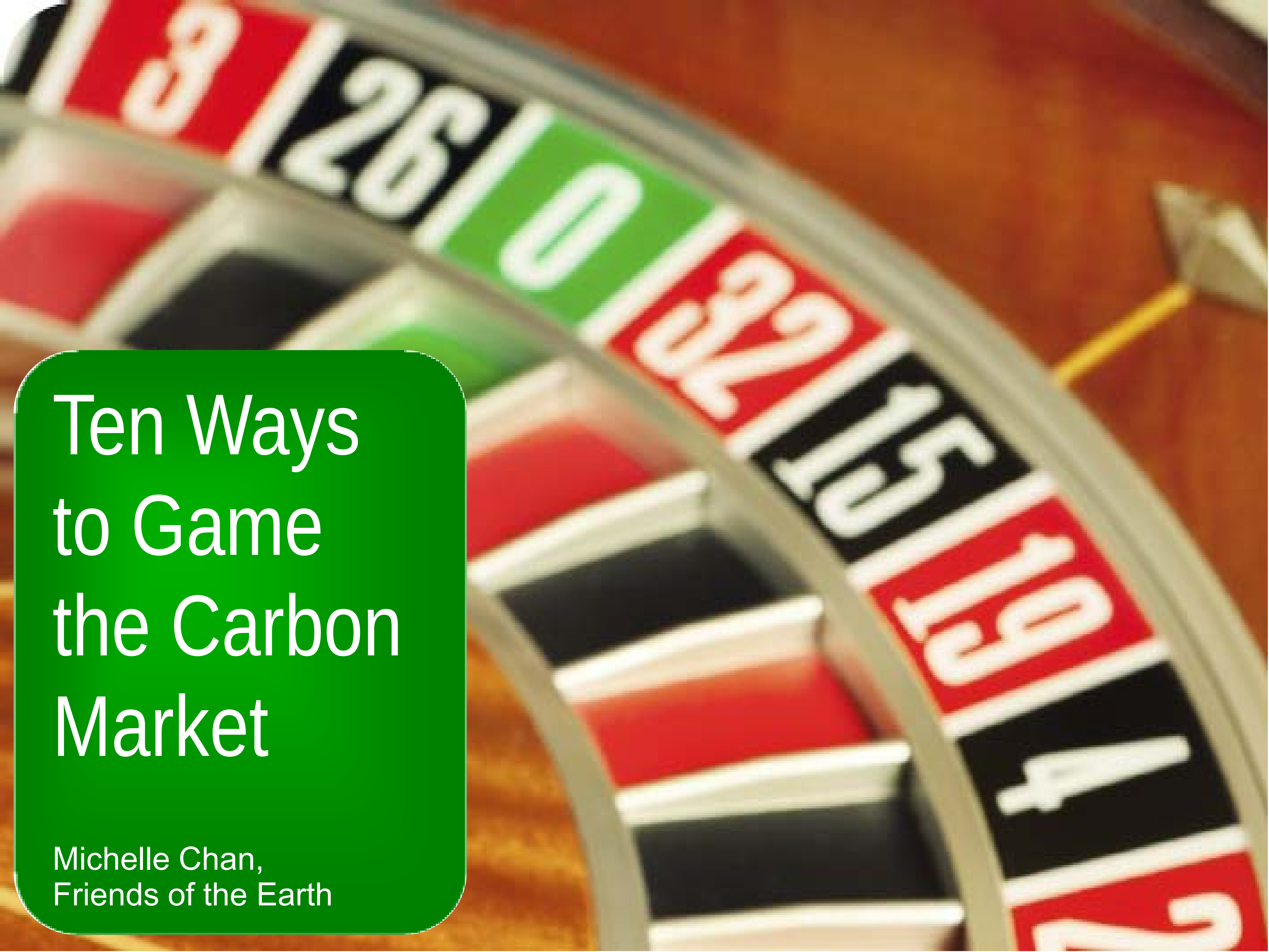


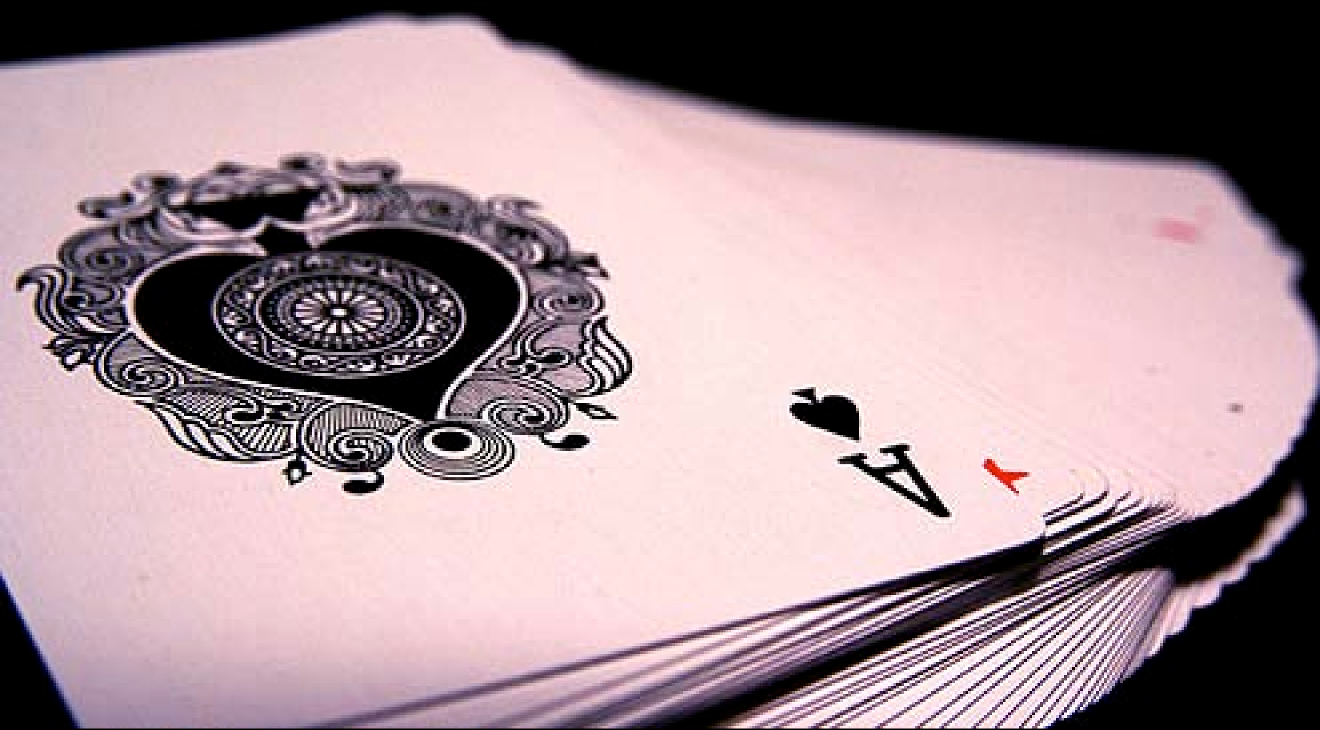
# Ten Ways to Game the Carbon Market

Michelle Chan,
Friends of the Earth

Remember how Wall Street traders crashed the economy in 2008 with their gambling on complex mortgage securities, and with 'dark market' derivatives?

