Forest Carbon Partnership Facility (FCPF)

Operating Arrangements under the Carbon Finance Mechanism

Issues Note

September 28, 2010

The current Issues Note highlights technical aspects of the Carbon Fund. This note is based on the original Information Memorandum of the FCPF that was discussed in the design phase of the FCPF in 2007-2008.[1] Each section of this Issues Note corresponds to a section of the original Information Memorandum, which it amplifies or clarifies.

This Issues Note aims to confirm the understanding of Carbon Fund stakeholders on some aspects discussed earlier in relation to each of these sections and to seek views on some new elements to feed into a revised version of the Information Memorandum, prior to the start of operations of the Carbon Fund. The bulk of this Issues Note was discussed over the course of 2008, 2009 and 2010 in meetings of entities interested in the Carbon Fund (in Washington, London, Frankfurt and Bonn) and Participants Committee meetings (PC4, PC5 and PC6).

Each section starts with a short note on how the FMT proposes to add or modify the Information Memorandum.

Contents

[1] The Information Memorandum was first issued in December 2007 and revised in June 2008 prior to the start of operations of the FCPF. It has been available in English, French and Spanish on the FCPF website at http://www.forestcarbonpartnership.org/fcp/node/14.

1. Emission Reduction Definition

The following text is a slight clarification of Section 4.1 of the current Information Memorandum and will be included in the Information Memorandum. It is provided for information:

The Carbon Fund will deliver Emission Reductions (ERs) from REDD+ activities to the Carbon Fund Participants. As a default, the ERs are all the rights, titles, and interests attached to a tonne of ER from REDD+ activities referred to here as an Emission Reductions Program (ER Program).

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2. Emission Reduction Creation

The following text is an amplification of Section 4.2 the current Information Memorandum suggested for inclusion in Section 4.2 of the Information Memorandum after consideration by Participants and observers:

A REDD Country Participant will be eligible to submit an ER Program for consideration for a potential Emission Reductions Payment Agreement (ERPA) with the Carbon Fund.

The process will be as follows, noting that the various steps are not necessarily sequential:

1. A REDD Country Participant (through its authorized representative, e.g., its national REDD+ committee or responsible institution) submits an ER Program to the FMT, using the ER Program Idea Note (ER-PIN) template;
2. The FMT establishes the eligibility of the proposed ER Program by verifying that:
    a. The ER-PIN template has been duly completed;
    b. The entity submitting the ER Program is from an FCPF REDD Country Participant and authorized to submit the ER Program;
    c. The proposed ER Program meets the ER Program selection criteria.
3. If the FMT assesses that the proposed ER Program meets the requirements above, it submits the complete ER-PIN to the Carbon Fund Participants for review;
4. The Carbon Fund Participants may request the FMT to establish an Ad Hoc Technical Advisory Panel (TAP) to assist them review the ER-PIN;
5. The Participants in each Tranche of the Carbon Fund make their decisions regarding inclusion of the proposed ER Program into their portfolio (see Governance section), taking into account the TAP's ER-PIN review, if applicable;
6. If the ER Program is included in the portfolio of either Tranche, the FMT posts the non-proprietary sections of the ER-PIN on the FCPF website;
7. If the ER Program is included in the portfolio of either Tranche, the Carbon Fund Participants approve a budget allocation for the preparation of a carbon finance transaction based on the ER Program;

