Market Framework for Natural Capital - Engagement Paper

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Scottish Government
Riaghaltas na h-Alba

Market Framework for Natural Capital- Engagement Paper

Section 1: Introduction

This section explains the purpose of Scotland's Market Framework for Natural Capital. It also describes how the Scottish Government will develop Scotland's Market Framework, it defines key terms and describes the current context.

BACKGROUND:

Natural capital is our geology, soil, air, water, plants and animals. We depend on our natural capital for goods and services that make our lives possible and worthwhile. The most obvious include food, clean water, energy, building materials and medicines. Other services include carbon sequestration, natural flood defences, pollination of crops and inspiration from nature.

The 2021 Dasgupta Review[1] highlighted the ways in which our economy is also embedded in nature. Economic activity is fundamentally dependent on the natural world to supply the resources and services it needs, to assimilate its wastes, including greenhouse gas emissions and sustain human health and wellbeing.

The Scottish Government's Environment Strategy and National Strategy for Economic Transformation (NSET) recognises this dependency on nature and set out a vision for building a wellbeing economy - creating an economy that is fairer, wealthier and greener. Within this strategy the Scottish Government committed to develop a values-led and high-integrity market for responsible private investment in natural capital.[2]

The Scottish Government is now developing a Natural Capital Market Framework (Market Framework) for publication in 2024. Drawing on extensive research and practice the Framework will set out how we will take forward the NSET commitment by:

- Providing useful guidance for those seeking to enhance Scotland's natural capital via private investment, taking into account the need and expectation for a financial return on investment;
- Strengthening Scotland's interim principles for responsible investment;
- Setting out expectations for market governance;
- Describing alignment with Scotland's current and emergent policy context (including the forthcoming biodiversity investment plan);
- Describing actions to develop a pipeline of investable projects in Scotland.
- Setting out the benefits from private investment in natural capital.

We are using the 'Scottish Approach to Service Design' to develop the market framework. The method places co-development at its core by engaging stakeholders, leveraging their expertise and insights. The process includes i) a discovery phase - to identify key areas of debate ii) an engagement phase - to

[1] https://www.gov.uk/government/publications/final-report-the-economics-of-biodiversity-the-dasgupta-review
[2] UN Principles for Responsible Investment

discuss key issues with interested participants and iii) a validation phase – to sense check early drafts of the market framework ahead of Ministerial consideration.

This engagement paper is designed to inform and structure the engagement phase. It summarises the key market development issues identified during the discovery phase and sets out a series of questions to get input on these issues. It will be shared with stakeholders ahead of meetings and workshops to inform discussion and elicit feedback. There will also be opportunity for written feedback between April and June 2024.

Natural Capital Markets

Natural capital markets are a composition of systems, institutions, procedures, social relations and infrastructures which enable people to pay for and invest in natural capital. They increase opportunities for investment in nature restoration by providing mechanisms through which companies can pay their fair share to restore and maintain the resources they rely on; or by quantifying the value of restoration activity to encourage investors; or by creating long-term returns for financial institutions such as pension funds.

There are already natural capital markets operating in Scotland:

- The Peatland Code steers private investment towards high-integrity peatland restoration projects for carbon storage and water management;
- The Woodland Carbon Code steers private investment towards the creation of high-integrity woodland habitats for carbon sequestration, recreation and timber production.

Meanwhile, likely market developments could help to increase the flow of private investment into a wider range of natural capital such as:

- restoring biodiversity;
- reducing flood risk through natural flood management. For example, riparian planting for flood mitigation, protection of salmon populations and pollution control, or the restoration of natural river channels to help reduce flood risk;
- planting high quality street trees to provide urban cooling and help manage air quality;
- implementing regenerative agriculture to ensure healthy soils for crop production for generations to come;
- improving access to and engagement with the natural environment;
- enhancing coastal and marine environments - investing in habitats to support species in these environments, blue carbon and restoration;
- enhancements of coastal ecosystems such as saltmarsh habitats to help manage coastal flooding and erosion.

Current Context

In 2019, Scotland's natural capital was estimated at £230 billion, comprising 13% of the UK's total asset value. Scotland's economy heavily relies on natural assets, including renewable energy, tourism, agriculture and fisheries. Ecosystem services

in Scotland were valued at £15 billion annually, constituting 30% of the UK's total. [3] Furthermore, nature-based jobs totalled 195,000 in 2019, representing 7.5% of Scotland's workforce. NSET (2022) acknowledges the significance of natural capital and advocates for investment in it to foster a wellbeing economy - one that thrives economically, socially and environmentally.

Furthermore, if investment in natural capital markets were to increase to a level sufficient to meet Scotland's climate and nature restoration goals, it is estimated that approximately 146,000 direct and 197,000 indirect jobs could be created with a significant portion of this increased prosperity located in rural areas. The most substantial job growth would likely occur in the forestry sectors with additional opportunities arising in the supply of agricultural machinery and equipment, as well as peatland and coastal restoration initiatives. Such an investment in nature restoration activities could generate a substantial output effect of £17 billion for the Scottish economy, highlighting the potential for both environmental and economic gains from such investments.[4]

The Scottish Government is currently developing a Green Industrial Strategy, setting out how the Scottish Government intends to help businesses and investors realise the enormous economic opportunities of the global transition to net zero. The net zero transition, including our natural capital, provides opportunities to build internationally competitive clusters in new global growth sectors.

[3] Scottish Natural Capital Accounts 2023
[4] Assessing the cumulative and cross-sector economic benefits of investment in natural capital in Scotland (www.gov.scot)

Section 2: Governance in Natural Capital Markets

The UK's National Standards Body, the British Standards Institution (BSI), has worked closely with the UK Government, the devolved administrations and a wide range of stakeholders to create 'BSI Flex 701 Nature Markets – Overarching Principles and Framework – Specification v1.0' (March, 2024). This standard sets requirements for the design and operation of high-integrity nature markets, including processes to generate, trade and store nature units. The BSI Standards provide an initial articulation for how UK nature markets should function to ensure high integrity. [5]

Section summary:

"Integrity is the bedrock of nature markets. It means that credits or units awarded and sold for benefits, such as biodiversity, carbon capture or water quality, must reflect genuine, lasting and additional environmental improvements, which are robustly verified and transparently documented, with no double counting, misleading claims or negative unintended consequences, for example for non-target ecosystem services or local communities." (BSI, 2023)

The Scottish Government welcomes the first iteration of the BSI's standards and will engage in their review, discussion, improvement and – crucially – adoption. We also support the likely development of further thematic standards, particularly for biodiversity and community benefit.

Please consider:

- **How should Scotland help to ensure schemes and projects conform to the BSI's standards?**
- **How can Scotland's Market Framework further strengthen the governance of natural capital markets, alongside the BSI's standards?**

Detailed discussion:

This section starts by presenting the case studies of the UK's Woodland Carbon Code (WCC) and Peatland Code (PC). The WCC and PC are important because they currently fulfil many governance requirements for woodland and peatland projects entering the voluntary carbon markets.