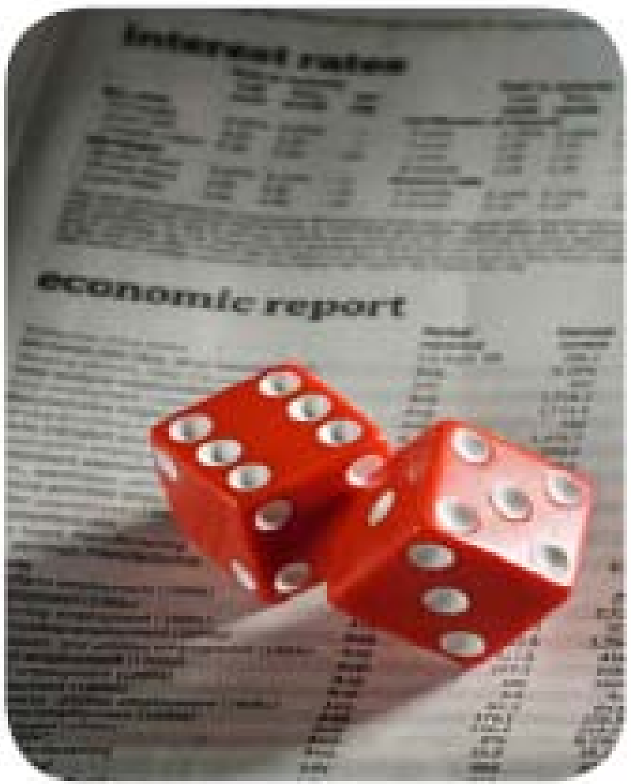
Well, the mortgage bubble may have burst, but the creation of carbon markets – one approach for reducing harmful greenhouse gas pollution – could create a whole new casino-like structure.

