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## Voluntary Carbon Market: Emerging Regulations Within The Eu And Portugal

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# VOLUNTARY CARBON MARKET EMERGING REGULATIONS WITHIN THE EU AND PORTUGAL



The growing necessity felt around the world to reduce greenhouse gas emissions, combined with the acknowledgment that climate neutrality cannot be achieved without the removal of emissions that cannot be avoided, has led to a growing interest in and development of Voluntary Carbon Markets (“**VCM**”). These, unlike the so-called Mandatory Carbon Markets, do not arise from a legal imposition linked to the activity being carried out by the operator, but rather from the will of the parties participating in the market.

The Intergovernmental Panel on Climate Change (“**IPCC**”) clearly states in its *Climate Change 2022: Mitigation of Climate Change Report* that “[C]arbon Dioxide Removal (CDR) is necessary to achieve net zero CO<sub>2</sub> and GHG emissions both globally and nationally, counterbalancing ‘hard-to-abate’ residual emissions”<sup>1</sup>. The IPCC validated findings suggesting that climate neutrality would not be possible only by reducing emissions into the atmosphere, but should be combined with carbon removals and the compensation of emissions that cannot be avoided or reduced, together with the need for a greater level of legal certainty, transparency and market attractiveness. These were the grounds for the drafting of legislation for VCM, at both the European and Portuguese levels. Fighting greenwashing cases, on the one hand, and profiting from the advantages of aligning the carbon price in the VCM with that of the regulated markets, namely of the European Trading System, are two relevant goals. This would allow to unlock financial resources for projects that otherwise would not be feasible, in line with the Paris Agreement objectives.

## I. Europe striving to be the first climate-neutral continent in the world

The European Union (“**EU**”) has been paving the way to become the first climate-neutral continent in the world. In view of such, both sectorial and cross-cutting policies and regulations have been approved and are being drafted to bring to life to this ambition.

The European Green Deal, a package of public policies and legislative initiatives put in motion in 2019 and aimed at establishing the grounds for the transformation of the EU as a “*fair and prosperous society, with a modern, resource-efficient and competitive economy*”, clearly established the goal of achieving climate neutrality by 2050, reinforcing the EU’s commitment to the implementation of the United Nation’s 2030 Agenda and the sustainable development goals (SDGs).

The adoption of the European Climate Law (ECL), in 2021, enacted into law the goal assumed by the EU on the Green Deal, making it legally binding for the EU to achieve (i) an intermediate target of reducing net greenhouse gas emissions (i.e., emissions after the deduction of removals) at least 55% by 2030 compared to 1990 levels, (ii) climate neutrality by 2050, through the balance between greenhouse gas emissions and removals, and (iii) the aim of negative emissions from 2050 onwards.

Consequently, in November 2022, the European Commission adopted a Proposal for a Regulation establishing a Union framework for the certification of carbon removals, aiming to establish the common quality criteria of the certification process, rules for independent verification, certification schemes, and a certification system. These would appear an indispensable step to closing the gap on reaching net zero GHG emissions, advancing EU Green Deal policies, and achieving the highly demanding EU climate objectives under the Paris Agreement.

#### **a. EU Proposal of Regulation: a framework for the certification of carbon removals**

The Proposal for a Regulation establishing a Union framework for the certification of carbon removals, presented in November 2022 by the European Commission ("**Proposal of Regulation**"), aims to ensure the deployment of high-quality carbon removals in the EU, and to establish an EU governance certification system to enhance transparency and prevent greenwashing through the application of EU criteria in a reliable and harmonised way across the Union.

Although consensus among the EU institutions is still in progress, and at the current stage it is not easy to foresee the Regulation's final shape, it is important to note that the Regulation includes within its scope three types of carbon removal activities: *(i)* carbon farming (practices and processes that result in carbon storage in agricultural land, soil, wood), *(ii)* permanent carbon storage (innovative practices or processes that allow the storage of atmospheric or biogenic carbon), and *(iii)* carbon storage in products (practices or processes that use new alternative products and materials for construction, enhancing long-term carbon storage).

In view of the need of carbon removal activity resulting in a net carbon removal benefit and delivering a positive climate impact, the Proposal of Regulation establishes Q.U.A.L.I.T.Y criteria that shall be complied with.

