Voluntary Carbon Markets Global Dialogue

Background on the Global Dialogue on Voluntary Carbon Markets
Fulfilling the promise of the Paris Agreement will require the widespread adoption of more ambitious mitigation commitments and significantly scaled-up flows of finance, technology, and capacity to developing countries. Well-designed voluntary carbon markets can help to achieve both aims.

The **Global Dialogue on Voluntary Carbon Markets** helps to identify how voluntary carbon markets can drive mitigation activities that support national climate plans, local priorities with additional benefits for communities and businesses', unlock greater levels of private investment, and help motivate more corporates to reduce their emissions and to neutralize their remaining emissions. The findings of the Global Dialogue will be publicly released at COP26 in Glasgow in November 2021 and will be informed by position papers and stakeholder consultations over the coming months. The implementation team for the Global Dialogue is led by Climate Focus, the Indonesia Research Institute for Decarbonization (IRID), SouthSouthNorth (SSN), and Transforma, with assistance from an inclusive team of leading carbon market experts and analysts, and with the support of Verra.

This paper represents the views of the authors
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The corporate perspective

By Sandra Garavito and Pedro Moura Costa[1]

To ensure that the Voluntary Carbon Market (VCM) incentivizes emission reductions and removals in a way that is consistent with global mitigation ambition and national and local priorities, it is important to understand the motivations of – and constraints on – VCM buyers to maximize their engagement. This paper looks at the needs, concerns and requirements of corporate buyers acquiring VCM carbon credits. It makes specific recommendations for policymakers and other key market stakeholders to address private sector concerns and increase impactful engagement of the private sector.

The paper seeks to answer the following questions:

- How can the VCM stimulate engagement and finance provided by voluntary buyers that accelerates the climate transition?
- How can such projects/investments be structured to increase benefits to the host country, and align these actions with Nationally Determined Contributions (NDCs) and Sustainable Development Goals (SDGs)?

The paper is developed on the basis of a series of interviews with companies from a range of sectors, including oil & gas, IT, and energy generation as well as carbon credit brokers and retailers in Europe, the United States and Colombia.[2] The author team also conducted a case study on the role of the VCM in Colombia, one of the few developing countries with a vibrant domestic voluntary carbon market, which allowed us to compare the needs of international buyers with those of domestic buyers in Colombia.

[1] With additional support from Pedro Carvalho and Pablo Fernandez, ecosecurities.
[2] The views of additional buyers, including from Asia and Africa, will be sought in regional consultations in June/July 2021.

Main findings

Companies engage in the VCM to identify cost-effective solutions for reducing the corporate carbon footprint or to meet carbon neutrality or net zero goals. They typically look to purchase credits from larger-scale and/or 'charismatic' projects that generate high volumes of credits and provide social and environmental co-benefits and contribute to other SDGs. Robust environmental integrity of credits is another key requirement from corporates, as the cost of remediating reputational damage could be real and significant.

For host countries, it is important that VCM investments are aligned with their development objectives, but corporates are wary of government involvement and regulatory requirements that slow down projects and create additional costs.

To enhance the effectiveness of the VCM, corporate interests, host country requirements and project development capabilities need to be aligned. Ongoing public – private sector dialogues to define developing countries' 2050 climate ambition provide an opportunity to understand and balance the relative benefits of different mitigation options and tools.

Recommendations

- Governments can align investment preferences with government policies through a number of strategies. The example of Colombia shows how a government can combine compliance measures (such as a carbon tax) with a voluntary compensation scheme to incentivize private investment in mitigation projects. To be successful, such an approach requires regulatory clarity and certainty about the eligibility of credits, clear procedures, close coordination among implementing entities and outreach and training for participating entities to understand the mechanism.

- Proactive governments can also establish a dedicated agency that promotes VCM investments. A Voluntary Carbon Investment Promotion Agency (IPA) approach, adopted by host countries, could create a framework to attract VCM investment into a set of identified priority projects that support national (climate) policy objectives. Such a framework could provide scale, efficiency, clarity of rules – enabling enhanced corporate engagement with the VCM. To facilitate financial flows to climate mitigation projects, the IPA would help promote, implement and manage a set of activities which together make successful VCM investments possible. These activities would be specifically designed to circumvent or remove some of the barriers currently preventing private sector VCM investment so as to overcome the evident paucity of bankable projects.

