Precedent-Setting Insurance for
REDD Project in Cambodia Raises Concerns

"US Agency protects the investor, but will it protect the forest?"

Introduction:

This paper discusses the world's first-ever political risk insurance policy for a forest carbon offset project, provided by the U.S. Government's development finance agency, the Overseas Private Investment Corporation (OPIC). This project aims to protect 64,318 hectares of forests in Oddar Meanchey Province, in Northwest Cambodia. The paper presents the concept of OPIC's political risk insurance and describes the agency's past and current developmental and environmental financing practices. It discusses how key aspects of a carbon offset scheme being advanced by international institutions to reduce emissions from deforestation—called Reduced Emissions from Deforestation and Forest Degradation (REDD)—work or do not work, according to proponents and critics. The paper elaborates how OPIC's political risk insurance for this REDD offset project is provided contrary to the customary use of this insurance—to protect against wrongful foreign (host) government action—and instead protects foreign investors against the potential for Cambodia to rightfully fulfill international climate change commitments. The paper argues that this, when combined with inherent weaknesses in the REDD model, may lead to perverse results in which the project's stated beneficiaries may not benefit–and some may even become entities that trigger the political risk insurance. The paper concludes that as a result, OPIC's precedent-setting political risk insurance for this REDD project may not ensure the environmental and community benefits predicted, nor the positive development impacts that OPIC is required to deliver.

Background:

In the deep woods of Oddar Meanchey Province in Northwest Cambodia, Terra Global Capital (a private investment firm) has teamed up with Cambodia's Forestry Administration and Pact Cambodia (an international non-profit development organization) to conduct Cambodia's first ever REDD project. The forest carbon offset project aims to generate benefits for project developers, local villagers and the environment. The plan is to generate a 30-year revenue flow that will be used to pay for conserving 64,318 hectares of forests by selling forest carbon credits in an international carbon market under the still-evolving REDD scheme (described below). The credits are generated by the investment firm's guarantee that the carbon that was at risk of being released through deforestation remains stored in the trees for the duration of the project. Project sponsors believe that if the project is successful, 58 villages can chart a course away from deforestation caused by mining projects, agro industrial crop plantations, military settlements (in response to border disputes), illegal logging and other conflicts that afflict local communities. Oddar Meanchey suffers from one of the highest rates of deforestation of any province in the country and addressing the drivers of deforestation is crucial for environmnetal sustainability as well as local livelihood security.

A large body of research shows that the support of national and provincial governments and full participation of local communities in project planning and implementation are crucial to the success of forest conservation efforts and sustainable forestry initiatives. Yet, in the case of the Oddar Meanchey REDD project, decisions made thousands of miles away in the board rooms of Washington DC may determine whether benefits will go to local communities or solely to project investors.

In November 2011, a U.S. Government agency, the Overseas Private Investment Corporation (OPIC), provided US$900,000 in political risk insurance for Terra Global Capital, the private investor in the project.[1] OPIC's support for Terra Global Capital is the world's first political risk insurance coverage for a REDD project. In a subsequent deal, OPIC provided $40 million in financing for Terra Bella, a private equity firm associated with Terra Global Capital, which seeks $100 million in capitalization for similar projects in Africa, Latin America and Southeast Asia.[2]

What is REDD, who is OPIC, what is political risk insurance, and how does all this relate to Oddar Meanchey's forests?

