Finding a path to REDD investment

How can finance be mobilised to protect the world's rainforests, in a climate of extreme policy uncertainty? *Environmental Finance* and Irbaris convened a panel of experts to try to find out. Mark Nicholls reports

There is a pressing and growing need to protect the world's rainforests and that, of course, will take financing. Mechanisms must be put in place to provide an economic incentive to keep forests standing – and, in the context of pressure on government budgets around the world, the private sector will be expected to deliver much of the money.

Step forward the carbon markets and the proposal, first put formally on the table at the UN climate talks in Bali in 2007, for an international system to award carbon credits to projects that reduce emissions from deforestation and forest degradation (REDD).

But, with slow progress in the international climate negotiations, and the uncertain future of climate policy in North America, Japan and Australia, what are the prospects for the carbon markets to channel significant flows of capital towards REDD projects any time soon? What conditions must be met to facilitate such flows? And what other options are there to channel support to at-risk rainforests?

It was to try to answer these questions that *Environmental Finance* and Irbaris, a business strategy consultancy specialising in sustainability and climate change, convened a roundtable of forestry finance and REDD experts, hosted by Irbaris at its offices in central London. The participants included bankers, investors, project developers, insurers, advisors and government officials with extensive experience in the field (see box) and with strong views on the issues at stake.

"The consistent message is that we need sustained demand for credits"

Simon Petley, EnviroMarket

Roundtable attendees

Phil Cottle, managing director at specialist insurance provider ForestRe
David Hampton, managing partner at business strategy consultancy Irbaris
Marisa Meizlish, director of research at asset manager New Forests
Simon Petley, director of advisory firm EnviroMarket
Georg Schattney, managing director at investor and offset provider Forest Carbon Group
Neil Scotland, forests and land use adviser, the Department for International Development
Geoff Sinclair, head of carbon sales and trading at Standard Bank
Michael Woods, principal advisor at Irbaris

The roundtable was chaired by **Mark Nicholls**, editor of *Environmental Finance*

Despite the general malaise in carbon markets – over which the lack of agreement on a post-2012 regime and continued US federal disengagement hangs heavy – the conversation took place amid growing activity in the REDD arena.

Progress was made on elaborating an international REDD mechanism at the climate talks in Mexico last December. Substantial government funding is flowing towards capacity building in forest nations. Californian regulators are setting out the criteria for REDD projects to generate credits that will be admissible in its cap-and-trade programme, slated – legal challenges permitting – for a January 2012 start.

"There's no shortage of capital willing to go into the right structure with the right risk"

Geoff Sinclair, Standard Bank

And the voluntary carbon market is mobilising. Demand for REDD credits jumped last year, according to a recent survey of the voluntary market produced by Ecosystem Marketplace and Bloomberg, which found that REDD credits accounted for 29% of voluntary volumes.

Fundamentally, a REDD market needs demand for REDD credits. The Waxman–Markey bill, which passed the US House of Representatives in 2009, would have created enormous demand for REDD offsets, to help US emitters meet targets in a federal cap-and-trade programme. That false dawn – companion legislation stalled in the Senate – generated a flurry of activity in REDD, much of which has met the same fate as the Senate climate change bill.

"The consistent message," said Simon Petley of EnviroMarket, "is that investors and project developers need sustained demand for credits – consistent, long-term demand. Project developers need some clarity on demand, while investors need some clarity on where they can get credits."

California's Air Resources Board (ARB), responsible for implementing the state's AB 32 climate legislation, is currently working on mechanisms that may allow for the inclusion of some REDD activities, thus creating some of that demand, said Marisa Meizlish of investment management firm New Forests. However, due to ARB's limits on "sector-based offsets" – under which REDD would be regulated – the absolute volumes are small: "We're only talking about a market for sector-based offsets of perhaps around 100 million tonnes between the start of the market and 2020 … a handful of projects could take out a large percentage of that."

Meanwhile, the EU Emissions Trading System (ETS) – which the World Bank estimates accounted for 97% of activity in the global carbon market last year – remains firmly closed to any

forestry offset credits. This reflects long-held fears among European NGOs and policy-makers that the carbon markets risk seeding millions of hectares of monocultural plantations, vulnerable to pest and fire – and which are deemed to be inferior to emission reductions delivered by clean energy technologies.