- Corporates should have an interest to invest in projects that are aligned with host country priorities. Supporting governments with the establishment of an IPA, including through funding its operationalization, is in the interest of corporates as it will stimulate (cost-)efficiency and ensure alignment of investment with national climate and development ambitions.

Context

The recent increase in demand for VCM credits reflects a growing interest from corporates to engage in global mitigation efforts and to use market mechanisms to reduce mitigation costs. The spike in demand and transactions on the VCM market has raised concern about the potentially negative impact of a flurry of uncoordinated VCM activities. The absence of regulation or a compliance framework may lead to inconsistencies between country- level and corporate greenhouse gas (GHG) accounting systems. Other concerns include limited coordination between countries' NDCs and VCM trading activities, the lack of coordination and harmonization between different carbon standards, and a lack of safeguards to regulate the impact of the VCM on communities. Discussions about the quality and transparency of VCM transactions have resulted in a list of potential conditionalities on the VCM. Such conditionalities would require, for example, an alignment of projects with jurisdictional approaches and national priorities, the creation of co-benefits, and for some, corresponding adjustments.

It is key to find a balance that ensures the right level of integrity that makes participation in the VCM meaningful and attractive, while avoiding the creation of complex rules and procedures that make such participation excessively burdensome and costly. Voluntary corporate buyers engage with the VCM of their own volition – because they feel a social responsibility, or because their customers and/or investors ask them to act – but there is no law obliging them to do so. The prospect of having to navigate local bureaucracies and protracted host country approval processes, or the lack of flexibility created by rigid rules, may reduce the attractiveness and flexibility supporting of voluntary mitigation projects. In addition, investors always try to minimize risk and maximize certainty. Insecurity over rules or changing investment requirements creates a major obstacle to incentivizing finance flows into mitigation activities.

Beyond tapping into cost efficient mitigation, corporates also have a clear interest in financing project benefits 'beyond' carbon, such as sustainable development and community impacts, looking to maximize returns on their VCM investments. This has resulted in buyers demanding a large "bang for their buck" – topping up emission reductions with co-benefits, SDGs contributions, country approvals, 'integrity' safeguards, corresponding adjustments and scale – without necessarily translating the extra quality attributes into higher prices. Whereas such corporate demand for benefits beyond carbon can boost the positive impact of mitigation projects, inadequate financing can make VCM investments one-sided and exploitative of the host countries and/or projects.

A concerted effort from buyers and host countries is needed to incentivize investments that contribute to host countries' low-carbon development objectives and NDCs, and meet buyers' need for returns and recognition of their contribution. The greater the effort made, the higher the overall returns and satisfaction can be extracted from these projects.

The corporate perspective

The interviews conducted for this paper identified a number of motivations for corporate carbon buyers to engage in the VCM, and implications for their demand of VCM credits. A primary driver of engagement is the desire to find *cost-effective solutions* for reducing the corporate carbon footprint or to meet carbon neutrality or net zero goals. While not all buyers provide price indications, a subset of the companies interviewed suggested that ideally prices should be under USD 5/tCO_2. The ability of projects to create social and environmental co-benefits and contribute to other SDGs is seen as positive attribute of the VCM, as corporates may be looking to strengthen their brand reputation and look to enjoy publicity benefits. Interestingly, while interested in co-benefits, most buyers did not see

the necessity of having a project aligned with the host country's objectives and/or to contribute to the host country's NDCs.

These motivations, in turn, translate into a series of requirements of VCM buyers.

- Buyers prefer larger projects that can generate *high volumes* of credits. Considering the average size of a VCM project (the average project generates tens of thousands of tCO2e emission reductions per year) and the expectations of large corporates, funds or traders of contracting projects that generate millions of tCO2e emission reductions per year, *there is a disconnect between typical supply and the volumes demanded***.**
- To minimize reputational risk, a unanimous requirement of buyers is that of '*environmental integrity***'** of credits, as the cost of remediating reputational damage could be real and significant. This is exacerbated by NGO campaigns and negative press.[3] The understanding of what constitutes "environmental integrity", however, is highly varied.
- However, there was little interest in requiring corresponding adjustments, as participants prefer to keep their projects independent from official accounting and regulation, and some suggested that this could create additional regulatory delays.
- Buyers also favor *credible and effective certification standards.* They are worried about the intense criticism of carbon standards by some sections of civil society and the press but, at the same time, most of the interviewees do not believe that additional rules and requirements are the solution, and some complain about the complexity and costs associated with the validation process under existing standards.
- There is a preference for '*charismatic carbon'*, such as nature-based solutions (land use and forestry projects) which are perceived to deliver more co-benefits than the renewable energy and energy efficiency projects that were popular under the CDM.