8. The Trustee sends a Letter of Intent notifying the submitting country of the Tranche Participants' intention to consider the ER Program for a potential ERPA with the Carbon Fund;
9. The Participants Committee, based on the information available (Readiness Package and/or Readiness Progress Report and/or non-proprietary sections of the ER-PIN), and possibly using the assistance of a TAP, assesses whether the submitting country has made sufficient progress towards REDD+ Readiness[2] to implement a ER Program;
10. The World Bank performs its due diligence in light of the applicable Operational Policies and Procedures, including on environmental and social aspects. The World Bank also advises the submitting country on ways to improve the quality of the ER Program during design and/or implementation[3];
11. The REDD Country Participant continues to develop the ER Program, based on the inputs from the FMT, Carbon Fund Participants, TAP and outside stakeholders, as appropriate, and presents an improved ER Program document to the FMT;
12. Based on the Pricing/Valuation Approach and the General Conditions for ERPAs, which will have been adopted by the Participants Committee, the Trustee drafts an ERPA for this particular ER Program, which is sent to the submitting REDD Country Participant and the relevant Tranche Participants. To the extent possible, the Carbon Fund will only commit to paying for a fraction of the Emission Reductions potential of the ER Program, leaving room for other interested entities to participate in one or several separate transactions. This (these) separate transaction(s) could be arranged with support of the Trustee if the REDD Country Participant so desired;
13. The REDD Country Participant and relevant Tranche Participants come to an agreement on the terms of the ERPA;
14. The authorized representative of the REDD Country Participant's government or approved entity and the Trustee of the Carbon Fund sign the ERPA;
15. The authorized representative of the REDD Country Participant's government or approved entity implements the ER Program and reports on performance, in particular ERs generated, on an annual basis;
16. An independent reviewer approved by the Participants Committee assesses the country's performance report;
17. The Trustee verifies that the ER Program is in compliance with the applicable Operational Policies and Procedures and ERPA provisions;
18. Based on the independent reviewer's verification report, and subject to applicable Operational Policies and Procedures and ERPA provisions being complied with, the Trustee of the Carbon Fund makes a payment to the REDD Country Participant or entity designated in the ERPA; and
19. The Trustee of the Carbon Fund accounts for the ERs delivered to the Tranche of the Carbon Fund and allocates a *pro rata* share of ERs to each relevant Tranche Participant through the World Bank's Carbon Asset Registry System.

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[2] For countries that intend to undertake sub-national REDD+ activities, this assessment considers the country's approach to ensuring that these sub-national ER Programs are consistent with the country's existing or emerging REDD+ strategy, REL/RL and MRV framework. This assessment must be available before an ERPA is signed, and earlier if possible. The Readiness Package and Readiness Progress Report are documents produced as part of the Readiness Fund processes.

[3] The World Bank may provide advice to the REDD Country Participant early on based on the ER-PIN but must have concluded its due diligence before an ERPA is signed.

3. Types of Emission Reductions Programs

The following text is an amplification of Section 4.3 of the current Information Memorandum using the outcomes of previous Carbon Fund discussions. It will be included in the Information Memorandum:

It is expected that the FCPF will be able to review a diversity of ER Programs depending on country circumstances and preferences. Interventions might range from forest policies and measures (such as community forestry or forest law enforcement) to non-forest policies and measures (such as land tenure reforms or intensification of agricultural activities in buffer zones).An ER Program might include a variety of different interventions leading to Emission Reductions. It is also important to highlight that drivers of deforestation and forest degradation are often located outside of the forest sector such that not only policies and measures in the forest domain are relevant to achieve the desired benefits.

Additional text (the bulk which reflects prior discussions) suggested for inclusion in Section 4.3 of the Information Memorandum:

Assuming a size of about $200 million, the Carbon Fund would support approximately five ER Programs undertaken by FCPF REDD Country Participants that have achieved, or made considerable progress towards, REDD+ Readiness. The final number of ER Programs selected by the Carbon Fund would depend on capitalization, preparation and transaction costs, the size of Programs proposed by REDD Country Participants, and the learning value provided by individual Programs.

REDD Country Participants may, on a voluntary basis, submit an ER Program to the Carbon Fund with a view to entering into an ERPA.

