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Europe's Carbon Emissions Trading -- Growing Pains or Wholesale Theft?

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Correction appended.

NEW YORK -- Have criminals found a lucrative niche in carbon markets?

Previously, many bankers and traders said no, insisting that one-off incidents involving theft or cheating in Europe's Emissions Trading System (ETS) were isolated events attributable mostly to the youth of the market. Advocates of a cap-and-trade approach to tackling climate change said that such growing pains are inevitable, but regulators and legitimate market participants would get better at warding off abuses.

But this month's mass theft of E.U. allowances (EUAs) from some national registries has gotten the broader carbon trading community very much up in arms. Many are blasting some nation members of the European Commission for not taking the threat seriously, undermining their case for spreading carbon markets beyond Europe, especially to North America and parts of East Asia.

And some researchers and carbon trading critics are now relishing in saying "I told you so," pointing to the thefts as just the latest example of a rash of scams, fraudulent activity and other criminal abuses.

One team of researchers at Dartmouth College tracking this issue says crime in the carbon markets is indeed growing fast, and that the criminals are getting more adept at stealing lucrative carbon allowances and avoiding detection.

The problem isn't isolated to Europe, they say.

Officials at Transparency International, for instance, say they are investigating bribery cases in the world's largest offsets trading program, the Clean Development Mechanism. And periodic questions concerning the legitimacy of some voluntary carbon offsetting programs in the United States are starting to draw the attention of the Commodity Futures Trading Commission and the Federal Energy Regulatory Commission, observers note.

But nothing on the scale of what has occurred in Europe has ever been reported in the United States to date. Still, carbon exchange operators here say the rise of reports of criminal activity in the markets of Europe has them on the high alert like never before, though they insist U.S. carbon trading systems are much more robust and less easily penetrated than the ETS.

Needed: a single set of standards

"There have been no incidents of any security issues or any irregularities of any kind in our registry," said Jonathan Schrag, president of the office that oversees the Northeast's Regional Greenhouse Gas Initiative, RGGI Inc. The key difference, he says, is that RGGI knows its membership and knows who trades in its market and why.

"Unlike the countries of the European Union, the RGGI participating states use a single registry, administered by RGGI Inc., with a single set of security standards and operating procedures," Schrag added. "That is a core structural difference."

The European Commission seems to be waking up to the seriousness of the problem, announcing last week that spot trading in EUAs would be suspended indefinitely until member governments could prove that their systems were impenetrable. It's too little, too late, say critics, many of whom joke that once all you needed to trade in the ETS was a telephone number.

Last year, Michael Dorsey, a professor of environmental studies at Dartmouth, stirred controversy when a research team he leads found that carbon market crime was spreading as the markets grew and matured. Though the researchers say they are still compiling figures on 2010 incidents, their initial study covering the entire run of Europe's carbon market showed that 90 percent of fraud or theft cases occurred toward the end of 2009.

That study estimated that fraudsters had successfully swindled the ETS of more than $6 billion. Dorsey said it's getting worse because regulators in Europe are not taking the problem seriously, and nothing they have done in response to last week's theft of more than 2 million EUAs straight from accounts assures him that they are moving more aggressively now.

"The lack of a structured process indicates to us that regulators don't see this as a significant problem that they need to respond to, and the lack of that structured process, we believe, will basically enable future misconduct of who knows what kinds," Dorsey said.

The leadership at the International Emissions Trading Association, one of the world's strongest advocates for carbon trading as an instrument in the fight against climate change, says it agrees entirely with Dorsey.

"The reason that this happened is essentially the registry authorities of the member states have been asleep on the job," said IETA President Henry Derwent.

In a brief interview, Derwent could barely contain his frustration over the lax attitude toward security at the European Commission and various government regulators. He said much of the problem will be solved when the entire system converts to a single registry by 2013, but argued that that transition should happen much sooner, as it is apparent to him that regulators aren't nearly as on top of the problem as they say they are.

Carbon crime is as varied as other financial or white-collar crimes.

In the final quarter of 2009, Dorsey's group counted 17 individual, publicly reported cases, covering about 90 percent of the total his researchers collected at the time. He fears many more cases are going unreported.

'Phishing' and 'carousel fraud'

Some of the most popular incidents were a rash of value-added tax (VAT) fraud schemes reported in the media beginning a few years back. It's a new take on an old problem Europeans call "carousel fraud" that experts say is normally done with cellular phones.

The fraud is achieved by brokers selling carbon credits across borders and collecting VAT on the sale, but then disappearing as soon as the transaction is over without turning over the tax revenue to the state. At the height of that crime wave, reports suggested that some 90 percent of carbon trading in certain countries was occurring solely to collect and pocket VAT revenues. The spate of carousel fraud was the first major challenge carbon market advocates faced.

The VAT fraud is estimated to have cost governments billions of dollars. But since the outbreak, dozens have been swept up in arrests, with seven more men in Britain charged with running a very lucrative VAT scam operation last week. Reports said they raked in about $60 million dollars in a short time span.

When the VAT scandal broke, carbon market advocates pointed out, correctly, that such cases didn't involve allowances or offsets credits *per se*, but were a new take on an old-fashioned scam common in Europe. But more recent incidents have directly exploited the weaknesses in the trading community's security systems.