When engaging with the VCM, there is a number of concerns shared between corporate buyers. A first concern relates to *the ability of host countries to coordinate the actions needed to host, facilitate, and/or approve VCM projects*. Buyers are concerned that local governments may introduce over-regulation to a sector that is currently independently (or externally) regulated. Another major concern is the potential for corruption associated with a government-regulated sector. While in theory many recognize the benefits that proper planning and coordination with the host country could bring (i.e., generation of co-benefits, alignment with NDCs, etc.), corporates are skeptical that such arrangements can be constructed and operated efficiently and transparently. As a result, many corporates prefer project-based approaches over jurisdictional models and nesting, as the latter jurisdictional approaches are very reliant on host country involvement.

Increasing buyer engagement by aligning with host country needs

There is a need to align corporate interests with host country requirements and project development capabilities. Corporate are interested in cost-efficient projects that generate emission reductions at scale and efficiently, with environmental integrity and creation of co-benefits. For host countries, it is important that VCM investments are aligned with their development objectives. Project developers, in turn, navigate this field trying to deliver these objectives within the framework of existing constraints.

Ideally, centrally planned or coordinated approaches (jurisdictional land use projects, sectoral energy or industrial projects) could address these needs, and these have been promoted by many as the way forward. In practice, however, there is concern that such approaches could result in additional red-

[3] See, for instance, The Guardian (2021) Carbon Offsets Used by Major Airlines Based On Flawed System, Warn Experts. Available at https://bit.ly/3wBUJCr; Bloomberg (2021) Startup That Rates Carbon Offsets Finds Almost Half Fall Short. Available at https://bit.ly/2QVRDtN; or Bloomberg Green (2021) A Top U.S. Seller of Carbon Offsets Starts Investigating Its Own Projects. Available at https://bloom.bg/3hXFmjC

tape and bureaucracy, slowing the pace of project development, creating restrictions to innovation, and increasing costs.

How governments can promote alignment

Many developing countries are implementing public – private sector dialogues to define their 2050 climate ambition, and to develop roadmaps for achieving their NDCs. This provides an opportunity to understand and balance the relative benefits of different mitigation options and tools. Regulatory and fiscal measures represent one of these options. As in the Colombian case study presented in this paper (see below), a combination of a compliance measures (such as the carbon tax) and a voluntary compensation scheme (carbon neutrality mechanism) could incentivize private investment in mitigation projects. Corporates may prefer the investment in VCM projects that yield attractive co-benefits and are highly visible, rather than comply with the measure, i.e. by making a tax payment.

If a government puts in place regulatory or fiscal measures that involve the voluntary use of carbon credits, the following elements are key to ensuring private sector participation:

1. Regulatory clarity and certainty about the eligibility of credits, implementation period of the regulation, eligibility of standards;
2. Clear procedures both for buyers and accreditation and validation entities;
3. Coordination among implementing government entities responsible for each procedure;
4. Outreach and training to understand the mechanism, in particular during the initial implementation phase.

In addition, or alternatively, host countries could establish Voluntary Carbon Investment Promotion Agencies (IPA) to help them attract private investment into the VCM and support national climate objectives. With this business-orientated approach, the host country government creates and operates an IPA to attract VCM investment into planned sectoral development priorities,[4] mobilizing and facilitating financial flows from the VCM to climate mitigation projects in the host country.[5] The IPA could capitalize on potential public sector financial support (e.g., DFIs, multilaterals) with the specific objective of leveraging higher levels of private sector finance. These IPAs would have the mandate to insert VCM investment into the needs of the host countries in a way that they contribute to their development goals and societal needs.

At an initial stage, an IPA would conduct a diagnosis of the development needs of the country or region in relation to VCM investment opportunities. In the case of the land use sector, a starting point would be a multistakeholder integrated land use mapping exercise identifying areas for production, protection and community use,[6,7] as well as other national and regional priorities and needs. In the case of the energy sector, it would quantify electricity demand, map existing energy sources, identify future expansion and development needs, etc. Undoubtedly, the complexity of initial diagnostic and planning exercises would depend on the circumstances of each country or region, but it is an essential component of a coordinated development and investment approach.