The following criteria will apply to the selection of ER Programs into the portfolio of either Tranche of the Carbon Fund. The ER Program must:

1. Focus on results achieved by the selected ER Programs, as compared with the Reference Emission Level (REL) or Reference Level (RL). Carbon finance should be seen as an incentive payment for good performance, in this case for the climate benefits, expressed in verified Emission Reductions from ER Programs. The Carbon Fund will not provide upfront funding for initiating ER Programs as carbon finance ought to be considered as performance-based finance, not investment finance. Programs such as those supported by the Forest Investment Program (FIP), the Global Environment Facility (GEF), the Congo Basin Forest Fund, the UN-REDD Programme, the World Bank, other multilateral and bilateral initiatives, government resources, private investments, are increasingly providing specific funding possibilities to fill the REDD+ financing gap. The Carbon Fund may cooperate with and piggy-back on programs under these initiatives;
2. Generate high-quality and sustainable ERs (including environmental and social benefits)[4];

[4] Additional work may be required in a number of areas to achieve greater clarity on what constitutes a 'high-quality' ER. In particular, clearer carbon accounting principles for sub-national ER Programs seem necessary.

3. Be consistent with emerging compliance standards under the UNFCCC and other regimes;
4. Generate learning value;
5. Use clear mechanisms so that incentives for REDD+ reach those who need them. In some cases, the national government can be the best actor to enact and implement the necessary policy changes and regulations. But many changes will also require the involvement of local communities, individuals and the private sector, in which case these stakeholders or right-holders would expect to partake in the REDD+ activities and the corresponding carbon revenues (or alternative financing or support) in recognition of their contributions. In other cases, local communities, individuals and the private sector would be the primary actors implementing the ER Programs and thus expect to be the principal beneficiaries of ERPA benefits. These arrangements will have to reflect the assessment of the drivers of deforestation. Adequate governance and financial management arrangement and transparent mechanisms will need to be in place to address the revenue distribution scheme before an ERPA can be signed;
6. Be based on transparent stakeholder consultations;
7. Generate ERs at a fair price;
8. Be submitted by the governments or government-approved entities of countries that are FCPF REDD Country Participants, i.e., countries that were selected into the Readiness Mechanism of the FCPF;

For sub-national ER Programs, these should also:

9. Be undertaken at a significant scale, e.g., at the level of an administrative jurisdiction within a country or at the national level, in line with the proposed national REDD+ management framework;
10. Be consistent with the (emerging) national REDD+ strategy;
11. Be consistent with the (emerging) national REDD+ MRV system;
12. Be consistent with the national REL/RL, or with the national approach establishing the REL/RL; and
13. Provide for an assessment and minimization of the risk of leakage and other relevant risks.

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4. National vs. Sub-National Implementation

The following text is an amplification of Section 4.4 of the current Information Memorandum using the outcomes of previous Carbon Fund discussions. It will be included in the Information Memorandum:

Whether to implement REDD+ at a national or sub-national level is the sovereign decision of each country and should take into account several factors, including:

- National forest law and regulations, which specifies who manages, owns, or has rights to, forest land, timber and non-timber forest products, and other forest services and amenities, including the carbon in the biomass and in the soil, and what institutions or political entities are responsible for land-use planning and/or forest law enforcement;

- Lessons from existing forest policies and programs with respect to the sustainable use of forest resources and biodiversity conservation;
- Whether law enforcement occurs mostly at the national or sub-national level;
- Current drivers of deforestation and degradation, and the current actors of protection against deforestation and degradation;
- Who could effectively start to protect against deforestation and forest degradation given the proper legal framework and economic incentives;
- Formal and customary property and user rights;
- Availability of public and private financial resources for investments in the sustainable use of forest resources and biodiversity conservation;
- The relative costs and effectiveness of various programs to achieve sustainable use of forest resources and biodiversity conservation;
- The need to respect and rely on traditional, including indigenous, knowledge about and practice in forest use and conservation, and to respect the rights of indigenous peoples and local communities;
- Arrangements for benefit sharing through centralized or decentralized mechanisms.

