

# Shoring up the Social Integrity of the Voluntary Carbon Market

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## OPERATIONALISING THE VCM INTERNATIONAL SHARE OF PROCEEDS (iSOP)

### Discussion Note

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## I. The Systemic Rationale for an iSOP

This Note is about (operationalising) an *international Share of Proceeds* (iSOP)<sup>[1]</sup> in the *Voluntary Carbon Market* (VCM) as tool to demonstrate international solidarity with the poorest and most vulnerable countries that fail to attract VCM projects.

The fact is that when (host) locations of credit-generating projects are chosen purely for market reasons (e.g. minimising the cost of generating credits, rewarding places with active project developers, or limited active climate policies), there is a strong likelihood for credit generation to be massed in a small number of large host countries, while others, particularly the poorest and most vulnerable ones, are left behind, failing to attract projects and, hence, benefits from VCM investments.

This could seriously damage the reputation of the VCM, and carbon markets in general,<sup>[2]</sup> as lacking what has been called (systemic) *social integrity* by “letting polluters get away with their emissions more cheaply while leaving the poorest and most vulnerable countries out in the cold.” Thus far, the effort to shore up the VCM’s systemic integrity has focused on *environmental integrity*, i.e. on making sure the environment (climate) is not degraded by the existence of the system (i.e. the VCM). The iSOP, however, is aimed at shoring up the VCM’s social integrity by ensuring the poorest and most vulnerable countries are not completely excluded from reaping VCM benefits, even if they fail to attract VCM projects. In short, the sole purpose of the proposed iSOP is to raise funds to generate VCM benefits in countries that lack VCM projects.

This can be done in several ways. Following the design of the market mechanisms of the Kyoto Protocol and the Paris Agreement, the iSOP could be used to fund concrete adaptation projects in the target countries, as discussed in two previous Oxford Climate Policy/ecbi publications:

- [Share of Proceeds for Adaptation in the VCM](#)
- [Share of Proceeds for Adaptation – How to operationalize a Share of Proceeds for the VCM](#)

Following the evolution of the multilateral climate regime since COP 21 in Paris, particularly in light of the establishment of a multilateral fund for responding to loss and damage, loss and damage programmes could also be funded by iSOP revenue. Moreover, some of that revenue could be used to cover the administrative costs of VCM projects in the target countries to incentivize project developers who would otherwise not undertake VCM-led projects in those countries.

## II. Who?

### a. Who should be in charge?

Who should be in charge of operationalising such a systemic risk mitigation tool? There are two bodies that, as reflected in their names, are concerned with shoring up the (systemic) integrity of the VCM, namely the [Integrity Council of the VCM \(ICVCM\)](#) and the [VCM Integrity \(VCMI\)](#) initiative, and it stands to reason that, as ‘system Regulators’, these bodies should be in charge of operationalisation.

### b. Who should be charged?

To answer the question of who should bear the costs of shoring up the systemic integrity of the VCM through an iSOP, one must, in fairness, consider who is already being charged for doing it in other ways.

Take, for example, the [ICVCM Core Carbon Principles](#) (CCPs), which are generally aimed at ensuring the *environmental* integrity of the VCM as a whole, particularly at the supply side. They ensure that the VCM is not trading ‘rotten apple’ credits, i.e. credits that do not actually reflect emission

reductions. It is blatantly clear that the existence of just some such rotten apple credits can spoil the whole VCM barrel, as potential users will not want to be associated with a VCM of flawed integrity. This could lead to credit price collapse due to lack of demand and possibly the demise of the VCM altogether. Being a supply-side tool, the costs of complying with the CCPs are generally borne by the credit suppliers, i.e. the project developers/owners.

The [VCFI Claims Code of Practice](#), in turn, seeks to ensure the *environmental* integrity of the use of credits from the demand side standpoint, with the costs generally borne by the users.

The proposed iSOP, as mentioned above, would shore up the VCM's systemic *social* integrity, complementing the current CCPs and Claims Code. The various types of systemic integrity must be key concerns of VCM participants. But while the costs involved in generating CCP-compliant credits cannot be directly charged to users, the iSOP can be collected from the user of a carbon credit. This, and the fact that users are the ultimate beneficiaries of carbon credits, is why one may wish to consider charging the iSOP to the credit user (at credit retirement) as a matter of sharing the integrity cost burden with the project developers.<sup>[3]</sup> Moreover, charging offsetting users at the point of retirement can also be interpreted as following the 'polluter pays principle'.

### III. iSOP Collection Modes

There are two ways in which to collect an iSOP: 'in-kind' (i.e. in the form of credits), and monetary (in the form of monetary payments). Both require addressing some cross-cutting issues.

#### a. Cross-cutting issues

To assure the effectiveness of the iSOP in shoring up the VCM's systemic social integrity, some system-wide decisions regarding modality and benefits (providers) will have to be taken by the ICVCM and the VCFI in their role as (system) Regulators:

**Modality:** For one, a decision will need to be taken as to whether the iSOP is 'systemic' ('mandatory'), in the sense of being part of the minimum good practice rules (i.e. ICVCM CCPs and the VCFI Claims Code of Practice), or merely an optional extra ('voluntary'). In order to fulfil its role of shoring up the systemic social integrity of the VCM, the iSOP collection has to be 'mandatory' in the same way in which the prescriptions that shore up the systemic environmental integrity of the market cannot just be a matter of choice for the relevant market participant. In other words, the iSOP, needs to be part of the CCPs and the Claims Code of Practice.

