

A RESPONSE TO CMIA:

TOWARDS A BROADER APPROACH TO ACHIEVING REDD

Prepared as a rebuttal to CMIA's response to our Forest Carbon Market report

6th December 2011

INTRODUCTION

In March 2011 we published a report on forest carbon markets¹. Our analysis brought us to the conclusion that “the range of potential outcomes is highly skewed towards problematic effects that would see REDD [fall well short of its objectives](#)” and therefore that forest carbon trading is “unworkable as currently constructed.”

Representing investors in climate markets, Climate Markets and Investors Association (CMIA) wrote a direct response to our report.² According to CMIA, our report ignores carbon markets generally, which leads to three fundamental analytical errors that “lessen its credibility and relevance.” We disagree, and this document’s purpose is to rebut their claims.

It begins by burying the curious and incorrect notion that the problem with REDD is a lack of liquidity, instead focusing on the real problem of the lack of alignment between the market structure for REDD’s development and forest conservation objectives.

We then explain why we do not believe that a comparison with carbon markets is either technically accurate or flattering, then respond directly to the three aforementioned errors CMIA believes our report contained.

Finally, we open a discussion about the urgent need for alternative financial solutions to REDD, and the need for experienced market actors such as CMIA to engage in this discussion.

This is not intended to increase the polemical noise surrounding REDD. While we disagree with CMIA regarding many substantive issues, both of our organizations care very deeply about seeing REDD fulfill its promise.

We respect that many of CMIA’s members have paid a significant opportunity cost to remain engaged in REDD. After all, REDD has been a very poor investment of time when viewed from a pure cost-benefit perspective. Any well-informed private-market advocate involved in REDD pays for that involvement by foregoing easier, less risky prospects in finance.

In other words, this is not about motives or intentions, but results. CMIA and we have a major disagreement regarding the best ways to achieve REDD’s goals. This disagreement

¹ To read the full report see: <<http://www.mundenproject.com/forestcarbonreport2.pdf>>

² To read CMIA’s report visit the following link:

<http://www.cmia.net/LinkClick.aspx?fileticket=X3_ZuccmQqw%3D&tabid=39&language=en-US>

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comes from two well-informed, but very different, views of the proper way to judge financial mechanisms.

We hope that this document will clarify what our view on this important question is, and inform a better effort to produce a viable financial approach to making REDD's outcomes a reality.

THE INSUFFICIENCY OF LIQUIDITY

CMIA asserts that our report does not have a solid understanding of commodities markets, stating³ that it:

[O]verlooks the crucial point that markets for commodities only emerge when there is sufficient liquidity. In the case of carbon markets, liquidity only comes when there is sufficient demand for compliance grade carbon instruments because governments have taken on emission reduction targets. Their view is that REDD+ projects are currently too heterogeneous and will therefore never fit within the commodities markets.

Note the reference to liquidity. It is important, because CMIA's analysis rests on the presumption that generating transactions – liquidity – is the essential challenge facing REDD.

They make a tacit assumption of a future convergence between increasing liquidity in forest carbon trading and improving quality standards for the sourcing of forest carbon. This virtuous cycle leads them to believe that increased liquidity will result in improved forest protection (economic development is curiously absent from their reply).

This is incorrect on a number of fronts. First, liquidity is not a standard by which one can judge a successful financial market. As the 2008 subprime mortgage crisis reminds us, markets should never be judged purely on their capacity to generate transactions.

The increase in trading of MBS, CDS, CDOs and the like prior to 2007 was an absolute success from a liquidity perspective. But it did not produce positive results, because the mechanisms that the liquidity was feeding were inherently dysfunctional.

This is an important point to remember when considering REDD. One can suggest many market designs to generate transactions in forest carbon, but this does not mean that those designs would result in successful fulfillment of REDD's objectives. What is important is not liquidity, but its consequences.

Second, the assumption that increased liquidity will incentivize people to create higher standards for forest carbon ignores quite a lot of market history. In fact, we see that liquidity tends to reinforce, not modify, existing market structures.

