



Strategic Government Engagement with the VCM

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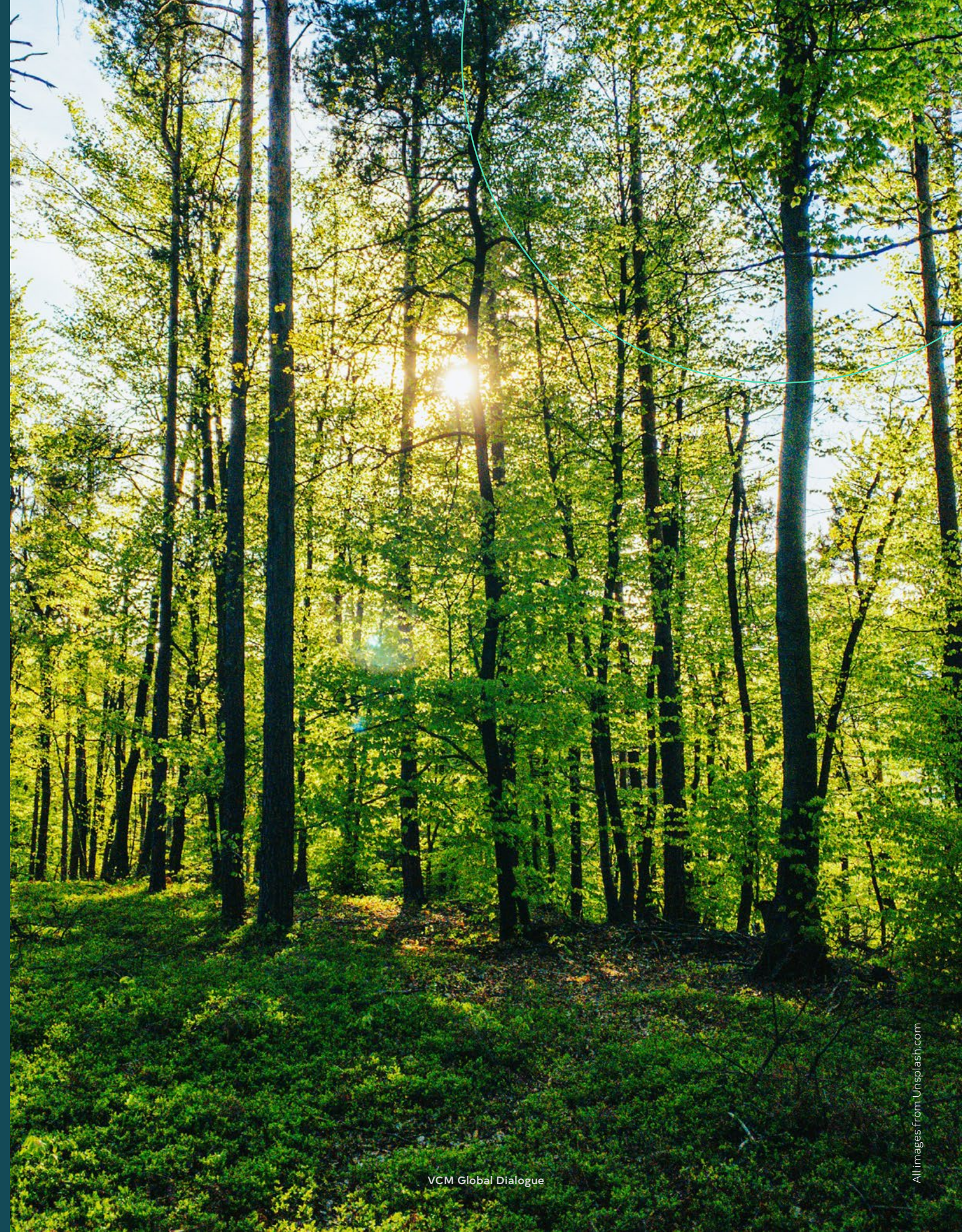
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About the Voluntary Carbon Markets Global Dialogue

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.



