

## Carbon credit fraud: The white collar crime of the future

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Australia's Carbon Pollution Reduction Scheme (CPRS) will soon require the largest emitters of greenhouse gases to offset their carbon footprint. Such schemes have already been subject to fraud, misstatement and the involvement of organised crime in the UK and Europe. Deloitte Forensic is now warning Australian companies and regulators to prepare for the potential fraud risks.

Fraud has traditionally been driven by desperation, greed, opportunity and the rationalisation that the perpetrator is entitled to commit the fraud. Rationalisation is typically 'they can afford it' or 'it's a victimless crime': both approaches significantly impact big business and government.

Even a cursory look at the global carbon market in its current form reveals some carbon credit fraud 'red flags' that simply cannot be ignored.

The global carbon market is now estimated to be worth approximately \$118 billion<sup>1</sup>. With the main participants to this market being big business and government, these features may attract highly organised fraud offenders to Australia's proposed CPRS. The CPRS is due to commence in July 2011 but already evidence of fraud is being uncovered that may seriously impact the reputation and financial viability of Australian corporates.

Deloitte Forensic Financial Crime Partner Chris Noble warned, 'An emissions trading scheme may well attract highly organised fraudsters from overseas and Australia prepared to exploit arrangements that will be trading in billions of dollars. The warning signs are already apparent, with many schemes falling into the traditional rationalisation approaches.'



### Regulation and Criminal activity

Australian Climate Change Minister Penny Wong's office recently announced that a new 300 strong regulatory body would be responsible for monitoring Australia's CPRS<sup>2</sup>. Interpol has warned that the carbon market will be highly attractive to criminal gangs because of the potential for large sums to be made. Possible rorts being reported by Interpol include under reporting of carbon emissions by firms and bogus carbon offset schemes<sup>3</sup>. Interpol environmental crimes specialist Peter Younger recently told Australian reporters that 'the carbon market would be irresistible to criminal gangs<sup>4</sup>.'

In October 2009, it was reported that officials in five European countries were investigating a carbon credit scam considered to be worth more than \$1.5 billion<sup>5</sup>. In August 2009, UK authorities arrested nine people in connection with a £38 million carbon credit scam<sup>6</sup>.

In both instances those involved were suspected of purchasing the carbon credits abroad (VAT free) before on-selling them in the UK VAT inclusive without passing on the tax to government agencies. The people involved and their associated companies then disappeared, but not before they had transferred their proceeds into offshore accounts.

The highly organised and executed operation left regulators, police and the legitimate companies involved in the transaction shocked and perplexed.

The CPRS Bill before Parliament stipulates that the sale and trading of emissions permits will be subject to GST, despite some debate as to whether it should apply at all.

While all international emissions units trading in Australia will be required to be held and transferred in the Australian registry, it is possible that a similar scam could be attempted locally relating to the non-remittance of GST. Accordingly, Australian companies should have strict screening processes of the entities from which carbon credits are acquired.

Whilst this type of fraud is most likely to have direct financial impact on government, the fall out and reputational risk to companies who are unwilling participants of a multi-million dollar scam is a business peril that will need to be risk managed. 'No company can afford to be seen as having done business with organised crime, even if they were unaware at the time of the transgression,' said Chris Noble.

Australia will need to learn from these lessons and set in place appropriate systems before the e-commerce world opens up the Australian carbon trading market to international players. Australia cannot afford to assume this type of fraud could not happen. In addition to the highly organised tax fraud, Interpol is warning EU member countries of 'bogus' carbon credits that are being sold on the market<sup>7</sup>. This will directly impact companies. Any transaction costing potentially millions of dollars that acquires something false, manipulated or duplicated will directly impact the bottom line.

July 2011 is the scheduled commencement date for Australia's CPRS. In preparation, Deloitte has examined some of the 'transactional' fraud risks that have been exposed in other markets.

### Fraudulent trading of CPRS permits

In these early days of the adoption of the CPRS, many companies required to buy permits won't necessarily have risk management or control frameworks in place to control trading activity in CPRS permits.

### Fraudulent measurement of emissions

The tampering with meters or other measurement devices could result in readings significantly differing from actual consumption. Marked changes in emissions should be investigated.

### Financial misstatement

There may be pressure within some organisations to misstate their carbon position to present a better financial position. Already the Australian government has flagged its commitment to monitor closely the reporting of emissions. Australian Climate Change Minister Penny Wong's office said a new 300 strong regulatory authority would monitor the CPRS. She has stated that if liable entities do not report, or the authority has reason to believe that the report is false, then the authority may investigate and assess the entity's liability under the CPRS<sup>8</sup>.

Deloitte's Chris Noble believes this presents clear obligations and a certain level of risks if companies do not take the time to understand their carbon profile. 'Advanced data analytics used to either profile up front, or provide independent quantification, of a company's carbon footprint will be of significant support when regulators ask questions.'

