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## Indonesia's Carbon Market and Nature-Based Solutions: A Discussion of Carbon Ownership, Article 6 of the Paris Agreement and Carbon Exchange

As Indonesia embraces the new era of the carbon market, there are some questions regarding the framework of nature-based solutions in Indonesia's carbon market mechanism. In essence, nature-based solutions (NbS) are actions that protect, restore, and sustainably manage natural or modified ecosystems to provide climate change mitigation and adaptation benefits, such as reducing greenhouse gas emissions and enhancing carbon sequestration. NbS has been gaining momentum in this decade with the premise that NbS could be used to generate carbon credits that could be traded on the carbon market. For example, an entity could restore a degraded forest and earn carbon credits for the reductions in emissions.

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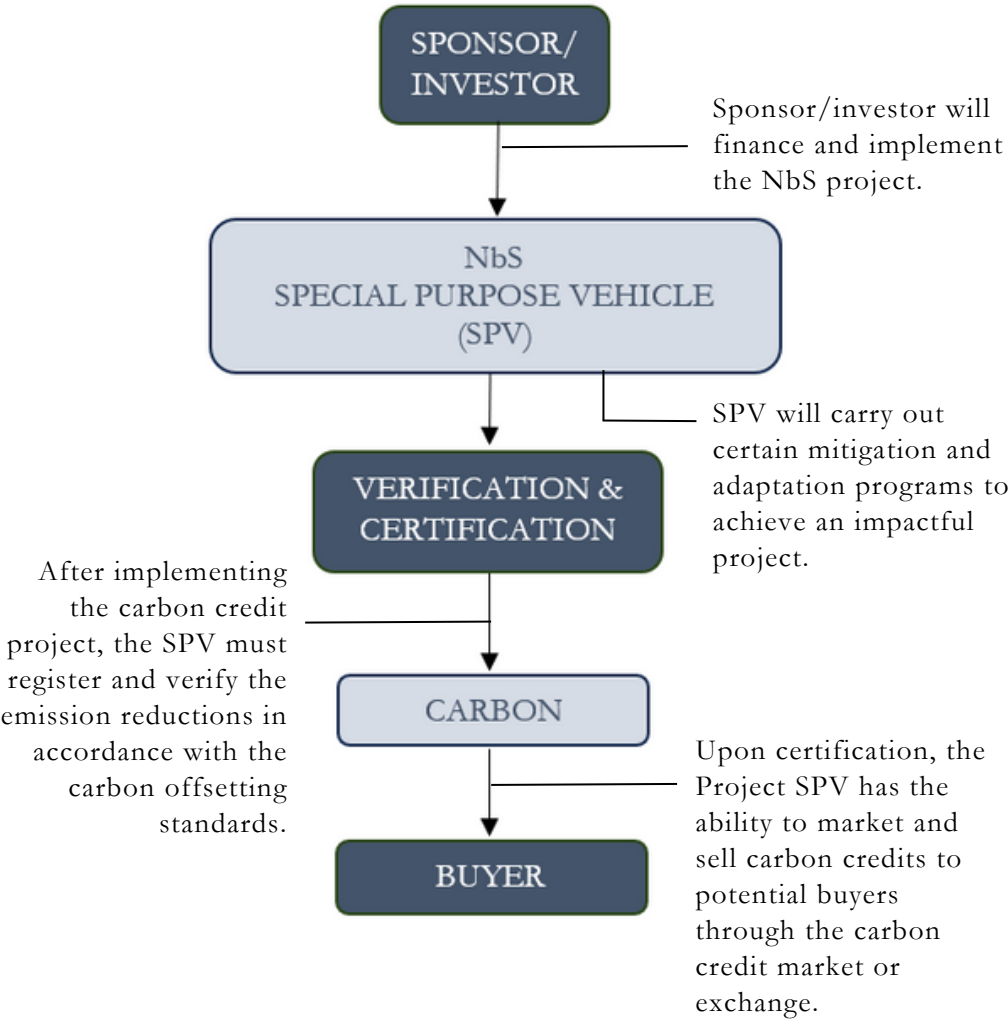
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With the enactment of few regulations regarding carbon credits in Indonesia, there are a few critical matters that need to be discussed and explored further.

