

## Forest Carbon Partnership Facility (FCPF)

### Participants Committee

#### Recommendations of the Working Group on the Methodological and Pricing Approach for the Carbon Fund of the FCPF

June 30, 2012 *REVISED FINAL DRAFT*

*The Participants Committee requested the FMT to establish a working group on the methodological and pricing approach for the Carbon Fund of the FCPF (Working Group). The PC invited designated REDD Country Participants, Donor Country Participants, Carbon Fund Participants and Observers to comprise the Working Group (in accordance with Resolution PC/10/2011/5 from PC10 meeting in Berlin, in October, 2011). The purpose of the Working Group was to make recommendations to the PC for consideration and adoption of policy guidance on a pricing approach and a methodological framework at its twelfth meeting (PC12). This note contains the recommendations from the Working Group.*

*Expected PC actions: The PC may wish to consider and adopt policy guidance on a pricing approach and guiding principles on the key methodological framework based on the recommendations from the Working Group.*

#### Introduction

1. Whereas:
  - i. Section 11.1(f) of the Charter Establishing the Forest Carbon Partnership Facility (Charter) provides that the Participants Committee (PC) shall adopt policy guidance on pricing methodologies for Emission Reductions Payment Agreements; and
  - ii. Section 11.1(i) of the Charter states that the PC shall, on the basis of the recommendations from the Facility Management Team (FMT), provide guiding principles on the key methodological framework.
2. The Participants Committee (PC) during its 10th meeting (PC10) requested the FMT to establish a working group on the methodological and pricing approach for the Carbon Fund of the FCPF (Working Group), and invite designated REDD Country Participants, Donor Participants, Carbon Fund Participants and Observers, with the aim of making recommendations to the PC for consideration and adoption of guiding principles on the key methodological framework and policy guidance on a pricing approach at its twelfth meeting (PC12).

#### Scope of the Working Group

3. The scope of the Working Group is to make recommendations to the PC on broad, overarching guiding principles for the key methodological framework and policy guidance on pricing methodologies as a proposal to the PC. The Carbon Fund's strategic objective is to pilot performance-based payment systems for Emission Reductions generated from REDD+ activities, with a view to ensuring equitable benefit sharing and promoting

future large-scale positive incentives for REDD+. The guiding principles for the methodological framework should reflect some or all of the following elements: (i) carbon accounting; (ii) programmatic characteristics, including inherent social and environmental benefits; and (iii) additional social and environmental benefits beyond carbon, to guide assessment and decision making. The World Bank safeguard policies will be met by each and every Emission Reductions Program (ER Program) for an Emission Reductions Payment Agreement (ERPA) to be signed.

### **Recommendations for guiding principles on the key methodological framework**

4. As identified in the scope of the Working Group, the methodological framework should address:
  - i. Carbon accounting (3 (i) above);
  - ii. Programmatic characteristics, including social, environmental and other non-carbon benefits (3 (ii) and (iii) above).
5. The methodological framework for the Carbon Fund (CF) is not expected to consist of detailed calculation methods or protocols. Rather the framework should provide the overarching guidance and act as a standard that is designed to achieve a uniform approach to carbon accounting and programmatic characteristics.
6. The Charter states that the PC is to provide guiding principles on the key methodological framework. In a standards-based approach, principles represent the fundamental statements about the desired outcome of a program, and elaborate on the objectives and define the scope. The Working Group felt that for the Carbon Fund, the objectives of the Fund are known and should already be further operationalized. Hence instead of recommending more general principles, the Working Group is recommending 'elements' that will be the building blocks for further development of the methodological framework.

7. The Working Group recommends the following elements:

8. **Overarching Accounting and Programmatic Element: Consistency with UNFCCC principles**

**The Emission Reduction Program (ER Program) strives to be consistent with evolving UNFCCC decisions on REDD+, particularly guidance and principles in place at the time of ERPA signature, as relevant and feasible.**

**Relevant principles include those on transparency, consistency, completeness, and accuracy.**

**Relevant guidance includes decisions on, for example, safeguards and reference levels.**

*Rationale:*

*UNFCCC principles and guidance may be considered for Accounting and Programmatic elements as follows:*