[4] For a longer discussion, description and analysis of the merits of an IPA model, see Moura Costa et al., 1999: Financial mechanisms for Sustainable Forestry. UNDP Profor. https://oxfordclimatepolicy.org/sites/default/files/undpproforfinmechsfsustforest9904-costa.pdf.

[5] An example of this model was the World Bank's assistance to Nicaragua in the wake of Hurricane Mitch "to create and operate a Sustainable Forestry Investment Promotion Office for the development of certification of sustainable forestry practices and for the promotion of investment in sustainable forestry and reforestation" in the context of a broader sectoral initiative aimed at building management capacity and reducing market barriers. See: World Bank (1998) Project Appraisal Document on a Proposed Credit in the Amount of SDR 6.4 Million to the Republic of Nicaragua for a Sustainable Forestry Investment Promotion Project. Report No. 18653-NI.

[6] An interesting recent example of this approach is the initiative of the Edo State government in Nigeria, that conducted a thorough land use planning exercise prior to engaging private sector operators for forestry and agricultural development (Personal communication, Abraham Baffoe, Proforest).

[7] See, for instance, Bass, S., Moura Costa, P., et al. (2000) Rural livelihoods and carbon management. DFID Forestry Research Programme project R7374. IIED

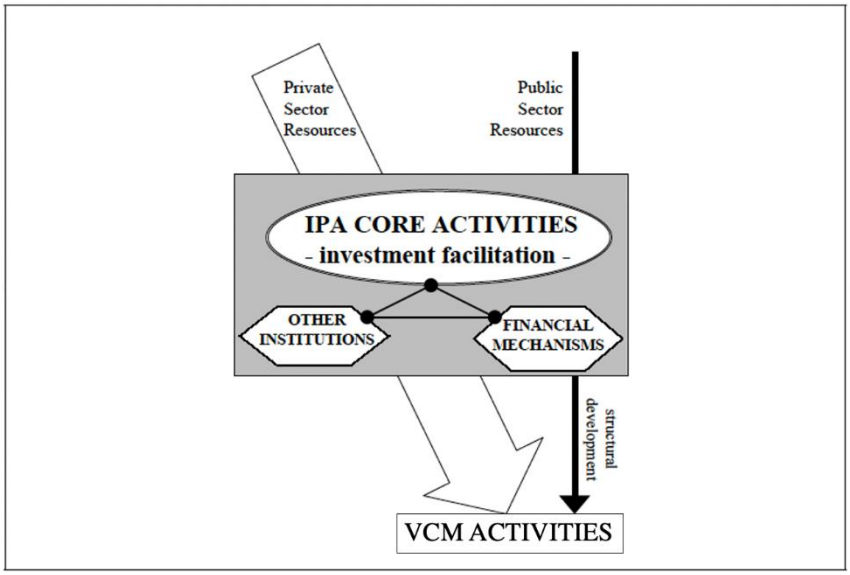

Figure 1. Schematic overview of an IPA setup

Based on this initial diagnostic, the IPA could create the framework necessary to attract investment to the set of identified priority projects, including:

- Mapping the location of different types of project interventions needed;
- Defining emissions baselines for the region and in relation to national level baselines;
- Calculation of emissions factors (in the case of energy and industrial projects when required);
- HCV and biodiversity assessments (in the case of land use projects), if appropriate;
- Stakeholder consultation and ensuring free prior and informed consent for the projects selected;
- Identification of potential local partners, co-investors and service providers;
- Connectivity with the local financial system, to ensure streamlined flow of finance to and out of the country;
- Providing clarity on the VCM standard to be used;
- Providing clarity on the treatment of VCUs to be generated, including whether they will be subject to royalties of share of proceeds;
- Providing clarity of the integration of the projects with the host country's NDC and whether the country proposes to conduct corresponding adjustments;
- Providing clarity on the legal treatment of these investments, as well as the applicable tax regime;
- Pre-approval of these projects, providing comfort to investors.