However, Georg Schattney of the Forest Carbon Group believes that the EU ETS – which from 2013 will bar credits awarded for the destruction of industrial gases – should open its door to REDD credits from some of the world's least-developed countries (LDCs). "In my dream world, Jos Delbeke [director-general for climate action at the European Commission], says 'we've killed off HFCs, now we want to offer access to LDCs' REDD credits. There's some sympathy for this in the European Parliament."

Schattney has a more audacious suggestion: that the airline industry cuts a deal with the European Commission to make deeper cuts than currently proposed for the aviation sector, in exchange for the right to use REDD credits.

At present, much of the demand for REDD credits is coming from the voluntary carbon market – with buyers, such as clients of Schattney's Forest Carbon Group, buying credits for retirement as part of their corporate social responsibility policies.

"I'm of the opinion that the future of REDD might lie with the voluntary markets for the time being," said Meizlish, noting that

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Marisa Meizlish, New Forests

REDD projects tend to offer multiple social and environmental benefits, but only the carbon element can be (relatively) easily monetised.

In principle, there is currently no shortage of funding available for putative REDD projects. "There's no shortage of capital willing to go into the right structure with the right risk," said Geoff Sinclair from Standard Bank.

But in the absence of large-scale demand from compliance markets, the participants agreed that there is a crucial role for governments to assume some of the risk in developing REDD projects. Meizlish noted that, during the debates around the Waxman-Markey bill, one idea discussed by New Forests and others was whether the US government could be a "buyer of last resort" of REDD credits, say offering \$2/tonne. "People responded well to that idea," she said.

However, purely voluntary demand constrains the types of financing available, noted Michael Woods at Irbaris. "If you're trying to structure a rainforest bond, for example, it may be more difficult to attract investors on the basis of a voluntary market – with bonds, it's about ensuring a return on investment, and for that you may need access to a mandatory market."

There are, of course, a host of technical challenges in designing an effective REDD mechanism. Perhaps the most significant, in the opinion of Meizlish at New Forests, is addressing the need for emissions targets to be set at the economy-wide level, so as to avoid projects simply shifting deforestation into neighbouring areas. However, this risks holding investors in one project hostage to the performance of the wider jurisdiction.

"Land tenure and property rights are at the crux of the problem"

Neil Scotland, DFID

"The private sector is in an awkward position. REDD has moved away from project-based financing to the jurisdictional level, where you are changing whole economies … How do I manage the risk of, say, Papua meeting its jurisdictional targets?

"The only way REDD can work is if it's on a 'nested' basis," she added, whereby projects, with their own emissions baselines and targets, can be nested within wider jurisdictions.

Meanwhile, Neil Scotland at DFID, with the perspective gained from years in Indonesia mediating between development agencies and those dependent upon the forests for their livelihood, argued that issues around land tenure and permitting are crucial. "Getting licences, concessions and permits can be … opaque, subject to allegations of bribery and corruption, and take a long time, without any certainty over the likely outcome.

"Land tenure and property rights are at the crux of the problem," he said. "The challenge is to focus on reforms around land

"To what extent do governments value their forests?"

Phil Cottle, ForestRe

tenure and parity of ownership, to provide the environment in which the private sector can invest."

Moreover, as Schattney argued, REDD projects – where forests are left unexploited – can be perceived locally as holding back local development. "It's a bit too romantic to think you can go to Kinshasa and be beloved because you're making a green investment."

"It's very easy to sit in London and talk about what this country or that country should be doing with their land tenure systems," agreed Sinclair. "To me, the key thing is that the government and the country have to want to do it. The first thing is national buy-in."

A crucial question, said Phil Cottle at ForestRe, is "to what extent do governments value their forests … and see them as a vital foundation to their entire economies?" noting that, for example, failures of policy and forest management in Russia contributed to the disaster wrought last year by widespread wildfires.

The consensus among those around the table was that the UN system is unlikely to deliver a top-down REDD mechanism any time soon – but also that this may not matter overly.

"The way climate investment more broadly is behaving now, there is no reliance on an international agreement – it's relying on a European trading scheme, which is seen to be approximately delinked," said Sinclair. "The potential is much more in bilateral, or small-scale multilateral agreements." Even when lending to CDM projects, he explained, banks don't look to the

UN system, but to the project's eligibility within the EU ETS. "I don't care what the mechanism is, as long as there's a fungible market," he added.

"Two or three years ago, REDD was about conserving forests and generating credits – REDD now is about shifting entire economic land-use sectors in the developing world onto a more sustainable path," said Meizlish. "The carbon markets are only

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Michael Woods, Irbaris

a sliver of that solution … and the UN is not going to deliver a Clean Development Mechanism [CDM] for REDD."