The section then selects some of the 'market principles' within BSI's nature standard for additional commentary. Finally, the section presents the BSI's remaining market principles as a list. For brevity, we've omitted most BSI standard's subclauses, these can be found in their original document (here).

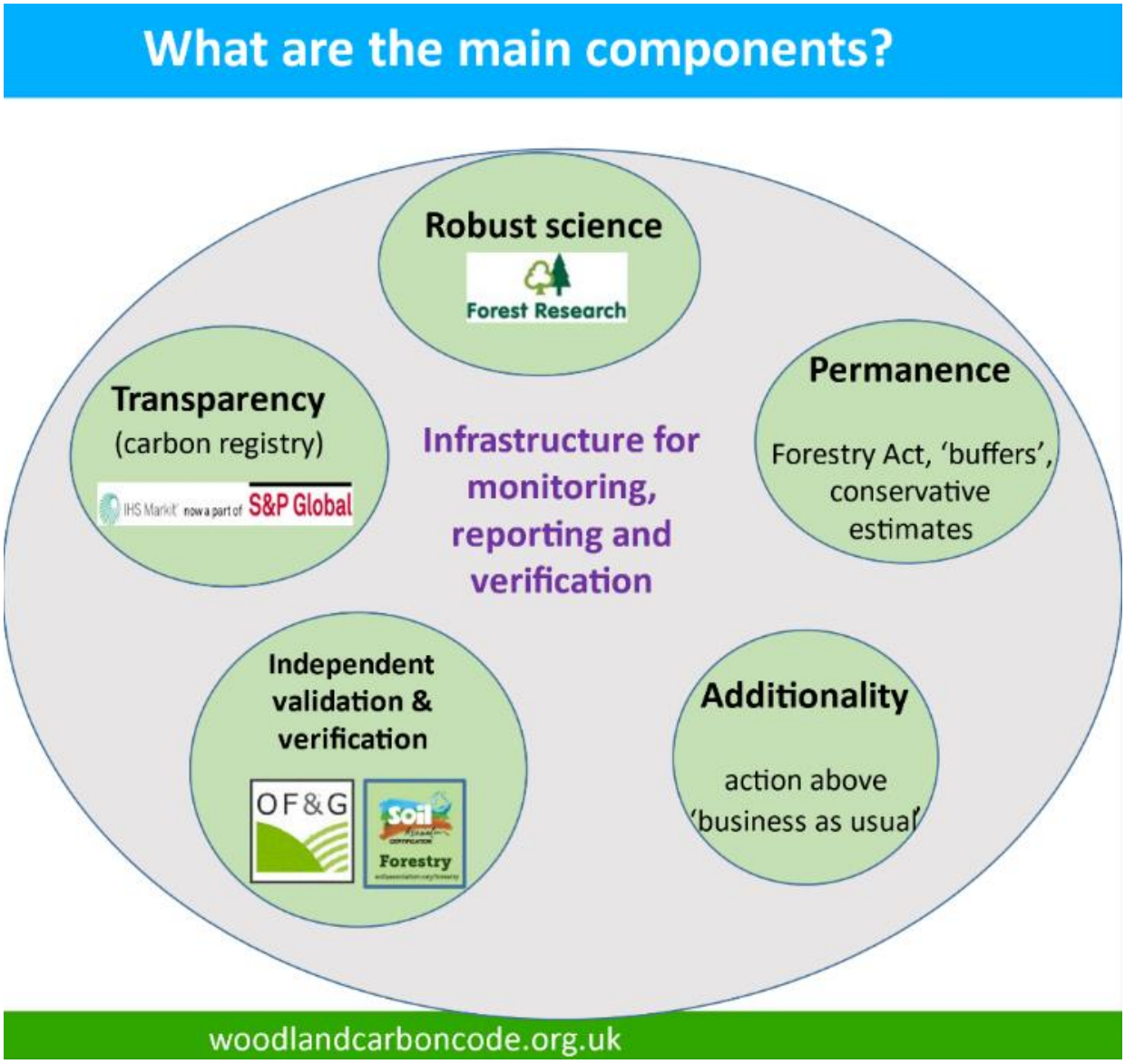
[5] There are a number of ongoing parallel international initiatives helping to define Scotland's vision for High Integrity Markets (see Section 4)

1. Case Study: The Woodland Carbon Code (WCC) and Peatland Code (PC)

Quality codes, standards, schemes, initiatives and other governance mechanisms are essential for high-integrity natural capital markets. They are needed to achieve the key natural capital principles including additionality, permanence, robust measurement and transparency. Their existence facilitates the creation of payment for, and investment in, units of natural capital.

The Government-backed WCC and PC have helped to position Scotland as a leading place for responsible investment in natural capital markets. These UK wide voluntary certification standards are currently the main mechanisms in the UK to attract private investment in natural capital. They issue units for each ton of naturally sequestrated carbon. Woodland and peatland projects looking to produce credits through these codes must first follow a process of validation. Projects are allocated Pending Issuance Units (PIUs)[6] which can be bought and sold. These are ultimately verified and converted to Carbon Units (PCUs and WCUs) which can be used by companies to report against UK based emissions or to use in claims of carbon neutrality or Net Zero emissions. The UK's WCC and PC are recognised for their high level of integrity. Independent validation of these standards provide assurance and clarity for buyers with regards the quantity and quality of emissions reductions purchased.

[6] A PIU is effectively a 'promise to deliver' a Unit of Sequestered Carbon in the future



1. BSI Principles on 'Buyer integrity'

The integrity of a nature market is reliant on the circumstances of a credit's sale. High integrity nature markets require credits to be used in the right way. For example, buyers can only use credits to offset unavoidable and negative environmental impacts (VCMI, 2023). The purchase of nature credits for less ambitious purposes, for example offsetting avoidable, minimizable or repairable impacts, is considered greenwashing. Such practices undermine market integrity.

The BSI identify three principles determining high-integrity purchase of units:

- Reducing Environmental Impacts Principle: Purchased units are used to reduce environmental impacts, based on a mitigation hierarchy (BSI, 2024).
- Claims Principle: Claims of environmental performance, based on units purchased in nature markets, measure that performance in a manner aligned to the measurement processes used to quantify the units for sale (BSI, 2024).

- Ethical Actors Principle: Buyers and suppliers provide information to allow market stakeholders to assess their integrity (BSI, 2024).

Additional Commentary: Most natural capital markets are yet to build processes to ensure the adoption of these principles. This is perhaps the key governance issue that needs addressing.

Nature markets will likely require buyer integrity checks, including:
- checks to ensure buyers have followed a suitable mitigation hierarchy;
- checks to ensure buyers have adhered to accounting and communications guidelines; and,
- know your customer and anti-money laundering checks.

Reviewed literature recommends that buyer checks should be:
- primarily funded by the buyer (polluter pays principle);
- accurate enough to be credible but cost-effective enough to avoid compromising the viability of natural capital markets (Kerchner & Keeton - 2015);
- equitable to ensure smaller entities are not shut out of the market.