Strategic government engagement with the VCM

By Sandra Greiner, Robi Redda and Carolina Inclan

The Voluntary Carbon Market (VCM) enables companies, non-profit organizations, governments, and individuals to support activities that reduce, avoid or remove Greenhouse Gases (GHGs) and compensate their own emissions. Through this market, direct finance is channeled to climate activities that would not otherwise be implemented, most commonly in the Global South. This paper addresses the opportunities and challenges of engaging in the VCM from the perspective of developing country governments. In doing so, it seeks to answer the following questions:

- How can governments engage in the VCM, and
- How can they engage with the VCM to maximize mitigation ambition under the Paris Agreement?

The paper was prepared in two phases. The first phase consisted of a series of structured in-depth interviews held with government representatives and those closely familiar with governments' climate change agendas in 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.

Main findings

National governments have little exposure to the VCM and are relatively uninformed about activities happening in their countries, except when the government is a co-implementer of an activity, is required to give permits to project developers, or links a domestic carbon pricing scheme to VCM activities.

The change of the global policy context from the Kyoto Protocol to the Paris Agreement presents both a risk and an opportunity for the future development of the VCM.

The risk is that, if not appropriately implemented, VCM transactions may undermine the achievement of a host country's Nationally Determined Contribution (NDC) under the Paris Agreement by transferring its emission reductions and/or removals to a buyer country. Some governments even consider blocking VCM activities due to uncertainties over how private credit transactions might impact their NDC accounting.

At the same time, governments realize that the VCM can be a tool that helps achieve and even enhance their NDC ambition through private investment and infrastructure. The benefits that host country governments associate with the VCM depend on the country, sector, and type of intervention. All types of activities and technologies are welcomed by governments as long as the benefits outweigh political, environmental or social risks. Governments perceive activities that are community-based or focused on nature-based solutions as particularly beneficial, as these activities tend to contribute to the Sustainable Development Goals (SDGs). From a government perspective, it is important to consider how to harness the VCM potential to drive private finance – often foreign direct investment – into strategically important mitigation technologies and activities.

Recommendations

- **Governments should engage strategically with different carbon market mechanisms.** The architecture of the Paris Agreement blurs the lines between the regulated carbon markets and the VCM. Rather than favoring particular carbon market mechanisms, governments should take a holistic approach and embrace all carbon market mechanisms as tools to leverage finance, technology transfer and investment promotion, and in their capacity to support the achievement of national mitigation goals. In this context, the development of national guidance to navigate different carbon markets could be a helpful tool.
- **Enhanced stakeholder relations and dialogue are essential.** The VCM has diverse stakeholders, including governments, corporates, project developers, investors, and civil society groups that lack forums or platforms for an exchange of needs, plans, and positions. Particularly at the national level, consultation of all stakeholders by the government to discuss opportunities and challenges would help to harness the VCM's full potential. The voluntary GHG crediting programs, private sector, and civil society actors should support governments in this effort and help them understand how the VCM works to increase capacity and willingness to engage.
- **Improving information on the VCM is a starting point for strategic engagement.** It is critical that governments have information about VCM activities within their jurisdiction, including the emission reductions and removals that are being generated, traded and used. For this to happen, databases and records of VCM activities and their impacts should be developed and available at country level.

What are government engagement levels and perspectives on the VCM?

