Governing Voluntary Carbon Markets:

Enhancing the ability of the TSVCM to contribute to climate goals

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Introduction

The Taskforce for Scaling the Voluntary Carbon Market (TSVCM) was established to create the conditions for the Voluntary Carbon Market to grow rapidly and so massively expand the flow of private finance to emissions reduction activities around the world and accelerate the transition to a Net Zero Economy. This is essential if we are to avoid the most dangerous potential climate change impacts and protect natural environments and the Taskforce is to be commended for the progress it has made to date.

As this process draws to its conclusion, we believe the Taskforce's proposals can be strengthened by additions to the Mandate and Terms of Reference of the Governance Body. Our suggestions, described below, will help build trust in the Voluntary Carbon Market, strengthen its governance so it is best able to meet the challenges that lie ahead and so ensure that the work of the Taskforce achieves the success it deserves.

In Brief

Voluntary carbon markets exist to deliver a public purpose, the net reduction of greenhouse gases (GHGs).

Voluntary carbon markets must meet specific governance challenges to achieve that purpose, related to their dynamic complexity and their dependence for success on upstream (credit buyer) and downstream (credit creator) behaviours and activities. This also includes anticipating an eventual transition into regulated and compliance regimes.

The TSVCM should build on its governance approach to ensure that it is fit for that purpose. *This includes establishing accountability mechanisms that address the potential for leakage and excessive/obscuring intermediation, real-time feedback systems and means for connecting effectively to the "upstream" and "downstream" levels that will determine whether the ultimate purpose of carbon emission reduction is, indeed, achieved.*

We set out three substantive recommendations to improve the proposed TSVCM governance:

- ***Open book accounting*** *(or transaction-level transparency): every transaction, in digitally-enabled real-time, needs to be fully transparent to everybody*
- ***Open governance*** *(or strategic grievance mechanism): any party impacted by any actual transaction can level a grievance that feeds into the core governance process.*

- ***Systemic oversight:*** *developing 'shadow' oversight over the upstream and downstream aspects of the system, of which TSVCN is dependent for its success.*

Our proposals set out how these recommendations can be taken forward without delaying the initiative by (a) making implementation commitments; (b) advancing executable elements in the short-term; (c) establishing a mandated governance design group, (d) incorporating proposals in board composition decisions, (e) conducting an annual governance assessment.

In addition, we believe that the Mandate of the Governing Body should explicitly include ensuring that the Voluntary Carbon Market meets its public purpose and that membership of both the Board of Directors and Expert Panel should include people with expertise in complex governance systems.

Governing Purposeful Markets

Voluntary Carbon Markets (VCMs) exist to deliver a public purpose: the net reduction of greenhouse gases (GHGs) and acceleration of the transition to Net Zero. Therefore, they are different from most other markets that evolve organically to serve the private interests of their trading participants. Over the last two decades, they have emerged to match corporate carbon credit buyers with carbon mitigation project developers and primarily operate without coherent infrastructure and standards.

The challenges of getting VCMs right are considerable. They have the potential to provide a flexible, dynamic way to minimise costs and accelerate and increase investments in emissions reductions. In practice, however, their track record has been viewed by many as mixed. Critics believe that VCMs (a) have provided an escape route for those wishing to delay meaningful operational changes at home; (b) disguise business-as-usual initiatives as something new, and (c) create rents and benefits that, at best, are not shared with local communities, and at worst have done them direct harm.

> *The Taskforce on Scaling Voluntary Carbon Markets (TSVCM) has been established to further the public purpose of voluntary carbon markets by overcoming such challenges by providing credible, scalable standards*.

Success requires credible, effective governance. The trust and integrity practices proven to work in regulated markets need to be applied and sustained in a voluntary market which i) serves a public purpose (carbon emission reduction), ii) trades a commodity with little or no value, and iii) is likely to evolve much like a complex financial market, with all the intermediation, derivation, and rent-taking that this can imply. This is a complex task.

Governing Complex Systems

Effective governance must be aligned to the purpose of the governed system. The governance of TSVCM is part of a broader system that has to come together to be fit for the purpose of carbon emission reduction. This system can be best understood as a "stack" of four distinct but profoundly inter-twined realms involving different institutional domains:

1. ***Tonne***: integrity of carbon offset credits in terms of additionality, permanence, leakage, etc.
2. ***Markets***: efficiency and effectiveness of the markets on which those credits are traded.
3. ***Initiative***: purpose-driven, adaptive, and transparent integrity of the Taskforce for Scaling the Voluntary Carbon Market initiative itself
4. ***Trading System***: integrity of the carbon trading system as a whole, including:
    a. Upstream: ensuring that credit buyers use credits to complement, not replace, their in-house/operational emission reductions.
    b. Downstream: ensuring primary benefits flow to reduce emissions, minimising rent-taking by project developers and intermediators and ensuring fair profit-sharing with host communities.
    c. Midstream: ensuring the efficiency of carbon markets themselves, including guarding against the dangers of excessive securitisation/derivation.