Evidence suggests many current buyers would require preparatory work to pass the introduction of high-integrity tests. For example, Trove Research (MSCI, 2023) finds that current voluntary practice worldwide does not yet meet the Voluntary Carbon Market Initiative's (VCMI) *'Claims Code of Practice'* criteria. Given reasons include buyers lacking sufficiently robust net-zero commitments; buyers being off-track on their emission reduction targets; buyers using offsets excessively; and buyers not disclosing credits accurately.

2. BSI Principles on Additionality

BSI Additionality Principle: "Sellers are responsible for selling units that are additional." (BSI, 2024)

Additional Commentary: All units issued in nature markets must be based on new environmental improvements that wouldn't have happened otherwise in absence of the intervention. This is known as additionality. Additionally is vital in nature markets and must be verified against appropriate baselines.

High-integrity codes should verify additionality using a legal additionality test, and at least one other additionality test.

- a legal test – is a check that actions to supply units were not required under a legal or statutory mechanism;
- a financial test – assesses whether the relevant nature unit-based revenues are needed for a project to be financially viable; and
- a common practice test or a barrier test – assesses whether actions are already part of normal environmental management, or if they face barriers that are not otherwise overcome.

3. BSI Principles on Stacking

BSI Stacking Principle: Multiple types of units can be sold from the same supply area[7] as part of a stack when there is robust measurement and verification of additionality in place for each type of unit in the stack.

Stacking is when a project developer sells separate environmental outcomes from the same supply area in more than one nature unit. This can create multiple income streams and assist in meeting the need and expectation for a financial return on investment. As the market develops, a key governance consideration will become the conditions under which different credits can be stacked. A reliable system of stacking could promote integrated land use by allowing income to be earned for delivering more than one benefit from the same area of land (see section 3).

However, staking credits increases the risk of double counting. To avoid risks such as this the BSI's subclauses include stipulations that every unit in a stack should:

- be quantified and verified;
- pass additionality tests; and
- be accompanied by a statement declaring that the units are stacked on a market registry that has interoperability of information with the registries for the other units in a stack.

The WCC states that in future it may be possible to 'stack' voluntary credits generated from a woodland creation project provided:

- there is a credible voluntary standard for other ecosystem services;
- these standards are approved for use by the WCC Secretariat;
- all income streams are declared in the WCC cashflow spreadsheet; and
- claims made are clear and explicit.

Similarly, the Peatland Code is working in collaboration with the UK Land Carbon Registry to make stacking operational in a future version of the Peatland Code. It says mechanisms would be needed to ensure stacking does not compromise the integrity of the market, including:

- the existence of credible voluntary standards for each ecosystem service in the stack;
- the development of methods that could be used by the Peatland Code Executive Board to approve their use with Peatland Code projects; and
- methods for distinguishing bundled projects (in which other ecosystem services are sold as part of a bundle of benefits) from stacked projects for buyers, including mechanisms to show this on the UK Land Carbon Registry and to ensure checks are made between registries to avoid double-counting, so that claims are clear and explicit.

4. BSI Principles on Permanence

BSI Permanence Principle: Standards and schemes issuing units set out provisions to enable permanence of contracted environmental outcomes (BSI, 2024).

[7] Supply Area = a spatially delineated area where actions are taken to create the units supplied to nature markets

Environmental improvements must be maintained indefinitely. This can be attained through legal means. For example, the Forestry and Land Management (Scotland) Act (2018) mandates the replanting of felled trees. Alternatively, contracts can be used to enforce long-term maintenance. High-integrity codes such as the WCC and PC safeguard permanence by requiring "buffers" of unsold units to ensure enough can be returned upon an unexpected reversal. They can also ensure the initial release of credit are structured against defined milestones.

The BSI standards require suppliers to plan and undertake actions to ensure their environmental outcomes are lasting. It requires suppliers to cover the costs of actions necessary to supply units for their whole duration, including recognising unit delivery risks and planning mitigations. This will involve suppliers anticipating and accounting for the increased risks created by climate change. For example, where climate change results in a supply area's increased fire risk, this should be included in management of the supply area; not doing so would be "neglect" that failed a permanency check. This will also mean that when land used to supply units is sold the obligation for that land to supply units must remain. Furthermore, suppliers must undertake proportionate actions to rectify losses should damage to a supply area reduce the supply of units sold (exempted by force majeure). Finally, the generation of nature units should include provisions such as contingency, insurance or a buffer of units to ensure positive environmental outcomes are lasting.

5. BSI Principles on Measurement

BSI Quantification Principle: The measurement of units is robust and is made transparent between market participants and stakeholders (BSI, 2024).

The BSI's subclauses include stipulations that the quantification of units shall:

- be defined using a recognised classification;
- use methods based on published science;
- provide the available information relevant to assess additionality, relative to the baseline;
- be carried out over the units' lifetime;
- specify the measurement metric(s), as well as the supply area, date and timing of the measurement; and
- state the party who undertook the quantification, and the skills and knowledge that makes them competent to do so.

6. Remaining BSI Principles

<u>Principles shared across market participants</u>

- Transparency Principle: Market participants make material information about the supply and trading of units available to market stakeholders, unless it is commercially confidential (for example, price) (BSI, 2024).
- Governance Principle: The status and governance of a market participant, and the governance processes of a market standard, is stated to other participants and stakeholders (BSI, 2024).
- Timing Principle: The timing of the material information is transparent to market stakeholders (BSI, 2024).
- Competency Principle: The requirements of the BSI standards are carried out by competent individuals and organisations (BSI, 2024).

- Innovation Principle: Rules and requirements of market participants facilitate the adoption of new technologies or practices (BSI, 2024).
- Integration Principle: Buyers, sellers and market initiatives recognise that nature is multi-functional, producing a range of benefits, including the ability to adapt and mitigate climate change, which different stakeholders value in different ways. (See Section 2)
- Engagement Principle: Nature market participants' engagement with local communities is transparent. (See Section 2)

Selling units

- Supply Principle: Sellers are responsible for the integrity of units sold, and for demonstrating that integrity to market stakeholders *(BSI, 2024).*
- Unintended consequences Principle: Actions to supply units from a supply area avoid material negative environmental impacts (BSI, 2024).
- Validation and verification Principle: Sellers supply units that are validated and verified (BSI, 2024).
- Engagement with communities Principle: Suppliers undertake proportionate engagement with communities in relation to material environmental impacts of management actions to supply units (See Section 2).

Registries

- Registry Principle: The quantification, generation, trading and storage of units is recorded in registries, which make material information transparent and accessible to market stakeholders (unless it is commercially confidential), and consistent across nature markets (BSI, 2024).
- Interoperability Principle: Information in nature markets is comparable such that it enables the regulation and understanding of interactions between markets (BSI, 2024).

Trading Practices

- Access Principle*:* Processes of market trading and/or engagement enable access of market stakeholders (BSI, 2024).
- No double counting Principle: Environmental outcomes from actions to supply units in nature markets, whether or not they are explicitly sold, are only counted once (BSI, 2024).