National governments are, by and large, not directly involved in the VCM. A distinctive feature of the market is that it operates outside the purview of national governments, enabling project participants to trade carbon assets with minimal government intervention. Private project developers, consultants and investors or, in some cases, civil society groups and communities, lead the development of activities. Whereas the Clean Development Mechanism (CDM) requires project participants to obtain a letter of approval from the country's government-appointed Designated National Authority (DNA), voluntary activities are a purely private affair between buyers and sellers. This allows VCM project developers to reduce transaction costs, delays and bureaucracy in their operations. On the flipside, it has created distance between the

VCM and national governments. Most national governments have insufficient knowledge of the VCM itself and are unaware of activities happening in their countries. The government institutions responsible for climate action tend to have little interaction with project developers and limited records on VCM activities. Some exceptions exist, for example, where government agencies are co-implementers of VCM activities or where a country's environmental and social performance standards (safeguards) require project developers to obtain permits. In some instances these permits are issued by the ministry that is in charge of climate action, and then become known to climate change departments, but that is not always the case. Government agencies are also by default more involved in Reducing Emissions from Deforestation and Forest

Degradation (REDD+), REDD+ activities and transactions.¹ More recently, some governments (e.g. Colombia) have also been actively engaging with the VCM in the development of domestic carbon pricing schemes, such as carbon taxes, emission trading systems or other voluntary reduction schemes that leverage the infrastructure developed in the VCM to account for emission reductions and/or removals. However, despite these recent developments and their increased participation in these markets, governments for the most part tend to be relatively unaware of the VCM.

With distance comes disengagement and a mixed appreciation of the VCM. Governments recognize the positive impact that certain types of activities have brought in terms of social and environmental benefits to local governments and communities. However, the national institutions responsible for climate actions know, in general, little about how local communities and the country as a whole are benefitting from VCM investments. Activities are not systematically recorded and their impacts on the SDGs are not monitored, and therefore not attributed to VCM undertakings. Instead, benefits are thought to accrue to project developers and consultants with some positive local spillovers in the case of community-based activities.

¹In the GuateCarbon project in Guatemala, for example, government entities participate through the granting of land-use rights to communities and private organizations that carry out sustainable forest harvesting and are helping to monitor the reserve.



Being uninformed about the VCM, governments also fail to play a positive role in the mobilization of national stakeholders and the dissemination of information. The formulation of nationally determined contributions (NDCs) by all countries under the Paris Agreement has changed the context in which VCM activities are implemented. Governments have a heightened interest in keeping track of mitigation activities in their countries, which challenges the status quo of uninformed co-existence. As governments have to report on NDC achievement, they are concerned that carbon credits generated and exported under the VCM without their knowledge or permission may undermine their ability to achieve their NDCs. How this would happen in practice is not well understood. However, there is a perceived risk that low-cost mitigation opportunities would no longer be available for meeting NDC targets or usable in

domestic carbon pricing schemes put in place for NDC achievement.² Similarly, governments may also be suspicious that any credits sold under the VCM would eventually be used by the country of domicile where the corporate is located to meet their targets, even though this could not happen without the explicit authorization of Internationally Transferred Mitigation Outcome by the host country. On a positive note, governments realize that the VCM may be a powerful tool for helping them achieve or even enhance their NDC ambition. This suggests the need to chart a new approach towards the VCM. Governments could seek a more proactive role in supporting VCM activities while anticipating obtaining more information on activities happening in their countries, including credit issuances and ultimately the use of credits by buyers, amongst others.

What types of activities and outcomes have been perceived as most beneficial, and what type of support would be most valuable from the VCM?

The benefits of VCM activities vary depending on the country, sector, and type of intervention. The potential of VCM activities to local communities consist of, inter alia, access to clean energy or clean water, reduced air pollution, improvement in health infrastructure, reduced time spent on the collection of firewood, job creation, technical training, water and soil retention and the protection of biodiversity.³ These benefits contribute to SDGs and address global challenges even beyond climate change, such as inequality, environmental degradation, social development, justice, and peace. At the same time, these activities need to work and engage on the ground for successful implementation. Many community-based activities are supported by non-profit organizations that support their environmental or social benefits. Most governments identify community-based activities

and nature-based solutions as particularly beneficial VCM project categories. These activities hardly received CDM support and have been early beneficiaries of the VCM. Government representatives understand that the VCM can provide financial incentives to activities and areas that have limited access to public funding, such as, for example, nature-based solutions. VCM activities focusing on forestry and other nature-based solutions appear to not only have a broad range of social and environmental benefits but are also sometimes packaged with additional community programs.⁴ In general, commercial reforestation activities bring profits to investors and developers, generate jobs and contribute to strengthening the local forest sector. Community-based restoration activities focus on social and environmental co-benefits and are often implemented in cooperation with indigenous or local community organizations.