Moreover, while the focus of the TSVCM and this paper is voluntary carbon markets, it is likely and probably desirable that these become increasingly integrated into regulated international and domestic carbon markets and aligned with national low carbon development plans. As such, the governance system must have the flexibility and responsiveness to be able to adapt smoothly to this transition.

TSVCM's governance-related consultation focuses exclusively on the third level of this "stack" (i.e. the governance of the initiative itself), with carbon credit quality as its primary issue. This memorandum accordingly confines itself mostly to the consultation's limited scope. However, governance experience, especially of complex systems, tells us that such a 'vertical', stove-piped approach, even if designed with the best minds and executed with the best intentions, lacks the feedback, accountability, and flexibility needed to be effective.

What is needed is a "transversal" approach across the four-part institutional stack. We appreciate that the TSVCM has chosen to confine its terms of reference to the 'midstream', i.e., the carbon market mechanisms within the larger system. However, we would caution that such limits will not prevent the initiative from being negatively impacted by upstream and downstream problems. We have therefore included proposals in this memorandum that provide for more 'transversal' governance aspects across the whole system.

The Nature of the Problem: Testing TSVCM Governance Fit-for-Purpose

Voluntary carbon markets are complex, dynamic systems. Hard-edged compliance-based approaches have their place but cannot be relied upon in the context of emerging and unintended consequences and self-interested gaming. Instead, they require adaptive and collaborative governance that emphasises:

(a) managing uncertainty over following predictions;

(b) adaptability over top-down control, and;

(c) real-time, distributed learning over centralised ex-post evaluation.

Governance has to serve the market's overall public purpose, not just functional elements thereof (e.g. efficiently working markets). This substantive purpose must be guarded against the complex challenges of gaming and rent-taking.

We highlight five governance shortcomings with the current proposal that need to be addressed.

1. ***Top-down governance is insufficient in a complex world***. VCMs will face considerable gaming "upstream" (i.e. buyer behaviour), "downstream" (i.e. local rent taking), and "midstream" (intermediary profiteering, derivatives) challenges. A classic top-down, 'non-executive board' approach, operating periodically with highly aggregated, slow delivery information, will not work effectively in such a context. The literature on the governance of complex adaptive systems[1] is replete with evidence and case studies documenting the failings of such governance when faced with highly dynamic challenges.

2. ***Inability to deal with the rise of the intermediaries***. The currently proposed Board structure will be unable to deal with the inevitable rise of the intermediaries. The VCM's ultimate beneficiaries, positive impacts and associated accountabilities are likely to become obscured as intermediaries step in offering market services. The public purpose, and the accountability of those committed to serving them, will become secondary to an increasing emphasis on trading patterns, volumes, and prices. This problem, linked to (1), will be made worse as derivatives begin to emerge as they inevitably will, whether within the initiative or off-platform and are likely to lead to further distrust of VCMs.

3. ***Unmanaged leakage.*** Building on (1) and (2), one of the principal weaknesses of all carbon markets is the danger of leakages across time and/or space. We know from extensive and bitter experience that top-down audit and certifications are unlikely to be sufficient to

[1] See: Stanley McChrystal, Tantum Collins, David Silverman, and Chris Fussell, *Team of Teams: New Rules of Engagement for a Complex* World (Portfolio/Penguin 2015); James C. Scott, *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed (*Yale University Press, 1998); Anne-Marie Slaughter, *The Chessboard and the Web: Strategies of Connection in a Networked World* Yale University Press 2017); Gillian Tett, *The Silo Effect: The Peril of Expertise and the Promise of Breaking Down Barriers* (Simon and Schuster 2015)

address this (i.e. inherently focused on what can be seen/measured rather than on the most critical problems). Effective governance of leakage requires constant and adaptive collaboration, involving many actors close to and impacted by the markets themselves, rather than relying on governance approaches dependent on aggregated, top-down representativity.

