

Six best practices for carbon offsets

As investors and companies increasingly seek to address the risks of climate change, there is growing debate about the use of carbon offsets in achieving net-zero emissions. We think there's room for a measure of offsets to achieve carbon neutrality, provided best-practices are followed.

Opinions have diverged about what contribution, if any, offsets make to net-zero emissions. Starting with the Kyoto Protocol, regional initiatives have encouraged offsets as building blocks to a standardised international marketplace for them. But some have grown concerned about “carbon indulgences,” where investors can use offsets to burnish their climate credentials without really solving the root problem.

While there are many pros and cons to offsets, we believe there is a strong case for investors and companies alike to use a modicum of offsets to achieve goals of carbon neutrality. And with the COP26 Summit now the epicenter of global attention, we expect even more dialog and interest, especially surrounding offset regulation and markets.

Offsets help “square” the carbon balance sheet

Offsets represent a small but effective weapon in the bigger war on climate change. Their purpose is to help make-up for greenhouse gases (GHG) an entity produces by allowing it to buy, sponsor or fund a carbon-reduction initiative elsewhere. Generally, offsets take the form of credits—each representing a one-metric-tonne reduction of CO₂—which freely trade in two distinct markets: compliance (a.k.a. “cap-and-trade”) and voluntary.

In the compliance, or mandatory market, offset credits are issued to entities that bring emissions within imposed limits to avoid hefty fines. With more net-zero emissions mandates becoming the law of the land, the compliance offset market has expanded to a wide list of credits with names conative of their respective goals (*Display, above right*).

Carbon offsets impact and reach are global

Name	Administered by	Established in	Type	Credit Name
Clean Development Mechanism	UNFCCC	1997	International	Certified Emission Reductions
Joint Implementation Mechanism	UNFCCC	1997	International	Emissions Reductions Units (ERUs)
American Carbon Registry	Winrock International	1996	Independent	Verified Emissions Reductions
Climate Action Reserve	Climate Action Reserve	2001	Independent	Climate Reserve Tonne
Gold Standard	Gold Standard Secretariat	2003	Independent	Verified Emissions Reductions
Verified Carbon Standard	Verra	2005	Independent	Verified Carbon Units
Alberta Emission Offset System	Ministry of Environment and Parks	2007	Subnational	Alberta Emissions Offset
California Compliance Offset Program	California Air Resources Board	2013	Subnational	California Air Resource Board Offset Credits
Australia ERF	Clean Energy Regulatory	2012	National	Australia Carbon Credit Unit

As of March 31, 2021
Source: World Bank Group Report, May 2020 and AllianceBernstein (AB)

The voluntary offset market is a bit more freewheeling by comparison. It comprises offset credits tied to verifiable GHG reductions from proactive programs, like a new wind farm. Governments, companies and high net worth individuals typically “retire” voluntary credits to claim the carbon reduction. Whether due to genuine environmental concern, the desire for better optics or something else, the voluntary offsets market has grown steadily in recent years, with forestry and renewable energy credits consistently out front (*Display, next page*).

On the long road to “net-zero,” offsets share some driving

With the proliferation of “net-zero by 2050” commitments across sectors, industries and geographies, we think offsets should play a part in every company's and investor's plan. Moreover, many companies may not have a viable path to net-zero emissions without offsets, a challenge that has been acknowledged by global initiatives, government policies and science. In fact, Article 6 of the Paris Climate Accord lays out the creation of a global carbon market, with offsets as its building blocks.

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Through our partnership with Columbia University's Earth Institute, we at AllianceBernstein have seen support for carbon offsets extend to leaders and lecturers across the scientific community, all attesting to the effective weapon they provide companies in the war on climate change. Even if the Accord misses its larger goal to limit long-term global warming to 1.5 degrees above pre-industrial levels, companies can still reach “net-zero” targets independently with the help of offsets.

As active investors, we also believe that a liquid offset market with transparent pricing can transmit signals that can be used in investment decisions at the portfolio and corporate levels. That is, a company's use of

offsets (or lack of it) is a litmus test for how authentically they're managing climate-related risks and opportunities.