Reduced Emissions from Deforestation and Forest Degradation (REDD):

REDD generally refers to a concept advanced at the 2007 Bali Climate Conference of the Parties of the United Nations Framework Convention on Climate Change (UNFCCC) that would reduce greenhouse gas (GHG) emissions by paying developing countries to stop cutting down forests. Since then, governments have been negotiating the rules and details for a global compliance framework for REDD. While the UN negotiations are ongoing, a number of pilot projects are being developed by a variety of actors, all termed 'REDD' projects, although they often differ significantly in detail. The common thread of these REDD projects is that they seek to create financial incentives to keep forests standing, claiming that such financial incentives will ensure that deforestation is avoided, thus reducing GHG emissions. Under REDD projects, the successful completion of predetermined activities designed to curb deforestation and forest

[1] Press Release: OPIC Signs First Insurance Contract for REDD Carbon Reduction Project, November 9, 2011, available at http://www.opic.gov/news/press-releases/2009/pr110911b

[2] OPIC Press Release: In Historic Commitment to Impact Investing, OPIC Board Approves $285 Million for Six Funds Catalyzing $875 million in Investments, October 27, 2011, available at http://www.opic.gov/news/press-releases/2009/pr102711

degradation – actions that project proponents argue would not have happened in the absence of the REDD project - can result in avoided carbon emissions and therefore can be rewarded with carbon credits (often referred to as “offsets”) that can be sold on carbon markets.

REDD proponents claim that, in addition to cutting and averting GHG emissions, these activities generate co-benefits such as the development of community forestry programs, including sustainable forestry systems (e.g., silviculture, forestry patrols, and fire training), tenure security, biodiversity conservation, watershed protection, local jobs and training programs, and poverty alleviation. But critics of REDD projects point out that these schemes often violate the rights of indigenous peoples and other local communities to land and forests, and lead to displacement and conflicts over natural resources. Also, these projects can define “forests” to include monoculture plantations that generate very few if any biodiversity benefits. Moreover, critics say that methodological flaws produce inadequate and inconsistent measurements of carbon fluxes that naturally vary in forests over time, resulting in dubious claims of reduced or avoided CO2 emissions from REDD projects.

Meanwhile, REDD projects that are dependent on revenue flows from carbon markets are exposed to the vagaries of these markets, which have experienced fraud, instability and large price volatility since their inception.[3] The weakness and instability of existing carbon markets creates knock-on effects that could devastate forest conservation efforts that rely on carbon offsets.

Terra Global Capital:
Terra Global Capital is a private investor whose goal “is to facilitate the market for land use carbon and other environmental credits…by providing technical expertise for the measurement and monetization of land use carbon credits and carbon finance through a dedicated investment fund.….”[4] Terra Global Capital seeks to raise funds to conserve forests through the sale of carbon credits generated by REDD projects, currently through voluntary carbon markets, and later through compliance carbon markets (see box below on voluntary and compliance carbon markets).

OPIC and Development:
OPIC is a development finance agency, which the U.S. Government spun off from the Agency for International Development, the federal government’s principal aid agency, in 1972. OPIC’s development mission is mandated in the U.S. Foreign Assistance Act, and requires the agency to support projects based in part on demonstrable development achievements.

3 Conning the Climate. Inside the Carbon Market Shell Game. Mark Schapiro 2010. http://www.harpers.org/archive/2010/02/0082826 ; Overview of fraud in the EU ETS carbon market: Protecting the Market. Carbon Finance 19 October 2011. http://www.carbon-financeonline.com/index.cfm?section= features&action=view&id=14007&linkref=cnews

4 About Us, Terra Global Capital, http://www.terraglobalcapital.com/About.htm

OPIC provides financing and insurance for U.S. investors involved in projects in developing countries in the belief that private U.S. investors, with government-backed financing and insurance, can advance development as much—or more—than traditional aid such as grants and concessional loans.

Historically, OPIC support has consisted mainly of direct financing and insurance to private investors of projects in the developing world, but since 1987 the agency has supported a growing number of private equity investment funds, many of which serve as financial intermediaries that in turn finance projects in the developing world. OPIC has now committed at least $3.6 billion to more than 50 private equity funds.[5] Proponents of private equity fund involvement in development claim that these firms provide vital capital to projects and investments that are often too small or otherwise challenged to raise investment through other means. Critics say, *inter alia,* that private equity funds often demand too high a profit to be suitable for development projects and often seek to liquidate investments in a few years, to the detriment of long-term sustainable development.