Second, NbS could be used to reduce the carbon market compliance cost. For example, an entity could use NbS to offset its emissions rather than having to purchase carbon credits on the market. Third, NbS could be used to improve the environmental integrity of the carbon market. For example, NbS could be used to ensure that carbon credits are generated in a way that truly reduces emissions.

Below is a simple illustration of NbS:



With the enactment of few regulations regarding carbon credits in Indonesia, there are a few critical matters that need to be discussed and explored further, including the following:



## **Compliance and Voluntary Carbon Mechanism: How will NbS be used in the compliance and voluntary carbon mechanisms? Will there be different rules for each mechanism? What's Indonesia's choice for the carbon credit produced by the NbS Project?**

Prior to answering this issue, it is essential to understand the distinction between the Compliance Carbon Market and the Voluntary Carbon Market. In essence, the distinction between the two mechanisms is as follows:

- **Compliance carbon markets** are government-created and regulated markets where entities shall participate and meet certain carbon reduction targets. These markets operate on a mandatory basis, meaning that participating organisations are legally required to participate in the market and shall meet certain carbon reduction targets. Examples include the Kyoto Protocol, the EU Emissions Trading System, and the California Emissions Trading System.

In Indonesia, one of the milestones to develop the Compliance carbon market is through Presidential Regulation No. 98 of 2021, which introduced the Compliance carbon market on the Implementation of Carbon Pricing for Achieving a Nationally Determined Contribution (“**PR 98**”). The core message of PR 98 is crystal clear: give priority to Indonesia's NDC. PR 98/2021 regulates carbon trading, which is a market-based mechanism to reduce GHG emissions by selling and purchasing carbon units that can be carried out through domestic and foreign trade. This trading operates under these rules: (i) based on the relevant Indonesia National Registry System for Climate Change Control (known as “*Sistem Registry Nasional Pengendalian Perubahan Iklim*” or “**SRN PPI**”); or (ii) by emphasising the use of GHG Emission Reduction Certificates obtained from the country's national emission reduction efforts. The carbon trading in the Indonesian compliance market not only covers emission trading through allowance (facilitated by the cap-and-trade system) but also covers carbon offsets (including the project-based system).

- **Voluntary carbon markets** allow companies, nonprofits, and individuals to voluntarily purchase carbon credits to offset their emissions. These markets exist alongside compliance markets, which are mandatory for certain entities. Entities can voluntarily purchase carbon credits within these markets to counterbalance their emissions. This practice serves diverse purposes, including backing initiatives aimed at mitigating climate change. When purchasing carbon credits, it is important to consider third-party standards such as Verra, Gold Standard, and Plan Vivo.

The inquiries concerning the NbS Project in Indonesia revolve around whether NbS will be integrated into both compliance and voluntary carbon mechanisms; whether distinct regulations apply to each mechanism; and what Indonesia's preference is for the carbon credits generated by the NbS Project?

The Government of Indonesia seems to be leaning towards the compliance carbon market through the development of a domestic carbon trading scheme. This is evident in PR 98 and its implementing regulations, which encourage a few sectors, including forestry, to participate in the domestic carbon market. The implementing regulation of PR 98/2021, Minister of Environment and Forestry Regulation No. 21 of 2022 on the Guidelines of Carbon Pricing Implementation (“**MOEF Reg 21**”), provides clear guidance on the mechanism for carbon trading through the SRN PPI. The regulation also specifies that a carbon credit reserves buffer of 0-5% should be set aside for domestic carbon offsets, 10-20% for international carbon offsets, and at least 20% for international carbon offsets outside NDC. The Government of Indonesia also provides a vague treatment regarding VCM, which stipulates in MOEF Reg 21 that any mechanism of international carbon trading that does not affect Indonesia's NDC target shall follow these requirements: (i) Registered in the SRN PPI; (ii) does not include carbon unit transfers to other countries NDC; (iii) does not include any claims of emission reductions from climate change mitigation actions; and (iv) not associated with the emission reduction target of foreign cooperation partners.