- *Transparency provides for transparent and consistent information accessible by relevant stakeholders on the assumptions, data collected, and methods used by an ER Program, other than confidential business information, to allow assessment of the credibility and reliability of data and assumptions.*
- *Consistency provides for use of similar methods to enhance comparisons across ER Programs, and over time within an ER Program, taking into account Accounting Element 1 on stepwise approach.*
- *Completeness helps assure that ER Programs consider all the relevant information. For carbon accounting, this includes carbon pools and categories of activities producing emissions or removals of carbon for reporting on the implementation of REDD+ activities. For Programmatic elements, this includes information on how the UNFCCC safeguards are being addressed and respected.*
- *Accuracy describes agreement between the reported value and the true value. For carbon accounting, this specifically refers to repeated measured observations or estimations of a quantity, relevant for quantitative estimates of carbon stocks and flows.*
- *UNFCCC guidance on safeguards includes consideration of stakeholder participation, benefit sharing and non-carbon benefits, and calls for the respect for the knowledge and rights of Indigenous Peoples and members of local communities, by taking into account relevant international obligations, national circumstances and laws.*

## ***Recommendations for elements on carbon accounting***

### **9. Accounting Element 1: Stepwise approach to reduce uncertainties**

**ER Program data and methods are consistent with IPCC Tier 2 standards, and ER Programs should, by using conservative assumptions and quantitative assessment of uncertainties, be incentivized to reduce uncertainties associated with all aspects of accounting, inter alia, reference levels, monitoring, and reporting (i.e., such that reductions in uncertainty are rewarded by a corresponding upward adjustment in ER volume).**

*Rationale:*

- *Countries may need to take a stepwise approach in the development of ER Program activities, measurement, monitoring, etc.*
- *Otherwise, very few countries would have the starting capacity to be able to participate in the CF.*
- *If the timeframe of the ER Program and the pace of improvements or access to enhanced data and methods allow, evolution in the quality of carbon accounting could be incentivized.*
- *IPCC Tier 2 standards are a reasonable starting point most ER Program candidates could reach, though Tier 1 standards may be considered in exceptional cases, with appropriate conservative accounting adjustments. (Tier 1 methods rely heavily on regional or international default values for land-use activity and carbon density data, and relatively simple methods.)*

### **10. Accounting Element 2: Reference level**

**ERs from an ER Program should be conservatively measured and reported relative to a transparently presented and clearly documented forest reference emission level (REL) or forest reference level (RL) for the ER Program area, following the guidance of the Carbon Fund Methodological Framework and informed by the emerging national REL/RL.**

*Rationale:*

- *Per UNFCCC REDD+ texts and discussions internationally and the FCPF Charter, the performance of REDD+ activities (and ER Programs for the CF) would be measured against a pre-established forest reference emission level and/or forest reference level.*
- *The CF should have flexibility to provide guidance on how ER Programs should set their own reference level, to meet its needs and to ensure environmental integrity. Detailed, operational methods have not yet been proposed by the UNFCCC, and maybe proposed for the CF in its evolving Methodological Framework.*

11. **Accounting Element 3: Consistency with monitoring system**

**ER Programs shall monitor and report ERs and other non-carbon variables consistent with the emerging national forest monitoring system, using methods appropriate for ER Program circumstances, including community monitoring, that are transparently presented and clearly documented.**

*Rationale:*

- *As per UNFCCC REDD+ decisions, discussions internationally, and the FCPF Charter, the performance of REDD+ activities (and ER Programs for the CF) would be monitored consistent with evolving UNFCCC guidance for a REDD+ forest monitoring system.*
- *Such consistency would allow comparison of ER Program benefits from different countries, and requires documentation of the data and methods used.*
- *Sub-national ER Programs should be consistent with the (emerging) national and sub-national REDD+ forest monitoring system.*
- *Community participation in monitoring can provide a cost-effective contribution to monitoring of ER Program activities and carbon and non-carbon benefits in many circumstances, when integrated with the ER Program monitoring system.*

12. **Accounting Element 4: Address reversals**

**ER Programs should identify potential sources of reversal of ERs (non-permanence); have the capacity to monitor and report any reversal of previously monitored and reported ERs; and have measures in place to address major risks of anthropogenic reversals for the ER Program area, to the extent feasible.**

*Rationale:*

- *Potential reversals of ERs from ER Program activities can be caused by fire, sustained drought, conflict, spontaneous immigration, etc.*
- *Potential reversals need to be avoided via the design of the ER Program, as feasible; and addressed via measures that may include, e.g., the creation of buffer reserves, use of insurance, effective forest management practices, or other approaches. Such reversals that do occur need to be accounted for to provide environmental integrity (i.e., net emissions to the atmosphere).*

13. Accounting Element 5: Address displacement

Potential sources of domestic and international displacement of emissions (leakage) are identified by assessment of all drivers of land-use change relevant for the ER Program; and measures to minimize and/or mitigate the risk of displacement of domestic emissions are incorporated into ER Program design and the estimation and monitoring of ~~emissions reduction~~ERs.

