How to use carbon credits on the pathway to net zero emissions?

Draft VCMI Claims Code

Key take-aways for stakeholders

On June 7, the Voluntary Carbon Markets Integrity group (VCMI) published its Provisional Claims Code, which provides:

- A **strong incentive for companies to reduce and eliminate their emissions (Scope 1, 2, and 3)**. Without a net zero target by 2050, and five-year interim targets, a company cannot use the VCMI labels.
- A **strong incentive to use carbon credits** to cover remaining emissions, incentivizing an increase in the uptake of carbon credits to cover remaining emissions (with a *VCMI Gold (Net Zero)* company-wide label available if all remaining annual emissions are covered by carbon credits).
- A **strong incentive to increase transparent reporting**, with annual reporting in corporate sustainability reports, including on the purchased carbon credits.
- No detailed guidance on criteria for **high-quality credits**, leaving such guidance to the IC-VCM (draft expected in July 2022). The Claims Code **allows companies to use carbon credits that are also used by the host country** to meet the country's international climate obligations, but a company must publicly communicate if it does so.
- An opportunity for **public comments** until August 12, 2022.

Companies are increasingly making claims about the impact of their operations on the climate: we are a "net zero" company, or we provide a "climate neutral" product. As a way to support these claims, companies oftentimes purchase carbon credits on the voluntary carbon market (VCM) to offset their own emissions and to achieve their net zero or climate neutral claims.

What should the public – consumers and investors – make of these climate claims, in particular of the role of carbon credits as a way to reduce the net climate impact of a company? Some companies may make genuine efforts to reduce emissions and then use carbon credits to offset only residual emissions. Other companies may not undertake any efforts to reduce emissions, and use carbon credits as a way to offset unabated emissions. In both cases, a company could claim net zero emissions. However, these two net zero claims have quite different climate consequences. In the former case, the companies' strategy will lead to lower absolute emissions as part of genuine action to reduce the carbon footprint, as compared to the level of emissions in the latter case where no such effort is made.

In the absence of any guidance or regulation, consumers and investors cannot unpack the emission-reduction efforts that lie behind a company's climate claims. This inability to identify genuine climate action can undermine confidence in climate claims, and in the use of carbon credits to support these claims. It also hampers the allocation of capital and marketplace purchases to companies offering leadership in climate mitigation.

To address these concerns, the Voluntary Carbon Markets Integrity group (VCMI) was established in 2021. In particular, the VCMI is developing guidelines to establish voluntary standards for how carbon credits are used by companies and other non-state actors in making climate claims.[1] The aim of these standards is to improve so-called "demand-side" integrity regarding corporate use of carbon credits.[2]

On June 7, the VCMI published its provisional Claims Code ("Claims Code"; available here). The Claims Code is supported by, among others, the UK Government and the United National Development Program (UNDP), and developed in consultation with civil society, business, Indigenous Peoples, local communities, and governments. The Claims Code is open for comments until August 12, 2022, and will also be tested among companies to ensure its practicability. The final Claims Code is expected in late 2022 or early 2023.

The Claims Code is voluntary, and companies would have to sign up to be subject to the Code. If they meet the conditions in the Claims Code, the Claims Code provides a set of VCMI climate claims or "labels" that a company could use to describe its net zero strategy (e.g., "we meet VCMI Corporate Gold"). The VCMI labels provide transparency and uniformity on climate claims, and signal that a company uses carbon credits in addition to – and not as a substitute for – emission reductions within its own value chain.

Because the Claims Code is voluntary, companies could still make other climate claims, and use carbon credits, without respecting the Claims Code. However, doing so may have reputational consequences, at least if the Claims Code lives up to its ambition to be recognized as setting the global integrity standard for the voluntary use of carbon credits. If the Claims Code succeeds, it could even be used by some regulators (through, e.g., corporate reporting requirements, consumer protection laws, or marketing rules).

Overview of the provisional Claims Code

To make a climate claim using VCMI labels, a company must complete four steps: (1) commit to net zero emissions by 2050, with aligned interim targets; (2) identify the VCMI labels it wishes to use; (3) purchase and retire high-quality carbon credits to meet the VCMI label; and (4) report transparently on steps 1-3. We discuss each step in turn.

A. Publicly commit to a net zero emission target by 2050

While offsets imply a degree of emissions "savings" achieved by a carbon credit project developer, if a company's own emissions continue unabated, its use of carbon offsets could potentially be viewed as greenwashing of the company's operations. Instead, to meet the 1.5°C climate target in the Paris Agreement, companies likely will need to develop and implement a pathway that reduces their own emissions.

Accordingly, under the Claims Code, a company can use the VCMI labels only if it publicly commits to reduce its own emissions as part of a **net zero emission target by 2050** at the latest, covering Scopes 1, 2, and 3 emissions;[3] and the company must have **interim targets** every five years to achieve their net-zero target. These are targets a company must achieve by reducing its Scopes 1, 2, and 3 emissions, before using carbon credits.