² Governments can also be suspicious of or even block VCM activities in their countries due to uncertainties regarding how private credit transactions might impact their NDC accounting. This is the case in Indonesia, where the government has blocked VCM activities until Article 6 rules have been finalized and in Argentina, where the national government stopped providing a "no objection" to project developers and subnational governments until it presents an official position on Article 6.

³ ICROA (2014) Unlocking the hidden value of carbon offsetting. International Carbon Reduction and Offset Alliance and Imperial College London. Available at <https://bit.ly/3DWRw4N>.

⁴ For example, in a successful case in Colombia, project developers and communities created fiduciary channels that tie credit revenues to well-defined community programs, like building schools and hospitals. COMACO's Landscape Management Project in Zambia established Community Conservation Areas covering over 1 million hectares while creating new income sources for farmers, such as beekeeping and community farming, alongside carbon payments for conservation efforts.

Sustainable agriculture practices hold significant potential for carbon sequestration with multiple co-benefits to smallholder farmers and the natural ecosystems. However, these activities still face several barriers, such as high implementation costs, lack of expertise and complexity associated with measurement and verification systems for emissions reductions.

Governments acknowledge the contribution of renewable energy and energy efficiency activities to attract direct investment, technology transfer, and create jobs. Given the maturity of these technologies in the market and the associated ease in measuring their emission reduction outcomes, activities in the energy sector provide more certainty and attract investors. Generally, the revenues go to the project developers, with some positive spillover effect to communities beyond stable energy access and reduced air pollution. Renewable energy and energy efficiency activities can deliver a vital contribution to the country's mitigation ambition. Carbon finance can leverage investments which, depending on national circumstances, would not

otherwise have been economically feasible. In the context of weak or unstable local currencies, for example, carbon finance can be a hedge against currency-related risks associated with the import of renewable energy technologies from abroad. Carbon finance can also play an important role in levelling the playing field for renewable technologies in countries where tariff structures and energy sector policies still favor fossil fuels. Some technologies, like geothermal energy, are structurally more expensive than most fossil fuels and depend on additional finance to be competitive.

In this context, the decision by some GHG crediting programs to no longer consider certain grid-connected renewable energy activities are eligible⁵ due to their increasing cost-competitiveness has received mixed responses. While the Latin American government representatives interviewed for this paper tend to agree with the policy, Asian and African government representatives have expressed concerns that the decision is too crude and does not consider national peculiarities. Some national and regional GHG crediting programs have recently

emerged and are stepping into the void.⁶

Finally, an important consideration for governments in assessing the value of VCM activities is whether benefits accrue to the domestic private sector or foreign actors. In Kenya, for example, the CDM has been more successful in mobilizing national actors, whereas the VCM is predominantly in the hands of foreign project developers, consultants and investors. Overall, governments tend to welcome all types of technologies, as long as the benefits of VCM

activities to the country outweigh potential costs or risks. Some governments suggested a move away from focusing on single sector activities towards cross-sectoral activities with multiple SDG benefits (e.g.: electric buses that contribute renewable energy and sustainable transport benefits). Others pointed out that a clear target area for the VCM could be the design of methodologies and implementation of mitigation activities in sub-sectors not incorporated in a country's NDC. Figure 1 provides an overview of how government stakeholders value different VCM activities.



Figure 1. Government stakeholders consider sectoral VCM activities as beneficial for different reasons

⁵ For example, under the Verra standards, all renewable energy activities remain eligible in LDC countries (as defined by the UN). However, for non-LDC countries, a renewable energy activity built primarily to supplement the National or Provincial Grid is not eligible, as these activities can seek funding via feed-in tariffs and Power Purchase Agreements (PPAs).