³ Here, CMIA substantially distorts our statements regarding commodities markets. Rather than saying REDD projects would not “fit” commodities markets, we made the more general argument that “the commodity-based approach is at loggerheads with the development benefits REDD is expected to generate.” We will return to this later in the document.

Once market participants allocate large sums of money within a substantially dysfunctional system, they develop a vested interest in defending that dysfunction, to the point where regulators fear removing the dysfunction out of concern about collapsing the entire market.

WHY IGNORE CDM?

CMIA makes one central criticism of our report: that it does not examine existing carbon markets. This was a deliberate choice – and in retrospect, a choice we should have explained to our readers.

Our concerns lie in ensuring REDD will achieve its environmental and development objectives. As we examined other carbon markets, we arrived at the view that they would be a poor basis for analyzing forest carbon.

This is because these mechanisms⁴ are considerably different from REDD. This analysis is based on several prominent issues:

- ☑ **REDD projects are more sensitive to carbon prices.** For many CDM projects, carbon credits represent an additional cashflow that supplements an existing operation.⁵ Those projects are therefore more resilient operationally as carbon prices change.

By contrast, forest carbon is designed to be the primary return component in any REDD project. This means that REDD projects are more likely to fail in the event of major market dislocations since they have no recourse to non-correlated revenue.

- ☑ **REDD investors must address land tenure issues.** CDM projects tend to be located in places with relatively clear ownership of land, such as factories, plants and other such well-understood investment environments.

By contrast, REDD projects must address major questions related to land rights, where ownership rights are often very unclear or informally exercised. This encumbers investors' assets in a much more substantial way than in CDM projects.

⁴ Such as the Clean Development Mechanism (CDM), which CMIA uses as an analogy for REDD.

⁵ See p.15 of the 'Guidebook to Financing CDM Projects' published by EcoSecurities on behalf of UNEPs CD4CDM programme, which shows very clearly that CDM payments must be *additional* revenue streams. Available at: <http://cd4cdm.org/Publications/FinanceCDMprojectsGuidebook.pdf>

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- ☑ **REDD projects often operate in an unstable political and economic context.** Whereas the CDM operates in and relies on a relatively stable macroeconomic and political context, REDD projects must be able to deal with higher risk and uncertainty due to the political and economic reality of the regions where there are high levels of forested land. The CDM supply is largely a Chinese market. According to recent figures, 53% percent of CDM project development takes place in China. China has a compelling, high-growth economic environment with a well-understood investment climate.⁶

For REDD, the story is very different. No country that would be a major provider of forest credits – including Brazil – comes close to matching China’s uniquely compelling risk-reward proposition. Locations like DRC, Tanzania, Angola, Myanmar and others present even stiffer challenges for investors.

In short, we felt that mechanisms like CDM shared the carbon label, but contained very different content.

With a poor environmental and developmental track record, the CDM has fallen significantly short of its intended positive socio-ecological outcomes and benefits.⁷ In addition, many reports have called the CDM’s ability to make real reductions in global CO₂ emission into question, mostly due to recent scandals over fraudulent projects.⁸

For these reasons, we believe that such an analogy does more damage than good to the credibility of REDD, leading to more questions than answers over the potential benefits and outcomes of REDD projects.

⁶ For more information see <http://www.sandbag.org.uk/site_media/pdfs/reports/offset2009.pdf>

⁷ For more information see Schneider, L. (2007) ‘Is the CDM fulfilling its environmental and sustainable development objectives? An evaluation of the CDM and options for improvement’ <<http://www.oeko.de/oekodoc/622/2007-162-en.pdf>>

⁸ For more information see Drew, M and Drew, J. (2010) ‘Establishing additionality: fraud vulnerabilities in the clean development mechanism.’

ABOUT THOSE THREE ERRORS...

In their response, CMIA claimed that “by ignoring the existing carbon markets,” we made “three key errors” in our analysis. On each count, we believe they were incorrect.

The first error CMIA mentions was cited earlier in this document: namely, that we “assume” that emission reductions based on credited projects will never be suitable for the commodity markets.

No such “assumption” exists. In fact, our report explains that the variability in the science that underpins the generation of forest carbon credits makes it unsuited to a commodities-style trading framework.

