The carbon credit conundrum: A new approach

Federated Hermes Limited

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The goal of linking verifiable carbon mitigation and nature restoration with a financial return has long been the holy grail for climate-aware investors. A new nature impact strategy set to be launched by Federated Hermes and its partner Finance Earth could bring that dream closer to reality.

Fast reading

- The current voluntary carbon market ('VCM') is littered with examples of projects that are not up to scratch – with a broad disparity between stated aims and actual outcomes.
- Buyers of carbon credits need to have full transparency around what they are buying and what the long-term impacts are likely to be.
- For the UK's VCM to develop in a credible way with the trust of investors, the quality and integrity of the buyers of credits is arguably almost as important as the quality of the projects. The current market is far too buyer-friendly and strewn with false claims, irresponsible off-setters that are not on Paris-aligned decarbonisation journeys, and project owners and developers ceding control of the entire future supply of carbon credits from their respective projects in return for upfront payments.
- A new UK Nature Impact strategy set to be launched by Federated Hermes and Finance Earth aims to take a new approach in partnership with some of the UK's largest environmental NGOs and landowners, with firm scientific foundations, genuine look-through into underlying assets, 'ex-post' sale of credits and rigorous eligibility criteria for buyers of environmental credits.
- The strategy will be the first in the UK to invest on a fully diversified basis across the full spectrum of land, river, coastal and marine 'nature-based solutions'.

It's not enough to say the right tree should be planted in the right place: Consideration must also be given to how nature-based investment can impact the resilience of rural communities.

As we hurtle towards a 2°C+ global warming scenario, the need to reduce CO_2 emissions becomes ever more pressing. Climate change and biodiversity cannot be separated – global warming is both driven by and drives land use change and the degradation of nature. Yet the structures linking carbon mitigation and nature restoration with a return for investors have to date been absent or at best problematic – and far too often have been divorced from the real lives of the people and communities they affect.

For Robert Hall, investment manager at Federated Hermes, it's a pressing concern – and one that needs to be addressed. "Investing into commercial forestry, for example may contribute toward the mitigation of climate change," he says, "but it may also negatively impact local biodiversity and local communities. It's not enough to say the right tree should be planted in the right place: Consideration must also be given to how nature-based investment can impact the resilience of rural communities."

A linked issue is the questionable quality of some existing carbon mitigation projects. Here, says Hall, while there has been an increase in demand, supply has not kept pace. This, in turn, means there are now real concerns around the credibility of some projects, not to mention the scope for increased 'delta' – in terms of both risk and return – between different VCMs.

"In international markets, there appears to be a large supply of voluntary carbon credits that companies can buy for as little as US$5 a tonne," says Hall. "But actually, the question is, do the buyers understand what these credits represent?"

Often, he notes, credits are derived from projects with necessarily long lead times – 50, 60, even up to 100 years. This means that at point of sale they are often some way off achieving the CO_2 reductions on which they are sold.[1]

Observes Hall: "Projects are selling a century's worth of carbon credits in advance of them being 'useable' by buyers as carbon offsets, and by doing that they're effectively pricing a century's worth of liabilities and foregoing the ability to generate meaningful revenues in the future. Projects may run

[1] These are known as 'ex-ante' sales which have dominated UK VCM transactions to date.

out of cash and no longer be maintained, in which case the underlying carbon credits may never pass independent verification and so be available for use as offsets. So potentially there's an enormous mismatch between what's been promised and what will be delivered."

By way of illustration, Hall offers the example of a UK afforestation project. Here, he says, the project owner could sell on an ex-ante basis 100% of the carbon credits the operation is expected to generate over the next, say, 80 years within just few short years of the trees actually going into the ground.[2] Yet the project will still need to fund the ongoing maintenance of the woodland – think insurance payments, maintenance fees, carbon credit verification fees, protection against invasive species and herbivore impacts, not to mention the impact of macroeconomic and fiscal change over the decades to come.

Says Hall: "If the project owners get their maths wrong – which, over an 80-year period is not altogether unlikely – then the woodland may not even last that long. In this scenario, the buyer of 80 years' of carbon credits up front may find the value of their credits falls to zero."

A question of integrity

For Hall, these sorts of transactions define many VCMs; they undermine the integrity of these markets and their ability to mitigate climate change, but they also expose carbon offset buyers – and carbon project end-investors – to investment risk.