7. Next steps

With a growing number of markets operating, or close to operating in the UK, a constant attention to building and maintaining effective systems of market governance is needed. To steer the development of market governance, the Scottish Government works in partnership with the UK government and other devolved nations to build the required infrastructure at a UK level. This approach ensures Scotland can use existing partnerships and collaborative efforts to support the growth and integrity of natural capital markets on a broader scale, ensuring consistency and coherence in approach across the UK.

Section 3: Supply in Natural Capital Markets

This section outlines the most important considerations regarding the use of Scotland's land for natural capital projects aimed at generating commercial returns. It argues that action is needed to boost the number, scale and variety of natural capital projects. It also argues that markets can only be considered high-integrity and values-led if they deliver public, private and community benefit and – for terrestrial projects – if they adopt integrated land use practices.

Section summary:

Natural capital markets have the potential to enhance Scotland's wellbeing economy. However, for this to happen:

- communities must share in any benefits;
- action is needed to boost the number, scale and variety of natural capital projects; and
- land-based projects should adopt integrated land-use practices.

This section's detailed discussion explores each of these in turn.

Detailed discussion:

1. Community Engagement and Community Benefit

DISCUSSION PROMPT

High-integrity, values-led natural capital markets must deliver public, private and community benefit. This requires engagement, collaboration and community agency. **Please consider:**

1. **What guidance should the market framework provide for those negotiating meaningful community benefit in natural capital markets?**
2. **How else can the market framework ensure the delivery of community benefits in natural capital markets?**

CONTEXT:

Natural capital investments can result in long term changes with the potential to impact upon the lives and livelihoods of local communities. This can include changes to the aesthetic and amenity of the area, the types of industries, jobs and employment, the number of people using or visiting an area, availability of housing and the viability and sustainability of a community. There will be a range of benefits and disbenefits from these changes.

Internationally, community engagement (process) and community benefits (outcomes) are established as important for undertaking responsible investment in natural capital markets (IC-VC, 2023; TCFD, 2017; TNFD, 2023; Vera, 2016).

In Scotland we are clear that communities should be engaged in, benefit from and exercise agency within natural capital markets (Scottish Government, 2022; WCC, 2022; IUCN, 2023). This is essential for ensuring that natural capital investments are

delivered in ways which benefit local communities and meet Scotland's wider land-use ambitions. It also minimises the potential for tension and conflict between stakeholders.

The market framework will incorporate the Scottish Land Commission's (2023) guidance on delivering community benefits from natural capital markets. It will also advance discussions about strategies for meaningful community engagement and delineate the known next steps for the development of community benefit tools.

WHAT IS COMMUNITY BENEFIT?

Scottish Land Commission (2023) finds that community benefits:

- are proportionate to the scale and impact of a landholding and how that landholding is used;
- benefit the local geographic community, inclusive of farmers and other land managers;
- can be monetary or non-monetary;
- promote the sustainable development of communities;
- can contribute to community wealth building;
- require meaningful engagement with the community;
- align with local strategic plans (where available);
- are tailored to the community's needs and agreed through deliberation;
- are monitored and reported on publicly; and
- are long term.

Specific examples of community benefits might include:

- shared ownership, use and governance of land and natural capital projects;
- ongoing community involvement in decision-making;
- the provision of things needed by the community (for example low-cost housing, enhanced amenity and recreational opportunities);
- supporting local enterprise through procurement and access to resources such as land;
- local employment, training and personal development opportunities;
- local climate change adaptations;
- creation of appropriately governed local or regional community benefit fund;
- improved local access to land and nature.

HOW TO DELIVER COMMUNITY BENEFITS IN NATURAL CAPITAL MARKETS?

Community engagement should be used as a means of finding out what the issues are for local people in relation to land use and negotiating suitable plans and benefits. Scotland has well-established guidance and practical tools for community engagement in land-use decisions.[8] The market framework will signpost these for use by natural capital projects.

[8] For example, Scottish Land Rights and Responsibilities Statement 2022; Scottish Land Commission's Protocol: Responsible Natural Capital and Carbon Management - Good Practice; Scottish Land Commission's Guidance: Community Benefit - Good Practice - Our work - Scottish Land Commission; and Scottish government: Guidance on Engaging Communities in Decisions Relating to Land (www.gov.scot).

The same tried and tested tools for delivering community benefit in natural capital markets do not exist yet. Although, there is emerging guidance and best practice case studies. The market framework will outline emerging good practice, including:

- engage early with the community;
- understand community needs and priorities, publish transparent information, set up inclusive decision-making structures;
- provide a clear point of contact for inquiries or concerns;
- share a draft engagement plan for feedback;
- understand the local context: refer to existing community action plans, local development strategies and engage with key stakeholders such as councillors, community councils and development trusts;
- engage widely on community benefits: formalise agreements with core local groups where possible;
- regularly review benefit agreements to align with project's market value and evolving community needs;
- seek advice from the Scottish Land Commission and other experienced parties for effective community benefit strategies.

WHAT NEXT STEPS MIGHT THE MARKET FRAMEWORK COMMIT TO?

From our research, these are known activities currently being undertaken in Scotland to help develop community benefit tools: -

- Scotland's 'Community Benefits Advisory Group' intends to:
  - generate more Community Benefit Case Studies from a wider range of contexts; and
  - engage with specific sectors, for example forestry, to identify practical approaches, guidance and tools.

- The Scottish Government, through its input into the BSI project intends to:
  - promote 'community engagement' and 'community benefit' within the BSI's Nature Programme.

- The Facility for Investment Ready Nature in Scotland (FIRNS)[9] projects include:
  - 'Deciding Matters' to develop and test a certification that would provide assurance on community benefits in natural capital projects.
  - Highland Rewilding's Joint Ventures to be explored as a mechanism for involving more people in nature restoration, boosting the economy, skills development, job creation and cohesion in local communities.

- Scottish Land Commission intends to:
  - develop model or standard partnership agreements;
  - refine guidance on delivering community benefits from land.

[9] See page 16.

2. Growing the number, scale and diversity of projects seeking private investment

Natural capital markets require a robust pipeline of nature-based projects that are sizeable enough to attract responsible private investment from institutional investors. Achieving a sufficient number of natural capital projects requires 1) the participation of users and owners or managers of natural resources, such as farmers and land managers and 2) the ability to collaborate or aggregate projects to a land-scape scale. Without a sizeable pipeline of projects, investors cannot be confident that they will receive a financial return on their investment.