With the framework, an IPA could prepare informational materials and conduct activities to attract investors, for example in the form of roadshows, investment fairs, calls for proposals, or tenders. These activities could be part of broader NDC investment promotion activities, especially where carbon finance is part of a package of funding from different sources.

The IPA approach enables host countries to plan an integrate investments in relation to their social, economic and environmental development needs, as well as with their NDC strategies. Other policy objectives could also be considered, such as supporting certain industrial or business sectors, integration with agricultural supply chains, job creation, etc.

While there are initial costs in setting up an IPA and conducting the preparatory work, the IPA could also attract public sector resources to leverage much larger amounts of private sector capital for financing climate-related investments through the VCM. Transaction costs could also be recovered through fees or royalties charged to investors.

How corporates could reduce risk and support alignment

Aligning VCM activity with host country priorities, through an IPA, may create additional bureaucracy and 'red-tape' that private buyers want to avoid. At the same time, corporates have indicated their interest in supporting meaningful VCM projects, and their concern for reputational damage when supporting weak or harmful projects. Corporates should seek an active dialogue with host country governments on how to be able to invest in meaningful projects and activities.

Supporting the establishment of an IPA by host country governments, including through funding its operationalization, is in the interest of corporates. First, an IPA can boost cost-effectiveness. It is a body that regulates, steers and facilitates VCM engagement at scale, and can thereby significantly reduce transaction costs for individual projects and increase efficiency of processes.[8] The operationalization of an IPA could also lead to cost savings in project development, by standardizing and providing clarity on project development requirements form the host country. Second, the IPA will help lower reputational risk, as investments will be directed to projects that are identified and selected by host countries, generating co-benefits prioritized by stakeholders. The IPA will ensure the integration and alignment of corporate investment with national objectives.

Finally, corporates need to pay realistic prices. Developing, operating and maintaining quality VCM projects that incentivize emission reductions generate meaningful co-benefits, at scale and with minimal risk, comes at a cost. Corporates need to be willing to make the necessary investment that keeps these projects operational, and justifies their offset-, climate or carbon neutrality claims.

[8] See Moura Costa, Fretz and Kohn 2001: Assessing the feasibility and operationalization of an Investment Promotion Entity for sustainable forest management. Lead paper on the Government-led initiative to support the UN Forum on Forests International Workshop, Oslo 2001. Published by CIFOR and UNDP.

Case Study: Colombia

Motivations and requirements of buyers in the Colombian market

Understanding the interaction between compliance obligations and voluntary carbon markets is now more relevant than ever for countries planning and implementing their NDCs. The vision of the private sector is key in providing inputs to address concerns, formulate recommendations and complement discussions already taking place in international technical and political fora. The Colombian case provides an example of how a mandatory policy (carbon tax with liable entities) and a voluntary decision to use carbon credits to compensate for such obligation can complement each other.[9]

There was limited interest from the Colombian private sector to invest in carbon credits prior to the implementation of the carbon tax and the carbon neutrality option. Volumes were low, usually linked to large corporations' image or commitments of internationally-owned companies. Some companies became project developers or credit buyers as they identified an opportunity to sell carbon credits through different international schemes.

However, the adoption of Colombia's tax compliance regulation and the voluntary carbon neutrality option created a new situation for both buyers and carbon project developers. Credits from VCM projects, as well as credits from CDM projects that could not find a buyer in the final years of the Kyoto Protocol compliance period, became eligible for the carbon tax flexible mechanism. Private sector demand for these credits increased under the assumption this was going to be a long-term regulation adopted within a countrywide tax reform (see box 1).

As a result of this engagement, the view of Colombian corporates on the VCM has changed a lot in the last ten years. Today, corporates perceive a risk of climate regulation, and carbon markets have become interesting instruments to meet voluntary or compliance commitments. The carbon tax will in the future be complemented by an emissions trading system. It is therefore relevant for companies to better understand the features of the various carbon market mechanisms. Some companies indicate that under voluntary or mandatory commitments, they would implement mitigation measures within their productive processes but would require additional mechanisms to meet their future regulatory requirements or increase their ambition. The relevant strategy depends on the sector where the company operates, the scope it wants to address and the perceived risk of compliance regulations.

Project developers promote the use of voluntary carbon credits to corporates as a way to improve the corporate image. Corporates are also driven by consumer preferences for more sustainable and carbon neutral products, however, this is a nascent trend in the Colombian context.