The danger, he says, is of a long tail of failed projects which, for whatever reason – a lack of funding, lack of competence, lack of scientific underpinnings – will be unable to deliver either a financial return or, worse, significant CO_2 reductions for future generations.

This is not to downplay the considerable legitimate need for carbon offsets, says Hall, but serves to illustrate the importance of buyers being aware of the quantity of 'snake oil' in the market, and the risks that low integrity carbon markets represent.

The carbon credit marketplace is littered with examples of this kind of mis-selling, he says. And this is before you consider the impact of these projects on local biodiversity and communities.

"Voluntary carbon markets to-date have been defined by extractive, acquisition-led approaches, both internationally and in the UK," says Hall. "Capital has often sought to make the most of the exponential increase in demand for carbon credits by acquiring land and planting as many rapidly growing trees as densely as possible – perhaps without fully realising how this can negatively impact local communities, and replace biodiverse landscapes with monoculture plantations."

At best, says Hall, commercial forestry initiatives may miss out on the opportunity to maximise long term benefits for local people by planting diverse, mixed, predominantly native woodlands that can support thriving wildlife populations with public access.

2 In this example, the carbon credits generated would represent the CO_2 removed from the atmosphere by the trees as they grow over this 80-year period.

Investing in nature (or why you should care)

Six of the 10 risks over the coming decade are to do with climate

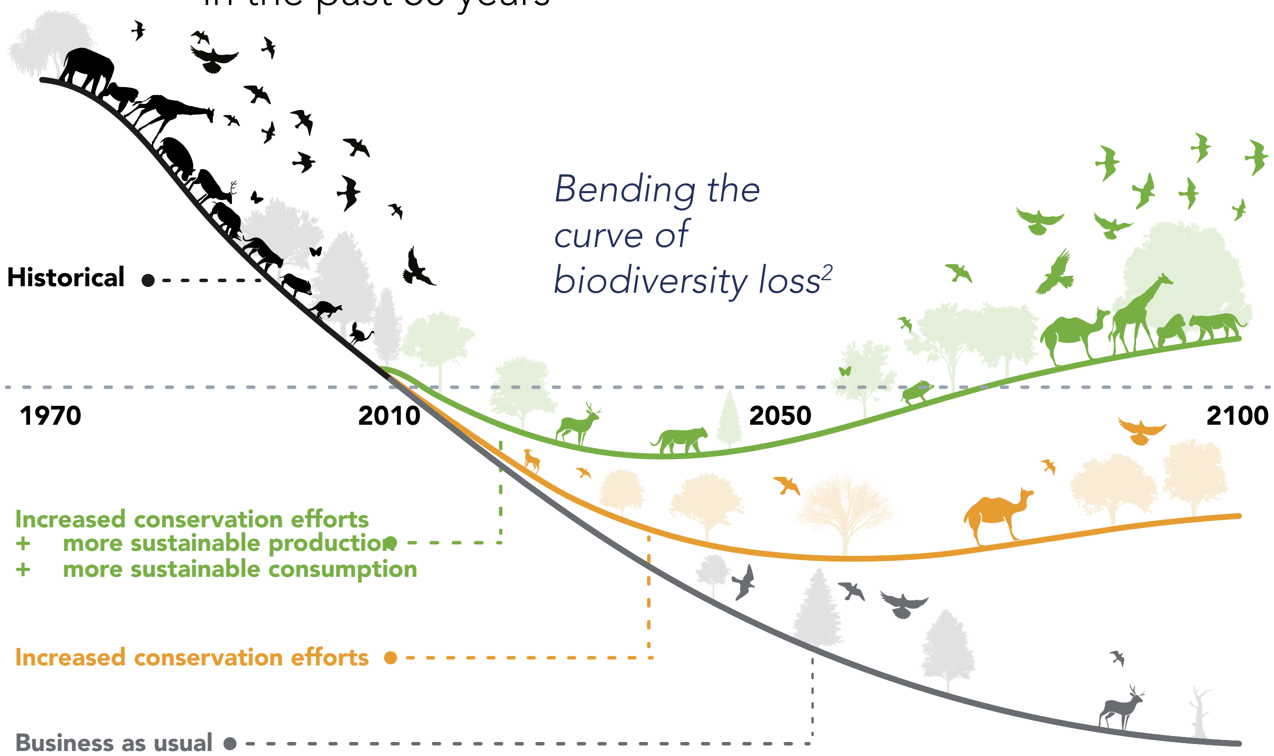
World Economic Forum, Global Risks Report 2023[1]