*Rationale:*

- *The unintended displacement of greenhouse gas (GHG) emissions from the ER Program area to elsewhere in a country also needs to be accounted for to provide environmental integrity.*
- *The potential for both domestic and international displacement is to be assessed, to recognize the importance of displacement.*
- *However only domestic displacement would need to be addressed via measures in the ER Program. (Measures to mitigate international displacement are not addressed in other sectors in UNFCCC policy and methods guidance.)*
- *Measures could include, e.g., accounting, enhanced law enforcement capacity, etc.*

### **Recommendations on programmatic characteristics**

14. The Working Group recommends the following elements:

15. **Programmatic Element 1: Endorsement and implementing capacity**

**The ER Program is endorsed by the national government (or governments, as appropriate) and is implemented by an entity (or entities) that has the capacity to implement the proposed REDD+ activities, potentially via a stepwise approach.**

*Rationale:*

- *The ER Program should, as far as possible, support the implementation and further development of the national REDD+ strategy.*
- *The ER Program should be submitted by the appropriate entity and there should be consistency between the activities and processes in the national REDD+ strategy and within the ER Program.*
- *The entity (or entities) needs to have sufficient capacity to implement the activities at the scale identified below in programmatic element 2 (capacity can include technical but also financial capacity).*
- *In a stepwise approach, an entity (or entities) could improve the quality of the ER Program over time by expanding and/or by improving the ER Program as capacity is being built.*

16. **Programmatic Element 2: Scale and ambition**

**The ER Program is ambitious, in that it demonstrates at a large scale the potential of the full implementation of the variety of interventions of the national REDD+ strategy, covering a significant portion of the territory.**

*Rationale:*

- *ER Programs should be undertaken at a significant scale and in line with the proposed national REDD+ management framework.*
- *Examples of significant scale include: the national level, the level of an administrative jurisdiction within a country, or some other level, e.g., large watershed or Indigenous Peoples' territorial unit.*
- *The Carbon Fund is set up to reward countries for their verified results in reducing emissions. To achieve emission reductions at large-scale, REDD+ countries and the Fund may seek to build on and mobilize other donor funding.*

17. **Programmatic Element 3: Safeguards**

**The ER Program meets World Bank social and environmental safeguards, promotes and supports the safeguards included in UNFCCC guidance related to REDD+, and provides information on how these safeguards are addressed and respected, including through the application of appropriate grievance mechanisms.**

*Rationale:*

- *The World Bank acts as both the Trustee and the delivery partner of the Carbon Fund.*
- *All ER Programs will need to meet applicable World Bank policies and procedures, including the safeguard policies triggered during Readiness Preparation, through the ER Program design and implementation of the country-specific ESMFs (which reflect relevant social and environmental sustainability issues identified in the SESA process)<sup>1</sup>.*
- *In addition, ER Programs should promote and support the safeguards included in the UNFCCC decisions on REDD+.*

18. **Programmatic Element 4 : Stakeholder participation**

**The design and implementation of ER Programs is based on and utilizes transparent stakeholder information sharing and consultation mechanisms that ensure broad community support and the full and effective participation of relevant stakeholders, in particular affected Indigenous Peoples and local communities.**

*Rationale:*

- *ER Programs should be based on transparent stakeholder consultations with groups affected by the ER Program and with local nongovernmental organizations about the program's environmental and social aspects and take their views into account to improve the design and implementation of the ER Program.*
- *As per the Cancun decision on REDD+, the full and effective participation of Indigenous Peoples and local communities must be respected.*
- *The World Bank Policy on Indigenous Peoples is designed to ensure that the Bank provides financing only where free, prior and informed consultation results in broad community support to the ER Program by the affected Indigenous Peoples.*

<sup>1</sup> The Strategic Environmental and Social Assessment (SESA) is the assessment process to be used in FCPF REDD+ countries during R-PP implementation and REDD+ readiness preparation. The Environmental and Social Management Framework (ESMF) is an output of SESA that provides a framework to examine the issues and impacts associated with projects, activities, and/or policies/regulations that may occur in the future in connection with the implementation of the national REDD+ strategy but that are not known at the present time.

