



VCS Consultation Document:
**Proposal for Compensation Mechanism
for VCS Methodology Elements**

Proposal for Compensation Mechanism for VCS Methodology Elements, v1.0

13 April 2010

1. Introduction

1.1 Background

Under the VCS Program, new methodologies, methodology revisions, additionality performance tests and tools/modules (“methodology elements”) are approved via the double approval process. Methodology elements are posted on the VCS website for public comment, followed by independent assessment by two validators and final approval by the VCSA. They are then freely available for project proponents to use. This bottom-up approach harnesses actors in the market for development and assessment of new methodology elements and ensures that the VCSA does not become a bottleneck or hold any conflict of interest with respect to the process.

The approach, however, does have two particular shortcomings:

- 1) Some developers may not have the financial resources required to take a methodology element through the double approval process, particularly if the public good created is then freely available for others to use.
- 2) There can be an incentive to develop overly narrow and project-specific methodology elements. This may be intentional (to prevent others in the market from using the methodology element) or unintentional (further potential uses of the methodology element are simply not considered).

The purpose of this document is to set out a compensation mechanism to overcome the above shortcomings, for the purpose of public consultation.

1.2 Compensation Mechanism Working Group

The proposal for the compensation mechanism has been developed by a working group convened by the VCSA and which also includes members of the VCSA. The VCSA would like to thank the (non-VCSA) members of the working group for volunteering their time thus far:

- Ricardo Bayon, EKO Asset Management Partners
- Belinda Ellington, Deutsche Bank (chair)
- Flavio Gomes, Bureau Veritas Certification
- Alexia Kelly, World Resources Institute
- Chris Staples, Linklaters
- Christoph Sutter, South Pole Carbon Asset Management

1.3 Public Consultation Process

The public consultation is open for 60 days¹ and all comments on the proposal should be sent to the VCSA at secretariat@v-c-s.org by 6pm Eastern Standard Time on 12 June 2010. Comments are particularly invited on the following issues:

- 1) **Disputes.** The proposed compensation mechanism creates the potential for disputes over know-how between methodology element developers. The proposal has been framed to minimize the potential for disputes to arise, but comments on how these might be further minimized would be welcomed.
- 2) **Dispute resolution.** Any new compensation mechanism needs to have a workable dispute resolution mechanism. This document sets out how disputes would be resolved under the proposed compensation mechanism and comments on this would be welcomed.
- 3) **Use of know-how.** Under the proposed compensation mechanism, a developer would be able to use know-how from approved methodology elements provided it secures authorization from the developer of the approved methodology element. Comments are invited on this proposed process and its efficacy.
- 4) **Compensation limit.** Under the proposed compensation mechanism, compensation would be payable on VCUs issued within the first ten years of VCSA approval of the methodology element. Comments are invited on the appropriateness of this length of time and whether a monetary amount cap or hybrid of the two approaches (time limit and monetary amount cap) might be more appropriate.

All comments received through the public consultation process will be reviewed by the working group and the VCSA, with a view to developing a final proposal for approval by the VCS Board.

2. Proposal for Compensation Mechanism

The requirements and specification of the proposed compensation mechanism are set out below.

2.1 Requirements

Any compensation mechanism must do the following:

- 1) **Incentivize more methodology element development.** The new mechanism must promote the further development of methodology elements, with the objective of ensuring methodology elements are developed for all scopes of the VCS Program where they are

¹ 60 days - best practice set out in *Guidance on the Application of the ISEAL Code of Good Practice for Setting Social and Environment Standards*, ISEAL Alliance, 2004. Available at <http://www.isealalliance.org/sites/default/files/P020%20Guidance%20on%20ISEAL%20Code%20PD2%20Jan04.pdf>

not currently available. This is particularly pertinent to areas of the VCS Program that are not within the scope of approved GHG programs.