That's not to say that the UN process is irrelevant – it can deliver standards and some level of co-ordination, even in a fragmented market.

"It seems to me that it's going to be a combination of top-down, bottom-up and bilateral, as well as the UN level, but the EU market is going to be pretty key," said Woods at Irbaris. "There needs to be a political shift there."

But perhaps policy-makers – and investors – are expecting the carbon markets to do more than they can, and more than is necessary. "Carbon trading is too often seen as a panacea," said Woods. "There are other approaches that should be pursued alongside."

While the absolute volumes of financing needed to halt deforestation look daunting – the UK government's Eliasch review put the figure at $30 billion/year – there is no reason why a REDD market has to deliver the whole amount.

"REDD outcomes could be achieved by, for example, growing the market for sustainably produced agricultural commodities," says Petley. "There is a whole suite of market forces driving deforestation, and yet we remain fixated with carbon markets as a solution. Undoubtedly they have a role to play, but it's not correct to say that we need a $30 billion carbon market – we need $30 billion of economic effort."

Petley suggests that carbon could be simply one catalyst among several to drive what he describes as taking a "landscape-level view" of the problem, with forestry as a component of sustainable land use and changes in agricultural practices. This would require financing to set up a "broader enabling framework" which could perhaps be financed via forest bonds, issued by sovereign governments and perhaps underwritten or guaranteed by multilateral banks or OECD countries.

Sinclair agreed that REDD markets "are just one way of raising finance", referring to a facility Standard Bank has in place to lend to African smallholders collateralised not by their land – over which they often struggle to show legal ownership – but by their expected cash flows from the sale of the commodities they produce. The novelty of the structure means that multilateral banks have had to come in with a first-loss guarantee but, over time, that should become unnecessary.

"Regardless of the financing instrument you use, there's a role for public intermediaries to mitigate some of these risks," he said.

However, Sinclair also noted that the CDM – often derided as a failure – enabled $90 billion of capital investment in 2009, a figure that is approaching the annual $100 billion of climate finance by 2020 called for in the Copenhagen Accord, and in last year's Cancún Agreements.

Successful REDD projects are likely to be implemented alongside and in conjunction with other forestry investments, and potentially with agricultural and biomass energy investments, to provide livelihoods for local populations.

Meizlish at New Forests described the 'mosaic' management strategy that her firm favours, where an investment combines degraded forests, which are converted to a high-growth plantation, an area of natural forest that is selectively logged and an area of high-conservation forest that is entirely protected. "But at the end of the day the returns are still driven by timber."

Moreover, there is likely to be growing investment in forest protection regardless of the existence or otherwise of tradable markets for the ecosystem services they provide, the participants agreed.

David Hampton of Irbaris suggested that water offers an example of where the private sector is driving the agenda in the absence of any traded market offering an external revenue stream. Companies are acting to protect watersheds because they recognise the importance to them of ensuring adequate supplies of water for their supply chains. The difference between water and carbon is that while the latter "is a problem at the UN level, water will actually bite".

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gested Schattney, making REDD investments in countries where they face supply-chain risks, and thereby mitigating those risks. "I see a story there," he said.

As with so many other areas of climate policy, those investors, developers and large companies which are engaging with REDD and forest protection are increasingly coming to terms with a world without the top-down international policy certainty, supported by a global carbon market, which seemed to be on the agenda two years ago.

Instead, they are coming to terms with disaggregated policy at a number of different levels – and there were a number of clear messages that emerged from the roundtable:

- There is an urgent need for regulatory frameworks at all levels to facilitate investment and create demand – not just at the UN;
- To implement REDD investments, there needs to be accommodation in terms of policy and politics, with governments in host countries putting in place the conditions for REDD investments while those in buyer countries create demand;
- Governments need to introduce the 'infrastructure' to facilitate REDD projects, not least through addressing land tenure and ensuring that property rights are enshrined in law;
- Policy-makers need to look beyond carbon markets, and encourage markets for sustainable forest products – such as bioenergy, timber or palm oil – to help transform the economics around at-risk forests; and
- The finance sector needs to be creative in producing financing solutions, and engage with the risks inherent in REDD projects.

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The roundtable discussion was kindly hosted by Irbaris, a business strategy consultancy with offices in London and Washington, DC, and which works with clients in Europe, North America, Africa and Central Asia.

It brings together a highly experienced, multi-disciplinary team of business advisers with deep international expertise in carbon, climate change and wider sustainability issues, as well as clean technologies.

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