Carbon trading systems are complex, and the more complex they are, the easier they are to manipulate.



This presentation shows ten ways that carbon markets can be 'gamed', at the expense of both the economy and the climate.

# Scam 1: Boost the baselines




### How to do it

If you are an industry facing carbon limits, inflate your projected emissions levels in order to claim a greater governmental allocation of carbon permits – preferably for free.

If you are a carbon offset developer, inflate the projected emissions scenario that would occur without your project; then, collect more credits than you really deserve.

### How it has already been done

Boosting baselines and collecting free permits is a well-known scam, one that is blatantly on display in the European Union Emissions Trading Scheme (EU ETS).

Estimates of profits vary, but an analysis by the carbon market news provider *Point Carbon* shows that in the 2008-2012 phase of the EU ETS, electricity generators in just five European countries could generate some $36 – 111 billion in windfall profits by receiving free permits while simultaneously charging higher electricity prices to consumers.

# Scam 2: Ponzi scheme

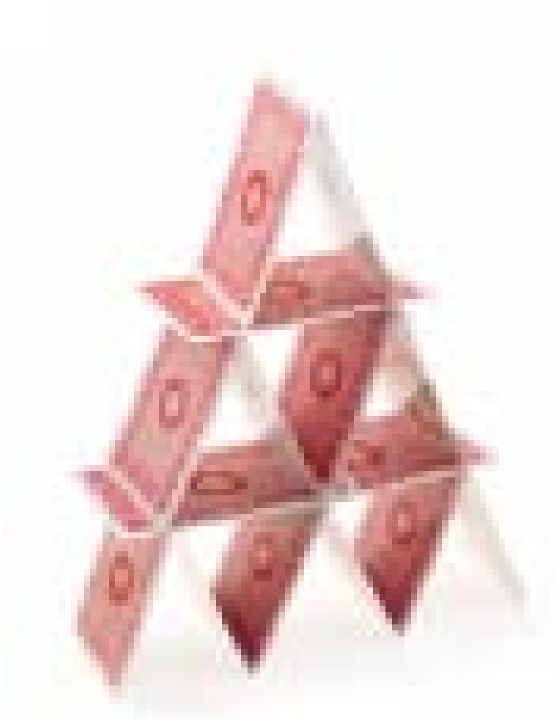
## How to do it

Like any classic Ponzi scheme, the trick is to use the buzz of a little-understood market to attract investors, who you pay off by recruiting new ones.

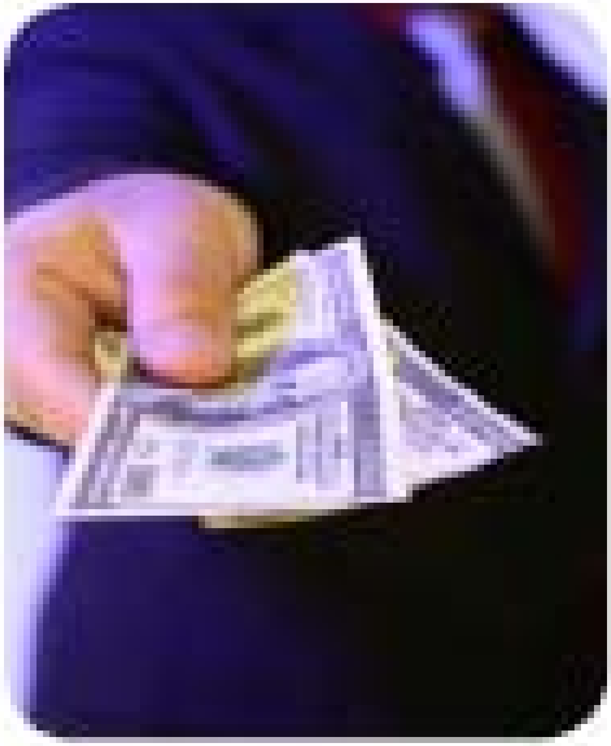
Claim that you have a company eager to buy carbon for a high price. All the investor has to do is buy carbon from you at a lower price, you can broker the sale, and they get to pocket the difference. But in reality? There is no purchase agreement; take their money and pay them back with funds from new investors.

