Project Developer Engagement with the VCM

BY SVEN KOLMETZ, PAUL BUTARBUTAR, AND CHRISTIAAN VROLIJK

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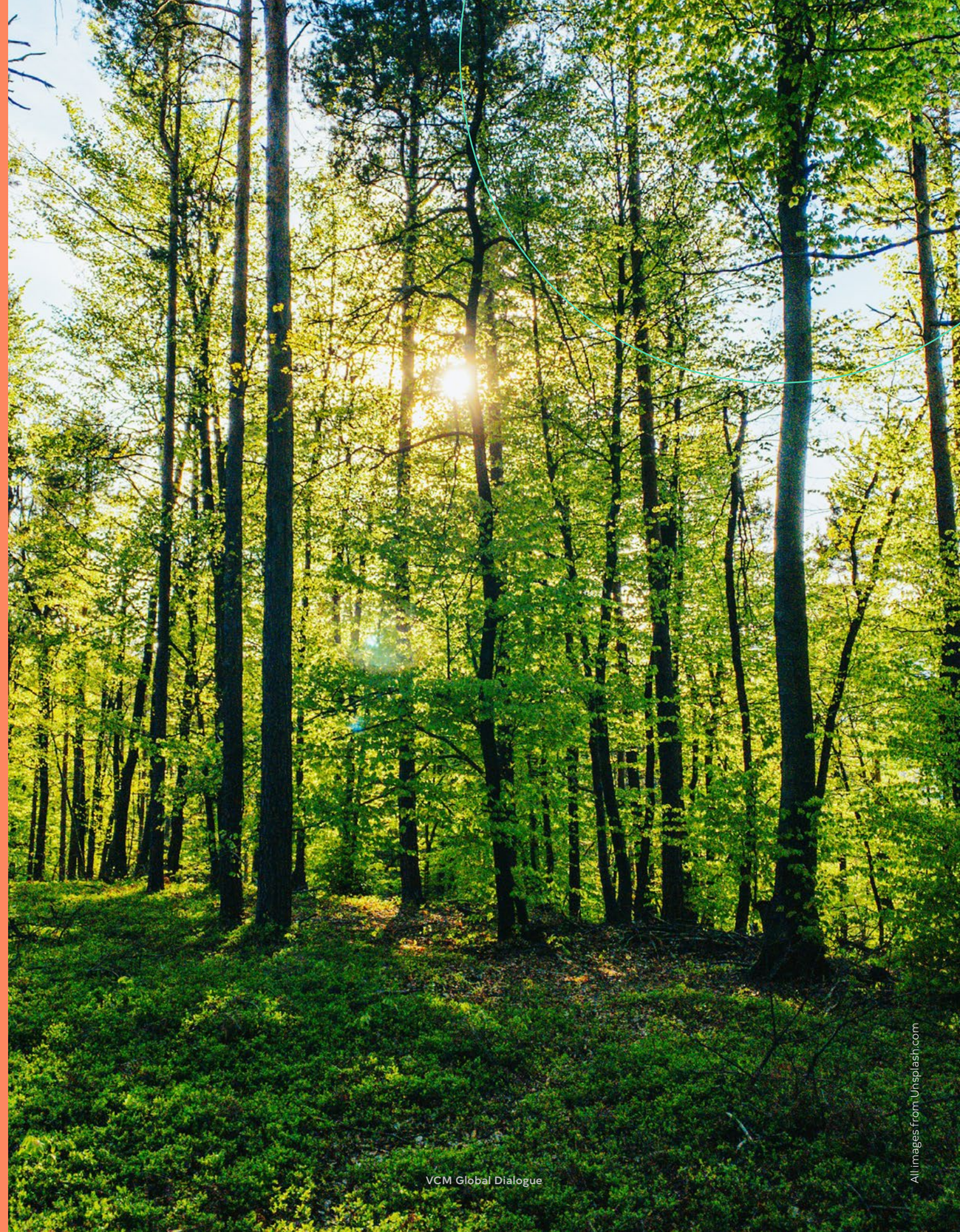
VCM Global Dialogue

About the Voluntary Carbon Markets Global Dialogue

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 Voluntary Carbon Markets Global Dialogue 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 Global Dialogue team 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.



