# Political Risk for ERC Activities

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Political risks are acute for ERC activities and arguably the most important and challenging to address to attract capital.

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Political risks are acute for ERC activities and arguably the most important and challenging to address to attract capital. ERC markets are fundamentally policy driven and still relatively novel, trading a credit that may not yet be considered by, let alone be clearly defined, in existing regulatory frameworks. Uncertain policy and regulatory frameworks, as well as unexpected government action, policy change including expropriation, or foreign investment restrictions, fundamentally put at risk the ability of an ERC activity to generate and transfer ERCs from a given jurisdiction. Several political risks are particularly salient in the context of ERC markets, largely arising from the fact that ERCs are a new type of product (and indices are beginning to emerge which allow VCM participants to assess country opportunity and risk[1]). Therefore, uncertainties exist in many countries, including with respect to legal and regulatory frameworks, clarity on rights to ERCs, and to what extent governments want to domestically retain ERCs for national-level commitments. Key issues include:

- ERC regulatory frameworks – A substantial number of policy and regulatory decisions are required for countries to effectively engage in domestic and international ERC markets. Uncertainty around the requisite frameworks creates a broadly challenging context for ERC developers and investors. Policy clarity is particularly important for:
    - ERC Rights – The definition of the legal nature of ERCs and required processes for engaging with relevant interest holders, such as landholders, local authorities, financial institutions, and IPLCs. Without this clarity, there is a heightened risk of potential inconsistencies or conflicts with stakeholders, which can arise where rights to ERCs are not clearly defined and protected. The legal nature of ERCs in a particular market also has consequences on tax treatment, risk weighting, and capital costs that may affect a financial institution's ability and willingness to finance ERC activities and hold ERCs on its balance sheet.
    - Transferability – Implementation of compliance markets, including domestic carbon pricing schemes and Article 6, as well as decisions with respect to whether and how VCM activities are integrated into domestic carbon pricing and Article 6 policy frameworks. This includes requirements and processes for authorization and corresponding adjustments.
    - Beneficiaries – Approach to benefit sharing arrangements with the government or IPLCs.
    - Institutional ownership – Policy should also serve to clarify institutional ownership of ERC regulatory frameworks. Roles and responsibilities related to ERC markets should be clearly defined and understood across different governmental entities (e.g., Ministry of Environment, Ministry of Finance, etc.).

- Article 6 authorization – Most countries have not clarified their process for authorizing international transfer of mitigation outcomes in line with Article 6 of the Paris Agreement. Some have begun to issue letters for specific ERC activities confirming the authorization, intended authorization, or no objection to the sale of associated ERCs generated. To date, the letters are simple, without detailed contractual agreements with respect to terms for dispute resolution or payments for breach of contract. This creates uncertainty around the ability to transfer ERCs out of a host country and into the larger global market.
- Export restrictions – Some countries have taken steps to prevent or restrict ERC exports while developing a policy framework governing ERCs (e.g., Indonesia).[2] Policy positions of this nature can pose a short-term barrier to project developers and financiers by enhancing uncertainty and the risk profile of ERC transactions regarding future ability to trade ERCs. However, if the pause results in the countries developing a clear policy framework affecting ERCs, then greater policy certainty may be beneficial in the long term.
- Government retention of benefits –Host governments may seek to retain mitigation outcomes achieved by ERC activities for the purpose of meeting their own NDCs or retain a share of revenues generated by ERC activities (Box 6). This could be implemented through requirements that a certain proportion of ERCs issued by an activity are retained by the host government, and at the extreme prohibiting any export (e.g., Papua New Guinea),[3] or taxing revenues from the sale of ERCs (either domestically or internationally). It will be important for governments to consider that such policy approaches will be relevant for project developers and financiers in assessing activity feasibility and selection of preferred markets to enter and will affect the level of investment needed to operate and maintain the project. Additionally, to the extent governments claim ERC benefits from voluntary ERCs (i.e., ERCs not authorized under Article 6) to meet their NDCs, it could impact the claims that can be made by the buyers of the ERCs.

Among many steps governments can take to improve the ERC policy environment, steps to clarify an ERC activity's fundamental ability to generate, own, and transfer ERCs are arguably most important from a financier's perspective**.** Even with these basic elements in place, ERC developers and financiers can benefit from effective public sector engagement and ERC financing may further benefit from ERC-focused political risk insurance.

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Cross-border ERC Trade

Government Engagement and Public Sector Participation

Political Risk Insurance

**Box 6**

Case of Zimbabwe's domestic retention of ERC benefits.

In May 2023, Zimbabwe's Minister for Environment, Climate, Tourism & Hospitality Industry declared all current ERC transactions in the country "null and void" and that the government will take a 50% revenue share of all future ERC contracts.[4] Zimbabwe subsequently backtracked on its "null and void" decision and instead gave developers two months to comply with the new policy.[5]

Further to the revenue share requirement, the Minister advised of additional rules, including that local authorities in Zimbabwe can no longer enter into ERC transactions at subnational level, foreign investors will be subject to a 30% revenue cap, local investors must receive minimum 20% revenue, and a new committee will be established to oversee the industry.[6] The move, enacted through a cabinet-approved Carbon Credits Framework, appeared to be driven by a government desire to obtain greater control over ERC transactions and revenue flows, with the Minister stating that Zimbabwe is "determined to make sure that climate finance resources, meant to empower the country, accrue to the most deserving."[7] These developments are especially significant because Zimbabwe has at least 30 current ERC projects (either operational or in the pipeline) and is the 14th largest global supplier of VCM ERCs, with 6.5 million nonretired ERCs currently in circulation.[8]

Zimbabwe is also developing a policy framework and supporting infrastructure which,[9] if well-crafted, will help to provide policy certainty required for a functioning ERC market. However, this demonstrates the short-term challenges of abrupt policy change without stakeholder participation.

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*Footnote 1:* See, for example, Trove Research, *"VCM Country Opportunity and Risk Index"* (2023), which quantifies seven risk factors (corruption, rule of law, land tenure, climate policy uncertainty, business environment, governance and political stability), and four measures of carbon trading risk (domestic market and taxes, trading restrictions, corresponding adjustments, and national registry issues).

*Footnote 2:* In 2022, Indonesia introduced a short-term pause on new ERC issuances. See: World Bank, *State and Trends of Carbon Pricing 2023*, 2023.

*Footnote 3:* In 2022, Papua New Guinea introduced a moratorium on all new ERC activities. See: World Bank, *State and Trends of Carbon Pricing 2023*, 2023.

*Footnote 4:* Carbon Pulse, *"Zimbabwe voids all existing carbon offset agreements, lays claim to half of future proceeds – report"*, 2023

*Footnote 5:* Carbon Pulse, *"Zimbabwe backs down from carbon deals bonfire threat – report"*, 2023.

*Footnote 6:* Carbon Pulse, *"Zimbabwe voids all existing carbon offset agreements, lays claim to half of future proceeds – report"*, 2023

*Footnote 7:* Reuters, *"Zimbabwe to regulate carbon credit market to curb greenwashing"*, 2023.

*Footnote 8:* Carbon Pulse, *"Zimbabwe backs down from carbon deals bonfire threat – report"*, 2023.

*Footnote 9:* Carbon Pulse, *"Zimbabwe eyes pan-African carbon trading registry as it prepares to host VCM summit"*, 2023.

## Sections


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Cross-border ERC Trade, high angle view of two businesspeople shaking hands over desk, over maps and plans

**Cross-border ERC Trade**

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**Government Engagement and Public Sector Participation**

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