**Benefit(s) and Benefit provider(s):** A system-wide decision must be taken by the Regulators on what sorts of benefits – such as concrete adaptation projects, loss and damage programmes, or VCM project administration support (see above) – are to be provided with the revenue generated by the iSOP. Regarding benefit provider(s), it would seem to be natural to start with designating the existing practice under the Paris Agreement, i.e. using the [Adaptation Fund](#) for adaptation and the [Fund for responding to Loss and Damage](#) (once it is fully operational) for loss and damage-related benefits. The case for the project administration support, the choice is self-evident: it would have to be the programmes administering the projects.

**Target Countries:** The iSOP target countries, as discussed earlier, are the poorest and most vulnerable countries that face being left out of VCM activities. To avoid interminable discussions on who is and is not in this category, the best way forward would be to use internationally accepted country groupings to define the iSOP target countries, such as the UN Groups of [Least Developed Countries](#) (LDCs), of [Small Island Developing States](#) (SIDS),<sup>[4]</sup> and of [African Member States](#).

**Exempting Credits:**<sup>[5]</sup> Under the Clean Development Mechanism, credits (certified emission reductions or CERs) generated in LDCs are exempted from the SOP. It is important, in this context, to keep in mind that the (sole) purpose of the proposed iSOP is to generate VCM co-benefits in iSOP target countries and *not* to provide globally additional adaptation or other benefits. Thus, a project, say in China, having adaptation co-benefits has no bearing on what the iSOP is trying to achieve, and so there is no reason why credits from that project should be exempt from the iSOP. The only credit exemption that makes sense is for credits generated in the iSOP target countries.

## **b. In-kind Collection**

In-kind collection – the mode chosen in the multilateral carbon compliance markets (CDM and Paris Agreement Article 6.4) – is the collection of a share of the credits to be issued to or retired by an iSOP contributor. Following the compliance market model, it would involve the establishment of iSOP accounts in the respective carbon credit registries to receive the iSOP in question. The iSOP credits, once collected, must be monetized to provide funding to the designated iSOP benefit provider(s).

One option is to have a single iSOP account in each registry, which would collect the iSOP for all potential benefit providers. Alternatively, the designated benefit providers could each be associated with a dedicated iSOP account (e.g. one for the Adaptation Fund, one for the L&D Fund, etc.).

In the multi-account model, the iSOP credits would be transferred by (or in accordance with the instructions of) the relevant iSOP contributor to the iSOP accounts. The iSOP account holders would then be responsible for the monetisation of the iSOPs and the transfer of the generated funds to the benefit provider associated with the account in question.

While an in-kind collection at the point of issuance can easily be enforced since the registry administrator issues the credits (and can therefore make the iSOP collection a pre-requisite to issuance), credit at retirement may not involve the registry administrator and other ways of verifying compliance would have to be found.

## **c. Monetary Collection**

Monetary collection – whether at the point of issuance or retirement – involves the payment of an iSOP rate per credit to be issued or retired. While there are a number of options of how such payments could be operationalised, it stands to reason that the simplest way would be for the iSOP provider (i.e. the project developer or the credit user) to make the monetary iSOP payments directly to the benefit providers of their choice. In the case of the Adaptation Fund this could be done without any further arrangements by using its [Donate button](#).

There are two issues that would need to be regulated. For one, there would have to be a systemic iSOP rate (a unit charge per credit to be issued or retired), as well as some compliance oversight to determine whether the correct amounts have been paid, to avoid, for example, iSOP contributions being used multiple times (say in different programmes). However, it should be possible as part of a transparency exercise to establish a simple compliance process to avoid this sort of abuse.

The second issue is of course setting the monetary iSOP rate, i.e. the iSOP charge. Ideally this would be linked to the in-kind iSOP rate spelled out in the Paris Agreement (5% of credits to be issued). However, as long as the same rate is used throughout the VCM, it would not matter too much how the rate is determined as long as it is re-visited from time to time. As to who is to set the rate, it stands to reason that the VCM system Regulators should be in charge of that.

## **d. Pros and Cons**

In-kind collection has the advantage of providing a simple compliance mechanism for the application of a systemic iSOP in the case of collection at issuance: the registry operator can make the iSOP collection – i.e. transfer of the iSOP credits to the relevant iSOP account(s) – a pre-requisite to issuance. However, having to monetise the iSOP credits in order to generate the iSOP revenue can complicate matters, if only because it reduces the predictability of how much is available due to credit price fluctuations.

Monetary collection has the advantage that the iSOP contributor can make the contributions by directly paying the designated benefit provider of their choice. Potential shortcomings that have been raised are the need to set a posted iSOP charge per credit to be issued/retired, and the need for a suitable compliance regime. But neither of these would seem to be insurmountable.

#### **IV. Conclusion**

The VCM system Regulators should collaborate in establishing the rules for a systemic (‘mandatory’) VCM iSOP (as part of the [ICVCM Core Carbon Principles](#) and the [VCM’s Claims Code of Practice](#)), preferably collected from credit users at the point of credit retirement. While this is likely to require the establishment of a compliance tool, it is preferable to collection from project developers who are currently bearing most of the costs for shoring up the systemic integrity of the VCM.

An iSOP enhances the value of the environmental and social benefit that a carbon credit user can claim upon retirement of the credit. It ensures that the use of carbon credits is further aligned with the Paris Agreement. A generally levied (non-optional) iSOP does not only increase the social value of an individual claim; it crucially also adds overall integrity and value to the VCM and to all VCM transactions.