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By Sven Kolmetz, Paul Butarbutar, and Christiaan Vrolijk

The Voluntary Carbon Market (VCM) has, since its inception, incentivized emission reductions and removals [1] and achieved a wide range of co-benefits in countries and communities hosting projects. Project developers are essential players in the VCM: they initiate projects, bring partners together, mobilize finance, reduce greenhouse gas (GHG) emissions or enhance carbon removals, and bear the financial risk of the project. They are international, national or local entrepreneurs that, often in cooperation with non-governmental organizations (NGOs) or local communities, react to the incentive provided by markets and identify GHG mitigation and carbon project opportunities.

Despite a thriving VCM market and increasing demand for voluntary carbon credits, project developers are faced with challenges that may hold back or complicate their engagement. These challenges mostly arise from the new context in which the VCM now operates, in particular the regulatory uncertainties on how the VCM relates to Nationally Determined Contributions (NDCs) and Article 6 of the Paris Agreement. The paper seeks to answer the following questions:

- What do project developers need to make investments flow into emission reduction or removal projects, and scale action?
- How can the VCM continue to be relevant in the context of the Paris Agreement, support NDCs and complement compliance markets?

This paper was developed in two phases. The first phase consisted of a series of interviews with project developers from Asia and the Pacific, Africa and Latin America and the Caribbean. In the second phase, a number of virtual regional stakeholder consultations were held in these same regions to discuss the findings with a wider audience and enhance and enrich the recommendations.

[1] When not indicated otherwise, "emission reductions" refers to both GHG reductions in emissions and the removal of GHG from the atmosphere.

Main findings

Since its inception, the VCM has brought significant value to communities hosting voluntary carbon projects, principally in developing countries. Benefits go beyond emission reductions or removals and include multiple benefits for communities and contributions to Sustainable Development Goals (SDGs). The VCM also empowers local actors to actively engage in climate mitigation. In doing so, the VCM complements compliance markets, and various GHG crediting programs encourage projects that are tailored to local circumstances. Over the last two years, company climate commitments have resulted in a significant increase of demand for voluntary carbon credits, resulting in more activity in the market.

Despite its potential to contribute to global environmental and social goals, the VCM is not a long-term solution to climate change.

Instead, it should be seen as a catalyst of the transition to a low carbon future by facilitating action without further delay or government action. It can mobilize emission reductions today, while public policies are designed and developed. VCM methodologies and business models can also inspire and inform government action.

The landscape for project development has become more complex with the lack of clarity on how the VCM relates to the Paris Agreement and the appearance of new GHG crediting programs, government regulations and buyer requirements. While there is demand for new projects, project development remains a risky business.

Recommendations

- The VCM should remain unbureaucratic and flexible regarding new technologies and methods to address those hard-to-reach areas that can still contribute to mitigation and adaptation.
- Project developers need as much certainty as possible about the rules that apply to the VCM. Further growth in the voluntary market would benefit from regulatory certainty around Article 6 of the Paris Agreement and guidance on how VCM transactions relate to NDCs.
- From the perspective of project developers, a stand-alone project should always be judged on its own merits rather than the quality of accounting between two countries (NDC accounting and Corresponding Adjustments), or the wording used by the corporates financing the reductions (corporate claims). This also applies with respect to the additionality of VCM-relevant technologies.
- The separate verification of SDG benefits could allow project developers to tap into additional income streams and support multi-benefit projects. Automation and new technologies could reduce costs and allow the monitoring and trading of multiple project benefits.
- Governments know little about the VCM and remain skeptical about its contribution to policy objectives. GHG crediting programs like Verra or Gold Standard could engage governments and offer training that could help to increase mutual understanding and build confidence in the GHG integrity of VCMs. In low-income countries and in relation to community projects, targeted support and the active participation of governments would be particularly beneficial.

The role of the voluntary carbon market in driving climate action

The VCM has developed and will continue to develop rapidly to deliver GHG mitigation around the world. It relies on voluntary action paired with entrepreneurial spirit as it develops in the absence of – and in a way that is complementary to – public climate policy and regulation. It has delivered benefits to buyers, developers, and local communities alike as it has opened new sectors for mitigation action, piloted new technologies, tested GHG-quantification methodologies, and delivered sustainable development benefits in host countries. [2] A study from Imperial College and the International Carbon Reduction & Offset Alliance (ICROA) estimates that each ton of emission reduction from a voluntary project creates additional co-benefits of USD 664, two orders of magnitude greater than the average carbon price. [3,4]

The type of additional benefits generated by voluntary carbon projects depend on the project type, but include local employment in the projects themselves, the use of local products and services when implementing and operating projects, provision of services or products for the local economy, conservation of domestic ecosystems, and more. Other project outcomes include technology transfer and capacity building using new technologies, and empowerment of local communities.

