

## Fixing the Integrity Problems with Australia's Carbon Market

Andrew Macintosh,<sup>a</sup> Don Butler,<sup>a</sup> Megan C. Evans,<sup>b</sup> Dean Ansell<sup>a</sup> and Marie Waschka<sup>a</sup>

<sup>a</sup> The Australian National University; <sup>b</sup> University of New South Wales, Canberra

Since 2014, the centrepiece of Australia's climate policy has been the Emissions Reduction Fund (ERF), a \$4.5 billion fund that incentivises emissions reduction activities across the economy and forms the basis of Australia's carbon market. Under the ERF, projects that reduce emissions receive credits that can be sold to the Australian Government and private entities that are required to, or that voluntarily choose to, offset their emissions.

Earlier this year, we went public with details of serious integrity issues with the ERF, labelling it 'environmental and taxpayer fraud'. While a number of long-held concerns with the scheme exist, we have initially focused on the ERF's most popular carbon credit methods: human-induced regeneration (HIR); avoided deforestation; and landfill gas. Our analysis suggests up to 80% of the carbon credits issued to projects under these methods lack integrity. That is, they do not represent real (emissions have not been reduced) or additional (the reduction would have happened anyway) abatement.

The decision to use the word 'fraud' was deliberate and considered. Offset projects are given a financial instrument (a carbon credit) in return for providing a service: the delivery of real and additional greenhouse gas abatement equivalent to one tonne of carbon dioxide for each carbon credit received. Where the credited abatement is not real or is not additional, the service has not been provided.

In our view, a process that systematically pays people to provide a service that is not provided is fraudulent. We do not suggest proponents have acted unlawfully. The problem is with the system—administered by the Clean Energy Regulator (CER) and the Emissions Reduction Assurance Committee (ERAC)—not the individual beneficiaries of it. By and large, proponents are acting in accordance with the rules, or at least in accordance with the CER's interpretation of them, but they are being paid for services that have not been provided.

For the ERF to perform its primary function of facilitating an efficient transition to a low carbon economy, the credits must have integrity. Yet the response to our criticisms from the CER and ERAC, and the 'industry' they are supposed to regulate, has been to deny there are any issues and try to sweep the problems under the carpet.

There is not sufficient space here to do justice to the many dimensions of the problems with the ERF. However, at a high level, the issues have arisen because of a focus on delivering large volumes of credits at a low cost for polluters. This has resulted in the use of carbon offsets in inappropriate situations and a failure to address manifest integrity issues.

Carbon offsets are a high-risk environmental instrument. This is a product of the difficulties associated with designing high integrity methods and the consequences of getting it wrong. Designing high integrity methods is hard because they involve:

- comparisons between reality and counterfactuals (what would happen in the absence of the incentive provided by the carbon credit?);
- dynamic markets with rapidly evolving technologies;

- abatement activities where it is often challenging to disentangle the effects of the project activity from those associated with natural variability; and
- emissions and removals that are often difficult to measure (at least cost-effectively).

These complexities mean mistakes are inevitable – no functional carbon offset scheme can ever get it 100% right. A degree of error must be accepted, with most professionals generally working on an 80/20 rule (80% of the credited abatement must clearly be real and additional and we accept that 20% will be less certain).

But decisions regarding risk tolerance must be made in light of the consequences of issuing low integrity credits. When carbon offsets are issued that do not represent real and additional abatement, and those credits are used by polluters to offset emissions, it makes things worse. Emissions will be higher than they otherwise would be because there is an increase in emissions from the polluter but no offsetting reduction elsewhere.

The risks associated with offsets is the reason the ERF's offset integrity standards require the methods to be supported by 'clear and convincing evidence', require all of the assumptions, projections and estimates in methods to be 'conservative', and require that the methods ensure the credited abatement is additional.

In simple terms, activities should only be eligible, and methods should only be made where: a) there is high confidence in the counterfactual; b) we are able to accurately measure relevant emissions and removals; and c) it is easy to separate out the effects of the abatement activity on emissions and removals from those associated with natural variability.

This has not happened with the ERF. Methods have been developed for activities where it is extremely difficult to develop reliable baselines, hard to measure the emissions and removals, and near impossible to isolate the effects of management activities on the timescales that are necessary to make projects viable.

The complex nature of offset methods, and the high risk of error, means that integrity can only be maintained with a culture of transparency, where administrators expect and actively seek out errors, and move quickly to correct them when they are found. To facilitate and encourage this, there needs to be rules that force the disclosure of information, guarantee disinterested third parties the right to be involved in rule making, give anybody the right to seek judicial review of administrative decisions, and require proponents to move off methods (and onto new ones) where they are found to contain material errors.

The ERF has none of these features. The CER and ERAC appear hesitant to seriously engage with critique. The scheme rules hinder the release of information and, even where they can, the CER frequently refuses to do so. Participation in rule-making is largely reserved for the beneficiaries of the scheme; other than token statutory public consultation processes that generally last for less than 21 days. The scheme seeks to block third parties from challenging administrative decisions. And the legislation allows proponents to stay on methods for the duration of their crediting periods (between 7 and 25 years), even when they have manifest integrity flaws.

If the carbon market was an 'ordinary' market, the impacts of these governance problems would be lessened by the scrutiny imposed by the consumers of the credits. In most markets, buyers are concerned with getting what they have paid for; they want to ensure they receive the relevant good or service and that it is of the represented quality. The incentives of carbon offset buyers are

different. Carbon offsets, like biodiversity offsets, are primarily compliance tools. Most are bought to meet compliance obligations, to tick boxes. Consequently, most offset buyers just want the credit and do not necessarily care whether it represents real and additional abatement, so long as it acquits their compliance obligation. This elevates the importance of the bodies that are responsible for administering carbon offset schemes – they are the guardians of integrity and the public interest.

Carbon offsets are essential to facilitate the efficient transition to a low carbon economy. They also have the potential to generate important co-benefits: providing employment in rural and remote communities; helping to restore degraded ecosystems, and; supporting the continuation of Indigenous cultural practices.

The ERF needs urgent reform to ensure these benefits are fully realised. The longer the current problems are left to run, the more obvious the gap between reality and the intended outcomes of the scheme will be, and the more jarring the inevitable correction.