

A recent report, entitled “REDD and Forest Carbon: Market-Based Critique and Recommendations” authored by the Munden Project seeks to construct and analyse a REDD+ funding scenario heavily reliant upon the use of traded markets. As carbon finance practitioners and Market participants, CMIA has identified three fundamental flaws in the assumptions used to construct the scenario and subsequent analysis, which we summarise in the following response paper.

Most notably the Munden report on REDD+ does not examine the existing carbon markets. This is highly important as the report contains a number of inferences about how REDD+ would fare under the carbon markets by drawing examples from a wide range of commodities but never from carbon itself.

We believe this is a fundamental error and that examining carbon markets in greater depth would have produced a report with far greater weight to its conclusions. By ignoring the existing carbon markets, the authors make three key errors in their analysis:

- 1) They assume that emission reductions based on credited projects will never be suitable for the commodity markets.*
- 2) They 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.*
- 3) They overlook the rapid pace with which carbon credit contract structures evolved to greatly reduce any market asymmetries and perceived inequity between buyers and sellers*

REDD+ and commodities markets

On the first point, the authors overlook 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.

The most common class of project credits currently in circulation are CERs which are issued under the Clean Development Mechanism. CERs are compliance based instruments, used by compliance buyers to meet emissions reduction commitments. In the EU ETS, there is a maximum demand of around 1.8 billion tonnes of CERs between 2008-2020. Because of this significant demand, exchange-traded contracts emerged relatively quickly to harmonize standards and liquidity for these carbon instruments.

Currently exchange traded CER contracts, benefit project developers by providing a visible forward curve for CERs that extends all the way to 2020.

Even though the underlying carbon credit projects delivering CERs are fundamentally different from each other, in terms of geography, technology, etc., once a CER is issued (i.e. enters the secondary market), it becomes a commodity.

There is absolutely no reason to believe that REDD+ credits will not evolve in exactly the same way if and when firm government demand materializes. In the case of CERs, the United Nations created the regulatory framework for the project-based mechanisms, governments created the demand for the credits through taking on emission reduction targets and the private sector developed the necessary market infrastructure (contract definitions, exchanges, etc) for a secondary CER market.

There is no reason to believe that the infrastructure for REDD+ would evolve in a different way once there is clarity on the regulatory framework for REDD+ and there is sufficient market demand to create liquidity and market interest.

REDD+ and primary and secondary markets

On the second point, the authors confuse the primary and secondary markets. Carbon credit projects in the primary markets (i.e., before credits are issued) are heterogeneous. Once credits are issued for all intents and purposes they become homogenous since they all share the same compliance value.

During the primary stage, with all forms of project based credits there are clear differences in both price and buyer preference, arising from the attributes of the projects that create them and the purpose for which they are being purchased. The stronger the buyer preference for a given project the more they will be willing to pay.

Although the division between the two is somewhat artificial, for carbon the secondary market can be defined loosely as being where buyers who are the end users receive the credits, the primary market is where the project developers sell their credits, crucially before they are issued. It is important to realise that participants active at each level- primary and secondary- can in fact be quite different.

The Munden report uses milk as an example of the relationship between primary and secondary markets. The price the milk seller receives, in effect the primary market price and the price the final buyer pays, the secondary market price. It then wrongly draws the inference that this is what will happen with REDD+ credits, i.e. that there will be a single primary market price that will be a lot lower than the secondary market price.

This is contrary to experience within the project based credit markets. There is no uniform primary market price, even where governments have imposed a floor, buyers are willing to pay more for credits from the right kind of project from the right kind of seller. The price that buyers are willing to pay for primary CERs, depends on a number of risk factors. Put simply the lower the risk profile of the project the higher the proportion of the secondary price the primary seller will receive. Some of the risks are listed below:

Project cycle risk; how far from implementation and registration is the project? The closer it is to implementation the lower this risk is deemed to be.

Counter party risk; is the seller a reliable counterparty? This is important as the ability for a seller to guarantee delivery hinges on their ability to compensate the buyer in the event that they fail to do so. The more certain the buyer is of receiving delivery the lower this risk is deemed to be.

Country risk; is the host country politically stable, does it have reliable institutions, will it nationalise the project.

Currency risk; is the seller asking to be paid in a different currency to that of the final market, in the case of CERs the Euro.

Technology risk; has the technology been used before in the region and context of the project.

Buy side regulatory risk; will the class of project be excluded or is it already excluded from use in a particular market. An example would be the upcoming restrictions on the use of HFC CERs in the EU ETS.