### Bribery and Corruption

The first of these risks relate to bribery and corruption surrounding a company's entrance into the CPRS market. For example, a company's investment in a wind farm may be a technique used to obtain carbon credits. However, the development of a wind farm generally requires large parcels of land. Large turbines are required to generate the amount of alternative energy needed to create a carbon offset. Recently in the US, there have been investigations into companies for alleged improper dealings with public officials in securing land to develop wind farms.

Companies are therefore driven to implement an effective compliance program to mitigate risk for corruption and bribery, and subsequent investigations by regulators and law enforcement officials.

In particular, companies entering into the carbon offset market should be aware of potential violations of the USA Foreign Corrupt Practices Act and more locally, the bribery of foreign public official act legislation contained in the Commonwealth Criminal Code Act. Such legislation makes it illegal for companies to corruptly offer (or give, either directly or indirectly through agents or intermediaries) money or anything of value to foreign officials in order to obtain a business advantage or to retain business.

According to the United Nations Framework Convention on Climate Change, current carbon offset projects are being developed in countries in Central and South America (such as Brazil and Argentina), as well as in Southeast Asia and the general Asia-Pacific region. According to the Transparency International Corruption Perception Index, these regions generally have among the largest perceived levels of corruption. Companies should design, implement and monitor the effectiveness of anti-corruption controls and perform the necessary due diligence before entering into such carbon offset projects. This will help ensure that funds are not being diverted either directly or indirectly to third parties to control the rights to develop and operate a carbon offset project.

### Money Laundering

Besides potentially violating local and international bribery and corruption legislation, companies should also be aware that third parties developing and operating these offset projects might use the project as a mechanism to filter illegally obtained funds. For example, a money launderer could use illegally obtained funds to purchase wind turbines for an offset project, especially those projects occurring in developing nations. The launderer would then seek reimbursement for the wind turbines from a company seeking to purchase carbon offsets. The launderer would use the sale of the wind turbines to remonetise the investment via an apparent legitimate business purpose, thus concealing the wealth obtained from illegal sources. Companies entering into these transactions should perform the necessary investigative due diligence on carbon offset projects. This information can help the company determine whether to pursue the investment and avoid damage to corporate reputation.

### Intentional Round-Trip Transactions

Companies should also be aware of the potential for revenue manipulation and intentional 'round-tripping' transactions related to carbon offset projects. A round-trip transaction is one in which a company sells an unused asset to a third party and agrees to buy back the same or similar asset for the same price.

In the carbon market, for example, a company seeking to purchase carbon offsets may need to contribute \$90 million to a third party to develop and construct a rural electrification project that might be built using solar panels. However, there is the risk that the company and third party will collude to artificially inflate the cost to \$100 million, and the \$10 million difference (potentially less after a 'cut' is given to the third party for participating in the fraud) will be refunded back to the company and recorded as revenue. In this example, by transferring excess cash between the company and the third party, the company would be able to fraudulently record a higher revenue amount.

Companies entering into these transactions should be aware of this risk, and then design, implement and monitor controls to mitigate the potential for intentional round-trip transactions.

### Consumer Fraud

Finally, many companies, especially in the tourism, hospitality and leisure industries have entered into arrangements with third-party partners to offer individual customers an opportunity to purchase carbon offsets designed to reduce the environmental impact of their miles flown, nights stayed at hotels or miles driven in a rental vehicle. These programs pose a risk of fraud. For example, factors determining the cost of an offset for an airline might include the average amount of fuel consumed, the flight pattern, weight of the plane, number of passengers and the plane type. With these estimates comes the potential for manipulation.

Once the amount of carbon emissions is determined based on the estimates described above, the third-party partner prices and facilitates the sale of the carbon offset to the customer. Regulators are likely to scrutinise if there might be potential risk of collusion between a company and third-party partners to manipulate these estimates so individual consumers pay a higher amount than necessary. The company and the third-party partner could potentially then split the excess money for their own corporate purposes.

Appropriate controls on estimates should be implemented by the company and its third-party partners to ensure estimates used for the carbon offset program are correct. Without controls in place to mitigate fraud, companies put themselves at risk for class-action lawsuits by consumers if a scheme is perpetrated.

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**Companies should consider developing a fraud and corruption risk assessment for going green and implement the appropriate level of green controls to mitigate fraud risk. With the necessary controls in place and proper monitoring of the effectiveness of such controls, green companies have the tools necessary to be eco-friendly without polluting their brand, and can effectively deter, detect and prevent fraud.**

1 <http://www.probeinternational.org/print/6632>

2 Packham, Ben - Herald Sun, "Frauds to hit clean air bid" - 10 June 2009

3 Packham, Ben - Herald Sun, "Climate laws add to police workload carbon cops' duties soar" - 12 June 2009

4 Packham, Ben - Herald Sun, "Frauds to hit clean air bid" - 10 June 2009

5 <http://www.probeinternational.org/print/6632>

6 Singh, Rachael - The Analysis, "HMRC fights back against carbon fraud" - 3 September 2009

7 Packham, Ben - Herald Sun, "Climate laws add to police workload carbon cops' duties soar" - 12 June 2009

8 Packham, Ben - Herald Sun, "Climate laws add to police workload carbon cops' duties soar" - 12 June 2009

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