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[1] The Claims Code does not address the use of carbon credits in compliance markets, e.g., by companies to reduce their liability under an emissions trading scheme (ETS) or a carbon tax; or to meet mandatory offset obligations (such as the obligation in Switzerland on fossil motor fuel sellers to offset part of the emissions resulting from the use of those fuels). In compliance markets, each regulator determines when and which carbon credits could be used.

[2] The Integrity Council for Scaling Voluntary Carbon Markets (IC-VCM) is developing guidelines to address the quality of carbon credits themselves, i.e., so-called "supply-side" integrity concerns. IC-VCM is expected to launch consultations on guidelines in July 2022.

[3] 'Scope 1' emissions are direct emissions from owned or controlled sources; 'Scope 2' emissions are indirect emissions from energy purchased or consumed by a company; and 'Scope 3' emissions are all other indirect emissions in a company's value chain, both upstream and downstream.

Further, the company also needs to provide detailed information on how it will achieve those targets, maintain a publicly available emissions inventory (following the GHG Protocol or equivalent), and make a public statement that its advocacy strategy is consistent with the goals of the Paris Agreement.

Compliance with all conditions must be confirmed by a credible, independent third party.

B. Which VCMI labels can a company use?

A company meeting the requirements in Section A, could use two types of VCMI labels: (i) company-wide; or (ii) brand, product, or service specific. Compliance with the conditions to use these labels must again be confirmed by a credible, independent third party.

First, three hierarchical company-wide VCMI labels are available, designed to incentivize companies to move up the hierarchy:

- A company could claim ***VCMI Gold (Net Zero)*** if (1) the company is on track to achieve its next interim target (through Scopes 1, 2, and 3 emissions reductions within its value chain); and (2) has purchased and retired high-quality carbon credits for all (100%) of its remaining emissions for the year in which the company wishes to claim VCMI Gold;

- ***VCMI Silver*** is available if (1) a company is likewise on track to achieve its next interim target, and, (2) has purchased and retired high-quality carbon credits covering at least 20% of its remaining emissions for such year (with the percentage increasing over time); and

- ***VCMI Bronze*** is available (only until 2030) if (1) a company is on track to meet its next interim target for Scopes 1 and 2 emissions, but not yet for its Scope 3 emissions. To meet its Scope 3 target, the company must purchase and retire high-quality carbon credits (up to a max of 50% of its Scope 3 emissions, and declining over time); and (2) the company has purchased and retired high-quality carbon credits covering at least 20% of its remaining emissions for such year.

Second, one VCMI label is available at the brand, product, or service-level. That is, a company could make a ***VCMI carbon neutral brand, product, or service-level*** claim. To use this VCMI label, a company should (1) maintain a publicly available emissions inventory identifying the brand, product, or service lifecycle emissions; (2) demonstrate ongoing reductions in lifecycle emissions and/or emissions intensity; (3) follow carbon neutrality guidance from a reputable standard; (4) purchase and retire high-quality carbon credits for all (100%) remaining emissions; (5) comply with all applicable regulations; and (6) avoid creating a false impression, hiding trade-offs, and/or overstating the beneficial environmental impacts of activities.

C. Which carbon credits must a company purchase to use VCMI labels?

The Claims Code requires that all carbon credits are of high quality, without giving detailed guidance on what that means (such guidance will be provided by the IC-VCM).

The Claims Code does require that the credits must be issued by a recognized and credible carbon crediting register (without explicitly identifying any registers). The Claims Code further requires that credits reflect high environmental quality, including meeting requirements of additionality; monitoring, reporting and verification (MRV); and permanence. The credits should also result from activities that, where relevant, are (1) compatible with human rights (including Indigenous People’s rights); (2) promote equity, apply social safeguards, and demonstrate positive socioeconomic impacts; and, (3) contribute to the protection and enhancement of environmental quality.

While strongly debated, the draft Claims Code does not currently require that carbon credits avoid double-counting between companies and the host country (where the carbon credit project took place).[4] This means that a company using a VCMI label could purchase carbon credits which the host country also uses to meet its international climate obligations. A company, however, needs to be transparent about whether or not the carbon credit was double-counted.

D. Which reporting requirements must a company fulfill to use the VCMI labels?

Finally, to use the VCMI labels, a company must report full information in public annual corporate sustainability reports, demonstrating that all Claims Code requirements are fulfilled. A company must also include all relevant information on purchased carbon credits (e.g., amount, name of carbon crediting register, host country, vintage year, methodology, avoidance, or not of double-counting).

Sidley stands ready to assist stakeholders in providing comments, and in preparing for the application of the Claims Code. Our full-service team also stands ready to advise on any other questions in relation to the development and use of carbon credits, for voluntary and compliance purpose.

[4] This is not inconsistent with the Paris Rulebook, adopted by the parties to the Paris Agreement at Glasgow in November 2021. While the Paris Rulebook prohibits double-counting when credits are transferred internationally, a host country is not required to trigger the application of the Paris Rulebook in the case of carbon credits to be used in voluntary carbon markets. *See* Coppens, D. and Lockhart, N. “The Paris Rulebook and its Implications for Carbon Credit Markets,” *The Oxford Institute for Energy Studies*, June 2022, Issue 132, available here.