All of these factors and many others affect the cost of capital available to the buyer and hence affect the price the buyer is able to pay to the project developer.

As a general rule the closer a project is in its cycle to being able to issue credits the closer the price will be to the ongoing market price.

This is because the smaller the amount of time between payment and receipt of the credits the less significant most of the risks listed above become.

Pricing evolution and REDD+

On the third point, the experience with CDM is that the spreads between primary and secondary prices have narrowed over time. This arises from an increase in the number of participants willing to get involved at the primary level, taking on some of the aforementioned types of risk. In early stage markets, there is a low willingness hence a small number of participants can command higher prices via the secondary market. As a market matures (which happened relatively quickly in CDM markets, e.g. approx 2 years) the spread narrows due to increased numbers of buyers and sellers (and resulting transparency).

Thus there is no uniform price for primary CERs. Drawing from this it seems logical to conclude that similar conditions would apply in a large-scale Market for REDD+ credits or at the very least not assume that this would automatically not be the case.

Parties designing a Market for REDD+ credits may wish to consider means by which the provenance of individual credits is easily identifiable and how factors beyond the value of the carbon may be included in the price. For example, under the CDM the Gold Standard has been a leader in considering the non-carbon attributes of projects.

There is currently no compliance demand for REDD+ credits. This has however not stopped projects being developed in the voluntary sector. These act as a clear illustration that many of the obstacles that the Munden report outlines are not only, solvable, but have actually already been solved by innovative approaches developed by stakeholders and the private sector.

Key amongst these approaches are the Verified Carbon Standard (VCS) and the Climate Community and Biodiversity Alliance (CCBA). The VCS has developed methodologies that address issues such as permanence of credits and leakage. The CCBA has developed methodologies for assessing community engagement, protection of biodiversity and other non carbon project attributes.

Taken together the VCS and CCBA present a dual approach for verifying REDD+ projects to a high standard. This was recognised by the WWF which recommended the VCS/CCBA dual approach as the optimal way to implement REDD+ projects.

In addition the Gold Standard which was founded by the WWF specifically to enhance stakeholder engagement in carbon projects is currently examining approaches to become involved in the REDD+ space.

There is a great deal of knowledge currently being accrued under all of these standards, that parties may wish to consider when designing a REDD+ crediting system.

The VCS, CCBA and Gold Standard are highly transparent systems, which are designed to be open to stakeholder scrutiny at all stages.

A database of VCS projects can be found at.

<http://www.vcsprojectdatabase.org/>

A database of CCBA projects can be found at.

<http://www.climate-standards.org/projects/index.html>

A databases of Gold Standard projects can be found at.

<http://goldstandard.apx.com/resources/accessreports.asp>

In addition all of the methodologies used are available on the relevant websites.

Parties designing a REDD+ mechanism may wish to consider the role of transparency in building trust.

Finally the Munden report assumes that the cost of verification will be prohibitively expensive. Again this is an area where a great deal of prior experience has been built up which the report overlooks.

With all quantified emissions reduction projects a balance is struck between the degree of accuracy with which emissions are measured vs. the time and cost involved in carrying out the verification. This is accounted for by reflecting the degree of uncertainty in the amount of credits that are issued. The higher the uncertainty the lower the number of credits and vice versa.

This approach allows project proponents to balance the value of 'lost credits' vs. the cost of verifying them. It also ensures that credits are only issued where there is a high degree of confidence in their validity.

Parties designing a REDD+ crediting mechanism may wish to consider the balance between the value of 'lost credits' vs. the cost of verification.

Conclusion

In conclusion although it is to be welcomed that the Munden project was examined potential REDD+ approaches in a report, the lack of reference to or apparent understanding of the existing carbon markets lessens its credibility and relevance.

We hope that our input, based on experience of existing carbon markets, has highlighted areas that parties examining Market based approaches to REDD+ will find useful.

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Additional note: Along with the Swiss and Philippine delegations, the Ateneo School of Government and Helvetas Intercooperation, we are hosting a workshop of REDD+ financing in Panama on 8 October 2011.

Please contact Leticia.Labre@cmia.net for more information on the workshop.

CMIA is an international trade association representing companies that finance, invest in, and provide enabling support to activities that reduce emissions. CMIA's membership accounts for an estimated 75 per cent of the global carbon market, valued at USD 120 billion in 2010. Solely representing organizations that provide services to and invest in the environmental sector, membership does not include any entities with compliance obligations under cap-and-trade schemes. This results in a unique advocacy platform with emphasis on the environmental integrity of market mechanisms and climate change policies.