- *Although the World Bank policy does not expressly refer to "free, prior and informed consent (FPIC)" per se, if the country has ratified ILO Convention No.169 and adopted national legislation on FPIC, or if the Bank is working on an ER Program with a development partner that expressly applies the principle of FPIC, the Bank should in turn require the application to the ER Program of ILO Convention 169 in that country, or should agree to the development partner's application of its provisions pertaining to FPIC in that country or for that ER Program.*

19. **Programmatic Element 5: Benefit sharing**

**The ER Program uses clear, effective and transparent benefit-sharing mechanisms with broad community support and support from other relevant stakeholders.**

*Rationale:*

- *ER Programs should use clear and transparent benefit-sharing mechanisms*
- *The design of the benefit-sharing mechanisms should respect customary rights to lands and territories and reflect broad community support, so that REDD+ incentives are used in an effective and equitable manner.*
- *The status of rights to carbon and relevant lands should be assessed to establish a basis for successful implementation of the ER Program. The assessment may identify potential key issues for the ER Program and agree a work program to advance progress on key issues to effectively implement the benefit sharing mechanisms.*

20. **Programmatic Element 6: Non-carbon benefits**

**The ER Program contributes to broader sustainable development. This could include, but is not limited to, improving local livelihoods, building transparent and effective forest governance structures, making progress on securing land tenure and enhancing or maintaining biodiversity and/or other ecosystem services. The ER Program should monitor and report on these non-carbon benefits as feasible, taking note of existing and emerging guidance on monitoring of non-carbon benefits by the UNFCCC, CBD, and other relevant platforms.**

*Rationale:*

- *ER Programs inherently provide social and environmental benefits beyond carbon and the mitigation of social and environmental risks.*
- *ER Programs are encouraged to further enhance non-carbon benefits, to contribute to broader sustainable development; and to measure non-carbon benefits in simple and cost-effective ways where feasible.*

## **Recommendations for policy guidance on pricing methodologies for Emission Reductions Payment Agreements**

21. In preparing the policy guidance, the Working Group considered the purpose of the policy guidance. The Working Group agreed that the policy guidance should:

- i. Encourage both buyers and sellers to transact ERs from REDD+ and protect their respective interests and rights in a reasonable manner;
- ii. Propose transparent mechanisms that reflect the risk allocation between parties to the transaction, and allow risk sharing and benefit sharing by sellers and buyers. In this context risks and benefits mainly refer to the uncertainty of performance-based mechanisms, and the effect this may have on the possible future valuation of Emission Reductions;
- iii. Consider the quality of ER Programs, including non-carbon benefits as appropriate; and
- iv. 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.

22. Based on this, the Working Group recommends the following guidance:

23. **Pricing Element 1: Fairness, flexibility and simplicity**

**Pricing should be fair and flexible, be kept as simple as possible, and protect both parties from extreme price fluctuations.**

*Rationale:*

- *The ER Programs to be considered by the Carbon Fund are likely to be diverse. Furthermore, although there is substantial progress in the international negotiations, the rules and modalities of REDD+ are not fully agreed. The pricing approach should therefore leave 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.*
- *In the learning-by-doing spirit of the FCPF, the lessons learned from the first ER Programs will help to enhance the subsequent ER Programs. While being flexible, the pricing approach should strive to ensure fairness among all ERPAs.*
- *The pricing approach should ensure fairness amongst the parties to an ERPA, and explore pricing mechanisms that protect their respective interests and rights, such as floors and ceilings (described below).*
- *The pricing approach should be kept simple. While all options should be analyzed, given the short timeframe of ERPAs in the Carbon Fund, there may not be an advantage in having comprehensive – but complex – pricing approaches. Complexity may lead to a lack of understanding by both parties, and increased transaction costs.*

