February 7, 2012

Forest Carbon Partnership Facility (FCPF)

Working Group on the Methodological and Pricing Approach for the Carbon Fund of the FCPF (WG)

2nd conference call (February 14, 2012)

Background Note #3

Quality and Non-Carbon Values as Price Determinants under the Carbon Fund of the FCPF

The objective of this note is to provide background information to the WG members, in order to help structure the discussion on the proposed topic for the second call of the WG.

1. Discussions on pricing to date

An initial valuation and pricing note was circulated and discussed in 2008 with a number of FCPF Participants and observers representing REDD Countries and potential Carbon Fund Participants. Progress made by the FMT was presented regularly at FCPF Participants Committee meetings. The note prepared by the FMT on Valuation and Pricing for the Carbon Fund, dated August 31, 2011, which was presented to CF2 and PC10, summarizes the state of the FMT's thinking on the topic.[1]

The Issues Note of the Carbon Fund[2], which highlights technical aspects of the Carbon Fund, was discussed during the design phase of the FCPF in 2006-2008, and reflects inputs from meetings of entities interested in the Carbon Fund held over the course of 2009-2010, in Participants Committee meetings (PC4, PC5, PC6 and PC7), and exchanges with Indigenous Peoples and civil society.

With regard to pricing of Emission Reductions (ERs) under the Carbon Fund, the Issues Note provides that the objective is to arrive at values that:

1. Entice parties to transact ERs from REDD+ and safeguard their respective interests and rights in a reasonable manner;
2. Represent a transparent mechanism that reflects the risk allocation between parties to the transaction;
3. May use both fixed and variable valuation/pricing options that would allow risk sharing to deal with large price fluctuations and provide the comfort of a fixed price component;
4. Reflect the quality of ERs generated by each ER Program, including non-carbon values as appropriate; and
5. Leave room for adjustments later to align with emerging guidelines under the UNFCCC and other regimes, as applicable, and as demand and supply for ERs from REDD+ activities evolve.

The WG confirmed this objective in its first call.

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[1] FMT Note 2011-14 is available at http://www.forestcarbonpartnership.org/fcp/sites/forestcarbonpartnership.org/files/Documents/PDF/Jan2012/FCPF%20CF%20Pricing%20Valuation%20Note%2002-01-12%20rev.pdf

[2] The Issues Note is available at http://www.forestcarbonpartnership.org/fcp/node/277.

The WG should now propose ways to achieve this objective in order to help the PC adopt "policy guidance on pricing methodologies for ERPAs" as provided for in Section 11.1 (f) of the FCPF Charter.

2. Proposed discussion approach

For call #2 of the WG, it is proposed to discuss how quality, including non-carbon values, can be reflected in the price of an ER (#4 in the objective above).

The following approach is proposed for the discussion:

1. Agree on the definitions of the main concepts: ERs, quality and non-carbon values;
2. Discuss the possible mechanisms to assess and reflect the quality and non-carbon values in the ERs price; and
3. Conclude on guidance and/or next steps.

2.1. Defining the main concepts

2.1.1. Definition of an ER

As per the Charter, the Carbon Fund's strategic objective is to pilot performance-based payment systems for Emission Reductions (ERs) generated from REDD+ activities, with a view to ensuring equitable benefit sharing and promoting future large scale positive incentives for REDD+.

As per the Issues Note, the Carbon Fund will deliver ERs from REDD+ activities to the Carbon Fund Participants, who will pay for the received ERs. The ERs are defined as all the rights, titles, and interests attached to a tonne of ER. The definition of an ER does not entail any rights, titles or interests to land and territories.

Forests offer deep spiritual values, and provide environmental services and other values beyond carbon, not yet widely reflected in land values, that are recognized. However, based on the Charter and the Issues Note, in the context of the Carbon Fund, the primary value of an ER generated by a REDD+ activity remains the reduction of CO_2 emissions in the atmosphere, i.e., its carbon value.

2.1.2. Quality of an ER

The Carbon Fund will target ER Programs that generate high-quality and sustainable ERs (including environmental and social benefits, and minimization of the risk of reversals); and that are consistent with emerging compliance standards under the UNFCCC and other regimes, as applicable.

"Quality of ERs" in the context of the Carbon Fund is therefore understood to relate to the climate change mitigation benefit of an ER. The ER Programs to be selected under the Carbon Fund will have to meet minimum quality standards and have adequate risk mitigation measures put in place. These minimum standards and risk mitigation measures will relate mainly to the carbon accounting and programmatic characteristics of ER Programs. However, the quality of the ERs delivered will likely differ from one ER Program to another.