The signal from MOEF Reg 21 has led to some uncertainty about the future of the VCM in Indonesia. The project developer needs to assess how NbS projects in Indonesia need to be in line with Indonesia's legal framework by considering the legal structure of the project, including considering to use of the compliance carbon market and assess the legal requirements for their NbS projects, including:

- **The legality of the concession license:** The project developer must ensure that the concession license is valid and that the project is being carried out in accordance with the terms of the license (i.e., forestry business license, social forestry license, or community forestry license).
- **Carbon ownership:** The project developer must determine who owns the carbon credits generated by the project. This may depend on the terms of the concession license, the applicable law, and the project's specific circumstances. (Please see section 2 for the carbon ownership).

- **The agreement or contract with the concession owner:** if the project proponent (that is not the concession owner) shall enter into an agreement with the concession owner, such agreement should distinctly outline the rights and responsibilities of each party involved. This agreement must encompass critical aspects such as the delineation of ownership rights concerning carbon credits, the distribution of benefits arising from the project, and the mechanism for resolving disputes that may arise. In essence, this contractual agreement serves as the foundation for regulating the relationship between the project developer and the concession owner. Further, MOEF issued Decree No. 716/2023 regarding the integration of carbon pricing in the approval, partnership, or business licensing in the Forestry and Environment Sector (“**MOEF Decree 716**”); it imposes certain requirements on concession holders who engage in strategic agreements with project proponents or carbon buyers shall be made into an agreement in form of a notarial deed and such agreements must not be construed as licenses being transferred and must be formalized through a notarial deed. In addition, the MOEF Decree 716 stipulates a limitation on the duration of sale and purchase agreements for carbon credits. Such contracts are restricted to a maximum duration of 5 years.
- **Authorisation of international carbon trading and corresponding adjustment:** The project developer must obtain authorisation from the Indonesian Government to trade carbon credits internationally. The Government may also require the project developer to make corresponding adjustments to the project design or implementation in order to ensure that the project does not affect Indonesia’s NDC target.

**Ownership of Carbon Credits: Who will own the carbon credits generated from the NbS Project? Will it be the entity that implements the project, the Government, or a third party?**

Initially, the straightforward approach to determining the ownership of carbon credits generated from NbS projects would involve assigning ownership to the entity that bears the costs and risks associated with the project. This entity would also be responsible for the management of the carbon credits. However, this scenario becomes more intricate due to the implementation of the Indonesian Minister of Environment and Forestry Regulations MOEF Regulation No. 7 of 2023 on the Guideline of Carbon Trading in the Forestry Sector (“**MOEF Reg 7**”), the Government of Indonesia emphasises that the

concession license holder should be the entity that owns and implement the carbon trading, on the other word, the concession license holder should be the project developers for NbS under Indonesia's compliance carbon market.

Under MOEF Reg 7, the Government of Indonesia accentuates the role of the concession license holder as the entity entitled to both ownership and execution of carbon trading activities. To put it differently, in the context of NbS projects within Indonesia's compliance carbon market, the entity possessing the concession license should also function as the designated project developer. This directive is particularly applicable to regions governed by forest business licenses, wherein the entity holding the Forest Utilization Business License, known as PBPH, emerges as the qualified project developer for NbS initiatives.

Notably, for social forestry or community forest areas where the PBPH designation doesn't apply, MOEF Reg 7 introduces an interesting facet. It mandates that these social forestry or community forest holders should collaborate with experienced carbon project partners possessing expertise in carbon project development and market access. However, what remains ambiguous is whether these partners, despite being integral to project management and bearing associated costs and risks, can rightfully claim carbon credits for their contributions to NbS projects in social or community forests.

In light of the intricacies outlined above, a few considerations emerge:

- **Transparency and Accountability:** It becomes crucial to ensure that the ownership structure of carbon credits remains transparent and accountable. Clear lines of ownership must be established to prevent ambiguity and potential disputes.
- **Equitable Benefit Distribution:** The distribution of benefits arising from carbon credits should be fair and equitable among all stakeholders involved in the NbS projects. This encompasses not only the project developers but also those partners contributing knowledge, expertise, and resources.
- **Inclusive Participation:** The configuration of carbon credit ownership should be structured in a way that does not deter other entities from participating in NbS projects. The framework should encourage collaboration and the involvement of various stakeholders, enhancing the scope and impact of NbS initiatives.