The second error CMIA claims to find is where we “*miss the concept that the primary and secondary markets for carbon credits can and do happily co-exist and in fact both are necessary to be able to help project developers hedge their carbon exposure and raise project finance.*”

Responding to this charge, we invite readers to re-examine our argument once more. We do not assert that they cannot co-exist – quite the contrary. In our report, we state that:

The primary-secondary structure is not a choice. It is anthropologically inherent to REDD’s design because the people generating the asset are neither qualified nor inclined to trade their assets on a market. This is a good thing. Much as we would prefer that farmers focus on growing food instead of trading commodities futures, those on the ground in REDD projects do not need the added distraction supplied by derivatives market speculation.

Here, our differences with CMIA are again quite evident. While primary and secondary markets may well “happily” coexist, this is not in itself enough. We take a contextualized view of primary and secondary markets, asking whether they serve the purpose for which they were created. To cite our original report, we suggested that:

The question is not, therefore, whether this type of market structure works in the abstract. It is whether this type of structure is appropriate for REDD. We believe that it is not only unsuitable operationally – in that it implies significantly higher costs for projects – but furthermore, that is highly likely to work at cross purposes with REDD’s stated objectives.

We continue to believe that this should constitute the guiding concern for any question asked about REDD.

Their third and final charge esteems that we have “*overlook(ed) the rapid pace with which carbon credit contract structures evolved to greatly reduce any market asymmetries and perceived*

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inequity between buyers and sellers.” In support of their charge, they refer to the “highly transparent systems, which are designed to be open to stakeholder scrutiny at all times.”

Though these quality assurances exist for carbon credits they have been shown to cover over a significant level of dysfunction, as an investigation of Indonesia’s Rimba Raya project has revealed.⁹

Despite the fact that it was the first to earn a triple-gold rating under the Climate, Community and Biodiversity Alliance (CCBA), a trusted independent body, Reuters exposed it as failing its investors, communities and the environment alike. That such a project could have received the highest of ratings reveals, conversely to CMIA’s assertions, how little carbon credit structures have indeed done to reduce market asymmetries.

To continue our examination of the Rimba Raya project in Indonesia, a closer analysis of the investment proposition supports our assertion that it is intermediaries and not communities that receive a considerable percentage of the overall value of any REDD credit’s final price due to asymmetries in pricing power that are inherent in over-the-counter (OTC) markets:

By preserving a large area of peat swamp forest, Rimba Raya was projected to cut carbon emissions by nearly 100 million tonnes over its 30-year life, which would translate into total saleable credits of about \$500 million [...] Gazprom, designated as the sole marketer of carbon credits from Rimba Raya, said it had already agreed long-term sales contracts with buyers at between 7 and 8 euros (\$10 to \$11.40) per tonne - contingent on the licence being issued.

The above account reveals that approximately 56% of the credit’s first pricing in the secondary market would go to the intermediary (in this case, Gazprom). Taking into account that the project’s investors expect a considerable share of the profit too, we can reasonably conclude that a very small share would be left for Rimba Raya’s community, defeating the broader development aim of REDD projects.

⁹ For more information, see the original report that can be found at the following link: <http://af.reuters.com/article/idAFTRE77F12W20110816>

A FEW WORDS ABOUT CLEARING

Finally, the CMIA response ignores important points we made with respect to clearing. We believe this undermines the credibility of their reply from a financial perspective. To review, our original analysis made four key assertions in connection with clearing:

1. The financial crisis has demonstrated that clearing dramatically reduces trading risk
2. Clearing relies on proper setting of contract margins, which in turn relies on the clearinghouse understanding likely price movements within the contract being margined
3. Price is a function of supply and demand
4. Therefore, the process for quantifying forest carbon (the “supply” portion of that calculation) must be consistent, clear and reliable.

We found that the current process for quantifying forest carbon credits was excessively malleable and consequently asserted that clearing issues would “either cause the [forest carbon] trading system to not be created in the first place, or (as seems more likely) will result in the creation of a substandard, risky and ultimately destructive forest carbon market.”