Projects must in the first place be financially attractive for project developers, but then create benefits for all stakeholders involved. Project developers invest in and run their projects commercially, using international carbon finance to make this possible. Most purchasers of carbon credits are interested in acquiring emission reductions that are cheaper than reducing their own operational GHG emissions. Local and national stakeholders, including directly affected communities, can and should benefit from direct payments in the context of benefit-sharing arrangements as well as sustainable development co-benefits created by the projects, which are often not directly monetized or even quantified. For governments, voluntary markets provide a lens into different mitigation technologies and their associated costs. This is valuable as governments have to balance many complex and interconnected issues related to economic growth, sustainable development and climate change, including impacts, adaptation and mitigation, and meeting their NDC targets. VCM projects help countries meet their sustainable development goals, and many voluntary project methodologies have been adopted by governments when designing their mitigation pathways. The VCM may also provide a source of finance for countries' NDCs, and the extensive knowledge and expertise of project developers can be an important asset to gain knowledge for NDC achievement. Figure 1 outlines the multiple benefits the VCM can provide to these diverse market participants.

[2] E.g. from Kountouris, Y. and Tan Loh, E.F. (2016) *Valuation of voluntary offset projects co-benefits using the benefit transfer method.* Imperial College London.
[3] ICROA and Imperial College London (2014) *Unlocking the Hidden Value of Carbon Offsetting.* Available at https://bit.ly/3fUa0YM
[4] The CDM Executive Board also reported on the very significant CDM benefits. See, for example, UNFCCC (2018) Achievements of the Clean Development Mechanism. Harnessing Incentive for Climate Action. Available at https://bit.ly/2RXpxPs

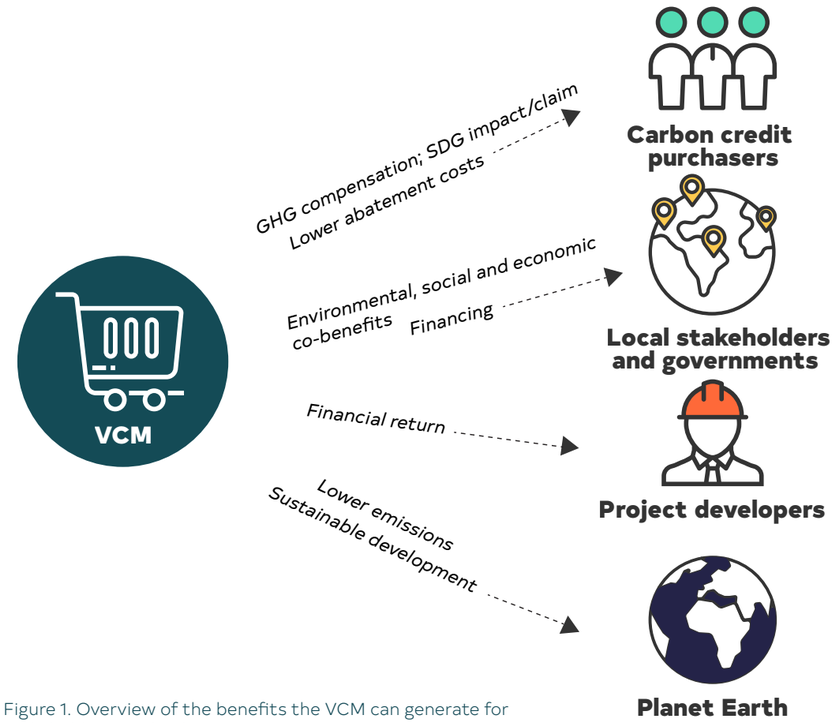

Figure 1. Overview of the benefits the VCM can generate for stakeholders involved

The VCM has typically complemented the Kyoto Protocol and other regulated carbon markets, with VCM project developers often filling the gaps left by the compliance market.[5] The distribution of clean and efficient cookstoves, energy projects in least developed countries, conservation of natural landscapes, sustainable land-use and blue carbon projects are just some examples of project categories that have received investment through the VCM. It includes a more diverse mix of project types than were initially developed under the CDM, with a strong presence of land use projects, household device projects, and renewable energy.