The Carbon Fund's procedures with respect to sub-national ER Programs, in particular the question of how to account for Emission Reductions generated by sub-national programs, should be consistent with emerging policy guidance in the UNFCCC and other regimes. The draft decision adopted by SBSTA at COP15 contains guidance on measurement and reporting, in particular on (i) the use of the "most recent Intergovernmental Panel on Climate Change guidance and guidelines, as adopted or encouraged by the Conference of the Parties, as appropriate, as a basis for estimating anthropogenic forest-related greenhouse gas emissions by sources and removals by sinks, forest carbon stocks and forest area changes"; and (2) the establishment, "according to national circumstances and capabilities, (of) robust and transparent national forest monitoring systems and, if appropriate, sub-national systems as part of national monitoring systems."[5] This draft SBSTA decision confirms the need for linking sub-national ER Programs to the national accounting frameworks being designed as part of the readiness process supported by the Readiness Fund.

Additional text suggested for inclusion in Section 4.4 of the Information Memorandum:

A REDD country contemplating REDD+ implementation at the sub-national level should ideally address a number of questions, among which:

- What kind of sub-national REDD+ activities are eligible? Where can these activities be undertaken, by whom and on what conditions?
- Are the rights attached to Emission Reductions from REDD+ activities defined? If not, how can they be, keeping in mind that effective, equitable and sustainable solutions to this question may be essential to securing financing for results-based payments for REDD+?
- Are the uses of Emission Reductions from REDD+ activities, including their sale on domestic and international markets, regulated? If not, should they be, and how?

[5] See FCCC/SBSTA/2009/L.19/Add.1

- Are the allocation, distribution and use of revenues from REDD+ activities, including sub-national REDD+ activities, regulated? If not, should they be, and how?
- How should indigenous peoples and local communities participate in, and benefit from, REDD+ activities, including sub-national REDD+ activities?
- Which national entity registers and/or approves and/or monitors sub-national REDD+ activities, based on what criteria and through what process?
- What laws and regulations may be necessary to adopt to establish the eligibility of these activities?
- What MRV and REL methods should be used to ensure the consistency of sub-national REDD+ activities with the national MRV system and REL?
- How should the risks of non-permanence and leakage be dealt with, at national and/or sub-national level(s)?
- What kind of capacity is needed to manage the processes relevant to the above questions?

In the case of the FCFP, sub-national ER Programs could be included in the Carbon Fund's portfolio as long as they:

1. Are undertaken at a significant scale, e.g., at the level of an administrative jurisdiction within a country or at the national level in line with the proposed national REDD+ management framework;
2. Are consistent with the (emerging) national REDD+ strategy;
3. Are consistent with the (emerging) national REDD+ MRV system;
4. Are consistent with the national REL/RL, or with the national approach establishing the REL/RL; and
5. Provide for an assessment and minimization of the risk of leakage and other relevant risks.

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5. Risks and Risk Mitigation

The following text is a slight clarification of Section 4.5 of the current Information Memorandum: :

The Carbon Finance Mechanism faces several risks, each of which could affect its performance and its overall impact of the FCPF, but can be mitigated:

- **Financial Risk to the Carbon Fund :** There is a risk that the payments made by the Carbon Fund do not lead to the generation by and acquisition of ERs from ER Programs:

  Mitigation of Financial Risk to the Carbon Fund: In principle the Carbon Fund would pay mostly on the delivery of ERs generated by the ER Programs. This means that there would be little by way of Carbon Fund resources that would be at risk of not translating into any delivery of Emission Reductions. The same principle of payment on delivery becomes a risk to the REDD Country Participant who undertakes ER Programs and may not be compensated for them in case they do not perform, and may actually deter the country from investing in the first place. This underscores the need for balancing risks and incentives, e.g., by being flexible regarding the possibility of upfront payments, and also being creative in combining different sources of finance, with some being available at the investment phase, and carbon finance through the Carbon Fund or other sources being mostly available after ERs are generated.

