Forest Carbon Partnership Facility (FCPF)

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

WG Background Note #8:

DRAFT GUIDANCE ON PRICING

This draft is proposed by the FMT for consideration by the WG based on the outcomes of Calls 1 to 4 of the WG. Its purpose is to help the WG prepare its guidance for the PC on pricing methodologies in order for the PC to adopt policy guidance on pricing methodologies for Emission Reductions Payment Agreements, as provided for in the Charter ((Section 11.1(f)). The in bracketed text requires further consideration by the WG. The FMT proposes that these topics be addressed during the face-to-face meeting in Paraguay.

1. Assumptions

1. 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]

2. 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.

3. 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:

i. Entice parties to transact ERs from REDD+ and safeguard their respective interests and rights in a reasonable manner;

ii. Represent a transparent mechanism that reflects the risk allocation between parties to the transaction;

iii. 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;

iv. Reflect the quality of ERs generated by each ER Program, including non-carbon values as appropriate; and

v. 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.

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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.

2. Policy guidance on pricing methodologies

4. The elements below could be part of the WG's recommendations to the PC and the eventual PC policy guidance on pricing methodologies:

Element 1	Pricing should be flexible and ensure fairness amongst ERPAs, while being kept as simple as possible.
Element 2	The basis for determining the price of ERs should result from the negotiation between the CF Participants, as buyer, and the ER Program sponsor, as seller, based on their respective willingness to pay/receive. Such negotiation process ought to be informed by relevant information such as market surveys or transaction benchmarks. Auctions could also be considered as a price discovery mechanism that would help the negotiation.
Element 3	A combination of fixed and floating price should be retained to determine the price of ERs. The respective shares of the fixed and floating portion may vary across ERPAs. It could be envisaged that the price be fixed for a certain period of time and then become to a combination of fixed and floating pricing. In any case, mechanisms to protect both parties from extreme price fluctuations should be adopted.
Element 4	Option 4.1: [There should not be a systematic mechanism leading to price differentiation based on the ER Accounting and Programmatic Elements of an ER Program]
OR	Option 4.2: [Given that the quality[3] of the ERs delivered will likely differ from one ER Program to another, there should be price differentiation based on the ER Accounting and Programmatic Elements of an ER Program]
Element 5	Option 5.1: [No premium should be considered for non-carbon values of ER Programs]
OR	Option 5.2: [Given that non-carbon values will likely differ from one ER Program to another, there should be price differentiation through the application of a premium to ER Programs with high non-carbon values.]

5. Each proposed element is further elaborated hereafter.

[3] "Quality of ERs" in the context of the Carbon Fund is therefore understood to relate to the climate change mitigation benefit of an ER.

1. **Pricing should be flexible and ensure fairness amongst ERPAs, while being kept as simple as possible.**

   Flexibility: One of the strategic objectives of the FCPF is to generate learning value by testing and demonstrating different approaches that can inform the international community. The ER Programs to be selected by the Carbon Fund are therefore likely to be diverse. This implies adopting a pricing approach that leaves enough flexibility to adapt to the variety of ER Programs on the one hand, and to the evolutions of the regulatory regimes on the other hand.

   Fairness amongst ERPAs: While being flexible, the pricing approach will have to ensure fairness amongst ERPAs. In the learning-by-doing spirit of the FCPF, the first ER Programs will help enhance the following ones which will build upon the lessons learned. The regulatory regimes will also evolve with time. While recognizing the differences amongst ER Programs, there should not be discrimination amongst them.

   Simplicity: While all options should be analyzed, the retained pricing approach should be kept simple.
   - Increased complexity might lead to lack of understanding from both parts which could end up in perceptions of lack of transparency.
   - The WG brings to the attention of the PC that the lifetime of the FCPF is up to 2020. The ERPAs under the Carbon Fund are very likely to have maturities not exceeding 6 years, with no more than 2 to 3 ER issuances (verifications). In this context, there might not be a real value in having comprehensive – but complex – approaches.
   - Complexity might also lead to increased transaction costs, which is not a desired outcome.