1	Failure to mitigate climate change	6	Natural resource crises
2	Failure of climate-change adaption	7	Erosion of social cohesion and societal polarization
3	Natural disasters and extreme weather events	8	Widespread cybercrime and cyber insecurity
4	Biodiversity loss and ecosystem collapse	9	Geoeconomic confrontation
5	Large-scale involuntary migration	10	Large-scale environmental damage incidents

Risk categories
Economic Environmental Geopolitical Societal Technological

Source: [1]Preface – Global Risks Report 2023 | World Economic Forum (weforum.org).

WWF Living Planet Report 2022: **global wildlife populations have declined by an average 69%** in the past 50 years



Source: [2] Living Planet Report 2022 | WWF (panda.org).

A new approach

What's needed instead is a new approach that's both reputable and verifiable – one underpinned by the science of climate change but also of ecology and biology, and that seeks to work equitably with existing landowners, regional supply chains, and communities.

Says Hall: "Clearly there's demand for projects that are designed to deliver multiple social and environmental benefits based on firm scientific foundations rather than chasing one particular outcome, that can deliver integrity, transparency and ongoing assurance over the long-term and – coupled with the potential for downside risk protection – an attractive return for investors seeking to contribute to both the mitigation of climate change and the reversal of biodiversity loss."

A new strategy – the UK Nature Impact investment strategy – set to be launched by investment manager Federated Hermes and impact investment adviser Finance Earth looks to deliver just that. The aim of the strategy is to invest in reputable nature restoration projects that mitigate climate change on a 'nature-first' basis, while generating financial returns for institutional investors through the sale of ecosystem services such as carbon credits and biodiversity units. And it's not all about trees – the strategy will be the first in the UK to invest on a diversified basis across a spectrum of land, river, coastal and marine 'nature-based solutions'.

Crucially – and in contrast to many of the existing schemes – all carbon credits generated by the strategy will be released to the market only after the underlying CO_2 sequestration or emission reductions have been independently verified to have already taken place. In other words, they will only be sold to investors once the projects to which they are linked are up and running and actually shown to be doing what they have been set up to do.

Project revenues – and returns – will be generated on a recurring annual basis across the full project life. Project revenues will also be shared with local stakeholders. And the strategy won't necessarily seek to acquire the freehold for land on which it finances projects, or target land more appropriate for food production. This innovative, impactful form of execution is the product of three years' research by a dozen-strong team which has worked closely with some of the largest conservation charities and leading scientists in the UK.

Clearly there's demand for projects that are designed to deliver multiple social and environmental benefits based on firm scientific foundations

According to Hall, the focus will be on projects in the UK where there is genuine look-through into underlying assets – a pre-requisite, he says, for rejuvenating the credentials of the VCM and the market for nature-based solutions more generally.

"It's really important for confidence," he adds. "Investors should be able to both understand and monitor the governance, scientific and legal framework underpinning impact projects. It's about creating transparency in things like the carbon or biodiversity pricing mechanism, but also the governance and legal framework. Ultimately, it even comes down to the most basic aspects like land tenure, and access to the land to observe whether what's been promised is actually delivered. The UK is well placed in this regard, with a solid legal framework governing land use and access claims."

Hall highlights how the scheme will leverage proven risk management frameworks from real estate and infrastructure, including the use of independent chartered surveyors and other experts to provide ongoing third-party technical assurance of project delivery, and its quality. The strategy will also be selective about who will be eligible to acquire carbon credits. Says Hall: "Only those that follow a science-based approach to net zero will be considered – and this should help avoid greenwashing."