- **Financial Risk to the ER Program**: There is a risk that the ER Program is not fully funded and finances (including the revenue sharing mechanism) are poorly managed.

  Mitigation of Financial Risk to the ER Program: The Carbon Fund intends to rely on financing sources from other initiatives, including government-sponsored programs, private sector investments, and internationally funded programs, e.g. by the Forest Investment Program (FIP), GEF, UN-REDD Programme, World Bank and other multilateral funding and bilateral initiatives.

- **Delivery Risk:** The performance and impact of the Carbon Fund depends on the performance of the ER Programs from which it will acquire ERs. The delivery risk can be classified in two sub-categories: (i) the ability of the ER Program to effectively reduce emissions and deliver those to the Carbon Fund; and (ii) the ability to credibly measure the ERs generated. If the ER Programs fail on either count, the Carbon Fund will not receive delivery of the expected ERs and will not disburse its capital according to plan.

  Delivery Risk Mitigation: (i) The 'non-effectiveness risk' can be reduced by adopting measures that increase the likelihood that contracted ER volumes will indeed be realized, in particular by: (1) applying tight selection procedures so that only the most promising ER Programs are included in the portfolio, that are fully funded and where good governance is in place; (2) applying conservative estimates of the ER potential of any ER Program; and (3) contracting for only a fraction of the ER potential of any ER Program.

  By reducing the quantities contracted, measures (2) and especially (3) tend to reduce the total ER value to the REDD Country Participant, which is a risk in itself for the delivery of ER. Hence the delivery risk ought to be mitigated without removing the incentive that the ERPA provides to the REDD Country Participant to deliver.

  (ii) The 'inability to measure risk' will depend on the standards set for each ER Program. The standards might be different for each ER program and the Carbon Fund will have to adjust the requirements for MRV to the ER Program conditions and elaborate, where needed, an action plan to further develop the MRV capacity of the ER Program up to a satisfactory level.

- **Non-Permanence Risk:** Once the Carbon Fund has received delivery of the ERs and paid for them, there remains a risk that the carbon will be released back to the atmosphere due to future disturbances, which might eliminate previously achieved climate mitigation benefits.

  Non-Permanence Risk Mitigation: The FCPF will rely on the proposed national management framework which should address the management of permanence risks. The use of reserves (buffer accounts), where a certain portion of the ERs generated by an ER Program could be set aside and maintained as a buffer for possible losses to the carbon asset, can reduce the non-permanence risk if the reserve is set at the appropriate level. The buffer could either be managed by the REDD Country Participant, or be managed at the program level, or even, if necessary, at the Carbon Fund level. Alternatively, the value/price of the ERs that is paid for could vary in accordance with the period of time for which the carbon remains sequestered in vegetation and soils, in line with a tonne-year methodology (the longer the time, the higher the value).

- **Political Risk**: Government does not have a long-term commitment to REDD+, e.g., it does not establish an adequate MRV system or strategy implementation framework or does not implement relevant policy decisions in the context of REDD+.

Political Risk Mitigation: The ER Program must be embedded in the readiness process and endorsed by the national authority, which will increase ownership and accountability for the selected ER Program.

- **Attribution Risk:** The Carbon Fund will have limited resources and may be led to pay for ERs with countries experiencing large emissions and large fluctuations in emissions from deforestation and degradation. The question arises as to whether the incentive created by the limited resources of the FCPF's Carbon Fund can explain the ERs paid for by and delivered to the Fund. In other words, can the impact in terms of ERs be attributed to the FCPF's payments? This question will especially arise in cases where the Fund pays for ERs based on a sub-national ER Program. These ER Programs may very well fulfill their objectives of reducing emissions within their boundaries. However, at the level of the whole country, the national accounting system may reveal that the balance for the corresponding time period is negative, in other words that the country as a whole has not reduced emissions as planned.