⁶ As is the emergence of the inclusive GHG crediting program in South Africa under the Carbon Tax Act and the Carbon Offsetting Regulation and the Global Carbon Council, Qatar based seeking to tap interest from Gulf-based companies.

How to ensure that the VCM develops its full potential?

While the VCM is already contributing to national climate and development goals, it can do a lot more in supporting governments. If used strategically, governments can harness the VCM's potential to attract investment into mitigation priorities.

During a series of consultations conducted in the context of this paper, stakeholders broadly agreed that more significant engagement by governments in the VCM will be beneficial. This engagement should also include regular dialogue with all relevant VCM stakeholders (corporates, investors, and civil society groups). Furthermore, there were suggestions that positive cooperation should be forged between host country governments and the organizations designing and managing VCM GHG crediting programs. GHG crediting programs could take the initiative and engage with governments to better inform them of opportunities that the VCM offers, and national governments can support the VCM by facilitating investments.

Although a range of ideas and suggestions emerged from these consultations on what governments and other actors could do to improve the workings of the VCM, the most pertinent ones broadly fit into the following three main areas of recommendations:

Governments should strategically engage with different carbon market mechanisms. The VCM would benefit from more significant government engagement, in a manner that creates an enabling environment for stakeholders. Historically, governments have given due focus to carbon markets under the UNFCCC such as the CDM and emerging domestic carbon pricing initiatives, while paying less attention to the VCM. However, with the Paris Agreement the lines between the regulated carbon markets and the VCM are becoming increasingly blurred. VCM activities have the potential to morph into Article 6 compliance transactions if they are complemented by corresponding adjustments. Likewise, some methodologies in voluntary carbon market GHG crediting programs such as Verra's VCS are recognized by CORSIA, the compliance scheme for airlines. Even more generally, the VCM can no longer be considered outside the sphere of interest of governments, given its intersection with NDCs. This underscores the need to look holistically at all forms of carbon markets, which governments should consider in

terms of their contribution to finance, technology transfer, and investment promotion and evaluate activities, regardless of whether they come from voluntary or compliance markets, against the same criteria. At the end of the day, it does not matter whether activities are developed in the context of a voluntary initiative or driven by a compliance scheme, as long as they generate finance and benefits to the country. However, this is not to say that governments should assume the same regulatory function, as under compliance markets, in approving VCM activities. Stakeholders tend to agree that, as is current practice, voluntary activities should not be forced to get formal approval from governments and recognize that such a requirement would place an additional burden on project developers, especially if securing such approvals is complicated and costly. At the moment voluntary carbon activities sell credits into cross-border compliance markets they of course become subject to the regulatory approval processes set up by the host country for Article 6.

Such a holistic outlook on carbon markets would allow governments to become more proactive and strategic in steering investments under the VCM. To this end, governments can identify those sectors that require more financing, technology transfer, or capacity building for NDC ambition raising or compliance and gear interventions towards the current development needs of a country, such as poverty alleviation, biodiversity loss, public health, etc. Furthermore, governments can also establish formal working links to develop sectoral priorities and activities and help forge public-private partnerships. Not only environment ministries, which are traditionally in charge of carbon markets, but also other parts of government, such as investment promotion agencies, finance and tax authorities and line ministries, are central to realizing the full potential of the VCM.

A helpful tool in this regard would be the development of national guidance to equip those responsible for climate action nationally with the tools to navigate different carbon markets. As part of this 'guide', specific protocols could be elaborated to ensure that environmental and social performance standards (safeguards) are met and potential issues such as carbon rights, land tenure (in the case of Agriculture, Forestry and Other Land Use (LULUCF) activities and/or REDD+ programs), and associated benefit sharing arrangements are clarified.