[5] These include, for example, mitigation projects in Turkey that were not approved under the UNFCCC due to the country's special status. Today there are many CDM projects that have started selling into the VCM.

Reputational and integrity challenges

Despite the many benefits that voluntary and compliance carbon markets have realized over more than two decades, there has been a continuing stream of criticism of voluntary corporate action in general and the VCM in particular. These criticisms tend to fall into the following categories:

- At a policy and broader mitigation level, that the VCM takes the pressure off governments to implement more ambitious climate policies as they lay back and rely on private sector will to move forward;
- At the level of corporates, that the use of offsets generated in the VCM allows companies to make claims about their carbon neutrality without taking sufficient actions to reduce their own GHG footprints;
- At the project level, that credits are issued to activities that would have taken place anyway, that more credits are issued than are justified, that emissions are simply displaced to other areas and host communities do not share in project benefits.

Despite some VCM challenges, evidence overwhelmingly points to the significant net benefits that the VCM has brought over the years. This is not to say that these criticisms should be dismissed out of hand but, rather, that they should not lead to the abolition of this powerful instrument. Instead, project developers, GHG crediting programs, validation and verification bodies, and other stakeholders should continue to work to address the legitimate concerns as a way of building trust and so supporting the continued growth of the VCM and the GHG mitigation it delivers. It is always possible to do more and better but doing nothing is not a preferrable option.

Barriers for project developers to scale action

Unmitigated risk is the biggest hurdle for any investor. Project developers deal with a range of risks in the context of the VCM, from host country and technology risks to the fundamental complexities of the carbon markets and all its rules, exacerbated by the constant policy changes that take place.

In the context of the Paris Agreement, countries have communicated their national emission reduction targets to the UNFCCC. This creates a new international context for GHG accounting in which all countries – including developing countries – are required to track implementation progress and report on achieving their mitigation contributions. Countries hosting voluntary carbon projects may therefore be reluctant to allow the emission reductions achieved to be transferred out of their country. A national emission reduction target may affect the voluntary markets, but there is no consensus on the interactions between NDCs, baselines, and additionality, nor on the rules for trading under the Paris Agreement and the potential impact of this on voluntary trades. The ongoing uncertainty created by the transition from the Kyoto Protocol to the Paris Agreement, and the (as yet incomplete) Paris Rulebook on Article 6 creates major uncertainties for project developers. There are a wide range of proposals on the role of governments, eligibility or exclusion of project technologies, possible transition of the CDM to Article 6, the interactions of VCM projects with NDCs, and the complexities of parallel compliance and voluntary markets.

This uncertainty is holding back the much-needed development of new mitigation activities. It introduces a prohibitively high level of risk for project developers to invest in new activities.[6] Moreover, some countries, such as India, Brazil and Pakistan, are waiting for the finalization of the Paris Rulebook before further developing NDCs or long-term emission reduction strategies, both of which can influence the eligibility of carbon market activities under the according standards.

[6] Land use projects may be an exception to this general market trend.

In the absence of certainty as to whether a project is covered by an NDC or not, the additionality testing and accounting is simply not possible – at least there is no guarantee, which is needed before making an investment decision.

Another source of uncertainty is whether standards and buyers – or their regulators – will demand Corresponding Adjustments (CA) i.e. an adjustment of the host country's GHG accounting to reflect the transfer of emission reductions). Generally, project developers tend to consider the idea of Corresponding Adjustments in the VCM as unnecessary as long as the emission reductions are not accounted for in two national accounts simultaneously. For example, it should not make a difference if an investor builds a solar PV plant on his own roof (where he and the investor country double claim) or if the same investor builds the solar PV plant onto a school building in another country (where he and the host country double claim). CAs are a theoretical construct that needs up to another decade to be fully implemented; nevertheless, some buyers are already demanding CAs without necessarily understanding the implications of doing so.

However, one risk that has decreased over the last few years is the concern over lack of demand. Many corporates (both local and multinational) are now being pressured by their shareholders, clients and other groups to reduce their corporate carbon footprints alongside other climate-related commitments, such as disclosing their emissions and mitigation strategies and increasing their renewable energy use and energy productivity.[7] The result is hundreds of companies signing up to initiatives such as RE100, [8] CDP, [9] Science Based Targets initiative (SBTi) and other carbon neutrality and net zero commitments. To meet the growing demand, project developers are devising new ways of achieving mitigation. This is already evident in the slew of new methodologies that have recently been submitted under various GHG crediting programs. It remains to be seen how this development will relate to the barriers experienced by project developers described above.