Please consider: -

- **How can the market framework increase the number, diversity and scale of projects ready for investment?**
- **How can the market framework help to ensure projects are encouraged at landscape level?**

SCALE, AGGREGATION AND COLLABORATION

Thriving, high-integrity natural capital markets are made-up of landscape scale, joined-up nature-based projects. This scale enables the enhancement of ecosystem services such as water management and biodiversity. It also aligns well with the preferences of institutional investors. It is thought that the following strategies might help achieve this scale without hindering market entry for smaller projects:

- aggregation mechanisms to pool resources from individual larger projects or several smaller projects, reducing transaction costs and improving participation.
- collaboration across ownership and management boundaries. There are existing landscape-scale mechanisms in Scotland that could play a facilitating role, some already do (for example, Deer Management Groups (DMGs), common grazings, Regional Land Use Partnerships (RLUPs), National Parks, landscape-scale collaborations including with public land estates and voluntary partnerships like Cairngorms Connect).

EXAMPLE: PARTICIPATION OF FARMERS AND LAND-MANAGERS

Natural capital markets, coupled with agricultural reform and the changing demands of supply chains, are further incentivising farmers and other land-managers to enhance natural capital. However, to take advantage of these opportunities, it will be necessary to consider how to make it easier for tenants and crofters to participate while providing appropriate protection for the interests of landlords.

There are currently cultural, practical and financial barriers to participation in natural capital markets. Scotland's Market Framework will have to describe how to begin overcoming the following obstacles:

- Tax: Uncertainty about the tax treatment of land management schemes is said to hinder the ability of land managers to engage with a range of natural capital markets. Areas where tax treatment is uncertain includes Income Tax, Inheritance Tax and VAT and Land and Buildings Transaction Tax.

- Ownership and tenancy arrangements: Land tenure can present both a constraint and opportunity for the supply of nature-based projects in Scotland. Some distinctive forms of tenure (for example crofting, including common grazing, and tenant farms) raise challenges for participation in natural capital markets as the division of risk and reward may be uncertain or skewed. Tenants cannot generally go ahead without the agreement of the landlord and landlords are limited in their ability to restore land without the agreement of the tenant. Conversely owner occupiers, particularly of larger landholdings (for example large upland estates), are relatively unconstrained and can have a large influence on the supply of projects (for example peatland) but may do so without consideration of land users and communities. This raises risks for equity of access to new markets, revenues and investment.

- Skills development: The availability of nature-based projects is hampered by limited capacity and skills for project design and delivery. Expertise and capacity within supply chains for nature-based projects are lacking. Furthermore, the capacity of verifiers to assess projects' performance against the Woodland Carbon and Peatland Codes has, at times, restricted the rate of project supply. Natural capital markets need significant development of skilled capacity across various sectors, including land management, ecology, remote sensing, and financial technology.

- (For land-based projects) Impact of deer and other herbivores: The success of nature-based projects on land is fundamentally constrained by deer and other herbivore pressure and the effectiveness of associated management (for example deer control) and policy. Woodland requires low or zero grazing pressure to establish, and peatland restoration is vulnerable to trampling, especially in the first few years following restoration. This is a cross-cutting issue of importance to many, if not all aspects of land management for nature in Scotland.

- Lack of guidance on the creation of commercial agreements.

- Diversification legislation. Including inconsistency between code rules and tenancy diversification provisions.

- Potential first-mover disadvantages. For example fear of missing out on future agriculture support policy and private supply chain requirement to be net zero.

Case Study: FIRNS (Facility for Investment Ready Nature in Scotland)

The Scottish Government and NatureScot currently partner with the National Lottery Heritage Fund to co-fund FIRNS. One of the fund's aims is to help create a pipeline of nature-based projects that are ready to meet the demands from responsible buyers and investors.

The 27 projects funded in 2023/24 cover saltmarshes, iconic Atlantic rainforests, peatlands, rivers, lochs, farmland, biodiversity and green spaces for nature and people. All projects are working to Scotland's Interim Principles for Responsible Investment in Natural Capital. There is a short summary of projects funded in

2023/2024 on the FIRNS webpage[10]. Relevant learning will be included in the market framework.

Case Study: The Scottish Marine Environmental Enhancement Fund (SMEEF)

SMEEF is an innovative new approach to increase funding for marine restoration and enhancement. SMEEF enables those interested in the health of Scottish waters to voluntarily contribute to blended public-private funding grant pots which are then strategically distributed to projects across Scotland. Since its inception in 2022, SMEEF has awarded £3.7m to approximately 50 marine restoration and enhancement projects across Scotland. The Fund is managed by a Steering Group of NatureScot, Scottish Government's Marine Directorate and Crown Estate Scotland, supported by an Ethical Contributions Board and Grants Panel. This provides critical insight, and assures robust governance and transparency.

3. Investment that delivers integrated land use

Discussion Prompt

High-integrity, values-led natural capital markets should strive for multiple outcomes that benefit both people and the environment. This includes biodiversity enhancement, community benefit, returns for investors, food supply resilience, local employment and natural flood management. **Please consider:**

- **What is needed to enable projects to deliver multiple benefits through natural capital markets?**
- **How can the market framework ensure natural capital markets deliver multiple benefits at scale?**

Context:

Integrated land-use is essential for maximising the contribution of Scotland's finite land to sustainable outcomes across social, economic, and environmental domains. Much of our land can accommodate multiple functions.

The Scottish Government's land use strategy sets out our commitment to integrated land-use. The Land Reform Bill and Agriculture and Rural Communities (Scotland) Bill will also influence this area. Success hinges on the support and collaboration of land managers, owners, developers and local communities.

Integrated land-use can be defined broadly as the allocation of land to different uses across a defined area to achieve various economic, social and environmental outcomes. Integrated land-use in natural capital markets optimises ecosystem service flows, such as food, carbon and water, while concurrently delivering other available benefits like flood prevention, biodiversity enhancement and community well-being. Research by the RSPB[11] underscores the imperative for strategic decision-making, particularly when planning large-scale land use.

[10] FIRNS - The Facility for Investment Ready Nature in Scotland - Successful Round 1 Projects

[11] Spatially targeted nature-based solutions can mitigate climate change and nature loss but require a systems approach - ScienceDirect

How to achieve integrated land management in natural capital markets?

Integrated land-use decisions in natural capital markets are influenced by various contextual factors, including the presence of relevant spatial plans specific to a given area (see below). Natural capital decisions can be best made at a large scale (regional, local authority, landscape, national park, or river catchment level). However, they can be simpler to implement at a small scale (estate, farm, field, croft, or common grazing area). In practice, a balanced approach that incorporates a range of scales is essential for comprehensive planning and achieving successful outcomes.

Important considerations for natural capital projects include:

I. Mitigation against possible harms;
II. Maximization of the environmental benefits;
    a. within an ecosystem (for example managing discrete woodlands for biodiversity, carbon and timber);
    b. between ecosystems (for example habitat connectivity and enhancement of watercourses);
    c. across ecosystems (for example ensure sufficient mix of different habitats, land uses on a holding);
iii. Amplification of economic and social benefits.

There are many sector-by-sector tools to help a project developer make integrated land use decisions.[12] Regional, landscape, and sub-regional spatial plans exist and can also help a inform integrated land-use decisions.

Landscape-scale Planning

Spatial plans can help a project developer to:

- plan according to the local context;
- address specific opportunities and constraints (for example community interests, protected sites, habitat networks, land tenure); and
- work more effectively across ownership boundaries, leading to a larger scale project.