2. **The basis for determining the price of ERs should result from the negotiation between the CF Participants, as buyer, and the ER Program sponsor, as seller, based on their respective willingness to pay/receive. Such negotiation process ought to be informed by relevant information such as market surveys or transaction benchmarks. Auctions could also be considered as a price discovery mechanism that would help the negotiation.[4]**

   Willingness to pay/receive as a basis for setting up a price*:* The CF is a pioneering initiative. Its strategic objective is to pilot performance-based payment systems for ERs generated from REDD+ activities. It will need to establish its pricing policy in a context of evolving and uncertain regulatory frameworks, with very few comparable transactions to draw from and in the absence of a relevant index that is publicly available.

   In this context of early stages of performance based payment for REDD+ with no clear price reference, an agreement between the CF Participants and the ER Program Host country based on their respective willingness to pay and receive is considered to be the preferred valuation

[4] In the absence of a relevant reference that could be used as an index for establishing a price, indexation is not considered to be a feasible option. However, if a relevant index appears in the future, it could be considered for the variable portion of the price in a context of combination of fixed and variable pricing (see below).

method. This valuation method would also provide the desired flexibility and allow addressing the very likely diversity of ER Programs.

Market surveys and transactions transaction benchmarks to inform the negotiation process: The CF is an initiative built on the spirit of partnership between the CF Participants and REDD+ countries. There should therefore be a common ground allowing for reaching agreement between parties. Objective sources of information such as market surveys or transaction benchmarks ought to be considered to inform the negotiation process, in order to ensure transparency and fairness.

Auctions as a possible source of information: In lieu of surveys or independent price quotations, auctions, whereby a certain quantity of ERs is offered for sale and buyers compete for these ERs, may be an efficient way to discover the buyers' true willingness to pay, especially at a time when there are few relevant data points available. Auctions may provide an interesting option for price discovery when large quantities are put for sale and there is enough competition from interested buyers. The exact conditions under which an auction could prove efficient for REDD+ ERs still need to be assessed. Also, the modalities of an auction, if any, have to be precisely determined. The FMT could further explore the feasibility of auctions in the context of REDD+ ERs and elaborate on the modalities under which an auction might be considered as a valuation option under the Carbon Fund. A TAP could assess the exact conditions and mechanisms under which auctions could be applicable.

3. **A combination of fixed and floating pricing should be retained to determine the price of ERs. The respective shares of the fixed and floating portions may vary across ERPAs. The price could be fixed for a certain period of time and then become a combination of fixed and floating pricing. In any case, mechanisms to protect both parties from extreme price fluctuations should be adopted.**

Combination of fixed and floating portions in the price: Under such combination, the base price is composed of a fixed portion and a floating portion. The fixed portion is set at the signature and for the term of the ERPA. The floating portion reflects the conditions at the time of ER delivery and is determined through indexation or by other means. By doing so, the pricing formula guarantees the seller a minimum level of carbon revenues (through the fixed portion) and allows the sharing of upsides and downsides between the seller and buyer.

Purely fixed pricing is not recommended as it may cause the base price not to be in line with developments (e.g., market trends) and thus lead to perceptions of unfairness from the disadvantaged party over time (seller being paid too low a price, or buyer paying too high a price). Also, ERPAs will not all be signed at the same time, which might lead to significant price differences amongst ERPAs.

Purely floating pricing is not recommended neither as it would reflect speculations of the parties (in opposite directions) about price fluctuations, which is contrary to the spirit of partnership. It would also expose both sellers and buyers to such fluctuations that they may end up in unacceptable price territory (either close to zero or much higher than expected).

Under the recommended combination of fixed and variable pricing, the proportion between the variable and the fixed portion may vary amongst ERPAs and ought to be determined based on negotiation between parties. It should mainly depend on the nature of each ER Program and the aversion to risk of the parties.