## How it has already been done

In 2000, emissions trader Anne Masters Sholtz ran a Ponzi scheme off California's pollution trading program, repaying old investors by recruiting new ones. In one particular transaction, Sholtz convinced AG, a New York energy trader, to buy $12.5 million in permits that she was supposed to sell (at a profit) to Mobil. However, there was no deal with Mobil, and to put off paying back AG, she falsified invoices and sales documents.



# Scam 3: Sell fake carbon offset credits



## How to do it

Wear a nice suit, prepare a nifty powerpoint presentation, and convince a buyer to purchase carbon credits, preferably generated by a project in a faraway place they will likely not visit.

If they do decide to visit, take them to a 'Potemkin village' – one carbon offset project that can be shown off repeatedly to visiting investors. After they are duly impressed, take their money and run.

## How it has already been done

Fake carbon credits are already a problem, particularly in voluntary carbon markets. One carbon broker approached an existing landfill gas project to become an offset project under the Chicago Climate Exchange.

The project owner began receiving carbon credit payments for continuing business as usual. Meanwhile, these credits were sold as 'reductions' and could be bought for polluters to emit over their promised limit.

# Scam 4: Carbon bribery

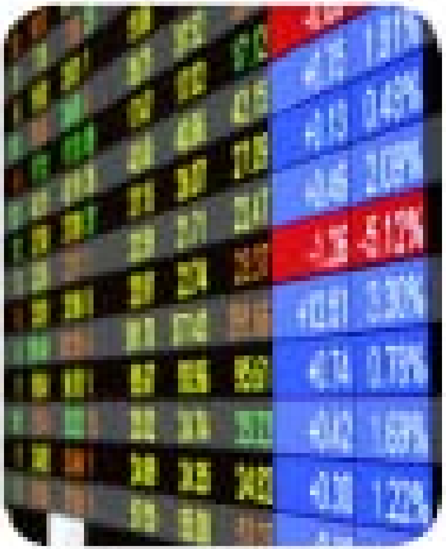
## How to do it

First, decide who you want to bribe. Pay them with money, favours, or promises of future employment. Similar to how credit rating agencies are tempted to confer high ratings to those who pay the bills (leading to wildly inaccurate assessments of corporate bonds, mortgage-backed securities, etc.), offset verifiers are paid by the project sponsors who make more money if and when the rating is more favourable.

## How it has already been done

Compared with carbon permits, carbon offsets run a greater risk of bribery, because an offset project needs to receive approval from an agency to receive carbon credits. Transparency International has pointed out several bribery risks in the world's largest offsets market, the Clean Development Mechanism (CDM).

After the Enron scandal, accounting firms had to split their financial auditing business from their management consulting work. But in the carbon markets, companies that verify a project's emissions savings may also offer project consulting services, creating a conflict of interest.



"It is estimated that in some countries up to 50 percent of the whole market volume was caused by fraudulent activities."

*Europol*

# Scam 5: Commit carousel fraud

> “In the future, if you are running a factory and you desperately need credits to offset your emissions, there will be someone who can make that happen for you. Absolutely, organized crime will be involved.”
>
> *Peter Younger, enviornmental crimes specialist, Interpol*

### How to do it

Buy and import carbon permits or credits tax-fee. Re-sell them, and charge your buyers tax. Disappear without paying the tax to the government. This is called carousel fraud, or “missing trader” deals.

### How it has already been done

Europol estimates that in just 18 months, carbon market carousel fraud has resulted in the loss of over €5 billion. After European officials cracked down, trading dropped dramatically.