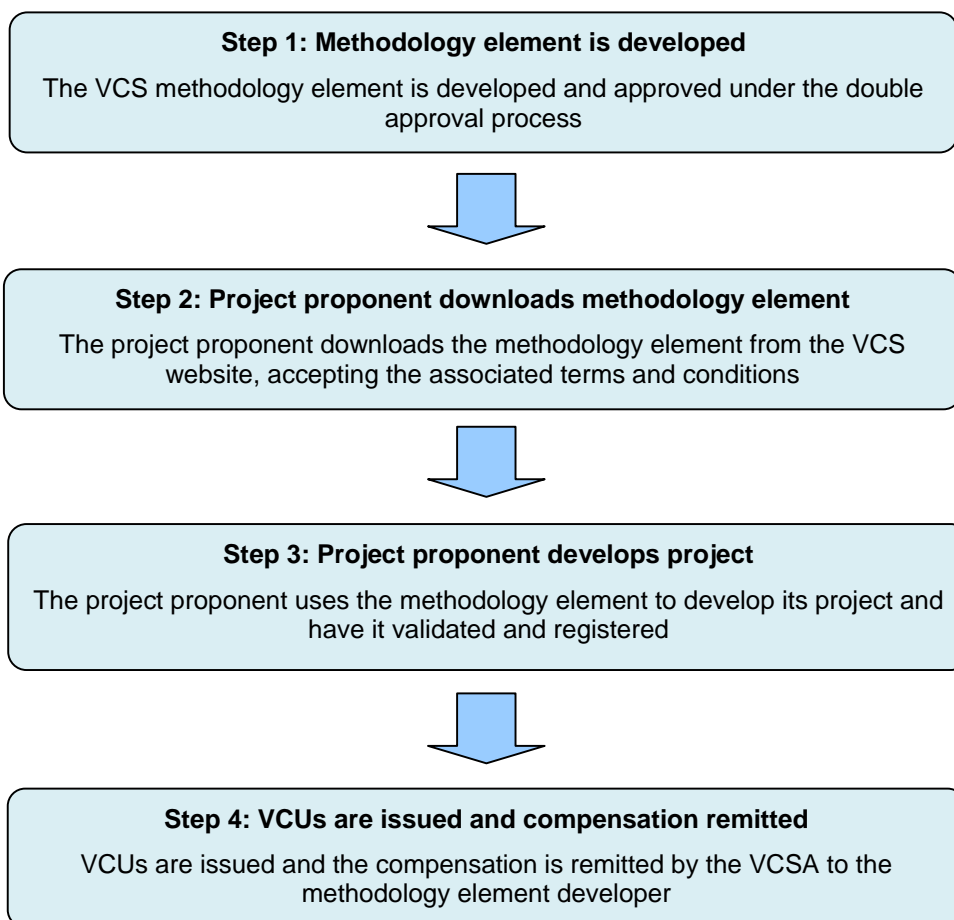
- 2) **Promote the development of broadly applicable methodology elements.** The new mechanism must promote the development of broadly applicable methodology elements, as opposed to methodology elements that are overly narrow and project-specific. Under the current paradigm, developers often (intentionally or unintentionally) develop methodologies that are suitable only for their projects. At the same time, methodology elements must be sufficiently defined that validators can envisage the full range of project types to which the methodology element could be applied. If validators consider methodology elements to be too broad they will be unable to provide positive assessments on them.
- 3) **Avoid unnecessary development of methodology elements.** The new mechanism must not lead to an unnecessary proliferation of methodology elements. If a suitable methodology element exists, it must be more cost-effective for a project proponent to use it than to develop a new (equivalent) methodology element.
- 4) **Provide certainty for developers.** To the extent possible, developers must be provided with certainty in the compensation they will receive for developing methodology elements. Developers must have sufficient confidence in the compensation available to allow them to develop methodology elements and take them through the double approval process.
- 5) **Protect the know-how of VCS methodology elements.** To the extent it is practicable to do so, the know-how embedded in VCS methodology elements must be protected and the developer must have recourse to any party that seeks to reuse the same know-how in a new methodology element. A dispute resolution mechanism must be available.
- 6) **VCSA independence and impartiality.** The market should decide in which areas to develop methodology elements, based upon the framework of the current double approval process. The VCSA would implement the framework for any new mechanism, though it should not choose winners nor be involved in resolutions of disputes over know-how.

2.2 Specification

2.2.1 Overview

The proposed mechanism would provide compensation to the developers of new methodology elements. The process is outlined in Diagram 1 below and applicability and process are set out in Sections 2.2.2 and 2.2.3.