One particularly damaging case involved a "phishing" scam in which criminals established fake websites designed to mimic the online registries of E.U. member governments participating in the ETS. They then sent e-mails to carbon traders asking them to update their information in the fake systems. That information was used to hack into EUA accounts and steal millions of dollars' worth of credits.

A less sophisticated version targeted market players and even some climate scientists who make the rounds at international carbon market conferences. Victims are sent e-mails inviting them to fake conferences and directing them to phony websites where they can register after submitting a "deposit" or "hotel fees" often amounting to hundreds of dollars.

Last week's incident is the most alarming for the ETS yet, experts say, because it involved direct hacks into accounts, where afterward millions of credits were stolen and bounced between registries in multiple countries before disappearing altogether.

Thievery goes wholesale

Warnings had come from a variety of sources, including IETA, carbon market opponents and even Interpol. At a conference held last year on environmental crimes, hosted by the international policing agency, Interpol officials warned European governments that the carbon markets were becoming increasingly enticing to criminals, including sophisticated organized crime rings.

Michelle Chan, who works at Friends of the Earth and is critical of carbon market security controls, says the theft should come as no surprise, given the earlier incidents. Though Interpol warned that outside elements are intent on exploiting the system, Chan says it's more likely that some traders themselves are capitalizing on their knowledge of systematic weaknesses to grab easy cash.

"Some of this kind of fraud is a little bit of what you'd expect with any new market," Chan said in an interview. "But with the wholesale disappearance, or theft right from registries ... that is a different animal."

"It's the kind of example that, had it not happened, people would not have believed that it could happen," she added.

Chan lays out the vulnerabilities of cap-and-trade systems in general in a brief she and Friends of the Earth published last year titled "Ten Ways to Game the Carbon Market."

In that brief, Chan warned of the possibility that market originators would exploit the systems directly. Companies facing a cap on their emissions could, she said, exaggerate the levels of greenhouse gas emissions in their operations to win extra allowances from regulators, selling those into the markets and collecting windfall profits. Suspicions that this had indeed occurred when allowances were first handed out put ETS operators on the defensive in the early days of the cap-and-trade program.

On the offsets side, Chan warned that offset project developers could cook their books to claim that they had achieved much higher levels of cuts in emissions than in reality. Third-party auditors have a strong incentive to play along, she notes, because they only get paid if the developer can claim the credits and sell them into the market.

Other potential examples include versions of the classic Ponzi scheme in which investors are potentially brought in to finance a nonexistent offset project that promises a profit by selling credits to customers who may or may not exist. There have also been cases of traders reselling, or "recycling," the international offsets credits called Certified Emission Reductions after they had already been counted against emissions rates, to double profits.

"Fraud and malfeasance are going to occur, and that's why we're skeptical of having a very Wall Street-driven, very liberalized market that basically is open to any and all comers," she said.

Sales of fake carbon offsets credits are also happening, Chan says. Specifically, she cites cases where existing landfill gas project owners in the United States were approached by brokers to claim credits on their "offsetting" even though they had been in operation for years and were set up not to fight climate change, but simply to sell methane to local utilities. Such phony offsets plagued the Chicago Climate Exchange back when it hosted open trading, Chan says in her report.

Chan also expressed worry about bribery in offsets projects, something that's already occurring, says Lisa Elges, a researcher at Transparency International, a group of campaigners against global corruption.

"There have been a lot of cases where different types of corruption have come into play with the Clean Development Mechanism, for sure," Elges said. "The rules and procedures that are in place try to be as transparent and accountable and try to safeguard against kind of corrupt behavior, but that doesn't mean that it doesn't happen."

Coming report on bribes and kickbacks

The Clean Development Mechanism (CDM) was set up by the Kyoto Protocol as a way for governments to earn emission reduction credits in the developed world by offsetting emissions in the developing world. Several layers of controls are in place to ensure the rules are followed and the environmental integrity of projects is honored, but many have long speculated that project developers could encourage or simply pay off their third-party auditors to ignore obvious abuses, or to directly falsify documents and information to claim credits they don't deserve.

Sources at the CDM management offices say they have not encountered any such instances, and vigorously defend the integrity of the CDM. But quietly, one source also admitted that regulators there do occasionally encounter information submitted in applications or allowance requests that seems deliberately intended to deceive them.

Elges suggested that bribes and kickbacks are being exchanged regularly among participants in the CDM, though she declined to name specific examples. Cases will be highlighted in Transparency International's forthcoming global corruption report, she said.

Despite the alarmism coming from opposition groups, carbon market operators in the United States say that the incidents overseas, while disturbing, don't give cause for heightened alarm in the United States. What's needed next is a much tougher response from the European Commission to tighten security at the ETS.

Schrag said RGGI is free from abuse largely because it's designed much more like existing electronic commodity exchanges, where fraud and abuse are rare. RGGI Inc. offices in Lower Manhattan monitor a single registry, rather than the dozens of registries in the ETS. And RGGI has a higher bar for determining who can be allowed in to participate.

The single registry, commodity market-driven model for has since become the *de facto* approach for emerging compliance markets in the United States, in particular the highly anticipated cap-and-trade market in California that officials there are now designing.

Correction: *An earlier version misidentified Dartmouth College as Dartmouth University.*

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