

ESG Viewpoint

Principles for carbon
offsetting

April 2022



At a glance

- ▶ There is increasing pressure on corporates to reduce their greenhouse gas emissions to limit global warming – many net zero commitments either implicitly or explicitly rely on carbon ‘offsetting’.
- ▶ The voluntary carbon market is growing quickly and over \$1bn worth of carbon credits were transacted on the market in 2021.
- ▶ We outline our principles on when companies should use carbon offsets and explore our engagement with businesses, especially in high impact sectors.



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Introduction

There has been increasing pressure on corporates to reduce their greenhouse gas emissions to limit global warming to 1.5 degrees, including from investors through engagement. This has led to many companies committing to achieve net zero emissions. While reducing emissions is an evident priority to limit warming to 1.5 degrees, often eliminating residual corporate emissions is either expensive or not yet technologically feasible. Thus, many net zero commitments either implicitly or explicitly rely on carbon 'offsetting': where carbon emitters purchase verified units of greenhouse gas emission reduction or removal to compensate for remaining emissions. Emitters are increasingly turning to the voluntary carbon market to source these carbon offset credits, or developing offset projects themselves, particularly through Nature Based Solutions (NBS).

The voluntary carbon market is growing quickly to meet this increasing demand. Over \$1bn worth of carbon credits were transacted on the market for the first time in 2021, a three-fold increase on 2020. However, with this rapid expansion has come considerable growing pain. Critiques of the market focus on the legitimacy of the claims made by both credit sellers and credit buyers. Some projects which sell credits have been criticised for failing to have the additional and long-term climate impact they claim, and for generating negative environmental and social side effects. Credit buyers can be embroiled in project

level controversies and can also be accused of greenwashing if they conduct profligate purchasing of offset credits with limited efforts to decarbonise. Even legitimate offset buyers and sellers face reputational risks due to the current lack of consensus on what constitutes credible offsetting.

We have a strong history of active engagement with the companies we hold and those we engage with on behalf of our Reo clients. Here we aim to communicate our perspective on when companies should use offsets, which offsets they should be using, and how companies should use and disclose on their use of offsets. Our principles build on the established quality standards already in the market but aim to raise the level of expectation. Our intention is that we will revisit and revise these principles as the voluntary carbon market evolves.

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Principles for best practice carbon offsetting

When should companies use offsets?

1 Corporates should focus on decarbonising their operations and value chains before resorting to using offsets. The option of carbon offsetting should not distract from the priority of decarbonising operational and value chain emissions.

2 Carbon removal offsets should be used to 'neutralise' residual emissions once all decarbonisation options have been exhausted to meet net zero targets. Carbon removal credits are derived from projects which draw down carbon dioxide from the atmosphere, such as afforestation or direct air capture and storage (DACs). These credits can be used to neutralise residual emissions to reach net zero.

For most sectors we expect residual emissions will be typically 5-10% of 2020 levels, but for hard-to-abate sectors with less clear decarbonisation pathways we anticipate the neutralisation requirements may be higher.

3 Avoided emission offsets can be invested in to increase the likelihood the world stays within a 1.5°C carbon budget. Avoided emission credits can be generated by projects which prevent future carbon dioxide from being released, such as REDD+ schemes which protect forests from deforestation, or renewable energy developments which displace fossil fuels from the grid. Avoided emissions offsets cannot be used to count towards corporate net zero targets. The practice of compensating for additional emissions en route to net zero is something we encourage, if it is done in tandem with true emissions reductions. Bayer¹ and Microsoft² are good examples of companies doing this.

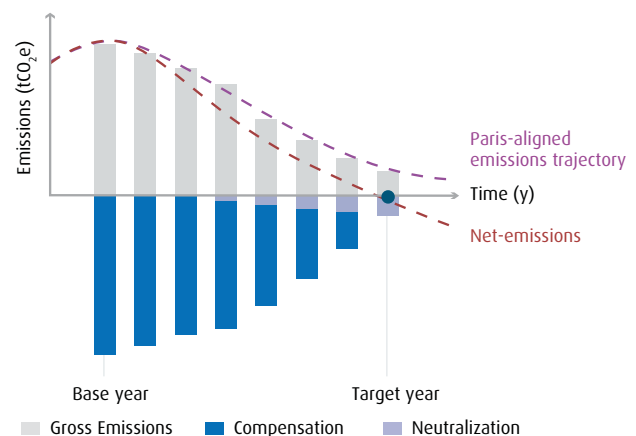
¹ <https://www.bayer.com/en/sustainability/climate-protection>