  The attribution risk also has to do with the fairness of the projected mechanism for paying for ERs. If a local community that is part of an ER Program and is supposed to receive ERPA revenues for reducing emissions does manage to reduce emissions, but the country as a whole has a negative balance, mechanisms have to be put in place to manage the trade-off between correct climate accounting and fairness towards local communities.

  Attribution Risk Mitigation: A range of mitigation measures can be envisaged, some of which go well beyond the FCPF, e.g., the securing of much larger financial resources to compensate for ERs such that the large fluctuations can actually be remunerated, in combination with a system of caps on emissions (based on voluntary or regulated commitments) such that there is no offset but net reductions. In the context of the FCPF, which will have limited capital and may work with sub-national ER Programs, a full treatment of the attribution problem may require elaborate operations working with program-level monitoring plans that are integrated in a national accounting framework. An alternative approach, somewhat less rigorous from an accounting point of view but still legitimate from a climate accounting point of view, is for the Fund to transact with REDD Countries that take a voluntary commitment to reduce emissions. In this case, if emissions are effectively reduced, it may not be necessary to pinpoint, for each tonne, the reason why it was not emitted. It may be acceptable to recognize that the REDD Country reduced emissions and can claim a payment for them. This approach would work better with national, policy-based ER Programs than for more specific and localized ER Programs.

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6. Additional Benefits

The following text is a slight clarification of Section 4.6 of the current Information Memorandum:

ERs from REDD+ activities will not be created equal. Some ER Programs may offer, in addition to climate change mitigation benefits, significantly more 'additional benefits' compared to ERs generated by other mitigation programs, in particular for local people and the local environment. How the FCPF may help create, monitor and value additional benefits is a matter for the Participants Committee to determine. It is recognized that the FCPF is, first and foremost, a climate change mitigation instrument, and that REDD+ will not solve all the problems affecting forests, including loss of biodiversity, poverty, land tenure issue, etc. However, ER Programs should be designed to avoid any harm to local people and the environment but also, where feasible, to improve livelihoods and ameliorate the local environment. For example, REDD+ activities could enhance biological diversity by protecting and restoring natural habitat (e.g., by concentrating ER Programs on biodiversity hot spots), and preserve or improve livelihoods for local communities (e.g., by securing customary property or user rights to their forest land, and their land's timber and non-timber forest products) and use ER revenues to finance programs that would help forest communities to protect their immediate environment. In many cases, unless poverty is reduced and governance is improved, the real driver of deforestation and degradation will not be altered, and few if any REDD+ benefits will be sustained over time.

REDD+ may offer a case of synergy between the climate change mitigation and adaptation agendas. A stronger resilience of ecosystems may entail a greater capacity for climate change adaptation, hence REDD+ may also enhance adaptation to climate change.

Especially in the early days of incentive payments for REDD+, when limited resources are available, there may be ways of directing these resources to those ER Programs that exhibit strong additional benefits for only a marginal increase in costs, if any at all. In this respect, some of the ER Programs selected by the Carbon Fund may be designed to achieve cost-effective ERs while also creating additional livelihood benefits, such as more secure land tenure rights or improved living conditions for Indigenous Peoples. This would require that that indigenous peoples and local communities be properly consulted, that appropriate responsibilities be given to them, and that they be able to benefit from incentive payments.

The Readiness Mechanism will help how to reduce trade-offs, and create synergy, between climate change mitigation and the additional goals of poverty reduction and biodiversity conservation. Furthermore, the question of the valuation of these additional benefits will be addressed. Should tonnes of carbon dioxide equivalent with higher additional benefits receive higher payments than those with lower benefits? Or should different buyers pay for different services – practically, can distinct sources of financing for the different services embodied in REDD+ ERs (e.g., carbon, water, biodiversity and poverty reduction) be bundled together? It must be emphasized that the improvement of livelihoods, consultations with local stakeholders and the inclusion of social groups in ER Programs represent mitigation measures to the delivery risk and may also be financially rewarded in this respect. The FCPF Participants will be asked to ponder these questions.