It is noted that the valuation method to be retained for the variable portion can hardly be based on willingness to pay/receive as this would re-open the negotiation process at each ER delivery which is not recommended. The variable should be linked to a clear indicator, such as the value that would reveal a transaction benchmark, a market quotation or an auction, to the extent applicable. The pricing method could also envisage linking the variable portion to a notional relevant index that might appear in the future.

Fixed pricing during the first years of the ERPA, and combination of fixed and variable thereafter: For the purpose of simplicity in these early times of piloting performance-based payment for REDD+, a variation of the combined pricing would consist of having a purely fixed pricing during the first years of the ERPA, and combination of fixed and variable thereafter under certain conditions**.** A fixed price would be set at the time of ERPA signing an effective for the first few years. After this first period, there would be an evaluation of the conditions and if certain conditions are met, the ERPA would move to a combination of fixed and variable. The simplicity of the fixed pricing would be kept in the beginning, while leaving room for adjustments in the future, if the conditions are right.

The WG however notes that setting the conditions or triggers for the move to a combination of fixed and floating may be challenging. The conditions would need to be assessed through objective elements such as the number of similar transactions occurring allowing for establishing a benchmark value or the existence of an index. Also, in order to safeguard the interests of both parties, the share of fixed and variable portions should be fixed at the time of signing the ERPA (when no party knows what the conditions will be in the future).

Mechanisms to protect both parties from extreme price fluctuations: To better safeguard the respective interests and rights of the ERP host countries and the CF Fund participants, the application of floors combined with ceilings or market discounts could be considered.

4. **Option 4.1: [There should not be a systematic mechanism leading to price differentiation based on the ER Accounting and Programmatic Elements of an ER Program.]**

<u>OR</u>

4. **Option 4.2: [Given that the quality of the ERs delivered will likely differ from one ER Program to another, there should be price differentiation based on the Programmatic and Carbon Accounting Elements of an ER Program.]**

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. 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.

Option 4.1

[Although the WG recognizes that the quality of the ERs delivered will likely differ from one ER Program to another, the WG recommends that, for the purpose of pricing, only a single high-quality standard should be considered. There should therefore not be price differentiation based on the ER Accounting and Programmatic Elements of ER Programs, as defined under the methodological framework.

This recommendation is made for the purpose of simplicity. It also prevents from the risk of some ER Programs being perceived as lower quality than the others, while the CF will only target high-quality ER Programs.

The WG recognizes, however, that prices might differ from an ER Program to another based on other characteristics or as a result of the negotiation process between the CF Participants and the ER Program host countries, such negotiation process taking into consideration the quality of the ERs.

Option 4.2

[The WG recognizes that the quality of the ERs delivered will likely differ from one ER Program to another and recommends that such differentiation be reflected in the price through the application of a premium. The premium would be the result of the quality assessment based on the ER Accounting and Programmatic Elements retained under the methodological framework. Such an approach would allow for a systematic, fair and transparent mechanism to reflect ER quality in the price, and would create an incentive for quality and enhancement over time (between the time of ERPA signature and ER delivery).]

5. **Option 5.1: [No premium should be considered for non-carbon values of ER Programs.]**

   <u>OR</u>

5. **Option 5.2: [Given that non-carbon values will likely differ from one ER Program to another, there should be price differentiation through the application of a premium to ER Programs with high non-carbon values.]**

   In most cases ER Programs 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.

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. It was suggested a premium could be applied to recognize the non-carbon quality attributes beyond the mandatory elements and characteristics.

Option 5.1

[However, given the possible complexity of developing an assessment framework leading to the determination of a premium for non-carbon values, the WG recommends that no premium be applied to reflect non-carbon values, especially in these early stages of piloting performance based payments for REDD+.

The WG notes that the non-carbon values are already taken into consideration for the assessment and the selection of the ER Programs under the Carbon Fund, which will target those that exhibit strong additional benefits [since bringing strong additional benefits is a Programmatic Element under the methodological framework].

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's 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.

Option 5.2

[A TAP would:

- 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.]