In its 40 year history, OPIC has financed projects that have helped advance sustainable development. However, OPIC has also been involved in wholly unsustainable schemes to enrich investors at the expense of local people and the environment. In particular, OPIC support of oil and gas export pipelines has been accompanied by human rights abuses, fostered corruption, and exacerbated regional conflicts. For example, OPIC financed the 1,768 kilometer Baku-T'blisi-Ceyhan oil export pipeline, which dissects Azerbaijan, Georgia and Turkey, and contributed to tensions surrounding the 2008 war between Russia and Georgia,[6] during which Russia bombed the pipeline route.[7]

More recently, OPIC has been ordered by Congress and the courts to reduce the agency's financing for fossil fuel projects and increase renewable energy financing. As a consequence of this and new agency leadership, OPIC is shifting its energy portfolio and pursuing a rapidly growing number of renewable energy projects, including 51 solar, 1 wind, and 1 geothermal energy project in 2011. OPIC now aggregates these more traditionally defined renewable energy projects into a larger category of projects that the agency calls "renewable resources," which includes REDD and other agricultural projects. OPIC's "renewable resources" commitments grew from $10 million in FY2008 to $1.1 billion in FY2011.[8]

5 Overview, Investment Funds, OPIC, available at http://www.opic.gov/investment-funds

6 See, inter alia, Russia's Georgia Invasion May Be About Oil, Rachel Martin, ABC News, August 16, 2008, available at http://abcnews.go.com/Business/story?id=5595811&page=1

7 Russia Targets Key Oil Pipeline with over 50 missiles, 10 August, 2008, The Telegraph, http://www.telegraph.co.uk/news/worldnews/europe/georgia/2534767/Georgia-Russia-targets-key-oil-pipeline-with-over-50-missiles.html; Russian Georgian Clashes, Kurdish Bombing, Exposes BTC Pipeline Weaknesses, 8 November, 2008, HIS Global Insight, Country & Industry Forecasting, http://www.ihs.com/products/global-insight/industry-economic-report.aspx?id=106596498

8 $1.1 Billion in OPIC Commitment Caps Historic Year for Renewable Resources, OPIC press release, December 2, 2011, available at http://www.opic.gov/news/press-releases/2009/pr120211

The U.S. Government now counts OPIC-financed and insured “renewable resources” projects towards US international “climate finance” commitments, which in 2011 represented one third of the total U.S. climate finance.[9]

The term “climate finance” generally refers to commitments from developed countries to provide funding to help developing countries respond to climate change. However, in the case of OPIC “renewable resources” support, financing and insurance is not usually directed to developing country governments, rather they are directed to OPIC’s private sector clients, which typically include U.S. investors in projects in the developing world. In so doing, the U.S. retreats from climate finance commitments to developing countries via aid and aid-equivalent support, and instead pursues a climate and development path that is increasingly defined by, and for the benefit of private interests. What’s more, political risk insurance involves no U.S. Government financial payout at all, unless an insurance claim is paid by OPIC to the U.S. investor.

OPIC Political Risk Insurance for REDD:
OPIC political risk insurance protects US investors against risks to their investment from wrongful events and actions that may occur in developing countries, including war, civil strife, coups, terrorism and other politically-motivated violence, as well as improper host government interference such as expropriation, abrogation, repudiation and/or impairment of contracts, and restrictions on the conversion and transfer of local-currency earnings.