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7. Valuation/Pricing

The following text is a clarification of Section 4.7 of the current Information Memorandum and will be included in the Information Memorandum after consideration by Participants and observers. In due course a more comprehensive note on valuation/pricing will be prepared and presented to the Participants Committee:

Determining a fair value for ERs under the FCPF is difficult given that there are few relevant precedents to draw from. Most 'REDD+ projects' are undertaken for the voluntary market. Those projects often have very different characteristics than, and are therefore difficult to compare with, large-scale national or sub-national ER Programs. To fill this vacuum, the Participants Committee will issue guidelines on how to value ERs under the Carbon Fund. The objective is to arrive at values that:

1. Entice parties to transact ERs from REDD+ and safeguard their respective interests 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. Leave room for adjustments later to align with emerging guidelines under the UNFCCC and other regimes and as demand and supply for ERs from REDD+ activities evolve.

If and when the regulatory risk is reduced in the coming years, the value of ERs might change accordingly. Besides sharing in the potential value/price upside, parties to ERPAs may also share the potential losses.

The Trustee will flesh out valuation/pricing options to help the FCPF Participants and facilitate the adoption of valuation guidelines.

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8. Ad Hoc Technical Advisory Panels

The following text is a slight clarification of Section 4.8 of the current Information Memorandum. It will be included in the Information Memorandum:

Ad Hoc Technical Advisory Panel(s) (TAPs) may be established by the Carbon Fund Participants or the FMT to provide technical review and advice on various aspects of the ER Programs, or the functions of the Fund. The procedures for establishing and managing TAPs shall follow those described in Section 3.8 for the Readiness Mechanism and already tested in the operation of the Readiness Fund.

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9. Safeguards

The following text is a clarification of Section 4.9 of the current Information Memorandum. It will be included in the Information Memorandum:

ER Programs that underlie an ERPA with the Trustee of the Carbon Fund will be expected to comply with the World Bank's applicable Operational Policies and Procedures, including the Environmental and Social Management Framework prepared in the context of REDD+ Readiness preparation work, where applicable.

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10. Procurement

The following text is a slight clarification of Section 4.10 of the current Information Memorandum. It will be included in the Information Memorandum:

Payments for ERs by the Carbon Fund will not be subject to the Operational Policy on Procurement since payments to be made under ERPAs will be for environmental services performed by the REDD Country Participant, namely ERs from REDD+ activities, as opposed the procurement by the country of goods, works and services in the future.

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11. Structure and Governance

The following text is an amplification of Section 4.11 of the current Information Memorandum. It will be included in the Information Memorandum:

The FCPF Carbon Fund is designed to be a public-private partnership. In order to encourage private entities' participation in the Carbon Fund, it is necessary to structure the Carbon Fund into Two tranches, with segmentation of the Participants, between public (or ODA contributors) and private entities. There are, however, a number of legal and operational issues related to the Tranche structure.

Criteria for determining participation in a given Tranche

The Terms of the Participation Agreement will determine to which Tranche a Carbon Fund Participant belongs. To date, the Trustee has signed two types of Participation Agreements – the first one ('restrictive') with specific provisions that the Participant's *pro rata* share of ERs must not be used for compliance purposes nor for resale and will be cancelled by the Trustee upon receipt of the ERs from the ER Programs, and the second one ('unrestrictive') with standard terms of participation without any restriction on the use of ERs. A potential Participant signing a restrictive Participation Agreement would belong to the restrictive Tranche, regardless of the source of funding (e.g., Official Development Assistance vs. other sources). Conversely, a potential Participant signing an unrestrictive Participation Agreement would belong to the unrestrictive Tranche, again regardless of the source of funding. It is expected that private sector Participants would therefore belong to the unrestrictive Tranche. Government Participants would likely make a choice between the restrictive and unrestrictive Tranche. The unrestrictive Tranche will be named "Tranche A", and the restrictive Tranche will be named "Tranche B".