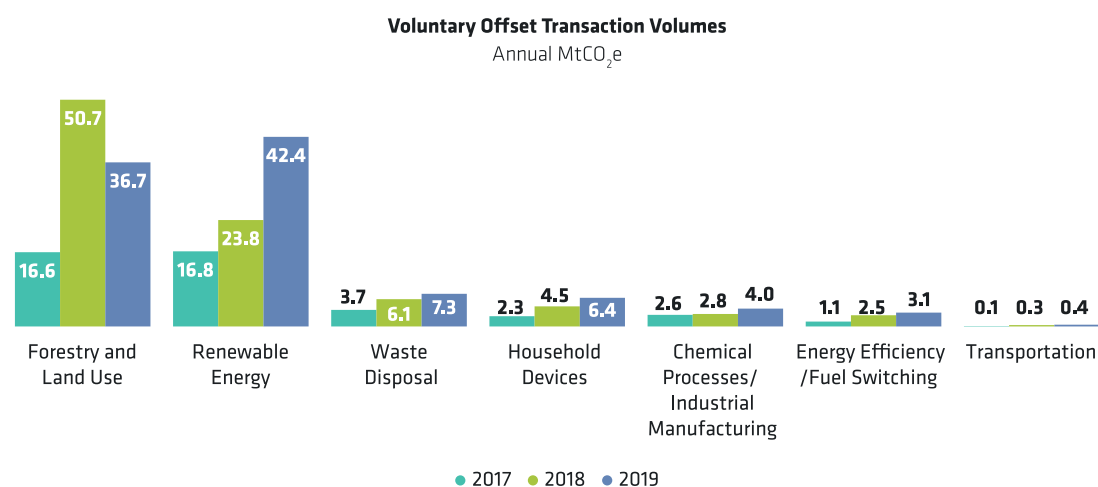
The prices companies pay for offsets is especially telling, offering key intel in an active investor's vetting process. It also helps stir up activity that could improve outcomes for the issuer, stakeholders and others across the value chain. For example, offsets can have wide impact as markets create steady revenue flows from wealthy emitters to areas with more genuine offsetting activities. This typically helps benefit more rural and poor communities, which usually have the greatest need for carbon reduction initiatives.

Better Impact Through Best Practices

Carbon offsets are well-intentioned, green investment vehicles in theory. But they vastly differ in scope and many have fallen short of goals. In our experience, however, we've honed six best practices that can help in the due diligence needed to improve investor results:

- 1. Use moderation.** Offsets should be residual in a long-term net-zero emissions strategy, not the focus. Even then, concentrate where data show they do the most good, like direct investment in renewables and energy efficiency and modernisation, which can reduce emissions by 75% to 95%. On the other hand, proceed very carefully with Carbon Capture & Storage offsets, as this is an area that draws intense scrutiny.
- 2. Use third-party quality certification.** Few investors have capacity to audit offset market quality. Turn to the certifications and guidance of national, sub-national or state bodies like the Australian Carbon Farming Initiative or the California Air Resources Board. For international offsets, non-profit certifiers like the Gold Standard and the World Wildlife Fund are also well respected.
- 3. Pay attention to price.** With such a wide cost range for credits (US \$0.20 to US \$50 per metric tonne), price is an important and useful proxy, and cheaper isn't always better. In fact, just making bulk purchases of low-cost offsets may not achieve much and could be considered disingenuous. In this vein, transparency on the assumptions and methodology behind offset pricing is also critical. Higher quality may cost more, but meaningful appreciation is also likely as investor demand eventually leans to the better-producing offsets.
- 4. Favor nature-based offsets.** The straightest lines are drawn from the planting or

Forestry, renewable energy offsets most sought



As of March 31, 2021

Source: State of Voluntary Carbon Markets and Forest Trends and AllianceBernstein (AB)

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preservation of natural habitats and carbon reduction, with deforestation prevention especially effective. So are projects that “sequester” carbon, as is possible in soil used for crops and grazing, or in marine environments, which is 70% of the earth’s surface. The Blue Carbon Initiative, for example, targets coastal communities to rejuvenate seagrass meadows and mangroves.

5. Lean toward compliance offsets. In the voluntary markets, companies make claims about their emissions goals and results, but in the compliance markets, results are certified. In time, we expect regulators, auditors and investors to bring higher scrutiny to voluntary markets, which will likely set the stage for the two markets to merge. In the meantime, we believe the compliance market has the better price stability now, and the potential growth advantage when the two markets begin to converge.

6. Seek out direct investments in projects. Many companies employ specialised areas to develop profitable businesses in the offsets space. Four New Zealand companies, for

example, have partnered to plant trees in marginal lands, which lowers their costs of providing offsets in their government’s compliance markets. Similarly, an Australia-based oil and gas company set loose its geological and development teams on a “basin-by-basin” approach to Aussie offsets production.

While we appreciate their current limitations, we believe offsets will form a small part of the solution to climate change. They’re not the lynchpin, but rather a critical component of a complete plan, particularly in mining, industrials and energy which, in our view, won’t have a realistic transition to net-zero without them. And like anything that determines a company’s success, active analysis with an eye toward best practices can help determine which carbon offsets are most effective at reducing emissions in a meaningful way.

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