OPIC argues that its political risk support for Terra Global Capital’s REDD project is good for development, and is a model that should be replicated elsewhere.[10] According to the agency’s President, Elizabeth Littlefield,

> *“This project represents a milestone in the development of the forest carbon sector. Tens of thousands of hectares of forest will be preserved while creating new opportunities – such as training in forest management, the establishment of microfinance organizations, as well as the creation of 355 new jobs – that will support both local communities and the environment at the same time.”*[11]

According to an OPIC press release,

> *Revenues from the sale of the carbon credits will be used to fund activities that reduce deforestation, including community forestry patrols and fire control, community-based water resource development projects, strengthening and clarifying land-tenure, sustainable farming systems, agricultural intensification and fuel efficient stoves.*

9 Ibid #8
10 Ibid #1
11 Ibid #1.

As a result, rural communities in Cambodia will gain legal tenure over local forests and generate a 30-year income stream that will significantly enhance household livelihoods and natural resource management capacity. The project will also preserve and increase carbon stocks in the area, enhance hydrology in the upland watersheds of the Tonle Sap Basin, as well as conserve endangered biodiversity.[12]

Many of the political risks that OPIC insurance protects against are certainly present in Cambodia. Yet, Terra Global Capital is particularly concerned about potential regulatory action or turnover by the government that could harm its investment, including "nesting regulations" (described below). According to Leslie Durschinger, Founder and Managing Director of Terra Global Capital,

"Given the long-term nature of our investment, we believe it is prudent to reduce our exposure to future changes in national and local governments and laws by executing this insurance policy."[13]

According to OPIC,

"One particular concern among investors in REDD projects is the possibility that additional regulations, known as 'nesting regulations,' will be imposed in the future, thus changing the way that REDD targets are measured and preventing existing projects from earning carbon credits."[14]

OPIC is using political risk insurance, which is supposed to protect against wrongful political actions, to protect REDD investors against the rightful and necessary actions of host governments. OPIC's worry, that nesting regulations "*will be imposed…changing the way that REDD targets are measured and preventing existing projects from earning carbon credits,"* indicates that the agency's political risk insurance protects Terra Global Capital against Cambodia doing just that. Cambodia's nesting regulations may not align with the government's current agreement with Terra Global Capital, potentially rendering that agreement invalid. Terra Global Capital and OPIC may consider invalidation of that agreement to be harmful to their interests. Yet, under the UNFCCC, countries have the right to negotiate levels of GHG emissions and to set regulations to achieve these levels within their borders. What's more, countries and provinces may eventually be required to regulate REDD projects in order to participate in compliance carbon markets and to otherwise be in line with agreements reached at international climate negotiations. ***Hence, OPIC's use of political risk insurance to protect against the rightful application of nesting regulations turns the concept of political risk insurance on its head, and suggests, inexplicably, that the U.S. Government is providing insurance against other countries fulfilling their future international obligations*****.**

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[12] Ibid #1

[13] Ibid #1

[14] Terra Global: Protecting Cambodian Forests, OPIC website, available at http://www.opic.gov/terraglobal

Nesting Regulations Explained

REDD project sponsors and potential investors fear that new rules, called "nesting regulations," will negatively affect the value and viability of their investment as a shift occurs between *voluntary* and *compliance* carbon markets. "Nesting regulations" refers to a concept still under development at the UNFCCC, in which developing countries and provinces that wish to participate in *compliance carbon markets* will need to "nest" (in other words imbed) project-level REDD carbon emissions reduction frameworks within the provincial or national REDD regulatory framework.

Compliance carbon markets (aka regulated markets) are created by governments under mandatory schemes in which greenhouse gas emissions are capped and traded, including through the purchase of carbon offset credits. An example of a compliance market is the European Union Emissions Trading Scheme, the first and biggest international regulated emissions trading scheme, involving 30 countries. In contrast, *voluntary carbon markets* are schemes in which companies, governments, non-governmental organizations, individuals and other entities attempt to offset their carbon footprint through the purchase of carbon credits voluntarily, that is, outside of mandated carbon emission reduction regulations. Since voluntary carbon markets are unregulated, they are often criticized as lacking consistency and integrity.[1]

REDD projects currently sell carbon credits only to voluntary carbon markets. However, voluntary carbon markets are a tiny fraction of the size of compliance carbon markets. In 2011, the market share of REDD voluntary credits was $124 million, a mere 0.01% percent by value of the total global carbon market. The assumption is that, if REDD is to scale up significantly, it will need to sell carbon credits to the much larger compliance markets.[1]