Decision making arrangements within a Tranche

Section 12.4 of the Charter envisages that each Tranche will have its own decision making process. The Charter includes a provision on voting arrangements for the Carbon Fund, namely a two-thirds majority, with each Participant casting a number of votes commensurate with the size of its contribution, namely one vote per $1 million in contribution. However, the Charter is silent on decision-making modalities within a Tranche.

It would be possible for each Tranche to adopt its own modalities, including voting arrangements. A Tranche could decide to adopt decisions by consensus, by majority votes, or other voting modalities. In the case of a vote, the number of ballots cast by each Participant could be determined by different methods. For example, each Participant could have one ballot regardless of contribution size; or the number of ballots for each Participant could link to the size of the Contribution, as is currently provided in the Charter. Options could be further explored to level the playing field for large and smaller contributors. This is particularly important to draw private sector Participants to the Carbon Fund.[6] The FMT will develop an option paper on the voting arrangement for consultation.

Finally, the Participants in a Tranche may decide to establish their Tranche Committee, which may be an efficient way to arrive at decisions, especially if the number of Participants should rise above a certain number, to be determined by the Participants in each Tranche.

Interaction between the two Tranches

According to the Charter, each Tranche will operate as a separate trust fund, with its own budgeting and accounting, and its own decision-making processes. In particular, each Tranche will sign its own ERPAs with given ER Programs. Nevertheless, although each Tranche would sign separate ERPAs with each ER Program, it should be noted that both Tranches would follow the same quality and due diligence approaches regarding ER Program selection and the ERPAs of both Tranches would follow the same General Conditions. In other words, there would not be a difference in the quality of the carbon assets created for the two Tranches, though it would be up to each Tranche to decide whether to enter into an ERPA with an ER Program submitted to the Carbon Fund and to agree on some specific commercial terms. It is envisaged that as a result of independent ER Program selection decisions made by the two Tranches, the two Tranches could end up with significantly different ER Program portfolios.

The relationship and the arrangement between the two tranches with respect to the ER Programs submitted by the Trustee, including ER distribution, need to be further discussed among the Carbon Fund Participants. However, as a matter of principle, if the same ER Program is selected and the same ERPA terms are agreed by the two Tranches, it is envisaged that the allocation of ERs would be *pari passu*.

With respect to the meetings of the two Tranches, to avoid unnecessary administrative costs and maximize learning value, the Trustee intends to organize the Tranche meetings together and would encourage the Carbon Fund Participants to make joint decisions whenever possible.

Participation by REDD Country Participants

The meetings of the Carbon Fund should be open to the participation of REDD Country Participant observers to ensure transparency and increase learning value. The Tranche Participants would still retain the discretion to decide to close the meetings to observers if necessary.

The Carbon Fund Participants, once the Carbon Fund becomes operational, could develop their rules of procedure and the participation of REDD Country Participants as observers could be regulated by these rules of procedures.

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[6] For example, instead of allocating 5 votes out of 100 to a Participant with a $5 million share of a $100 million Tranche (10 votes to a Participant with a $10 million share, and 50 votes to a Participant with a $50 million share of that same Tranche), the Participant with a $5 million share could be allocated between 6 and 9 votes out of 100, the Participant with a $10 million share 10 votes out of 100, and the Participant with a $50 million share, say, 20 votes out of 100.

12. Start of Operations

The following text is new compared to the current Information Memorandum and will be included in the Information Memorandum after consideration by Participants and observers:

The FCPF Charter provides that the Carbon Fund will become operational once $40 million in contributions has been received. In addition, at least two contributors representing private entities should sign Participation Agreements for the Fund to become operational.