##### ***(i) Q.U.A.L.I.T.Y Criteria***

Bearing in mind that the main objectives of the Proposal of Regulation are the acceleration of the deployment of high-quality carbon removals, building trust with stakeholders and industry, ensuring transparency and a quantification methodology, and enabling a wide variety of financing options, Q.U.A.L.I.T.Y criteria, comprising four principles, were set as the cornerstone of this framework:

- **QU**antification: which determines that carbon removal activities shall be measured accurately and deliver unambiguous benefits for the climate;
- **AD**ditionality: requiring that carbon removal activities go beyond standard practices and beyond what is legally required;
- **LT**ong-term storage: determining a measurement and certification that clearly accounts for the duration of carbon storage and distinguishes permanent storage from temporary storage, through monitoring activities and mitigation of the risk of carbon being released into the atmosphere and the provision of liability mechanisms to address any release of carbon during the monitoring phase;
- **SUSTAINABILITY**: implying that carbon removal activities shall support sustainability objectives, having a natural impact or generating co-benefits for the sustainability objectives of climate change mitigation and adaptation, as well as the sustainable use and protection of water and marine resources, biodiversity, and the circular economy.

Notwithstanding the relevance of all these principles, it is worth taking a closer look at the additionality principle, as it is intrinsically related to the establishment of a baseline scenario and the development of methodologies.

The baseline determines a minimum level beyond which carbon removals are additional, i.e., that an activity is considered to have a positive climate benefit. Setting a baseline is far from a consensual debate, with the coexistence of different approaches that may vary what should be taken into consideration, notably, not only the standardised baseline but also the legal requirements to be complied with by a certain activity, as well as the market conditions in which the carbon removal activity takes place. Whenever a carbon removal activity is imposed upon operators by the applicable law or, on the contrary, takes place without any incentives, such will be reflected in the baseline. Accordingly, a carbon removal activity generating carbon removals and exceeding the baseline provided should be presumed to be additional.

The Proposal of Regulation determines that for a carbon removal activity to be considered additional, the following criteria shall be met: *(i)* going beyond Union and national statutory requirements, and *(ii)* taking place due to the incentive effect of the certification. In practical terms, these criteria being cumulative, a specific carbon removal activity may only be considered additional if it meets both regulatory and financial criteria.

#### ***(ii) Methodologies, certification schemes, monitoring and reporting***

The definition and development of detailed certification methodologies for the different carbon removal activities are one of the cornerstones of the Proposal of Regulation. This is the way to achieve standardised, verifiable, and comparable measures under the Q.U.A.L.I.T.Y criteria. Such methodologies aim to ensure a robust and transparent certification of the net carbon removal benefit, to overcome the mistrust generated in the market and to dampen the criticism usually made regarding lack of methodologies.

Accordingly, to promote the harmonised and correct implementation of these criteria, the European Commission, supported by an expert group, will develop tailored certification methodologies for the different types of carbon removal activities. Those certification methodologies shall include a minimum of elements (set out in the Annex to the Proposal of Regulation), among which: *(i)* description of the carbon removal activity covered, including its monitoring period, *(ii)* rules for the identification of all carbon removal sinks and GHG emission sources, *(iii)* rules for calculation of the carbon removals under the baseline and the total carbon removals, *(iv)* rules on the monitoring and mitigation of any risk of release of the stored carbon, and *(v)* rules on appropriate liability mechanisms. For such purpose, the European Commission is empowered to adopt delegated acts to establish the technical certification methodologies for activities related to permanent carbon storage, carbon farming and carbon storage in products, which shall consider, among other elements, the relevant Union and international certification methodologies and standards, as well as the relevant national legislation.

In addition, carbon removal claims made by operators shall be regularly monitored, reported, and independently verified by certification bodies, being subject to an initial certification audit before implementation, aimed at verifying compliance with the Q.U.A.L.I.T.Y criteria.

As for the certification schemes, it is important to underline that the Proposal of Regulation intends to

provide for an independent verification conducted by a third-party auditor, in line with the transparency principle. Only recognised certification schemes can be used by operators to demonstrate compliance with the Q.U.A.L.I.T.Y criteria and the relevant certification methodologies.