Solving the issue of additionality

An emission reduction or removal project needs to be additional to be eligible for crediting under all voluntary carbon standards. Depending on the project type and carbon standard applied, this additionality typically has both an economic and regulatory component, with the latter demanding demonstration that the project or associated mitigation activity is not already a legal requirement. However, many NDCs contain vague or aspirational targets that are not backed up by policies that are ready to be implemented or enforced when they are implemented. Therefore, it is often unclear if a project meets the regulatory additionality test, even if it depends on carbon finance for its realization.

Some NDCs propose domestic carbon pricing initiatives which would have significant positive impacts on the potential for project development. However, most NDCs are good at describing a target but not how the target will be achieved. For example, the South African NDC defines an GHG target and trajectory, but does not describe clearly how the country will achieve this target. It is not clear, for example, which sectors are to contribute to the GHG target and which activities are conditional on external finance, making it difficult to define project additionality with reference to South Africa's NDC. It is therefore essential that – unless an aspirational NDC target is backed by clear policies with a timetable for implementation and an indication of where VCM projects are needed – realities on the ground continue to be the reference point for the demonstration of additionality. It must be assessed on a case-by-case basis, using the tools the voluntary and compliance markets have developed over the last two decades.

[7] Investors in corporates for example have received a letter from Larry Fink, the CEO of BlackRock, one of the biggest investment firms globally, to consider climate change in their business decisions.
[8] RE100 is a global corporate renewable energy initiative that aims to accelerate change towards zero carbon grids at scale. See https://www.there100.org/
[9] CDP is a charity that runs a global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts. See https://www.cdp.net/en

This also applies to GHG certifying standards and crediting programs which should carefully consider the negative impact of sweeping rules. For example, the ban on larger renewable energy projects in countries that are not Least Developed Countries (LDCs) has created disincentives for the development of projects that would still have passed individual additionality tests (see Box 1). The decrease in generation costs of renewable energy plants can be considered without a blanket ban on most renewable energy projects. Project specific additionality tests would have been sufficient to exclude non-additional renewable energy projects. Alternatively, the concept of "special underdeveloped zones" – as exists in the CDM – taking into consideration that bigger countries are often not heterogeneously developed, could have provided a more targeted solution than a ban of most renewable energy project opportunities from the VCM. See Box 1 on the impact of banning renewable energy projects on the VCM on grid-connected renewable energy projects.

Box 1.

Barriers to scaling renewable energy created by carbon standards

South Africa provides an example of how well-intended rules have eliminated many important VCM investments. In South Africa there is a clear imperative to decarbonize the energy sector. Unfortunately, the main GHG crediting programs no longer allow the registration of largescale renewable energy (RE) projects in grid-connected areas in non-LDCs as they are deemed to be economically feasible without carbon finance. But this is only half true. While central RE plants feeding into the national grid may be very competitive and island RE-plants are still allowed by the GHG crediting programs, decentralized micro grids are still struggling as there is no central grid that serves as a storage facility to deal with oversupply at certain times. Additional investments into storage or demand side management are needed that often overstretch the financial capacity of local communities.

This issue affects not only South Africa but all countries in which there is no nationwide grid. Indonesia has a similar national target for its sectoral energy mix but there are other barriers as large plants benefit from tax breaks while renewable energy projects are often below the stipulated size threshold and need to compete with subsidized power prices.

Supporting tradable SDG benefits

VCM projects also have the opportunity to claim positive contributions towards SDGs. The Gold Standard has adopted a very systematic approach towards reporting and verifying SDG impacts. With SD VISta, Verra developed a dedicated standard to certify SDG contributions. Today, almost every buyer with ambitious corporate social responsibility policies demands that the projects they acquire credits from also yield SDG benefits, and an increasing number of buyers put a meaningful premium on carbon credits with verified SDG impact.