2.1.3. Non-carbon values

ERs from REDD+ will not be created equal. In most cases they will feature, in addition to climate change mitigation benefits, a range of additional benefits, in particular for local people and the local environment. For example, REDD+ activities could enhance biological diversity by protecting and restoring natural habitat by concentrating ER Programs on biodiversity hot spots, or preserve or improve livelihoods for local communities by securing customary property or user rights to their forest land and the land's timber and non-timber forest products. REDD+ may also create synergy between the climate change mitigation and adaptation agendas by improving the resilience of communities and ecosystems to climate change. These additional benefits are recognized as the "non-carbon values" associated with ER Programs. It is likely that these non-carbon values associated with ERs will be different between different ER Programs in the Carbon Fund.

The Readiness Mechanism will help countries test methods and tools for increasing additional benefits and reducing possible trade-offs between climate change mitigation and policy objectives of socioeconomic development and biodiversity conservation. For the case of the Carbon Fund, applying the World Bank environmental and social safeguards is a minimum requirement. In addition, in these early days of incentive payments for REDD+, the resources available will be limited, so these limited resources will be directed to ER Programs that exhibit strong additional benefits. The ER-PIN template proposed by the FMT is explicit on this choice though the level of monitoring required and the technical and financial implications are not yet clear.

2.2. Assessing and reflecting the quality in the price

During the Carbon Fund's video-conference of September 1-2, 2011, and the PC11 and CF2 meetings in Berlin in October 2011, the FMT made a proposal for an approach to reflect quality in the price.

The proposal made by the FMT last September-October can be summarized as follows. For the purpose of pricing in the FCPF Carbon Fund:

- The methodological parameters taken into consideration to assess the quality of an ER would be priced with regard to the elements retained in the methodological approach;
- The quality of an ER would be assessed with regard to its methodological characteristics only, including carbon accounting and programmatic characteristics. Characteristics of a different nature, such as social risk, political risk, or overall delivery risk, would have an impact on the actual ER volumes expected and effectively generated by the ER Program. It was considered that, since the principle is for payments to be made primarily upon delivery (this still remains to be discussed in detail), these characteristics would not have to be accounted for in the context of price adjustment to quality; and
- A price premium or discount would be assigned depending on the quality of the ER (which was referred to as "stage" in the methodological approach to reflect the fact that quality may improve over time as the country's capacity for MRV and REL/FRL improves). For example, ER Programs assessed to be at stage 2 quality (medium or intermediate) would receive a base price. ER Programs assessed to be at stage 3 quality (high or advanced) would receive the base price plus a premium. ER Programs assessed to be at stage 1 quality (low or developing) would receive the base price minus a discount.

While the participants to the meetings confirmed the need to reflect quality in the price, the strong preference expressed in Berlin was for not including differential quality levels or stages in the methodological and thus the pricing framework. The participants rather expressed a preference for a single high-quality standard to be developed, which would entail mandatory accounting elements and ER Program characteristics, and for applying this standard for selecting ER Programs into the portfolio. This way, all Programs would meet the standard and there would be no perception of 'low-quality' Programs being part of the portfolio. All ER Programs selected in the portfolio would have to meet the standard.

Based on the guidance received to date, the FMT is therefore proposing to the WG to discuss the following options:

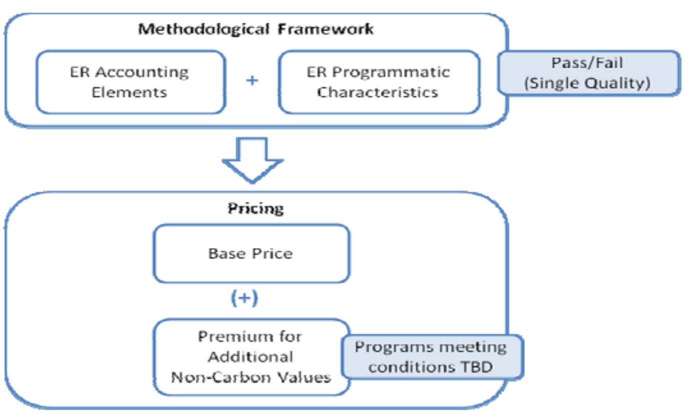
1. If the assessment of quality is to be done with regard to the methodological framework (for the reasons explained above), two options could be developed:

   (i) Option 1 is a single high-quality standard (i.e., no differentiation amongst ER Programs): then there should not be price differentiation based on quality either (the price paid for an ER could however be different from an ER Program to another based on other parameters, including the non-carbon values, the conditions at the time of signing the ERPA, or the conditions at the time of delivery[3]). Option 1 is shown in Figure 1 below;

   (ii) Option 2 would apply if the methodological framework to be developed for the Carbon Fund does allow for quality differentiation. Then the approach proposed initially could be retained. However, only application of premia would be considered, i.e., ER Programs assessed to be at stage 1 quality (basic, but meeting the minimum standard) would receive a base price. ER Programs assessed to be at stage 2 quality (medium or intermediate) would receive the base price plus a premium. ER Programs assessed to be at stage 3 quality (high or advanced) would receive the base price plus a higher premium. Option 2 is shown in Figure 2 below.