Such certification schemes shall be built upon a public registry that provides not only accessible information related to the certification process (including the certificates and their updated versions, as well as the quantity of carbon removal units certified), but also traceability of carbon removal certificates, thus establishing a basis of reliable and transparent rules and procedures that ensure protection against fraud of information and of data submitted by operators. The proposed Regulation also allows the European Commission to adopt implementing acts.

## **II. The Voluntary Carbon Market in Portugal: A step forward on the path to achieve climate neutrality**

Portugal has been reinforcing its national policies in recent years to achieve climate neutrality by 2050, in line with the EU policies in these fields and other cross-cutting agendas, such as the United Nations 2030 Agenda, in particular with respect to innovation, climate change, and the safeguarding of marine life.

More specifically, Portugal approved the Roadmap for Carbon Neutrality 2050 (RNC 2050) and the National Energy and Climate Plan 2030 (PNEC 2030), which together shape the strategies for promoting the decarbonisation of the economy and the energy transition based on a model of wealth generation and efficient use of resources. Both enshrine ambitious goals, however, the entry into force in 2022 of the Portuguese Climate Framework Law, approved by Decree-Law no. 98/2021, of 31 December, represented a greater step towards reinforcing Portugal's commitment to achieve carbon neutrality faster.

The Portuguese Climate Framework Law sets higher goals and ambitions, not only by establishing national mitigation objectives with reference to 2005, but also by establishing the obligation for the Government to study and evaluate the possibility of achieving climate neutrality by 2045.

Achievement of this objective by 2045 or, at latest, by 2050, requires not only key changes in the way resources are being used, and the fast decarbonisation of the electricity generation system and urban mobility, but also the increase of the country's carbon sequestration potential. In what regards the net CO<sub>2</sub> equivalent sink of the land use and forestry sector, the Portuguese Climate Framework Law established a target of at least 13 megatons on average for the years 2045 and 2050. It also assumed a commitment for the CO<sub>2</sub> equivalent sink of coastal and marine ecosystems (including salt marshes, seagrass meadows, reefs, and kelp forests), by determining targets estimated and adopted to anticipate the goal of climate neutrality.

Following the entry into force of the Portuguese Climate Framework Law, PNEC 2030 was updated to align its strategic objectives with the targets set for Portugal up to 2030, highlighting the potential contribution and relevance of a national VCM.

### **a. Portuguese Legal Framework on a Voluntary Carbon Market: Decree-Law no. 4/2024, of 5 January**

In line with the European efforts regarding the VCM, Portugal decided to move faster in the approval of rules to create a regulated market at the national level. Portuguese Decree-Law no. 4/2024, published on 5 January ("**Decree-Law 4/2024**"), sets the rules for the operation of a VCM, and was built upon the assumption that VCMs can play an important role in supporting GHG emissions mitigation efforts, strengthening the potential of nature-based solutions, and contributing to achieve other key ambitions and national public policies, notably the reduction of the territory's vulnerability to the risk of forest fires and the conservation of biodiversity and natural resources.

In view of these ambitions, the Portuguese legal framework provides for both emission offsetting actions and financial contributions to climate action, by individuals or by companies, enabling the development of actions under mitigation objectives and commitments or climate action strategy through the issuance, and subsequent transaction and cancellation, of certified carbon credits.

Accordingly, and going beyond that envisaged in the Proposal of Regulation, the VCM in Portugal comprises both GHG emissions reduction projects and carbon sequestration projects developed in the national territory, which are subject to a set of specific principles and criteria.

### ***(i) The key principles***

Although Decree-Law 4/2024 has a broader scope than the Proposal of Regulation, it is aligned with the key principles discussed at the EU level regarding VCMs, particularly with the *(i)* additionality, *(ii)* permanence, and *(iii)* monitoring, reporting, and verification ("**MRV**") principles.

Firstly, the principle of additionality, which assumes a decisive role in the approval of a proposed project, is intrinsically related to a baseline scenario and mirrors climate, legal and financial dimensions. In particular, the legal framework provides that additionality is only assured *(i)* when the reduction of GHG emissions or carbon sequestration associated with the project exceeds the baseline scenario and *(ii)* is based on activities that do not constitute legal impositions, or *(iii)* when the financial attractiveness of the project results from the certification of the activity in the scope of the VCM.