Additional revenue streams

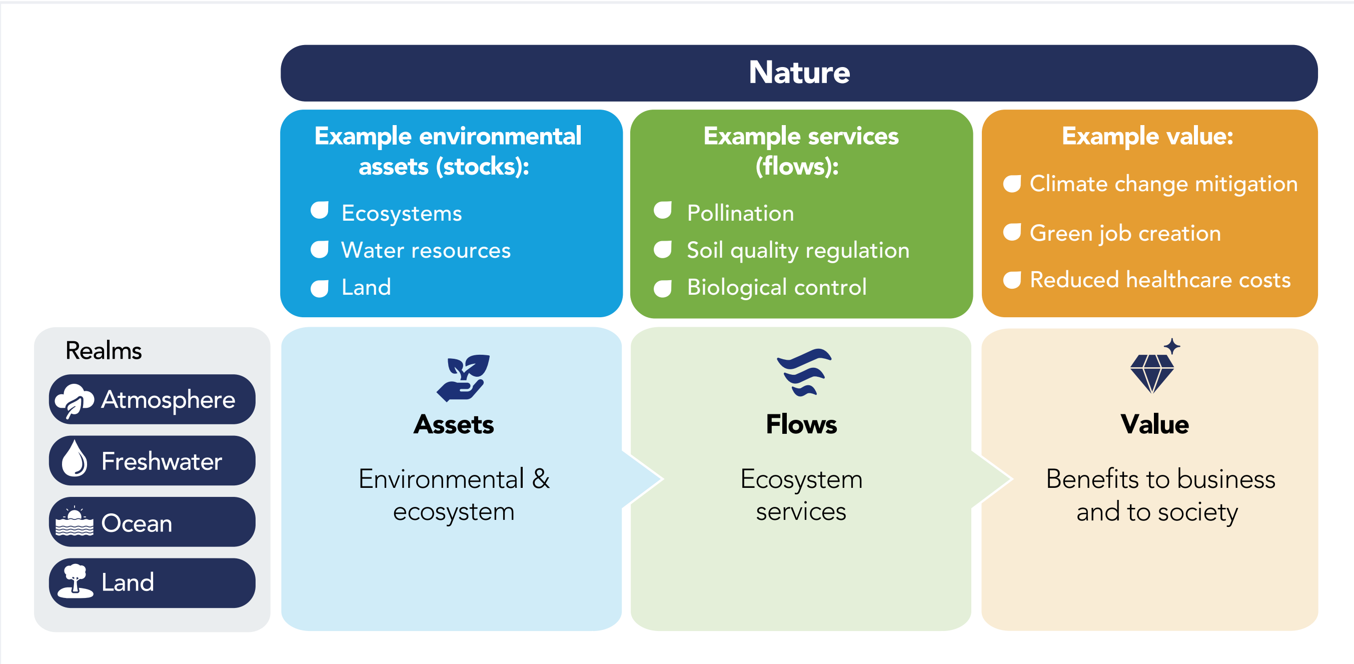
In addition, Hall points to the involvement of local stakeholders and monitoring of community benefits as one of the core principles of the strategy, noting that this hasn't always been the case in carbon mitigation projects of the past. "We've already started to see negative – and frequently legitimate – commentary around some of the earlier nature impact projects where communities were not brought along on the journey," he says. "Our view is that this was a mistake and actually presents a risk for investors."

Instead, by engaging systematically with local stakeholders, the strategy looks to add to the social impacts it will deliver through its investments into both projects and supply chain businesses – including the creation of skilled 'green' jobs in so-called 'left behind' and rural areas, and contributing to growth in the local economy.

Says Hall: "Our aim is to establish long-term equitable partnerships and recurring revenues. The advantage of local stakeholder involvement is this scope to deliver tangible long-term benefits to local people, local economies, local landscapes and investors."

The UK Department for Food and Rural Affairs (Defra) has provided £30m of seed money for the strategy, with private and institutional investors expected to provide additional funding.

A natural nexus: environmental assets and value-creation



Dos and don'ts of climate impact investing:

- Do consider project integrity. Is there a verifiable scientific basis to the projects being funded? There is a sound scientific basis for the use of carbon offsets in certain circumstances, but not in unlimited quantity.
- Do be prudent in considering the long-term economic and operational resilience of projects – how will project owners ensure this?
- Don't fall prey to greenwashing. Is there full transparency into the underlying projects, how capital is allocated, the long-term aims of the underlying projects and the mechanisms to create a financial return to investors?
- Do consider the broader social and environmental impact of the project – is it seeking to maximise the generation of carbon credits at the possible expense of the health of the landscape? Is it considering local social impacts?
- It's not all about trees! Do consider how your investment may support habitats of different kinds, including those that are under pressure or systemically important (including carbon sinks such as peatlands that in the UK are a significant contributor to national CO_2 emissions due to their degraded condition)

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