² <https://query.prod.cms.rt.microsoft.com/cms/api/am/binary/RE4MDlc>

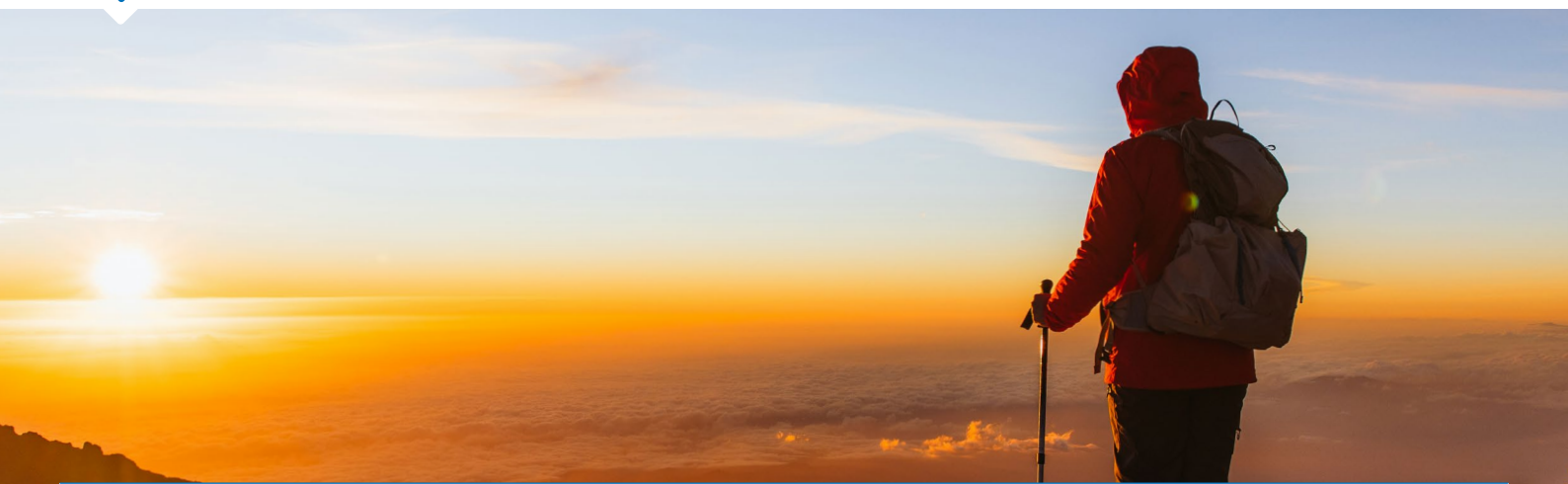
³ <https://www.nature.com/articles/s41893-021-00803-6>

Corporates could prove that investing in offsets is not detracting from their own decarbonisation activities by providing clear capital expenditure disclosures on spend on offsetting against spend on other decarbonisation endeavours. We believe that nature-based avoided emissions credits, such as those certified by the ART/TREES standard, are currently more credible than technology-based avoided emission and emission reduction credits, as they ensure that 'irrecoverable carbon' remains in natural habitats³.

Figure 1: stylised decarbonisation trajectory showing the role of neutralisation (carbon removal offsets) and compensation (avoided emissions offsets) on the road to net zero



Source: [SBTi](#)



4 Offsets should meet the industry-accepted minimum quality standards. These are the principles outlined by Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), the International Carbon Reduction and Offset Alliance (ICROA), and the draft Core Carbon Principles by the Taskforce for Scaling Voluntary Carbon Markets (TSVCM)⁴⁵⁶.

5 Credits should preferentially be sourced from projects which have strong environmental and social co-benefits. Buyers can ensure this by: (a) preferentially sourcing from nature-based solution projects, (b) embedding the delivery of environmental and social outcomes in supplier codes of conduct and procurement standards, (c) sourcing credits which have been validated as having co-benefits (e.g. Gold Standard for the Global Goals, W+ and climate community and biodiversity (CCB)), and (d) conducting due diligence on projects to verify that claimed co-benefits are being realised.

6 Companies should look to inset in their own value chains wherever possible. Carbon insetting is where businesses invest in greenhouse gas reductions or carbon sequestration interventions that are directly related to their value chain. Pursuing insetting offers several benefits for companies, including building climate resilience, improving supplier relationships, and supporting companies to achieve their climate targets. We expect any insetting projects to be verified by an accredited and independent third-party entity against a recognised standard.