Box 1. Carbon tax and carbon neutrality mechanism in Colombia

In 2016, Colombia adopted its first carbon pricing mechanism, a carbon tax on fossil fuels. The tax applies to liquid fossil fuels, natural gas for some selected activities and exempts coal from the obligation. Producers and importers of such fuels are considered liable entities and passthrough is direct to different industry users. Oil and gas corporates, airlines and some other industries were therefore indirectly reached by the measure. The carbon tax is currently at a level of approximately $5 USD/tonCO2.

[9] It is important to note that the Government has some level of decision making about the rules of quality of such carbon credits including the valid credits to use and the standards allowed in the system. Modifications in such rules have happened in the 3 years of operation with different results and responses from the private sector and project developers.

In 2017, the Colombian government also adopted a regulation that allows tax liable entities to voluntarily use carbon credits to compensate for their carbon tax obligations. This has created a positive environment for carbon credits transactions and increased demand among the private sector.

In the past four years, the private sector has engaged in a dynamic market mechanism opportunity through carbon offsets. The Government of Colombia has defined eligibility criteria for credits, as well as rules for validators and for the reporting of credits used for carbon tax compliance. Regulation has evolved in the past years to attend both NDC priorities (in particular related to MRV) and the functioning of this flexible mechanism.

Carbon credit selection criteria

Abatement costs are driving corporates to choose carbon credits over the tax payment. However, one of the companies interviewed mentioned that when faced the decision, despite a very small cost difference between the tax and the credit, they chose the credit because it benefited communities and had higher visibility than a tax payment.

In a country like Colombia, where most of emissions come from land use sector, it makes sense for corporates to source land use carbon credits. The private sector prefers solutions for climate mitigation that are appropriate to local conditions and priorities, and they indicated that in the Colombian case, efforts should be directed to the land use sector and forestry. However, it was also mentioned that the complex and expensive monitoring methodologies, the complexity of managing and implementing nesting and jurisdictional approaches, as well as national REDD+ policies guided by international cooperation requirements, are barriers in increasing investment in such credits because of uncertainty about changing national MRV provisions.

Corporates look for quality credits (with high integrity), benefits to communities and, in the Colombian case, contribution to the implementation of the peace process. Even with all these elements in place, one key and relevant factor to increase the volumes of their investment was certainty that the credits would be eligible for the carbon neutral option of Colombian carbon tax legislation.

What do Colombian VCM buyers expect?

Clear information. Corporates adapted fairly quickly to the carbon tax regulation and the carbon neutrality voluntary option. Although they indicated that initially regulation was not as clear as they expected and quite new for many of them, both the outreach process of the government and the advisory services of project developers, was useful in understanding the mechanism, the eligible standards and in general the benefits of using the carbon neutrality option.

Processes certainty and eligibility of credits. Corporates have faced low availability of credits due to bottlenecks in the validation process and validators eligibility. Uncertainty about the potential future eligibility of some standards, partly due to a delay and unclear responsibilities in the regulation for validators process approval and the deadlines the regulation imposed for the eligibility of certain standards, further hampered their engagement.

Quality. Corporate credibility is at the forefront in the investment decision process, and corporates prefer acquiring credits from recognized standards accredited through local accreditation bodies.

Key findings from the Colombian case study:

- There is general acceptance of innovative mechanisms such as the carbon neutrality option in Colombia to engage the private sector in increasing their mitigation actions even beyond compliance. One company with presence in several countries in Latin America is planning to offer carbon neutral products to their clients with the option to expand the ambition of their clients in becoming carbon neutral through the use of carbon credits.
- Clear and realistic regulation related to eligibility of credits according to the capacity of the country is important. If a mechanism is to be in place, it has to respond to local realities and capabilities of the government to manage each piece of the regulation. Creating too complex processes that overwhelm the government creates investment risks that is detrimental to the active participation of the private sector in such carbon market mechanisms.
- Reputational risk is an important consideration in company decision making. It is therefore important for companies to assess quality of credits in order to make investment decisions. Internationally recognized standards are relevant for companies with operations beyond Colombia and operations in international markets.
- Corporates in the Colombian context consider it to be very relevant to be able to invest in credits that benefit local communities and national development goals. The ability to integrate emission reductions and other benefits for communities where they have presence was highlighted as a key driver in investing.