Diagram 1: The Proposed Compensation Mechanism



2.2.2 Applicability

The double approval process is applicable to new methodologies, methodology revisions, additionality performance tests and tools/modules. Only the developers of (VCS) methodologies would be entitled to compensation under the proposed compensation mechanism, for the following reasons:

- 1) New methodologies are the main methodology element that the market needs if it is to start developing new project types. As such, this should be the focus for the new mechanism. The development of new additionality performance tests would be incentivized to the extent that where they are part of a new methodology they will benefit from the compensation mechanism.

- 2) Providing compensation for methodology revisions and tools/modules would entail an additional layer of complexity. Specifically:
 - a) When a developer revises a VCS methodology, it would be logical that a proportion of any fee be provided to the developer of the underlying methodology. Given that some methodology revisions may be minor and others substantial, determining the appropriate proportion of any fee that should flow back to the developer of the underlying methodology is not straight-forward. There is also the risk of creating a perverse incentive whereby developers would make minor revisions to a methodology merely to try to capture compensation from the methodology revision.
 - b) Tools/modules are used in (referenced by) methodologies, so any compensation mechanism for them would not be straight-forward. As with methodology revisions, given that tools/modules vary in their complexity (and therefore development effort), determining the appropriate proportion of any compensation that should go to the methodology developer and the tool/module developer would not be simple.
 - c) The above two challenges are further compounded by the fact that methodology revisions can use new tools/modules, so determining the proportions of any compensation that should be paid to the developers of the underlying methodology, the methodology revision and the tool/module is not a simple matter.

For all the above reasons, the proposed compensation mechanism would be applicable to methodologies only. Extending the mechanism to other types of methodology elements could be considered in a future phase, subject to a workable framework being developed.

2.2.3 Process

The compensation mechanism would operate as set out below. Note that there are two ways in which a methodology element developer may be compensated. First, by developers, for use of the methodology element's know-how in the development of new methodology elements. Second, by the VCSA, when the methodology element has been approved and VCUs are issued to projects that use it.

Step 1: Methodology element is developed

The methodology element is developed and approved under the double approval process. As part of this process, the initial version of the methodology element is available to the public when it is posted for public comment during the global stakeholder consultation process. Protection of the methodology element's embedded know-how would be afforded to the developer by requiring any party downloading such version of the methodology element to accept specific terms and conditions. The downloading process and the terms and conditions would be the same as for approved methodology elements (see Step 2 below).

Step 2: Project proponent downloads methodology element

The project proponent downloads the methodology element from the VCS website, so that it can use it to develop the project description. Protection of the methodology element's embedded know-how would be afforded to the developer of the methodology element by requiring any party downloading the methodology element to accept specific terms and conditions. Note that this same protection is provided on the version of the methodology element issued under the global stakeholder consultation process, as set out in Step 1 above.

The terms and conditions which the project proponent accepts when downloading the methodology element would form a binding contract between the party and the developer setting out the following:

- 1) The confidentiality provisions with respect to the methodology element. The party agrees not to disclose the methodology element and its embedded know-how to any other party. The party thus becomes a holder of confidential information, on terms agreed with the methodology developer. There may be multiple holders of such information and each forms part of a so-called 'confidentiality club'. Note that a methodology element's know-how would only be protected to the extent that the know-how does not become publicly available outside the confidentiality club.
- 2) The process for use of the methodology element's embedded know-how. The party agrees to secure authorization from the methodology element developer for any use of such know-how for the purposes of developing a new methodology under the VCS or any GHG program which is not a VCS-approved, national, regional or international treaty organisation GHG program, unless confidentiality provisions no longer apply to the methodology element (see Step 4 below on termination of confidentiality provisions). Note that authorization would not be required where the methodology element was used for the purposes of developing a methodology revision or tool/module under the VCS. Likewise, authorization would not be required where the methodology element was being consolidated with one or more other methodology elements and such consolidation was sanctioned by the VCSA.
- 3) Notice of the process for dispute resolution where a party has not secured authorisation from the respective methodology developer to use a methodology element's know-how and such developer has reason to believe that the party has copied all or any of the know-how of the methodology element. It would be the responsibility of such developers to monitor the development of new methodology elements (all methodology elements are made available during global stakeholder consultation) to determine whether there has been any breach of the terms in respect of its methodology element. Any disputes would be settled between the developer and the party. The VCSA does not play any part in dispute resolution.

