

## Guest Commentary

### Auditing offset projects: Next steps for North America

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Emissions offset systems have become a favored method of containing the compliance costs of cap-and-trade systems. By allowing covered firms to purchase credits from emissions reduction projects outside the capped sectors, regulators can broaden the participation in the mitigation effort while reducing its net cost.

However, the use of offsets can present challenges. Under the clean development mechanism (CDM), the world's largest offset system, not all of the credited projects have proven to be additional. Some have ramped up production of industrial gases just to earn offset credits for destroying the byproducts. Some hydropower projects have received credits even though they were in development prior to the CDM's inception. Crediting these projects can not only subsidize business-as-usual behavior, but also raise environmental integrity concerns if the credits are used to offset capped emissions.

These issues have arisen even though the CDM has an offset quality control mechanism in place. Currently, before a CDM project can be issued credits, a third party auditor called a Designated Operational Entity must validate that the project will likely result in the emissions reductions it claims and, later, verify that these reductions have occurred.

The CDM experience offers lessons for existing and future North American offset systems. First, the CDM has not incorporated the concept of materiality into the validation and verification process. Materiality recognizes that the transaction costs of verifying minute emissions reductions can be an inefficient use of resources; so a materiality threshold is applied so that the auditor is only required to assert that the total reported emissions reductions are free from material misstatement. The CDM requires DOEs to certify every relevant claim, however immaterial to the project's total emissions reductions. According to one former DOE manager, the absence of materiality "is the one single thing that is killing the CDM." Its absence has caused validations and verifications to be delayed and

some DOEs to focus more on technical precision than robust additionality assessments.

Furthermore, some CDM validators adhere to a management system auditing style, focusing on whether a project developer has the systems in place to produce a satisfactory offset project, but less on the project itself.

Finally, the CDM is still working to find the right mix of incentives for DOEs. Hired by the developers whose projects they audit, some DOEs acknowledge that market pressures have at times made it difficult to reject non-additional projects. Others have found that resource and communication constraints throughout the CDM have made it difficult to build competence in the face of evolving rules and methodologies. As a result, according to one project developer, in the early days, "I think a lot of projects that got through were undeserving." The EB has recently taken a more aggressive approach to enforcing the CDM's auditing standards, temporarily suspending four of the largest DOEs. However, the EB has a limited enforcement toolkit, and many feel the suspensions unfairly impact project developers, risk driving DOEs out of the market, and fail to counteract market incentives.

Recent US and Canadian federal and regional cap-and-trade proposals, such as the Western Climate Initiative (WCI), would use third party auditors to certify the integrity of offsets entering those systems. However, there has been little discussion about how to successfully implement these auditing regimes, even though the pressure on auditors to deliver efficient and effective services will be high. Consideration should therefore be given, as has been done in the WCI, to how a materiality standard can be incorporated into the validation and verification process. Auditor accreditation systems should emphasize the need for substantive auditing. And regulators should provide strong incentives and clear channels of communication to help auditing firms keep their interests aligned with the system's environmental goals.