“It is estimated that in some countries, up to 90 percent of the whole market volume was caused by fraudulent activities.”

# Scam 6: Phishing for carbon

### How to do it

First, identify companies that need to comply with carbon regulations and notify them that they must re-register their permits with the emissions trading authority.

Send them to a fake internet site where they input their account data. Transfer their permits into another account, and re-sell them before you get caught.

### How it has already been done

In February 2010, German authorities uncovered a carbon phishing scam perpetrated upon several companies in Europe, Japan, and New Zealand. The fraudsters made off with some 250,000 permits, worth €3 million (approximately US$4 million).

The German Emissions Trading Authority immediately suspended trading and several other countries followed suit. Trading resumed the following week, but the damage had already been done.

# Scam 7: Falsify information

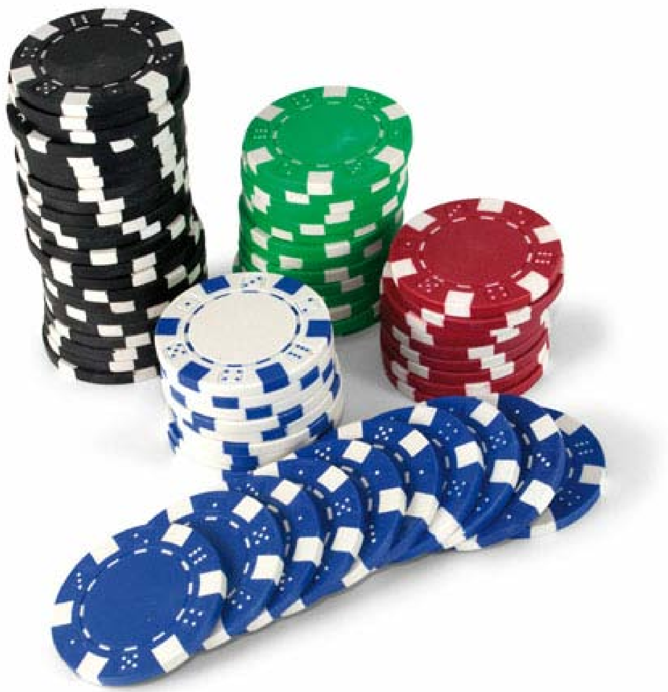
## How to do it

An important part of the offsets business is telling a story about how your project would not be possible without offset revenues (or proving additionality). You also can overstate how many greenhouse gas emissions would have been emitted were it not for your project (see Scam 1, “Boosting the baselines”). Since no one can ever prove these counter-factuals with any certainty, it is easy to stretch your story.

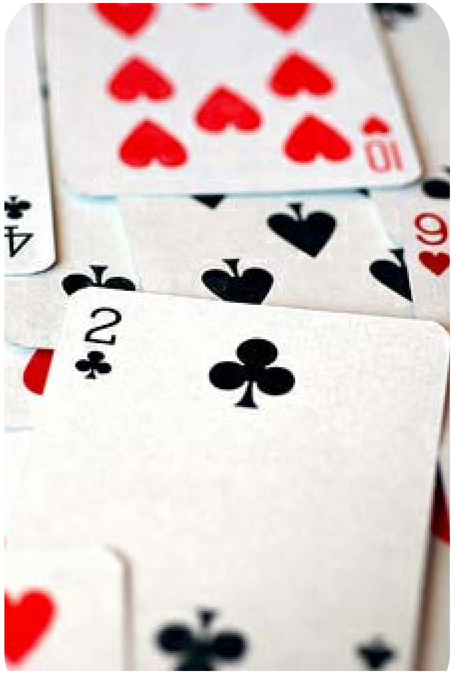
## How it has already been done

Offset companies are not just stretching their stories, they are forging documents to back them up. In CDM projects, the body responsible for approving and issuing carbon credits for offset projects has already found problems with “attempts of falsification of documents by project participants and information on financial statements.”

Transparency International notes examples of project developers backdating documents or manipulating ratesof return calculations in order to demonstrate that they “need” CDM credits in order to make the projects viable.