In essence, while the initial premise of straightforward carbon credit ownership appears logical, the introduction of regulatory intricacies adds layers of complexity. Striking a balance between ownership clarity, equitable distribution, and encouraging participation is vital for ensuring the success and sustainability of NbS projects within Indonesia’s evolving compliance carbon market framework.

**International Carbon Trading: How will Indonesia’s carbon market interact with international carbon markets? Will carbon credits be tradable across borders?**

The Government of Indonesia also specified the requirement for international carbon trading in MOEF Reg 21. The details outlined in MOEF Reg 21 shed light on the global collaborations related to carbon reduction that were hinted at in PR 98; international carbon trading arrangement permits relevant sectoral Ministers to engage in carbon trading between governments (known as “G2G” cooperation) after coordinating with the Ministry of Environment and Forestry (“MOEF”). Within this G2G cooperation, a portion of the outcomes from climate change mitigation actions that reduce emissions can be shared with partner countries, subject to the following conditions:

Host Countries Authorisation	Reported in National Registry	Corresponding Adjustment	Cooperation Object Determined	Cost and Fees	NDC alignment
The participation must be officially approved and authorised by the MOEF;	The results should be reported in the Indonesia National Registry System for Climate Change Control (SRN PPI);	Corresponding adjustments are made for the initial transfer in the international registry under the United Nations Framework Convention on Climate Change (UNFCCC) and reported in SRN PPI.	The sector or sub-sector is determined as the objective for cooperation by the partnering countries.	All costs and fees are settled in line with international decisions under the Paris Agreement.	The transactions involve greenhouse gases (GHG) measured in tons of carbon dioxide equivalent (CO2e) and align with the Nationally Determined Contribution (NDC).

It is important to note that international carbon trading collaborations are not solely limited to the G2G scheme. Private entities can also engage in collaborations with foreign counterparts, following MOEF approval. The outcomes achieved can assist the foreign partner in reaching their NDC, after being authorised by the MOEF (Authorisation). However, additional prerequisites for international carbon trading must be met, including achieving the sector's NDC target to enable international trading.

To gain MOEF's approval for international carbon trading, the proposal and draft cooperation agreement must be submitted. Furthermore, to receive authorisation for the international transfer of emission reduction results or carbon rights, the SPE-GRK or emission reduction certificates issued by recognised certification agencies need to be submitted to the MOEF for approval.

Based on the information above, it appears that the Government of Indonesia is committed to implementing Article 6.2 mechanism of the Paris Agreement for emission reductions or removal as internationally transferrable mitigation outcomes (“**ITMO**”).

Article 6.2 Paris Agreement:

*“Parties shall, where engaging on a voluntary basis in cooperative approaches that involve the use of internationally transferred mitigation outcomes towards nationally determined contributions, promote sustainable development and ensure environmental integrity and transparency, including in governance, and shall apply robust accounting to ensure, inter alia, the avoidance of double counting, consistent with guidance adopted by the Conference of the Parties serving as the meeting of the Parties to this Agreement.”*

Article 6.2 primarily provides guidance to the Paris Agreement Parties on monitoring and documenting the transfer of ITMO. Further, if Indonesia approves mitigation outcomes for international carbon trading, the Government needs to make a corresponding adjustment. Corresponding adjustments are accounting measures that ensure that two countries do not count the same emissions reductions or removals. This means that if Indonesia sells carbon credits to another country, it will need to make an adjustment to its emissions to account for the transfer of those savings. This is an important step in ensuring the integrity of the international carbon market and preventing countries from “*double counting*” their emissions reductions.



Currently, it remains unclear how the Government of Indonesia will implement the Article 6.2 mechanism, including the specifics of corresponding adjustments and the implementation buffer requirement. It is anticipated that there will be implementing regulations issued by the MOEF to govern the authorisation of ITMOs and corresponding adjustments.