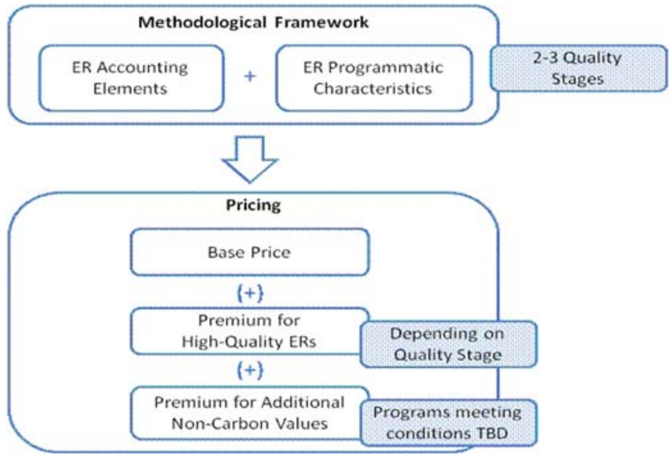
   Under option 2, with application of a premium, the premium could be a percentage of the base price or an absolute value. In any case, the value of the premium should be high enough to incentivize quality but kept in reasonable proportions so that ER programs meeting "only" the minimum standards are not discriminated.

Figure 1: Pricing Based on Single High-Quality Standard



3 This would be the case in the context of variable pricing, because of change of index value. This specific topic will be addressed later

Figure 2: Pricing Based on Differentiated Quality



2. Other characteristics such as social risk, political risk, and overall delivery risk indeed have an impact on the actual ER volumes expected or actually generated by the ER Program, and would therefore be reflected in the actual payment made, not influence the price per tCO_2e negotiated in advance, with the possible exception of situations involving advance payments.

2.3. Assessing and reflecting the non-carbon values in the price

In the context of the Carbon Fund, it has been suggested that the price should reflect non-carbon values, meaning that tonnes of CO_2e with relatively higher non-carbon values could receive a higher price than those with lower non-carbon values. The participants to the PC11 and CF2 meetings in Berlin in October 2011 confirmed the willingness to recognize the non-carbon quality attributes beyond the mandatory elements and characteristics. The application of a premium was considered as an option but the possibility of applying discounts was eliminated from the range of options to be examined, in order to avoid the perception of "low-quality" programs under the Carbon Fund.

The question that needs to be addressed is how non-carbon values are assessed and how such assessment is taken into consideration for the determination of the premium.

Work under progress within the World Bank on related topics such as the establishment of a Wildlife Premium could be an inspiring source for building a an assessment framework for non-carbon values. The high uptake of the CCB standards that is observed, in addition to a primary carbon standard in the voluntary markets could also be analyzed, even though it is hard empirically to discern a premium associated with CCB certification.

It is proposed by the FMT that the WG recommend the appointment of a Technical Advisory Panel (TAP) by the Carbon Fund in order to:

- Synthesize the different approaches developed to date to assess and price the non-carbon values associated with REDD+ activities; and

- Help identify options for consideration by the Carbon Fund on how to build an assessment framework for non-carbon values that would also be reflected in the price.

3. Discussion topics and next steps

Based on the background information provided in this note, it is expected from the WG to fully consider the following topics:

- <u>Ways to reflect quality in the price: The WG is expected to address the following questions</u>:
    1. Does the WG confirm that there should be no differentiation in the price paid for an ER based on quality (Option 1) given that all ER Programs selected in the Carbon Fund should generate high-quality ERs (subject to other adjustments such as non-carbon values or market conditions at the time of signing the ERPA)?
    2. Does the WG consider that other characteristics, beyond the methodological characteristics should be factored into the price? The other characteristics that could be considered may include:
        - social risks,
        - political risks
        - overall delivery risks

       In addressing this question, the WG should keep in mind these risks will have an impact on the actual ER volumes expected or actually generated by the ER Program, and would therefore be reflected in the actual payment made, not influence the price per tCO_2e negotiated in advance, with the possible exception of situations involving advance payments. Also, in the context of early performance based payments for REDD+ in an evolving regulatory environment, the pricing methodologies should be kept as simple as possible.
    3. What would be the recommendations of the WG regarding premia if such premia are to be applied?
- <u>Ways to reflect non-carbon values in the price: The WG is expected to address the following issues</u>:
    - Does the WG confirm the principle of applying a premium to reflect differences in non-carbon values amongst ER Programs (and incentivize ER Programs with higher non-carbon values)?
    - Does the WG support the appointment of a TAP by the Carbon Fund in order to:
        - Synthesize the different approaches developed to date to assess and price the non-carbon values associated with REDD+ activities; and
        - Help identify options for consideration by the Carbon Fund on how to build an assessment framework for non-carbon values that would also be reflected in the price?