7 Long-lived storage credits should be preferred. Different carbon offset types have different storage timeframes:

- No storage. Some offset project types have no ability to store carbon which is reduced or removed, such as renewable energy avoided emission offsets.

- Short-lived storage. Projects based on habitat protection, restoration or creation can store carbon for millennia, but are vulnerable to reversal risks from changing political priorities, economic pressures, fire, disease and climate change.
- Long-lived storage. Project types which use geological storage can store carbon for millennia and have a low risk of reversal. Examples include carbon capture and storage (CCS) in geological reservoirs, or mineralisation of carbon into stable forms.

Companies should look to transition their offset portfolios towards longer-lived storage and away from shorter-lived storage over time, in line with the Oxford Offsetting Principles⁷. We suggest that buyers could approach this in the short-term by looking to phase out credits with no storage (Oxford Principles Category I), especially those with few co-benefits.

8 Credits which are over five years old should not be purchased. Unlike a good wine, offset quality reduces with age, as verification standards, monitoring, reporting, and verification (MRV) technologies, and buyer expectations keep evolving. To keep abreast of this change, we expect buyers not to buy credits which are over 5 years old, and ideally less than 3 years old.

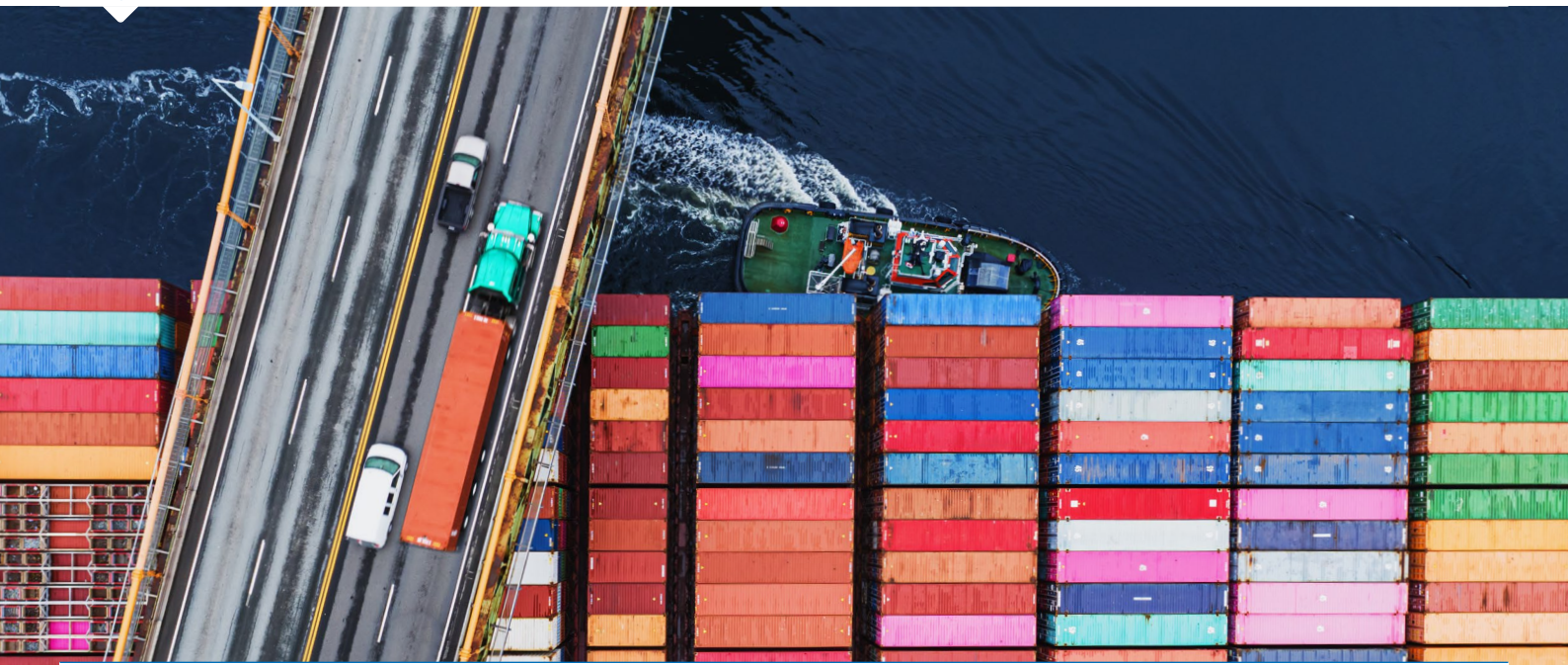
9 Purchased credits should be certified against methodologies approved by high quality verification organisations. We have the most positive view on the larger international programmes, such as Gold Standard, Verified Carbon Standard (VCS) and ART/TREES. However, we encourage buyers to look beyond the verification organisation to appraise the specific methodology which credits are issued against. While some smaller carbon standards play important roles in the market development and can offer high quality credits, we would expect buyers to have strong rationale and risk management practices in place when using these credits.