# Scam 8: Round trip your carbon



How to do it

first set up a special purpose entity, preferably in an offshore tax shelter, to develop carbon offset projects. The special purpose entity charges your company a hefty $75 million to develop a $60 million offset project, and refunds the excess $15 million to you. Fraudulently book the $15 million as revenue, giving a boost to your bottom line. This trick is your classic round-trip tax scam with a carbon twist.

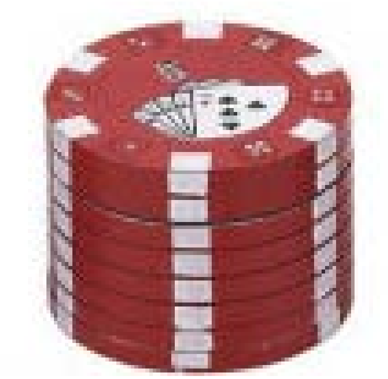
How it has already been done

Some $11 trillion is already socked away in tax havens, which not only allows companies and investors to evade taxes, but regulations as well. When roundttripping is done with carbon, it becomes a form of carbon credit fraud, which according to Deloitte is “the white collar crime of the future.” .

# Scam 9: Recycle your carbon

## How to do it

Find an inventory of credit permits that have already been used. Buy them for a discount and re-sell them quickly. Look for buyers in the over-the-counter market, where monitoring is more lax; launder it through a foreign exchange, which is not subject to the same regulations, or hide it in a bigger transaction.



## How it has already been done

Two European exchanges had to suspend trading in March 2010 when it was discovered that a trading firm was dealing in 'recycled' carbon credits – credits that had already been used and were supposed to be retired. Recycling is actually legal; a government is allowed to re-sell used carbon credits as long as they cancel an equivalent number of permits, and do not sell them in the same market.

But here's how it went wrong: Companies surrendered 2 million carbon credits to the Hungarian government, which then re-sold them to a trading company called Hungarian Energy Power (which had set up its website only two weeks prior). Hungarian Energy Power then sold the credits to another company, Microdyne, which in turn sold them to a trader in Hong Kong, who put them on BlueNext, a carbon exchange. European banks and brokers unwittingly bought the credits (now illegal for use in Europe).

This resulted in a tidy – and fast – profit of €2 million (approximately US$2.6 million) for the fraudsters.

# Scam 10: Rig the rules

## How to do it

Help write the rules yourself! For example, if you stand to make most money from brokering or trading in carbon, then make sure that there are as few restrictions as possible on the kinds of trading you can do.

And of course, when offset protocols are being developed, weigh in to ensure that environmental standards, social safeguards and other requirements are as lax as possible. After all, the more pesky standards you have to follow, the fewer offsets will be generated and the less money everyone will make!

## How it has already been done

This hustle has played out in all the major carbon trading programs in the world, where well-heeled interests used their influence to affect the outcome of political and regulatory processes. These processes are generally dominated by those who have a financial interest in ensuring that an active offsets market is created, rather than ensuring that offsets have the highest levels of environmental integrity possible.

Within the CDM, offsets developers are strongly lobbying for a mechanism that will allow them to appeal when they are not granted as many offset credits as they hope for, while also lobbying against allowing public interest organizations to appeal  against credits granted to offset projects that are shown to not actually reduce carbon.

Fundamentally, it is this misalignment of interests – that those involved in carbon markets are not inherently interested in the environmental integrity of the system – that creates the risk of gaming in the first place.

# Conclusion

Carbon trading has a real detrimental effect on our ability to respond to the climate change crisis in a timely and appropriate manner. At its worst, it provides a smoke screen for increased levels of emissions.  The fact remains that after more than a decade of carbon trading, the level of $CO_2$ in the atmosphere continues to rise each year and we are still perilously far from finding alternative energy sources to fossil fuels.

There is not one way forward, but many, and tested and proven policy instruments already exist. These include regulation to promote the best available technology; energy efficiency regulation; public investment in low carbon technologies and infrastructure; and public procurement to aid early disbursement of new low carbon technologies – along with drastic reduction in energy and material consumption, especially in industrialised countries. It is to policies such as these that we must look if we hope to move to a low-carbon economy before catastrophic climate change becomes a reality.

Texts except Scam 10 and Conclusion, adapted from ‘Gaming the Carbon Market’, Friends of the Earth 2010