Governments could also consider integrating the VCM into domestic carbon pricing schemes. As a result of this proactive cooperation, governments will be able to prioritize the

activities, projects and methodologies that are most aligned with their social development and climate action plans.

Some governments – and this is already underway in a number of middle-income economies – foresee the significant potential for the VCM to become integrated into domestic carbon pricing schemes, such as carbon taxes, emission trading schemes, or voluntary neutrality programs. Domestic markets tend to give greater certainty to investors while encouraging reduction measures in the country itself. In some countries, stimulating a domestic carbon market has strengthened the dialogue between public institutions and local emitters, project developers, and domestic GHG crediting programs. The result has been a significant stimulation of activities, new methodologies and regulations, and even a supply shortage of national emissions reductions.⁷ Figure 2 provides an overview of the steps governments can take to strategically engage with the VCM.

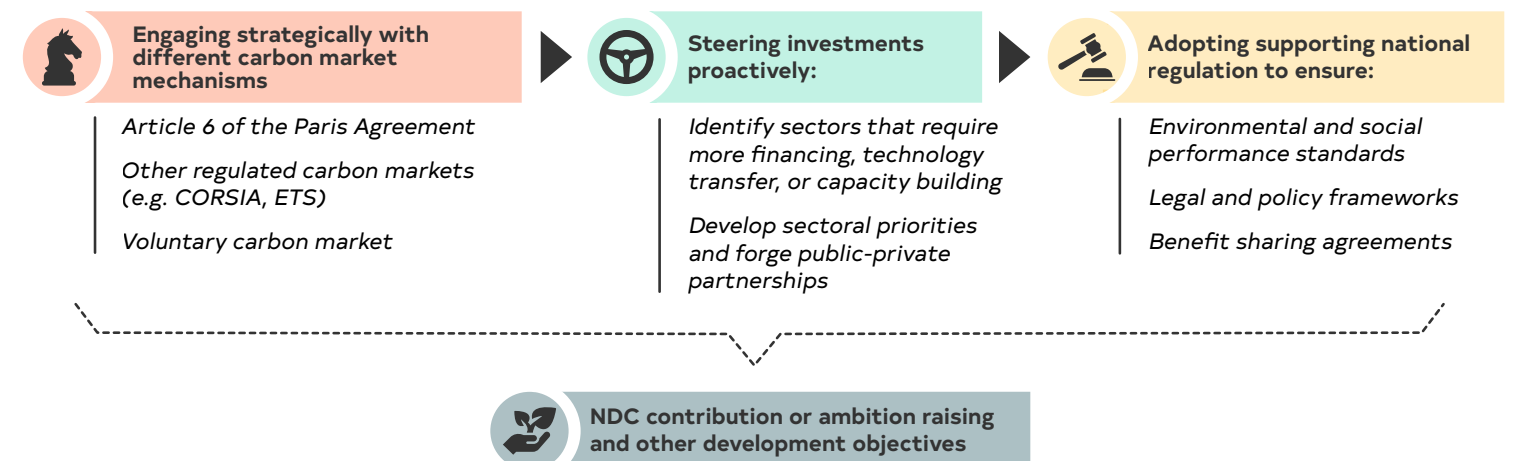


Figure 2. Steps governments can take to strategically engage with the VCM.

⁷ In Colombia, the supply of carbon credits currently meets only a third of the demand - trading only 42 MtCO₂ for the tax exemption with a potential of 135 MtCO₂. This gap is due to the nascent state of the market and investors' uncertainty on the financial returns of activities. In South Africa, the integrated energy and chemical company Sasol secured more than 100,000 carbon offset credits from Bethlehem Hydro, a South African independent power producer (IPP), in fulfilment of its obligations under the new South African carbon tax regulations that came into effect in June 2019.

⁸ In early 2021, the government of Brazil created the Forest+ Carbon Program to strengthen the conservation of native forests by crediting emissions in the VCM. This program foresees the development of a digital platform to register the activities, including its co-benefits. The registry is expected to be fully developed by the end of the year, facilitate accounting issues, and ensure that it complies with quality requirements. It has assured investors that the government recognizes the activities and provides transparency about where the credits are coming from and who is buying them.