The place-based frameworks established by Scotland's five Regional Land Use Partnerships pilots (RLUPs) offer valuable structures for local natural capital projects. These frameworks articulate a clear vision and aims for land use within their respective regions. They delineate and endorse local land use changes that can contribute to Scotland's climate change and nature conservation goals. Moreover, they have the potential to help project developers when embarking upon their community engagement and benefit obligations by outlining the prioritised concerns of the diverse stakeholders affected by regional land use decisions.

There are other useful spatial policies and plans to guide the development of natural capital projects, including nature networks, landscape-scale collaborations and National Parks.

[12] For example, for woodland, the UK Forestry Standards (UKFS) sets out the requirements for sustainable forestry practices and aims to increase the positive impacts of forests and woodlands on air, water, soils, biodiversity and landscapes.

Proportionality

The scale of projects will influence approaches to land use integration. Large-scale projects can deliver more integrated management and therefore should be subjected to higher expectations.

Risk Management

Procedures should be in place to ensure social and environmental risks of a project are correctly identified, assessed and managed. For example, this may include guidance on the identification and protection of heritage sites that could be damaged by project activities or threatened and rare species from invasive and alien species.

Section 4: Demand in Natural Capital Markets

This Section describes the nature of demand in natural capital markets. It covers voluntary and mandatory markets; investor motivations; and market development.

Please consider:

- **How can the market framework help to increase demand in natural capital markets?**
- **How should public investment work alongside and enable private investment?**
- **What market developments are required?**

Section summary:

Presently, the voluntary carbon market, facilitated by the Government-backed Woodland Carbon and Peatland Codes, stands as the most developed market in Scotland. It is likely that public funding could be used in a more targeted way to boost private investment in these markets and support increased nature restoration. Other desirable developments in the voluntary carbon markets include a reliable system of stacking or bundling that enables income to be earned for delivering more than one benefit from the same area of land.

Other less well-developed markets such as biodiversity, water quality, soil, hedgerow and natural flood management will likely benefit from the emergence of new voluntary codes or the creation of compliance markets to generate demand.

Detailed discussion:

1. Market Type

The nature of demand differs by market type. Demand in voluntary markets is different from demand in compliance markets.

COMPLIANCE MARKETS

Compliance can be regulated by regional, national or international bodies. In these markets demand is generated by the need for organisations to comply with mandatory regulation.

The UK Emissions Trading Scheme (ETS) is the UK's largest compliance market. It trades finite carbon credits to support the UK 2050 Net Zero target. In 2023 The ETS Authority confirmed its intention to incorporate engineered greenhouse gas removal (GGR) technologies (such as direct air capture and carbon capture and storage) into the UK ETS and to further explore the possibility of including nature-based solutions into the system. This expansion could increase both nature-based and engineered carbon removals, but further work and consultation is needed to ensure integrity and that it supports Scotland's vision for responsible investment and a just transition.

It is possible to set up compliance markets for other types of natural capital. For instance, in February 2024, Defra implemented Biodiversity Net Gain within the English planning system, mandating developers to buy biodiversity credits for off-site habitat enhancements when on-site restoration proves impractical. Scotland's

planning policies have not sought to establish a mandatory market for biodiversity, opting instead to use its National Planning Framework 4 and Scottish Biodiversity Strategy to safeguard, conserve, restore, and enhance biodiversity.

Voluntary Markets

Voluntary markets are where credits are bought, usually by organisations, for voluntary use rather than to follow legally binding obligations. Private sector actors are primarily motivated to buy these credits to offset their own environmental impact. Initiatives like the Taskforce on Climate-Related Financial Disclosure (TCFD) and the emerging Nature-Related Financial Disclosure (TNFD) aim to stimulate demand in voluntary markets by setting up frameworks and expectations for multinational corporations with large annual turnovers to disclose their climate and nature impacts.

Carbon sequestration is Scotland's largest voluntary market. Carbon credits, standing for a unit of sequestered carbon dioxide, are sold to and retired by a buyer looking to enhance their climate credentials. At present, these credits are generated through the enhancement of woodland and peatland habitats and are verified by the UK's high integrity Peatland Code and Woodland Carbon Codes. It's likely voluntary markets will continue to expand to cover other ecosystems (for example marine, saltmarsh and soil) and other credit types (for example biodiversity credits and water management).

2. What motivates private investment in nature recovery?

Money moves from finance to investment to delivery vehicles (projects, companies) for planned (and measured) outputs and outcomes. Investment has an expectation of a return, by definition. The return has traditionally been financial cash flows. While the types of returns that are acceptable are expanding, the need for some type of financial return will always be there as far as private investment is concerned.

The following is a summary of the key motivations. How important each is would depend on the investor and investment:

- financial cash flows from traditional goods and services;
- compensating harm caused in the past or will be caused in the future through mandatory or voluntary offset or net gain requirements;
- meeting planning conditions with regards to biodiversity, flood risk management and water quality improvements;
- cost savings or risk management for own operations or others;
- investment in developing goods and services for nature recovery. For example, new green technologies;
- peer, consumer, investor, other stakeholder pressures and relevant initiatives like The Task Force on Climate Related Financial Disclosures (TCFD)[13], The Taskforce on Nature-related Financial Disclosures (TNFD)[14] and others;

[13] The Task Force on Climate Related Financial Disclosures (TCFD)
[14] The Taskforce on Nature-related Financial Disclosures (TNFD)

- achieving product differentiation or regulatory standards through investment in nature or industrial design of a consumable product that reduces impacts on nature, green product labelling;
- philanthropy (donations by private individuals) or other reasons to improve wellbeing from the flows of ecosystem services maintained or enhanced without any associated financial cash flow.