4. ***Lack of transversality***. Ensuring that the initiative delivers against its systemic purpose requires that its governance can consider both upstream (delay of substantial carbon transition) and downstream (sovereign governance of carbon project) aspects - even although these are in different institutional domains and often lack formal, enforceable governance and accountability mechanisms. The current TSVCM proposal is almost entirely focused on carbon credit integrity and enabling as frictionless trading as possible and is not designed to address transversal upstream/downstream challenges – it is in danger of becoming a healthy element in an unhealthy system. Structural constraints on demand (Article 6) and supply (national sovereignty) can only be solved if the TSVCM governance gives a voice to all the relevant institutional realms.
5. ***Insufficient accountability***. The current scheme allows for procedural accountability but does not provide effective agency to those with a legitimate interest in outcomes. The focus on procedural transparency is laudable but, by all experience, all-too-easily gamed and especially ineffective in complex and linked systems. It will not suffice for governing the interactions between carbon and derivate exchanges or even between corporate carbon credit buyers and public carbon credit issuers. Moreover, this limited accountability will hinder its ability to respond rapidly and effectively to concerns expressed from within the market - for example, dealing with the perennial problems of leakage and additionality - and broader changes in climate change policy, corporate action, and societal expectations, including the integration of VCMs into domestic and international policy frameworks.

The TSVCM is a crucial initiative if we are to massively scale up voluntary investments in low carbon technologies and Nature-Based Solutions but needs to have a governance system that effectively stewards its public purpose and actively builds trust among all stakeholders.

Recommendation: Three Essential Solutions

Effective governance of the TSVCM can be secured by implementing three linked design elements. We propose three simple to communicate priorities: self-evident in their logic, technically wholly workable, and, by proxy, inclusive of a much larger set of governance objectives.

1. ***Open book accounting*** *(or transaction-level transparency): every transaction, in digitally-enabled real-time, needs to be fully transparent to everybody*, including all particulars of the

deal, the project baseline and proof of additionality, counterparties, ultimate beneficiaries, benefit-sharing arrangements, etc.

Voluntary carbon markets are created to deliver the public good of carbon sequestration (while benefitting the counterparties); real-time transparency of every transaction is needed to permit confirmation that the market is delivering that public good. While private markets develop more organically with a private interest in mind, disasters such as the 2008 financial crisis have made transparency the best, expected and often required practice across today's most sophisticated financial markets, drawing on what would be information provided to financial regulators (especially in highly exposed markets such as mortgage-backed securities). Given that many carbon offsets are located where national regulatory capacity is not well developed, it is particularly important to have transaction information available publicly, not just to regulators. Moreover, as we have seen in, for example, the disclosure-based regulation of chemical pollution, providing full transparency empowers civil society to supplement regulators in the monitoring function.

Open book accounting does not pose a technical problem. It will discourage bad-faith actors and incentivise good-faith actors whilst providing a robust foundation for real, democratised accountability (see below). it will also enable fast responses and fixes to problems that may arise at any point in the chain so as to minimize uncompensated emissions. As with tainted food products, if you can trace exactly where it came from and who it went to, you can quickly ensure safety while minimizing cost to the whole production.

2. ***Open governance*** *(or strategic grievance mechanism): any party impacted by any actual transaction can level a grievance that is visible on submission, linked to and flagged against the specific transaction, handled separately from the executive of the initiative/market, and fed directly into the Board for its strategic consideration and oversight*.

   It is now well-understood and incorporated into best practice (e.g. major DFIs) that grievance systems are a primary governance mechanism, not an afterthought or add on. This creates an open system that ensures that governing bodies are in receipt of and informed by transaction-level grievances. The initiative and its transactions are flagged publicly where grievances have occurred and are outstanding. This helps to prevent unlocking and vested interests undermining the quality of governance.

3. ***Systemic oversight:*** *developing 'shadow' oversight over the upstream and downstream aspects of the system of which TSVCM is dependent for its success, with requisite mandates, structures, and capabilities*. The expertise and interest of carbon credit suppliers, buyers and market makers must be fairly represented and those of potentially affected communities and jurisdiction. The focus must be squarely on the VCM's good public purpose, even at the expense of discomforting incumbents. Board expertise must go beyond the functional and

academic and also include governance expertise and geographic/contextual knowledge; new voices must be included.

Taken together, these three proposals shift the envisaged governance arrangements towards a more dynamic, distributed approach that can be more responsive, more quickly, to both specific and strategic unintended consequences and so also performance enhancement opportunities. ***By adopting these proposals, the TSVCM will bolster its authority and thereby improve its effectiveness in delivering on its mission.***

It is worth noting is that such approaches will not work in a watered-down form, as there are non-linear, adverse effects on their potential if they are diluted or delayed. This includes how these proposals are managed and governed, which cannot be subject to the same governance arrangements that they intend to strengthen.

Process for Improvement

Recognising the governance and broader initiative train is leaving the station. The TSVCM has worked tirelessly for nearly a year to create the Core Carbon Principles and establish standardised processes for transacting and accounting for carbon credit transactions. In parallel, the size of the VCM and demand for credits has continued to grow, generating anticipation for the TSVCM's outputs.