⁴ https://www.icao.int/environmental-protection/CORSIA/Documents/ICAO_Document_09.pdf

⁵ https://www.icroa.org/_files/ugd/653476_7dfd2506469442bfac72c9d56de96447.pdf

⁶ https://www.iif.com/Portals/1/Files/TSVCM_Report.pdf

⁷ <https://www.smithschool.ox.ac.uk/publications/reports/Oxford-Offsetting-Principles-2020.pdf>



How should companies use and disclose on their use of offsets?

- 10** Buyers should have processes to identify, assess and manage the risks associated with purchasing carbon credits. These might include: (a) project level risk management, (b) embed standards in supplier code of conduct, procurement considerations and supplier contracts, and (c) commission due diligence conducted internally or by external providers.
- 11** Companies should have clear procurement and retirement strategies, including retaining a margin of redundancy when retiring credits. We expect buyers to consider and disclose on their rationale for credit purchase, how they are looking to invest, and their budget and scheduling of investments and retirements. Building on the Article 6 rulebook agreed at COP26, we encourage companies to build in a minimum 5% margin of redundancy when procuring carbon credits and contribute 5% of their carbon credit procurement budget to climate adaptation funding⁸.
- 12** Companies should have consistent and clear disclosures on their use of offsets. We would expect consistency between sustainability narrative and financial reporting when disclosing on offsetting, aligned with the principles of Paris-aligned accounts⁹. We expect companies to disclose:
- the contribution of offsets to their current emissions and emissions targets
 - the average price they have paid and expect to pay for their offsets, and the total spent on offsets in a calendar year as
- an absolute figure and a percentage of climate-related CapEx
- details on offset parameters, including:
 - The proportion of carbon removal and carbon reduction offsets
 - The proportion of offsets by storage mechanism
 - Project type
 - Offset vintage/issuance year
 - Adjusted credits (under Article 6.4)
 - Verification body and methodology (e.g. VCS, VM0010 Methodology for Improved Forest Management: Conversion from Logged to Protected Forest, v1.3)
 - Investment method
 - A narrative section outlining offsetting strategy, risk management, co-benefit approach and use of offsets to facilitate climate-related claims at the company, business unit or product/service level.



Companies should have consistent and clear disclosures on their use of offsets.

⁸ <https://www.bmogam.com/gb-en/intermediary/news-and-insights/cop26-and-carbon-markets-what-are-the-implications-for-investors/>

⁹ <https://www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/>



How will we be using these principles in our engagement?

Carbon offsetting is a powerful tool in the race to net zero, but it has the potential to cut both ways. A robust offsetting strategy can magnify corporate decarbonisation efforts by financing projects which reduce or remove carbon emissions today, and enabling the future neutralisation of residual emissions to meet net zero targets. However, corporates which invest in poor quality credits with weak risk management and limited strategic planning will undermine the validity of their climate commitment, exposing themselves to financial and reputational risks. A robust and clearly communicated approach to carbon offsetting is critical for any corporate climate strategy to be considered legitimate.

We will be reaching out to companies in sectors which have strong ties with the voluntary carbon market – such as airlines, shipping, energy and consumer products – to

ask them to abide by these principles. In our engagements we plan to clearly articulate these principles and call out specific areas where we believe companies are falling short. If companies continually fail to develop robust practices on the use of good quality carbon offsets, we will escalate our engagement if their activities undermine their decarbonisation strategy.

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A robust offsetting strategy can magnify corporate decarbonisation efforts.

Get to know the author:**Joe Horrocks-Taylor, Senior Associate, Responsible Investment**

Joe joined the Responsible Investment team in 2021 and is focusing on climate change and biodiversity. Before joining us, Joe worked as a sustainability consultant with a range of private and public sector clients. Outside work he enjoys playing sport, hiking and birdwatching.

Responsible Investment – a glossary of terms

Its wide-ranging nature means that responsible investment involves a host of associated language and jargon. Here we explain some of the most commonly used terms.



Explore our glossary

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