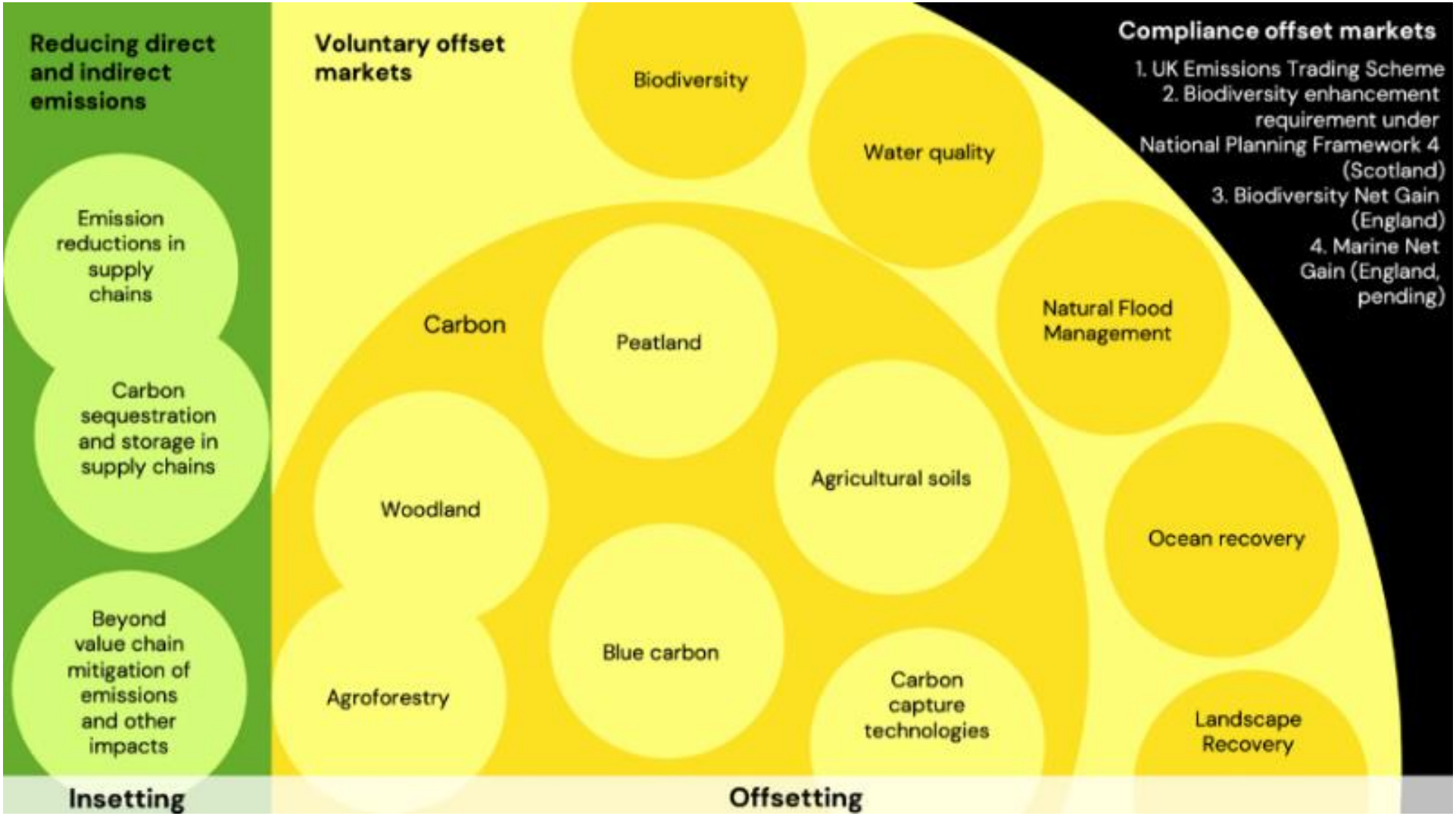
3. Future market development

Presently, the voluntary carbon market, facilitated by the Government-backed Woodland Carbon and Peatland Codes, stands as the most developed market in Scotland. Its core offering is the provision of high-integrity carbon offsets. While these codes incorporate provisions to promote co-benefits and integrated land-use decisions, natural capital markets could benefit from further market development.

Code Development

The emergence of new codes such as biodiversity credits, water quality credits, soil codes, hedgerow codes and natural flood management might help to promote diverse and integrated land use and improve a developer's investable proposition. The Scottish Government is involved in work to understand the potential for the creation of high-integrity voluntary biodiversity markets. Biodiversity is more challenging than carbon because a unit of biodiversity is more complex to quantify and cost. In a future voluntary market, biodiversity credits could be a mechanism for driving private investment into nature restoration, they could help an organisation measure progress towards becoming nature positive, they would not be considered offsets and could not be tied to biodiversity losses elsewhere.

Fig 2: Types of ecosystem market in the UK (from Reed et al., under review).



Stacking

So long as additionality rules are preserved, a robust and high-integrity system of stacking between codes could be a benefit because it will provide another route through which holistic, integrated natural capital projects can be made financially rewarding and viable (See Section 1). For example, stacking is one of the ways woodland creation could be recognised for its carbon, biodiversity and water benefits. Alternatives (or companions) to stacking might be bundling (see below) or regulatory mechanisms that insist on co-benefits (such as the UK forestry Standard).

Bundling

There is also the potential for the emergence of high-integrity codes aimed at providing a more comprehensive valuation of a project's outcomes (also known as bundling). Bundling is when a suite of ecosystem services produced by the same activity is sold at a price premium as a single combined unit in the market (for example the biodiversity and water quality improvement provided by wetland restoration). CivTech's funding of CreditNature aims to advance this concept.

Case Study: CreditNature

CreditNature aims to develop an option for a new voluntary biodiversity market to help scale responsible private investment into nature restoration in Scotland in a way that aligns with our market vision.

They are currently developing:

1. a framework for measuring ecosystem integrity before and after an intervention.
2. a nature credit – a digital asset certifying a project's nature positive claim.

4. Project Finance

In November 2023 the Investor Panel made recommendations for mobilising capital to finance Scotland's transition to Net Zero.[15] Several of these recommendations are relevant to natural capital markets including:

- a preference for projects to be undertaken at scale;
- an upskilling of public sector leaders who engage with investors; and
- a need to maintain a high degree of focus on outputs, as opposed to process.

In response to these recommendations Scottish Government and its agencies have committed to exploring new approaches for attracting the scale of capital required.[16] One area of consideration is 'blended finance' mechanisms, where public funding is used in a more targeted way to support nature restoration alongside responsible private investment. There are many different sorts of blended finance mechanisms discussed in the literature. These mechanisms are not mutually exclusive, some can co-exist. All mechanisms have strengths and weaknesses, and their costs and benefits vary according to a) future market price, b) nature of demand (i.e. voluntary

[15] Investor Panel: Mobilising international capital to finance the transition to Net Zero - gov.scot (www.gov.scot)
[16] Investor Panel - Scottish Government Response to Investor Panel Recommendations (www.gov.scot)

or compliance), and c) the type of market the mechanism is applied to (i.e. peatland, woodland, biodiversity, water etc).

Table 1: blended finance mechanisms identified during the discovery phase.