There has been little formal rejoinder to this point, but anecdotally, we can report that one of the common replies we have heard is that forest carbon might well remain uncleared and, therefore, that clearing considerations need not apply. For our purposes here, we shall assume that CMIA shares this view, in light of their unwillingness to even mention clearing in their response.

Ignoring the importance of clearing-related considerations does not magically remove their importance. Whether government applies these standards or not, they remain relevant in analyzing how functional a given market may be. Forest carbon is no exception.

It is therefore important to note that, since March, the case for clearing’s importance has become more evident and received wider acceptance in the general context of financial markets.

First, the CFTC has definitively supported our view regarding the superiority of cleared derivatives (or “swaps”) relative to uncleared ones. In April, the Commission declared that:

During the recent financial crisis, derivatives clearing organizations (“DCOs”) met all their obligations without any financial infusions from the government. By contrast, significant sums were expended as the result of losses incurred in connection with uncleared swaps, most notably at AIG. A key reason for this difference is that DCOs all use variation margin and

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initial margin as the centerpiece of their risk management programs while these tools were often not used in connection with uncleared swaps.

Groups like CMIA might well respond to this by arguing that forest carbon will eventually end up being uncleared, and on this point, they may be right.

But they – and along with them, the regulators currently contemplating forest carbon markets – would do well to heed CFTC’s judgment regarding margin requirements for uncleared swaps. In their proposed rules governing uncleared swap transactions, the Commission clearly stated that being “uncleared” is not a valid reason to escape margining considerations:

*Given the Congressional reference to the “greater risk” of uncleared swaps and the requirement that margin for such swaps “be appropriate for the risk,” the Commission believes that establishing margin requirements for uncleared swaps that are **at least as stringent as those for cleared swaps** is necessary to fulfill the statutory mandate.*

We therefore believe that our original emphasis on margin requirements remains a valid methodological approach for analyzing forest carbon from a financial point of view.

Indeed, the very same set of rules supplies us with an objective standard against which to judge putative forest carbon contracts. CFTC laid out a point-by-point standard for calculating initial margins, one that required that any model used to calculate initial margin, “shall set margin to cover at least 99% of price changes by product and by portfolio over at least a 10-day liquidation time horizon.” This requirement is even more stringent than the one we envisioned in our original analysis.

Most importantly, it represents a standard that we think forest carbon (under current calculation methodologies) could not possibly reach.

TOWARDS AN ALTERNATIVE

Our report made the analysis that forest carbon markets, as currently envisioned cannot achieve REDD's environmental and development objectives.

Work must now be done to find an alternative, one that provides money on the same ambitious scale as forest carbon markets, but that requires certain conditions for the outcomes of investment. **We are currently collaborating with a small group of interested parties on a paper that describes this¹⁰.**

In the interim, we can offer some general thoughts. Our view is that the following issues are key to creating a stable and effective mechanism to reduce deforestation:

- Shift away from carbon towards broader performance objectives
- Create an operating track record that shows how money leads to results
- Produce a portfolio of best practices that shows how money is most effectively spent
- Develop community-driven approaches to achieving REDD's objectives

Shift from Carbon

Forests are not just carbon sinks, but also hold vast amounts of biodiversity, regulate ecosystems and water sheds and provide vital resources to one in six people on this planet who rely on them for daily survival. Until REDD's financial mechanisms acknowledge the multi-functionality of forests, their focus will be too narrow to truly tackle deforestation.¹¹

The carbon focus on REDD is an intuitive financial choice: avoided emissions from deforestation can be sold as carbon credits on a carbon market, thereby incentivizing governments and businesses that have emissions reductions obligations to buy these credits.

However, deforestation is happening not only because standing forests are not valued, but because of poor governance and corruption, unclear land tenure and over-consumption.¹² Spending money on dealing with these broader issues would mean that investment opportunities are more stable and have a better return. Work must now be done to explore how this work could translate into investment opportunities.

¹⁰ This document should be released in January of 2012. Those interested in receiving it are invited to contact Benedick Bowie (benedick@mundenproject.com) and Hannah Mowat (hannah@mundenproject.com) to request an update when the white paper is issued.