But scaling up REDD through revenues from compliance carbon markets is not so easy to achieve. The world's main carbon market, the European Union Emissions Trading Scheme (EU ETS), is performing terribly, stalling amidst crashing prices and fraud scandals, and excludes REDD offset credits until at least 2020. The nascent California carbon trading scheme has not yet established rules regulating REDD.[1]

Discussions continue at the UNFCCC that may result in requirements for countries seeking to participate in REDD schemes to establish regulations governing REDD activities at the national or provincial level. Such regulations would potentially include the setting of national or provincial emissions reductions targets, accounting and monitoring systems, and other rules for REDD projects operating in those territories.

Nesting project-level requirements into provincial or national REDD frameworks could require that a REDD project sponsor changes the way they conduct their projects (e.g., require different accounting & monitoring systems) and even determine how ownership of credits and revenue sharing from credits is determined. This has potentially large financial implications for REDD project investors who are making investments ahead of these negotiations and are assuming a potentially different set of conditions governing their investments.

What's more, OPIC states that it and other branches of the U.S. Government intervene to pressure host governments to prevent or remedy what the agency views as actions triggering the political risk insurance policy.[15] OPIC's political risk insurance for Terra Global could therefore result in the U.S. Government pressuring Cambodia *to drop or weaken nesting and other regulations that the country has the right to establish to* meet international climate change regulatory obligations and to access compliance carbon markets.

Who's Protecting Whom, and from Whom?

OPIC's political risk insurance for Terra Global Capital is based in part on claims that:

> *[The] project will have a positive developmental impact on the host country, as the development of carbon assets by Terra Global Capital, LLC with the local implementing partners --the Forestry Administration and Pact --will facilitate the protection of forests located in the northern part of Cambodia. These forests will be preserved by local communities, who will be provided employment opportunities and will share in the net income from the international sale of the carbon credits the project will generate.*[16]

This implies that the implementing partners, including the Cambodian Forestry Administration, Pact (an international implementing NGO), and local communities are beneficiaries of OPIC's development finance support. Yet, OPIC's political risk insurance policy is with Terra Global Capital.. If events or actions occur that trigger the political risk insurance policy, any payout by OPIC will presumably go to Terra Global Capital. Based on available information, it is not apparent that Terra Global Capital is obliged to pass on any of the political risk insurance payout to the implementing partners or local villagers and hence, there is no assurance that OPIC's development mandate would be met through any insurance payout. Implementing partners and villagers may benefit, therefore, only if the project succeeds.

Where are the Revenues?
To succeed, Terra Global Capital's scheme (like all current REDD initiatives) relies on generating revenues from carbon markets.

According to Terra Global Capital,

> *"the project is developing a mechanism for the allocation of income from the sale of carbon credits, after project costs and management costs for the project are covered, that will be acceptable to participating communities, the Forestry Administration, the provincial government, the implementing organization, and the buyer. The goal of*

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15 Claims & Arbitral Awards, OPIC, http://www.opic.gov/insurance/claims-arbitral-awards
16 Information Summary for the Public for Terra Global Capital Political Risk Insurance, OPIC

allocation will be to direct income from carbon credits to benefit participating communities, restore the health of forests and develop new REDD projects."[17]

Yet, separately, Terra Global Capital projects a 25 – 30% return to its investors.[18] Since voluntary carbon markets are tiny and compliance carbon markets are in shambles, how can Terra Global Capital generate revenue flows sufficient to deliver such generous returns to investors, while still providing adequate revenues to fulfill income allocation agreements and to otherwise support project implementers and beneficiaries? This suggests that if a potential struggle ensues between investors and project beneficiaries over revenue sharing, and a scenario arises in which there are insufficient financial incentives to keep trees standing, the REDD project could be rendered non-viable. Thus the promised benefits from the project would not materialize, more sections of the forests could be cleared for mining, agro-industrial plantations and other environmentally destructive projects, and OPIC will not have achieved its development mandate.