24. **Pricing Element 2: Price structure**

**The ERPA price should be a combination of fixed and floating portions, where feasible.**

*Rationale:*

- *The future prices of emission reductions from REDD+ are difficult to predict, e.g., the regulatory regime is still evolving. The pricing approach therefore should leave room for adjustments as demand and supply for ERs from REDD+ evolve, in order to entice the parties to an ERPA to enter into a transaction and to protect their respective interests.*
- *A combination of fixed and floating portions offers the seller a minimum level of carbon revenues (through the fixed portion), and allows the sharing between the seller and buyer of both price risks and price benefits inherent in a volatile pricing environment (e.g., establishing price floors (~~protecting for~~ sellers) and price ceilings (~~protecting for~~ buyers) for the ~~floating portion~~ price of ERs).*
- *The fixed portion of the ERPA price is the percentage that is set at the time of signature for the term of the ERPA. The floating portion of the ERPA price reflects the price environment at the time of ER delivery (several years after ERPA signature). Use of a floating portion is feasible only if and when the parties to an ERPA can clearly agree on the relevant information or index that will be used to determine the value of Emission Reductions at the time of ER delivery.*
- *The ratio of fixed and floating portions may vary among ERPAs, and should be determined based on negotiation between parties. The ratio may depend on the characteristics of each ER Program and the aversion to risk of the parties to an ERPA.*

25. **Pricing Element 3: Informed negotiation**

**The ERPA price should be determined by negotiations between the CF Participants, as buyer, and the ER Program entity, as seller, based on their respective willingness to pay or to receive payment. This negotiation process should be informed by relevant information such as market surveys or transaction benchmarks.**

*Rationale:*

- *An agreement between the buyer and the seller based on their respective willingness to pay and receive payment is the preferred valuation method. Conditions today represent the early stages of performance-based payment for REDD+, with very few comparable transactions to*

*draw from and no clear price reference. This valuation method also would provide the desired flexibility to address the very likely diversity of ER Programs.*

- *Objective sources of information such as market surveys or transaction benchmarks should be considered to inform the negotiation process, in order to ensure transparency and fairness. Auctions also could be considered as a price discovery mechanism that would help the negotiation, to the extent feasible.*

#### 26. Pricing Element 4: Non-Carbon benefits

**The ERPA price negotiation process offers an opportunity for non-carbon benefits to be taken into consideration, although there would be no systematic quantification of non-carbon benefits for pricing under the Carbon Fund.**

*Rationale:*

- *ER Programs will feature, in addition to greenhouse gas mitigation benefits, a range of additional benefits, as described in the Programmatic element on non-carbon benefits. For example, REDD+ activities could enhance biological diversity, or preserve or improve livelihoods for forest-dependent Indigenous Peoples and local communities.*
- *ER Programs will be assessed and selected primarily for their potential to generate emission reductions, in a sustainable way. By giving consideration to the potential non-carbon benefits, ER programs will be encouraged to enhance these benefits for broader sustainable development.*
- *The price negotiation process also offers an opportunity for both parties to discuss any specific non-carbon benefits in the ER Program, and to decide whether and how they should be taken into consideration in pricing.*

## **Annex 1: Summary of Working Group process**

27. The Working Group consisted of:
  - i. 3 financial contributors to the Readiness Fund or the Carbon Fund: Australia, Germany/Norway (shared seat), The Nature Conservancy;
  - ii. 3 REDD+ Country Participants: Mexico, Nepal, Suriname;
  - iii. Observers: 1 representative from civil society, 1 representative from Indigenous Peoples and 1 representative from the private sector.
28. The Working group conducted 8 conference calls and several face-to-face meetings in the margins of CF3 and PC11.
29. The FMT prepared the following 8 background notes to feed WG discussions:
  - i. Background Note #1: Scope of the Working Group;
  - ii. Background Note #2: Carbon Accounting Aspects for the Methodological Framework of the Carbon Fund of the FCPF;
  - iii. Background Note #3: Quality and Non-Carbon Values as Price Determinants under the Carbon Fund of the FCPF;
  - iv. Background Note #4: Examples of Non-Carbon Values as Price Determinants in the World Bank's Carbon Finance Business;
  - v. Background Note #5: Programmatic Elements for the Methodological Framework of the Carbon Fund of the FCPF;
  - vi. Background Note #6: Options for Valuing Emission Reductions;
  - vii. WG Background Note #7: Draft Elements for WG Discussion for the Final Product for the FCPF PC;
  - viii. WG Background Note # 8: Draft Guidance on Pricing.
30. The background notes and summaries of the first four conference calls are available at: <http://www.forestcarbonpartnership.org/fcp/node/369>.