¹¹ For more information see Putz and Redford (2009) 'Dangers of carbon-based conservation' *Global Environmental Change*, 19, 400-401,

¹² For more information see Karsenty, A and Ongolo, S (2011) 'Can "fragile states" decide to reduce their deforestation? The inappropriate use of the theory of incentives with respect to the REDD mechanism', *Forest Policy and Economics*

Operating Track Record and Portfolio Approaches

Though one can broadly outline what those investment opportunities are, it is important to do exploratory work into defining them more precisely, in order to show investors how their money translates into measurable results. Investors need to see an operational track record of how money leads to performance.

Public support could go towards providing funding for a diverse portfolio of projects that tackle deforestation, with the aim of creating an operational track record of how money spent on particular approaches produces results.

These initial projects should forego a singular focus on carbon and concentrate on a broader range of performance indicators. In doing this, projects can achieve broader environmental and development benefits, things that investors might be interested in financing once they can prove their performance.

For money to be most effective, we believe it must invest in projects that:

- Channel money to directly reach the ground, rather than channelling it through expensive external intermediaries
- Create positive environmental and developmental outcomes by ensuring that the drivers are identified by the communities themselves and that any projects to tackle them are defined by forest dependent communities. Not only is this the fairest way to stop deforestation, it also makes it a more stable and diverse investment opportunity
- Manage risk by matching a diverse portfolio of projects with a diverse range of capital partners so that a failure for either side to perform does not result in a collapse of the mechanism.

The Importance of Communities

Most importantly, REDD projects must see the wood from the trees, and more importantly, the people living in them. Community-owned projects have a demonstrated track record of success, showing that when communities are strong, the environment is more likely to be protected.¹³

¹³ For more information, see Bowler, D., Buyung-Ali, L., Healey, J.R., Jones, J.P.G., Knight, T. & Pullin, A.S. (2010) 'The Evidence base for community forest management as a mechanism for supplying global environmental benefits and improving local welfare' *CEE review 08-011*. See also Agarwal, A and Chhatre, A (2009) 'Trade-offs and synergies between carbon storage and livelihood benefits from forest commons' *PNAS*

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In a paper published by the World Bank – quoted below– the authors make comparisons between rates of deforestation in areas where forest peoples’ rights are recognized, indigenous territories are demarcated with areas that are simply put aside as conservation areas.

Their findings strongly support our belief that investing in communities is the most effective way of reducing deforestation:

Our results suggest that indigenous areas and multi-use protected areas can help accomplish better goals, also suggesting some compatibility between environmental goals (carbon storage and biodiversity conservation) and support for local livelihoods.

The results also reinforce findings from a field-survey based study of 84 protected areas in Asia and Africa, which found a positive association among biodiversity richness, forest support for livelihoods, and local people’s participation in forest governance.¹⁴

By letting forest peoples drive the solutions to deforestation, they are empowered and incentivised to identify and tackle the root causes of deforestation much more efficiently than external contractors, as is currently the case. In addition to being the most just and effective approach, community driven approaches are also more time and cost efficient than alternative approaches.

¹⁴ For more information see Chomitz, K and Nelson, A (2009) ‘Effectiveness of Strict vs. Multiple Use Protected Areas in Reducing Tropical Forest Fires: A Global Analysis Using Matching Methods’, *Plos One*, 6, 8, 1-14.

CONCLUSION

Our starting point for this discussion is the twin objectives of forest conservation and economic development for forest communities. For the reasons stated in our March paper, we do not believe carbon markets do an effective job of meeting these objectives.

By this point it is apparent that CMIA and The Munden Project are, in fact, asking very different questions.

CMIA's starting point appears to be the development of carbon markets, and their critique focuses on the technicalities of how the markets function, without addressing their effectiveness in meeting the underlying goals of REDD.

Our starting point instead is trying to meet the twin objectives of forest conservation and economic development. It is grounded in a very different view of how markets work, and based on a close reading of community needs, aspirations, and capabilities.

We invite CMIA to engage in a more substantial conversation about how to build financial mechanisms that achieve the underlying goals of REDD. This is where we are putting our focus.