What is needed now is a commitment to improve the proposed governance framework by explicitly recognising the Governing Body's public purpose and adopting the three proposals and a time-limited process for design and implementation. Each of the three proposals is practical and can make up a core part of effective governance arrangements. That said, although they are entirely consistent with existing proposals (i.e., we are not proposing anything be dropped), they require time to complete a detailed, operational design. Therefore, to move practically and in a committed fashion in implementing these proposals, we recommend the following steps:

(a) ***Commitment:*** at this stage, prior to a board being established, commit to the principle of the proposals set out above and their implementation within a reasonable time frame, not more than six months and ideally before the formal launch of the Core Carbon Principles ahead of COP26.

(b) ***Executable Governance Innovations:*** implement, in the shorter-term context of the new governance arrangements, executable aspects of the proposals made above, which could include, for example, steps on transparency, grievance and composition.

(c) ***Governance Design Group:*** establish a governance design group comprising a small group of experts relevant to the three proposals (and indeed any other proposals adopted from the consultation but not implemented in the first iteration of the governance arrangements) mandated to develop and submit publicly available proposals to the board.

(d) ***Board Composition:*** ensure that the initial board composition considers capabilities required to implement the three proposals and establish a governance design board sub-group that interfaces with the external governance design group.

(e) ***Assessment:*** publish a report within a year prepared by the governance design group in consultation with the governance design board sub-group of the experience of the governance approach to date, including the implementation of the proposals.

Sample text that could be included in the TSVCM's final report is included in the Annex to this Memorandum.

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ANNEX: Language for incorporating the three proposals in the July 8th TSVCM report

The text proposals below are all made with reference to the Executive Summary of the Terms of Reference for the New Governance Body (Document for Consultation). They should also be applied to the main body of document.

1. <u>Substance</u>

- Add a third sentence to the fourth paragraph Terms of Reference:

"*Subsequent work on the governance body has shown that it must also act to build trust in the VCM by ensuring its full transparency and accountability and by including board members with specific experience of governing complex systems*".

- Add after "integrity of credits" in the middle of the second sentence of the first paragraph of the Mission and Mandate section:

"building in full transparency, accountability and adaptive decision-making…"

- Add a final sentence to the first paragraph of the Mission and Mandate:

"*It will also engage and coordinate actively with bodies that govern other elements of the VCM, including those overseeing corporate claims, financial and GHG accounting and financial compliance."*

- Add a new first bullet to the mandate elements in Mission and Mandate section:

"Ensure that the VCM serves its primary purpose of reducing GHG emissions and accelerating the transition to Net Zero."

- Add a bullet to the description of the Board of Directors in the Organisational Design section:

"In its set-up phase, the Board will include members with specific expertise and experience in establishing governance arrangement for complex markets, especially those for public goods"

- Add a bullet to the description of the Expert Panel in the Organisational Design section:

"In its set-up phase, the Expert panel will include members with specific expertise and experience in establishing governance arrangement for complex markets, especially those for public goods"

- Add the following text to the first sentence of the second paragraph of Transition section:

"*establishing a governance framework that enables real-time transparency of all aspects of the VCM, open book accounting, effective grievance mechanisms and systemic oversight of the market."*

- Change the second bullet of the Transparency Mechanism subsection of the Operating Principles section to:

"Trades of carbon credits: the governance body will actively promote maximum transparency across all transactions in the voluntary carbon market. It will act on the principle that all information – from project design and approval, through issuance and trading to retirement and cancellation of credits - should be made publicly available in real-time as the basis for creating lasting trust in the system."

- Add a fourth bullet to the Grievance Mechanism subsection of the Operating Principles section:

"A system for ensuring that grievances and their resolution feed directly into the decision making of the Governance Body and enable the continuous improvement of the CCPs and their implementation"

2. Process

- Add a new section at the end of Part I of the Executive Summary with the title:

"*Process of Establishing the Governance Framework/System"*

- Add the following text to this new Section"

"*In its initial set-up stage prior to formal launch in late 2021, the TSVCM will convene an ad hoc Governance Design Group with experts in the governance of complex markets, public goods and environmental management to guide the Board of Directors on the design and implementation of its operating guidelines and procedures, transparency and grievance mechanisms, stakeholder participation and systemic oversight.*

The result of this work will be a set of clear operating principles for the Governance Body and concrete recommendations for the Board's ongoing work once it is formally established.

After its formal establishment, the Board of Directors may want to maintain the Governance Design Group as an informal advisory body to advise on and oversee the implementation of its recommendations, provide ongoing governance support and assist with the development of appropriate metrics for measuring the success of the VCM in achieving its public purpose.

At the end of its first year of operations the Governance Body and Governance Design Group will publish a progress report detailing the advances made in implementing the governance system and recommendations for ongoing improvements."