Secondly, the principle of permanence, which requires that carbon sequestration is maintained for a certain period of time, not less than the duration of the project, implies several obligations for the promoters of carbon sequestration projects, including the assessment of emission reversal risks and identification of proper mitigation measures, and the contracting of insurance or making of a contribution to a public Guarantee Fund (or both combined).

With a view to promoting the robustness and quality of the VCM in Portugal, Decree-Law 4/2024 sets forth transparency requirements, which directly imply a MRV system for the accounting of GHG reductions or carbon sequestration, as well as means of public access to information on the activities carried out to avoid double counting of carbon credits.

The MRV system is based on three pillars – monitoring, reporting, and verification –, the first and second under the responsibility of the promoter of the project and assessed by the Portuguese Environment Agency (*Agência Portuguesa do Ambiente, I.P.* – "**APA**") based on reports presented by the promoter, and the third under the responsibility of a duly qualified independent verifier, in accordance with the criteria set forth in an ordinance to be approved.

During the verification phase, carbon projects are subject to (i) an initial validation process, with the purpose of assessing compliance with the applicable carbon methodology, and (ii) a periodic verification process, which aims to confirm the effective reduction of GHG emissions or carbon sequestration by the project. As for the monitoring and reporting components, the promoter is required to have a monitoring plan to keep track of the project's activity, including the respective reduction or sequestration of GHG emissions, and is required to periodically submit its results and any substantial changes to the project for the purpose of assessing the project's maintenance in the VCM.

In line with the abovementioned market transparency concerns, under Decree-Law 4/2024 public information, including regarding project promoters, carbon credits and acquirers, shall be made available on the registration platform and APA shall publish an annual report on the evolution of the VCM.

**(ii) Project categories, methodologies, and carbon credits**

As referred, the Portuguese VCM includes GHG emissions reduction projects and carbon sequestration projects, which must comply with the aforementioned principles and the guidelines established for each project methodology. Therefore, registration of a project in the digital platform that supports the VCM ("**VCM Platform**") is intrinsically dependent on the prior approval and publication of the methodology applicable to such project.

The methodologies detailing the criteria and guidelines for the recognition of certain types of projects and the credits generated (for example, in case of forest carbon sequestration projects or blue carbon sequestration projects) shall provide for a set of requirements, including (i) assessment of the project's additionality, (ii) quantification of planned GHG emission savings or carbon sequestration, (iii) maximum and minimum project durations, (iv) guidelines for risk assessment, including the risk of reversal of emissions, and (v) requirements for MRV. These are some of the most relevant steps to ensure the measurability and transparency of a project.

Consequently, Decree-Law 4/2024 determined the constitution of a technical commission, coordinated by APA, which will be responsible for the development of the applicable methodologies. Decree-Law 4/2024 also provides for the possibility of private entities presenting methodologies that, following a specific procedure (which includes a public discussion phase), may lead to the approval of new methodologies by private initiative and their subsequent inclusion in the public list of methodologies.

It should be noted that Decree-Law 4/2024 distinguishes between two types of carbon credits in the context of verification, namely: (i) future carbon credits and (ii) verified carbon credits. GHG emission reductions and carbon sequestration achieved through projects under the VCM generate carbon credits, each of which correspond to one ton of CO<sub>2</sub>, their nature being determined by how the credits were generated.

In practical terms, whenever registering a project, the promoter shall indicate its intention to generate future carbon credits. These shall not, however, exceed the total amount of 20% of the total credits foreseen for the duration of the project, being calculated on an *ex-ante* basis (i.e., by estimate) by the promoter and confirmed during the verification phase prior to the registration of the project in the platform. The verified carbon credits are generated during the execution / implementation of the project, after the periodic verification carried out by the independent verifier.

Once validated, both types of carbon credits are registered on the **VCM Platform**. The flows of credits between market agents are also subject to registration on the VCM Platform to ensure transparency and the traceability of those credits. Carbon credits generated under the national VCM, once used, must be cancelled on the VCM Platform to avoid double counting and cannot be used to comply with European or international obligations, including under the Paris Agreement, nor for the purposes of the European Emissions Trading System (ETS) and the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA).