## **Carbon Exchange**

To support the domestic carbon market, the Government of Indonesia prepared the legal framework for the establishment of carbon exchange. The Financial Authority Service (Otoritas Jasa Keuangan or “**OJK**”) issued Regulation No. 14 of 2023 on Carbon Trading through Carbon Exchange (“**OJK Reg 14**”). This regulation is a landmark regulation that establishes the framework for developing and operating carbon markets in Indonesia.

It is important to highlight that this regulation does not specifically designate or establish a particular platform for carbon trading. Instead, it establishes the prerequisites for any entity seeking to operate as a carbon exchange facilitator. OJK Reg 14 concisely designates carbon units traded within the carbon exchange as securities (*efek*). Furthermore, the carbon trading system is anticipated to streamline the process of matching buy and sell offers for carbon units, either directly or through intermediaries. The carbon ownership that can be traded in the carbon exchange is in the form of (i) GHG Emission Reduction Certificate (*Sertifikat Pengurangan Emisi Gas Rumah Kaca* or “**SPE GRK**”) or (ii) Cap and Trade Allowance Credit in the form of Emission Ceiling Technical Approval for Business Entity (*Persetujuan Teknis Batas Atas bagi Pelaku Usaha* or “**PTBAE-PU**”). For the NbS project, the carbon units that are tradable in the carbon exchange shall lie in the form of SPE GRK.

Another noteworthy aspect highlighted by the OJK Reg 14 is that carbon exchange operators possess the capability to enable transactions involving carbon units from foreign countries that have been recorded in the SRN PPI or have not been recorded in the SRN PPI, as long as it does not contrary to laws and regulations. For foreign-sourced carbon units that have not been recorded in the SRN PPI, they must meet the following conditions:

- Have been registered, validated, and verified by accredited institutions from an international registry;
- Fulfil the international carbon exchange trading requirements; and
- Other requirements may be determined by the OJK (after coordinating with MOEF).

The ability to trade foreign-sourced carbon units is a significant development that will help to expand the Indonesian carbon market further. Nonetheless, it is crucial to establish proper collaboration between MOEF, OJK, and carbon exchange operators before introducing foreign-sourced carbon units to the exchange, including the alignment of MOEF approval and/or authorisations, mutual recognition and clarity on corresponding adjustment regarding foreign-sourced carbon units. The issuance of OJK 14 is a step forward to establish the credibility of Indonesia's carbon market, including carbon units that resulted from the NbS project; however, there are still a few actions that need to be carried out by the relevant stakeholders to implement the carbon trading including:

- Alignment between SRN PPI and the carbon exchange system to match the carbon unit transactions, and the collaboration between MOEF and carbon exchange operators to anticipate this issue is highly encouraged.
- Aligning the regulations set forth by OJK, enacting self-regulatory measures for carbon exchange operators, and harmonising MOEF regulations related to international carbon trading, mutual recognition, and corresponding adjustments and buffer obligations are crucial steps. This alignment ensures a seamless and consistent operational landscape; and
- The development of carbon unit derivatives. This will help to ensure the transparency and liquidity of the carbon market.





- International carbon trading is significant. Indonesia's adherence to Article 6.2 of the Paris Agreement mechanism highlights its commitment to international cooperation, requiring adjustments to prevent double counting. It is anticipated that there will be implementing regulations issued by the MOEF to govern the authorisation of ITMOs and corresponding adjustments.
- The carbon exchange establishment, under OJK Reg 14, advances Indonesia's carbon market. Clear operational requirements for carbon exchange operators are defined. Notably, foreign-sourced carbon units' inclusion extends the market scope. Aligning SRN PPI and the exchange, harmonising regulations, and developing carbon unit derivatives are crucial steps that need to be carried out.

In essence, Indonesia's journey in the carbon market and NbS realm showcases intricate legal dynamics, operational nuances, and international collaboration. The nation's efforts in sync with global climate goals while fostering domestic carbon markets, signify a significant stride toward sustainability. The interplay of regulations, partnerships, and technicalities underscores Indonesia's commitment to a greener future.

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