Improving information on the VCM is a starting point for strategic engagement.

It is critical that governments have information about VCM activities within their jurisdiction, including the emission reductions and removals that are being generated, traded and used. For this to happen, databases, records and MRV processes of VCM activities and their impacts should be developed and available at a country level. This will allow a better understanding of the contribution of VCM activities to the country's NDC and SDGs, and provide confidence to project developers that their activities are recognized by the government. Transparency and suitable information systems are pre-conditions for government engagement and appreciation of the VCM. Such systems can be set up nationally and be supported by carbon market GHG crediting programs. In a first step, governments could create a simple online registry to keep track of activities, which would provide more clarity on how these align with national objectives and

relate to the NDC. In this registry, project developers would register activity information and the achievement of relevant project milestones, such as issuances and transfers of credits. In a second step, the national VCM registry (or database) could be linked to national MRV tools and processes for tracking NDC achievement. It may even be possible to link national VCM registries with those of the international GHG crediting programs.

Such information systems and their linkage to national NDC monitoring and accounting systems are also a pre-condition for the government to effect corresponding adjustments for VCM transactions. While the role of corresponding adjustments in the VCM is heavily debated, especially in the form of a mandatory application (see VCM-GD position paper on accounting), it is clear that the integration of VCM activities into national accounting systems is beneficial. Project developers report that the same metric ton of carbon can



be sold at a multiple of its base price if it is complemented by a commitment of the government to implement corresponding adjustments. Governments can therefore actively support higher prices for VCM activities in their countries by building information systems and committing to corresponding adjustments. Such engagement may come at a cost as governments may require support for their activities or compensation for giving up low-cost mitigation opportunities available for NDC achievement. Finally, it should be acknowledged that the information needs of host country governments are not currently met by the registries of voluntary market GHG crediting programs, especially given the

limited information available on the use of carbon credits, which underscores the need for a dialogue between host country governments and the GHG crediting programs.



Enhanced stakeholder relations and dialogue is essential. The VCM has diverse stakeholders, including governments, corporates, project developers and investors and civil society groups that do not necessarily have the platform for regular exchanges. This generates the need to organize and facilitate platforms for structured exchanges on opportunities and barriers for VCM project development. Structured exchanges will provide confidence to project investors and support the alignment of investments with domestic priorities and social and environmental goals. Such platforms are particularly important to have at the national level, but even regional, global or peer groups (e.g. countries of similar economic standing, or those that have integrated the VCM into domestic carbon pricing schemes) can be relevant. In this regard, harnessing and customizing existing platforms for stakeholder exchanges (e.g. global and regional DNA fora, IGES CDM stakeholder network, etc.) can ensure continuity and potentially reduce the transaction costs associated with the setup of new fora.

As an initial step to strengthen the awareness and engagement of governments in the VCM, the GHG crediting programs (or other entities, such as the International Carbon

Reduction and Offsetting Alliance - ICROA, or International Emissions Trading Association - IETA) can promote active cooperation, support open dialogues, and provide information regarding the dynamics, benefits and potential of the VCM for the country. Providing the necessary support for governments to understand how the VCM works will increase trust, willingness to collaborate and engage, and incentivize the provision of information and transparency. In this manner, governments can popularize the VCM more actively by informing and guiding stakeholders, thereby increasing the participation of local actors. Cognizant of its potential importance in forging North-South partnerships, some governments also suggested that the VCM can play a proactive role in enhancing environmental and social safeguards implementation in the Global South, for example, by defining best practices at the level of the international GHG crediting programs. This was foreseen to have a number of advantages, such as demonstrating the benefits (and/or in confirming no harm) of VCM activities to communities and ensuring that there is an improved interaction, interface, and capacity building of the government body responsible for providing safeguards oversight.