In addition to the nature of the credits based on their verification and the way in which they were generated, it is worth highlighting that Decree-Law 4/2024 provides for the possibility of a special category of carbon credits (*Carbon Credits+*), to be generated and registered in the VCM Platform in cases where, in addition to carbon sequestration, the carbon credits incorporate significant additional benefits for biodiversity and natural capital. These special credits can be identified on the VCM Platform as allowing the market to assign them a higher value compared to other carbon credits. As Decree-Law 4/2024 places special emphasis on promoting forest carbon sequestration projects, especially those that contribute to conserving natural capital and building a more adapted and resilient landscape, priority areas have been defined enabling the possibility of generating *Carbon Credits+*.

### ***(iii) Unintentional emissions reversal and security***

One of the topics of major concern and relevance is the possible vulnerability of nature-based solutions. In view of the exposure of nature-based solution projects to natural hazards, such as floods, droughts, fires, and other force majeure situations, and, in particular, the exposure of forest sequestration projects to fire risk, measures to ensure security have been developed and approved.

Decree-Law 4/2024 foresees the possibility of a promoter opting between (i) contracting an insurance policy, (ii) contributing to a public Guarantee Fund, or (iii) combining the previous two options to cover possible unintended reversals of emissions during the duration of the project.

Accordingly, in the event of an unintentional reversal of emissions from a project – for example, due to a forest fire –, carbon credits that have not yet been traded, in an amount equivalent to the reversal of the verified emission, must be cancelled on the VCM Platform, therefore determining a weighting between the verified emission reversal and the existing verified carbon credits. When the cancelled carbon credits are not sufficient to cover the amount of the verified reversal, the project promoter shall use one of the options identified above to compensate the carbon credits that have been transferred and are no longer existent.

### ***(iv) A penalty system for non-compliance with the VCM framework***

The MRV system is designed to assess the progress of projects generating carbon credits. Notwithstanding such, Decree-Law 4/2024 also foresees the possibility of imposing penalties on market agents in the event of non-compliance in the development of projects, including the provision of false information. These penalties may include (i) the suspension of the market agent's registration in the VCM Platform, (ii) the "*freezing*" of the carbon credits existing in the accounts held by the market agent, and their subsequent reversion to the Guarantee Fund, and (iii) inhibition from participation in the market for a period of five years.



Furthermore, as the permanence of projects constitutes one of the main concerns and priorities of the VCM and the Portuguese framework to ensure a robust and liable voluntary carbon market, intentional reversal of emissions is subject to an additional specific financial penalty.

#### **(v) Next steps**

Lastly, it is important to stress that the effective operation of the recently instituted Portuguese VCM is dependent on the approval of complementary regulation and administrative procedures.

As such, from a legislative standpoint, a specific framework shall be approved, establishing rules for (i) the qualification of independent verifiers, (ii) applicable fees for opening and maintaining an account, registering projects on the VCM Platform, carbon credit transactions, and approving methodologies proposed by market agents, (iii) insurance conditions and their minimum capitals, and (iv) VCM Platform requirements.

From an administrative standpoint, the development of the VCM Platform and constitution of the monitoring and methodologies for each type of project are expected to occur.

### **III. Final remarks**

The two examples of legislation presented, recently published (Portugal) or under preparation (EU), clearly illustrate the importance of the VCM in the achievement of climate goals and demonstrate a level of technical complexity that requires sophisticated legal expertise and the ability to dialogue with the specific sectors in which the relevant projects will be developed. On the demand side, both Portuguese and European legislation, namely the Nature Restoration Law, the Corporate Sustainability Reporting Directive, and the European Sustainability Reporting Standards, together with the upcoming EU Corporate Sustainability Due Diligence Directive, suggest a relevant potential from the demand side. Finally, the growing climate awareness of the public in general, particularly among the younger generations, supports an optimistic forecast for the regulated VCM.

#### Footnotes:

<sup>1</sup> IPCC Working Group III (2022), Technical Summary. In: Climate Change 2022: Mitigation of Climate Change. Sixth Assessment Report.

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