Currently, for all but a handful carbon projects, the only tradable "commodity" is the carbon credit, and any benefit is considered a premium to the carbon. However, if project developers consider commoditizing other SDG impacts they may be able to access alternative income streams. Others argue that stripping out the co-benefits would reduce the intrinsic value of the underlying carbon credit. For example, a water utility may prefer projects that can deliver co-benefits regarding water usage. It may not be enough for this company just to quantify the benefits, but it may also be important to translate such benefits into a quantifiable credit attribute. There are already some attempts in this area, such as SD VISta or the Gold Standard for Global Goals. To further strengthen these efforts, we suggest to define parameters and necessary data that are needed to quantify the achieved co-benefits, so these can be monitored and verified in parallel during GHG verification but reported separately.

Some developers and GHG crediting programs are exploring the use of blockchain to facilitate the monitoring, reporting and verification of multiple project benefits. Host countries could create an enabling environment for this process by collecting and making available the data underlying their sustainable development goals, which projects would be able to support through the VCM. For example, small household-level projects such as cookstove projects rely on the availability of data about the current use of cooking technologies to be able to show the change in practice triggered by the project. Acquiring baseline and performance data needs significant statistical work on the ground. If relevant data were made available or data collection supported by governments project monitoring and verification would be greatly simplified. This is but one example of how governments and project developers can work together to support projects with necessary infrastructure. Such support would be especially beneficial to decentralized community and household-level projects that are often complex and expensive to implement and manage.

The VCM should remain nimble and independent of heavy regulation

To continue leveraging the significant contribution of the VCM, it is important to see it as complementary to regulatory action (see Figure 2). The VCM allows more engaged businesses to contribute to mitigating climate change. With increasing actions and set regulations under the Paris Agreement, there may be more overlap between different carbon markets in future, but voluntary and mandatory should remain separate and synergistic – accessing different mitigation opportunities and enabling different actors to contribute to climate mitigation.

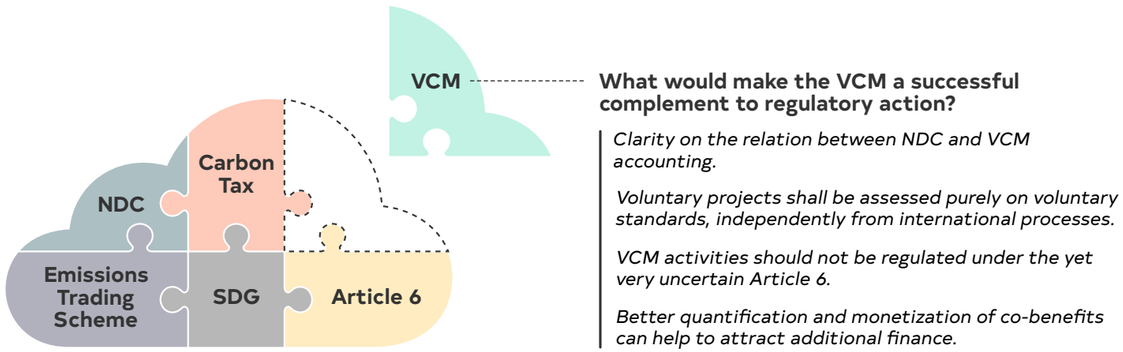

Figure 2. VCM is one of many puzzle pieces in effective climate action and policy

To ensure that project developers continue to drive mitigation action, the following should be considered:

- The VCM does not need more bureaucracy but does require regulatory certainty on the compliance part of the carbon market. This will help to establish certainty over which projects can be developed under Article 6 (and require the associated bureaucracy), and which projects can be developed under a more flexible voluntary umbrella. Such certainty comes from international processes, national governments, and GHG crediting programs.

- From the perspective of project developers, a stand-alone project should always be judged on its own merits. This also applies to the consideration of project additionality.

- How VCM projects relate to NDC targets or NDC accounting should be considered in the context of reporting under the Paris Agreement and the Global Stocktake. How a corporate uses carbon credits should be considered in how they are permitted to make certain claims, and not act as a barrier to developing projects by requiring Corresponding Adjustments or other bureaucratic procedures.

- There is no need for the uncertainty that exists under the Paris Agreement to spill over into the VCM, as the VCM does not aim to present a global solution for the next few decades, but rather a pragmatic opportunity to take real action today. If the Article 6 negotiations are concluded swiftly, the focus can shift to a structured conversation about the relationship between the compliance and voluntary markets, as well as between the VCM and NDCs.

- The SDG contributions of projects are currently not appropriately acknowledged, as they are only reflected through a subjective top-up to the carbon price. Quantifying these co-benefits in a more structured manner may allow monetizing these assets and provide a greater incentive for projects to better track and enhance SDG contributions.