It is also conceivable that, in the absence of adequate revenues and benefits, provincial or national government authorities may take other land use decisions, leading to a perverse result in which one of the project "beneficiaries" ends up being the entity that triggers the political risk insurance and become a target of U.S. government pressure in an attempt to avoid an insurance payout.

Insufficient Due Diligence:
Concerned organizations, including Pacific Environment, FERN and Focus on the Global South challenge the adequacy of OPIC's environmental and social due diligence on the Terra Global Capital REDD project. According to OPIC policy, Category A projects are those that are likely to have significant adverse environmental and/or social impacts that are irreversible, sensitive, diverse, or unprecedented, and that employ inadequate mitigation measures. Given the precedent-setting nature of the Cambodia REDD project, including country risks high enough to warrant political risk insurance, an uncertain revenue flow to local partners, and the potential for environmental and social damage if the project fails, Category A designation is wholly appropriate. Despite this, OPIC classifies the Oddar Meanchey REDD project as Category B, or likely to have limited adverse environmental and/or social impacts that are generally site-specific, largely reversible, and readily addressed through mitigation measures.[19] Category B projects require far less due diligence, transparency and public participation than Category A

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[17] Project Design Document for Validation under Climate, Community and Biodiversity Standard (second edition), 11 July, 2011, Terra Global Capital, https://s3.amazonaws.com/CCBA/Projects/Reducing_Emissions_from_Degradation_and_Deforestation_in_Community_Forests-Oddar_Meanchey%2C_Cambodia/Oddar_Meanchey_CCB_PD_for_Validation_v1.pdf

[18] Fact Sheet, Terra Bella Fund: Forest and Land Use Carbon; Impact Asset Class with Early-Stage Investment Return Opportunities.

[19] OPIC Environmental and Social Policy Statement, available at http://www.opic.gov/sites/default/files/consolidated_esps.pdf

projects, begging the question of whether OPIC adequately assessed the risks—to itself, to the environment and to Cambodian villages—posed by the Oddar Meanchey REDD project.

Additionally, OPIC is required to generate a Development Impact Profile in order to demonstrate developmental impacts for each project it supports. OPIC has declined to disclose the Development Impact Profile for the Oddar Meanchey project, throwing into doubt the agency's willingness to disclose the full positive and negative development impacts of its support.

Conclusion:

Legal and Congressional pressure, combined with new agency leadership, have pushed OPIC to shift its portfolio away from large fossil fuel projects and towards so-called renewable resources projects, including REDD. OPIC's support for the Oddar Meanchey REDD project in Cambodia sets a global precedent—including the first ever political risk insurance policy for a REDD project. OPIC and the project developers claim that the Oddar Meanchey REDD project will have significant climate, and local environmental and development benefits. But the viability of REDD projects rests largely on carbon markets, which are not reliable, thereby creating the risk that OPIC-supported REDD projects will fail to provide the revenue stream needed to deliver the promised benefits to implementing partners and local communities, and the high returns to investors.

Perversely, OPIC's political risk insurance may protect against actions that the Cambodian Government may take to defend its own interests in the event that the project fails to deliver promised benefits. Moreover, OPIC's political risk insurance is designed to protect project investors, and not necessarily local communities, in the event that the covered political risks manifest themselves. In fact, local communities residing around the forests—whose forest protection efforts have made the REDD project possible—seem to be the last in line for receiving project benefits, making decisions about the project, and protection against market and political risks. And inexplicably, OPIC's political risk insurance for the Oddar Meanchey project protects against the risk that the host government rightfully acts on its international climate change responsibilities. Meanwhile, OPIC support for REDD and other renewable resources projects is counted toward the U.S. Government's climate finance commitments to developing countries, even though this support is provided to private parties rather than to governments. Given these potentially intractable problems, OPIC's support for the Oddar Meanchey REDD project does not set the kind of positive global precedent that the agency claims.