular and accurate reporting on GHG emission reductions achieved through VCC projects. This could include setting an annual target for the total volume of GHG reduced or removed due to VCC derivatives trading, with the goal of showing incremental progress year-on-year.

    - *Annual Emission Targets:* To provide the public with measurable insights, the CFTC should issue annual reports that track milestones for emissions reduced or removed as a result of increased VCC derivatives trading. These reports should highlight incremental increases in the total emissions reductions, offering stakeholders a clear view of the market's contribution to climate goals over time.

2. Transparency and Data Availability

    - *Public Access to Data:* The CFTC should establish benchmarks requiring that detailed project data, including methodologies, verification processes, and impact assessments, are made publicly accessible for all VCC projects linked to derivatives. A milestone could be set to achieve 100% data transparency for VCC projects by a specified deadline, providing stakeholders with clear insights into the carbon credit market's operations.

    - *Verification of Transparency:* To ensure continuous visibility, all VCC projects linked to derivatives should provide updates on project progress and methodologies, which should be made publicly available. The CFTC should track this to ensure transparency is upheld across all participating markets.

3. Permanence and Risk Mitigation
    - *Mitigating Risk of Reversals:* The CFTC should encourage DCMs to require all VCC projects to include mechanisms, such as buffer reserves or insurance, to address the risk of carbon reversal, ensuring that carbon reductions or removals remain permanent.
    - *Buffer Reserve Utilization:* The CFTC should set metrics to monitor buffer pool usage, with targets for reducing withdrawals as projects demonstrate greater permanence over time.
4. Double-Counting Prevention
    - *Preventing Double-Counting:* The CFTC should encourage DCMs to implement procedures to conduct cross-checks across multiple carbon credit registries in order to prevent the double-counting of emission reductions.
    - *Zero Double-Counting Goal:* The CFTC should establish a milestone to ensure a zero double-counting target within a set time period.
5. Regular Progress Reporting
    - *Annual Reports on Performance:* The CFTC should publish annual reports that detail the performance of VCC derivatives against established benchmarks, highlighting both successful outcomes and areas requiring improvement. In addition, the CFTC should implement continuous progress assessments, providing regular, publicly available updates on whether VCC derivatives are making meaningful contributions to climate change mitigation. This will ensure that the public remains informed about the market's actual impact on environmental goals.

By establishing these green milestones, the CFTC can create a framework to track and assess the performance of VCC derivatives, ensuring that the voluntary carbon market evolves into a credible and impactful tool for climate change. These milestones will allow for a thorough evaluation of whether the market is genuinely driving emission reductions or merely providing symbolic gestures. With clear information and time-bound goals, stakeholders can better determine if the voluntary carbon market is delivering tangible progress in the global fight against climate change or simply offering a false sense of environmental achievement. Moreover, the combination of the CFTC Guidance for the listing of VCC derivative contracts, enforcement actions, and the introduction of robust green milestones should help the CFTC tame carbon fraud and create trust in what is now a broken system.

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