Name	**Description**
Grants	This is a keyway through which public money is used to enhance Scotland's natural capital. Current grants include the Forestry Grant Scheme, agriculture support payments, the Peatland Action fund and the Scottish land fund
Public Land Ownership	Scotland's public agencies own about 11% of its land mass and continue to consider land acquisitions that can deliver natural capital benefits such as tree planting, peatland restoration and flood alleviation. Investment in these sites is another way public money is put to work enriching Scotland's natural capital
Carbon Price Floor Guarantee	Hypothetically, such a fund would be used to offer the entire market a guaranteed minimum price for carbon
First Loss Capital Fund	Hypothetically, such a fund would consist of private money supported by public first loss capital. As returns accrue, such a fund would first pay profits to investors, until it reaches a certain threshold or 'strike price', after which the Government would start to receive a return as well
Project Finance Vehicle	Hypothetically, this would see a public-private fund provide project developers with finance in the form of a loan or equity injection to support the upfront capital costs
Liquidity Vehicle	Hypothetically, such a fund would act as a guaranteed off taker of PIUs, buying credits from projects upfront and holding onto them until they vest into PCUs (Peatland Carbon Units). Projects receive a one-off upfront payment from the sale of PIUs to the fund. Investor returns are generated by the expected increase in value of the credits over time
Operating Costs Endowment	Hypothetically, a natural capital project would contribute a certain proportion of their revenues from sales to an endowment. The amount contributed by the projects should be a function of the modelled project lifetime cost. This centralised fund, would then be used to support all projects operating costs
Individual carbon contracts	Hypothetically, a government could enter a contract with individual natural capital projects whereby a government agrees to buy a portion of the resulting carbon credits at an agreed price, often above the existing market rate, with guarantees that the project will report against a variety of co-benefits
Corporate ESG (Environmental, Social and Governance) fund	Hypothetically, such a fund could be administered by public agencies that allows large corporates to donate to restoration costs as part of meeting their ESG/Corporate Social Responsibility (CSR) requirements

5. Next Steps

Especially with regards to meeting important and urgent peatland restoration targets, Scottish Government believes it necessary to explore blended finance approaches. Such an exploration will include:

- achieving a better understanding of the existing private finance market for peatland restoration, emerging actors, and their current approaches;
- deciding what proposed blended finance solutions are practical and appropriate for peatland restoration in Scotland, including undertaking an economic appraisal of these options;
- assessing whether and how to make any blended finance schemes permanent and develop an understanding of how long each potential scheme would take to develop and reach maturity.

Section 5: Policy alignment

This Section lists the Scottish, UK, and international policies, practices and principles that shape Scotland's natural capital markets and help to define what high-integrity natural capital markets mean.

Section summary:

Policies and practices shape Scotland's natural capital markets and help to define high-integrity. Scotland's natural capital markets could also benefit from specific changes in Scottish, UK and international policies and practices.

As we write the market framework it is worth considering the ways in which the policy landscape supports what we are trying to achieve in Scotland and how can this be taken forward. Please consider:

- **Which Scottish policy dependencies should be reflected in the market framework?**
- **How do existing codes and standards support what we're trying to achieve in Scotland? How should the market framework incorporate these?**

Detailed discussion:

Existing principles for natural capital markets include:

- Scotland's Interim Principles for Responsible Investment in Natural Capital;
- the Voluntary Carbon Market Initiative (VCMI) Claims Code of Practice;
- the Integrity Council for Voluntary Carbon Markets (IC-VCM) Core Carbon Principles;
- The International Carbon Reduction Offsetting Alliance (ICROA) Code;
- The Taskforce for Nature-related Financial Disclosures (TNFD) Risk management and Disclosure Framework;
- The Science-Based Targets Initiative (SBTI) net zero standard;
- UN Principles for Responsible Investment (UNPRI);
- UK Gov (2023) Nature markets: A framework for scaling up private investment in nature recovery and sustainable farming; and
- BSI UK nature market standards.

NATIONAL, UK, AND INTERNATIONAL POLICY ALIGNMENT CONSIDERATIONS INCLUDE:

Scottish Policy	
Agricultural Reform Programme	Scotland's new Vision for Agriculture seeks sustainable food production, a Just Transition for farm businesses, reduced greenhouse gas emissions, and biodiversity recovery
Land Reform	Natural capital markets should align with Scotland's ongoing process of Land Reform, including the measures within the forthcoming Land Reform Bill. N.B The Land Reform (Scotland) Act 2016 gave Scottish Ministers a duty to issue guidance about engaging communities in decisions

Regional Land Use partnerships	Five Regional Land Use Partnership pilots were set up in 2021 to enable natural capital-led consideration of how to maximise the contribution that our land can make to addressing the twin climate and biodiversity crises
Scottish Land Rights and Responsibilities Statement	Provides an overarching definition of responsible land ownership, use and management, which should underpin any strategy or policy relating to land. Includes reference to the importance of community engagement and collaboration; the need for transparent decision-making; references just transition and fairness; talks about balancing interests and benefits
Community Wealth Building consultation	In 2023, the Scottish Government published a consultation on Community Wealth Building (CWB). The responses from the consultation will be used to help inform the development of CWB legislation and policy.
UK Policy	
The UK nature markets framework	The framework set's out how the UK government will act to build trust, confidence, and scale of nature markets. There's currently a degree of alignment between Scottish and Westminster Governments' market visions. There will need to be some deviation to reflect the diversity of nature markets visions, for example Scotland's market framework will have a stronger requirement for community benefit
The British Standard Institute's (BSI) UK nature market standards	The BSI standards are intended to ensure that the quantification of ecosystem services delivered by nature-based projects is carried out rigorously, consistently, and that they deliver the claimed outcomes. The BSI has a three-year project plan. A further iteration of our market framework might be needed to accommodate future BSI publications
UK Emissions Trading Scheme (ETS)	The ETS Authority expanded the UK ETS scope last year, intending to include greenhouse gas removals (GGRs), including nature-based removals like afforestation alongside engineered ones
International Policy	
Voluntary Carbon Market Initiative (VCMI)	VCMI aims to build buyer integrity in Voluntary Carbon Markets. Its voluntary claims code provides a rulebook for companies and non-state actors on proper usage of voluntary carbon credit in emissions reduction goals and net-zero commitments
Integrity Council for Voluntary Carbon Markets (IC-VCM):	IC-VCM, an international governance body, enforces high standards for ethics, sustainability, and transparency in global Voluntary Carbon Markets. It has established ten Core Carbon Principles for high-quality carbon credits on the supply side, defining valid programs and methodologies
International Carbon Reduction Offsetting Alliance	ICROA's Code of Best Practice outlines international guidelines for offset-inclusive carbon management, accrediting organizations based on minimum requirements. The Woodland Carbon Code is ICROA accredited, and the Peatland Code seeks accreditation in 2024
Taskforce for Nature-related Financial	TNFD provides recommendations and guidance for organisations to report and act on evolving nature-related dependencies, risks, and opportunities, promoting a shift

Disclosures (TNFD)	towards nature-positive outcomes aligned with the Global Biodiversity Framework. It follows the 2017 Taskforce for Climate-related Financial Disclosures (TCFD). The UK Government has since mandated TCFD-aligned disclosures for large entities in the UK private sector
Science-Based Targets Initiative (SBTI):	SBTI, backed by the CDP, the UN Global Compact, WRI, and WWF, enables organisations to set science-based emissions reduction targets. It has recently proposed exclusion of emissions reductions, such as those achieved from peatland restoration, from their criteria. If this policy decision is confirmed it will likely reduce the demand from private investors for carbon credits from peatland restoration
UN Principles for Responsible Investment (UNPRI):	UNPRI's The six Principles for Responsible Investment offer possible actions for incorporating Environmental, Social and Governance (ESG) issues into investment practice

Please consider:

- **How else can Scotland's Market Framework help to realise the opportunities of natural capital markets?**

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