- 4) Notice that the VCSA will retain information about parties that download methodology elements and will make this information available upon request to methodology element developers who have cause to believe that their methodology element's know-how has been used without their granting prior authorization.

The following would apply to the downloading process and the terms and conditions:

- 1) The terms and conditions would be general in nature and would not need to reference the specific methodology element being downloaded.
- 2) The VCSA would track the information about parties who accepted the terms and conditions, recording the name of the individual, their organization, their email address and the date and time that the methodology element was downloaded. This information would be available upon request to any methodology element developer who had cause to believe that its methodology element's know-how had been used without authorization.
- 3) The terms and conditions would apply to both initial versions of methodology elements posted on the VCS website for public comment during the double approval process and to approved (VCS) methodology elements. Thus, both versions would be protected against use without authorization from the methodology element developer.
- 4) The terms and conditions would be incorporated, by reference, at the front of each methodology element document.

The VCSA would reserve the right not to approve methodology elements where it determined that the developer had used know-how from another methodology element without the securing appropriate authorization from the developer of such methodology element. However, once a methodology element was approved, the VCSA would not reverse its approval decision if it were to subsequently come to light that such authorization had not been secured.

The VCS website would provide contact information for the developer of each methodology element and state which methodology elements are subject to confidentiality provisions. If another developer wanted to use know-how from a protected methodology element to develop a new methodology element, it would contact the methodology element developer and enter into bilateral discussions to secure authorization to use the know-how. The VCSA would not be involved in such discussions and the terms and conditions (including costs) would be a matter for the parties to agree. The VCSA would reserve the right to strip a methodology element of its confidentiality provisions where it deemed that the methodology element developer had not acted reasonably with respect to agreeing to third party use of the methodology element's know-how.

A methodology element developer could elect not to protect the methodology element's know-how via the confidentiality provisions, in which case parties downloading the methodology element would not be required to accept the terms and conditions described above and the know-how would be available for use without authorization.

Step 3: Project proponent develops project

The project proponent produces the project description, has the project validated and registers it on the VCS project database.

Step 4: VCUs are issued and compensation remitted

The project proponent produces the monitoring report, has the GHG emission reductions or removals verified, pays the VCS registration levy and has the VCUs issued.

Compensation would be based upon the volume of VCUs issued to projects using the methodology element and would be remitted by the VCSA to methodology developers as follows:

- 1) Compensation would be USD 0.02 per VCU, payable on VCUs issued within the first ten years of VCSA approval of the methodology. The methodology developer would be entitled to such compensation where VCUs were issued to projects using the methodology or a revision of the methodology. The developer of a methodology revision (where it is not the developer of the underlying methodology) would not be entitled to any compensation. Where a methodology is withdrawn, compensation would continue to be payable in respect of VCUs issued to projects that are already registered and using the methodology. Where the VCSA sanctions the consolidation of a number of methodologies, the compensation due to the developer of the consolidated methodology and the underlying methodologies respectively would be determined on a case-by-case basis by the VCSA.
- 2) Compensation would be paid to the methodology developer by the VCSA, transferred on a monthly basis. Where the accumulated compensation due to the methodology developer is less than USD 5,000, the transfer would roll over to the subsequent month, until such time as at least USD 5,000 is due. Where less than USD 5,000 has accumulated over a 12 month period, the VCSA would transfer to the methodology developer the outstanding compensation due.

Once ten years had passed since the VCSA approved the methodology, the confidentiality provisions (see Step 2) would terminate and the methodology's know-how would be available for use without authorization from the methodology element developer. In providing a cut-off point at which authorization for use of the methodology element's know-how is no longer required, it allows other developers to further develop aspects of the methodology element at a future point in time. If, on the other hand, authorization were required indefinitely, opportunities for further development of the methodology element would be stifled.

A methodology element developer could waive its rights to any compensation under the compensation mechanism, in which case the VCSA would not pay any compensation to the developer.

2.2.4 Implementation

The compensation mechanism would become effective immediately upon its introduction. Additionally, methodology elements posted for global stakeholder consultation by 13 April 2010 would be eligible for compensation under the new compensation mechanism, though methodology elements already approved by the VCSA by such date would not be eligible for compensation. Note that protection/confidentiality provisions with respect to know-how cannot and would not be afforded to methodology elements already in the public domain before the introduction of the compensation mechanism.