

# The Interminable Politics of Forest Carbon: an EU outlook

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# Background Paper

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### 1. Introduction

Deforestation is rapidly moving up the international climate policy agenda. The Bali Action Plan commits to reduce emissions from deforestation and degradation (REDD), as well as support forest conservation, sustainable management, and carbon stock enhancement (UNFCCC, 2007). However, the plan indicates no preferred financing mechanism. The EU and Brazil are pushing the establishment of a fund to support REDD, whereas most other parties, and indeed rainforest nations, support some type of market or combined approach. This background paper casts the spotlight on Europe, and aims to describe the history and logic of European forest-carbon politics in order to assess the future of REDD in the EU Emissions Trading Scheme (ETS).

The European Commission has concluded that tropical deforestation must be cut in half by 2020 and completely stopped by 2030, in order to achieve stabilization at 450ppm CO<sub>2</sub> and possibly stay below the EU's 2 degree target ceiling (COM/2007/2).<sup>i</sup> This is a huge task. Emissions from deforestation and wetland drainage (including peat forests) in 2004 totaled 17% of global GHG emissions, or 8.7 billion tons of carbon dioxide equivalent per year (GtCO<sub>2</sub>e/year), according to the IPCC (2007) best guess. The gross rate of global deforestation was almost 13 million hectares per year from 2000 to 2005 (IPCC, 2007).

The drivers of deforestation (and the opportunity costs of forest conservation) vary significantly between countries, as do the key actors and ownership regimes. Responding to this complexity is challenging. For instance, the framework must simultaneously (i) provide incentives to reduce small-scale conversion of forests to farmland in Africa; (ii) tackle large cattle ranching and soya farming in the Amazon; and (iii) address illegal logging and oil palm expansion in Southeast Asia. Incentives are also likely required for countries (and indigenous communities) with forest stock and low deforestation baselines. REDD means coordinating complex governance structures covering more than 30 percent of the world's land area.

Despite daunting scale and complexity, REDD appears to be a smart investment. According to the Stern Review, opportunity costs of forgoing forest conversion for agriculture are often between \$1 and \$5 tCO<sub>2</sub>e/year, though marginal costs could reach \$30 tCO<sub>2</sub>e/year to completely halt deforestation (Stern, 2007).<sup>ii</sup> The European Commission has assessed the cost of halving deforestation by 2020 as somewhere between US\$3 billion and US\$250 billion (SEC/2008/2619/2). Global top-down models justify the low end of the Commission's range, a recent study finding that halving deforestation by 2030 (a reduction of 1.5-2.7 GtCO<sub>2</sub>/year) would cost between \$17 and \$28 billion, or about \$10-\$21/tCO<sub>2</sub> (Kindermann et al., 2008).

The EU is considering a number of options for raising the necessary finance, and including REDD in carbon markets is an unlikely option. The European Commission, and to some extent the Parliament and Council, has consistently and adamantly opposed the inclusion of REDD credits in the EU ETS, at least until 2020. The Commission is concerned about possible market flooding by cheap REDD credits, and also remains somewhat bogged down by the (perceived) technical issues that kept avoided deforestation out of the Clean Development Mechanism (CDM) and contributed to the rejection of afforestation and reforestation CDM projects for EU ETS compliance purposes. Instead of harnessing markets to raise finance for conservation, the Commission has proposed a Global Forest Carbon Mechanism—essentially a fund tied to successful forest protection—fed by a portion of revenues from the auctioning of emissions allowances.

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This background paper is structured in four parts. Section 2 describes the EU's current and past policy positions regarding forest carbon. Section 3 reviews official EU concerns with trading REDD, and forest carbon generally. The penultimate section considers political pressures and ethical arguments which may explain or justify the EU position. Section 5 concludes with a discussion of the Global Forest Carbon Mechanism and the political possibilities of trading REDD in the ETS sooner than the Commission would like.

### 2. What is the EU's position?

EU opposition to REDD crediting is far from new as is clear in Table 1, which outlines the relevant decisions of the European Commission (EC), European Parliament (EP), and the Council of Ministers.<sup>iii</sup>

Markets have not been considered to be a viable short-term solution for raising forest finance. The 2004 Linking Directive, which made Kyoto emissions currencies mostly fungible in the ETS, stymied global demand for CDM afforestation and reforestation (AR) projects by excluding those projects from use for sub-national compliance. European member governments could technically still use AR to offset up to 1 percent of base year emissions annually (restricted by the Marrakesh Accords of COP 7). However, since governments cannot transfer AR credits to their industries, and because AR credits require eventual replacement, very little has been achieved. The EC's plan to stop deforestation and biodiversity loss (COM/2008/645/3) introduced a strategy whereby only REDD pilot projects and limited government compliance trading would be allowed until 2020, and finance would be raised in the interim with revenues from auctioning emissions allowances. The Council of Ministers, also, only considers REDD as appropriate for compliance in the “medium to long term” (Council of Ministers 2008). Finally, in January 2009, the EC proposed to raise €1bn between 2010 and 2014 for a Global Forest Carbon Mechanism (GFCM) to bridge the gap until full implementation of a Copenhagen agreement (GFCM; COM/2009/39). The GFCM would be performance-based, meaning tranches would be dispersed conditional to the accomplishment of objectives. Discussions of a resolution to earmark auctioning proceeds to the GFCM began in the European Parliament on February 17<sup>th</sup>, 2009. The resolution focuses the geographical scope of a future GFCM on Eastern Europe, but does not consider market-based REDD (Euractiv, 2009).

In many ways, REDD politics today parallel the late 1990s land-use, land-use change and forestry (LULUCF) debates in the UNFCCC. There were three contentious issues concerning ‘sinks’<sup>iv</sup> in the Kyoto negotiations. First, which activities are included in the definition of a ‘sink’? Since Annex-I countries could offset emissions-reduction obligations with domestic sinks, the inclusion or exclusion of, inter alia, plantations, selective harvesting, agro-forestry, and agricultural sequestration was quite important to some countries. Second, should limits be placed on how much domestic sinks can offset obligations? Third, which sinks, if any, should be included in the CDM?

Umbrella Group countries<sup>v</sup>, including the USA, pushed hard for domestic sinks to offset future obligations and were joined by other countries including Bolivia, Chile and Columbia to lobby for avoided deforestation in the CDM (Boyd et al., 2008). In contrast, Europe could not agree on sinks during Kyoto negotiations, which kept the EU position in flux and uncertain through COP 7 in 2001 (Fry, 2002). On the one hand, leading up to COP 3 in Kyoto, the EU preferred the inclusion of all sinks in the protocol. On the other hand, it recommended that the first Meeting of the Parties (COP/MOP 1) make a decision regarding limits to counting

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**Table 1 – Summary of EU decisions**

Date	Body	Document	Description
04/10/1999	EC*	COM/1999/554	The forests and development approach sets an objective to maintain forests and improve forest management in developing countries. Notes UNFCCC as relevant commitment, but only considers EU aid programs as means to achieve forest development objectives.
27/10/2004	EU	2004/101/EC - Linking Directive	CERs and ERUs from LULUCF projects are not allowed in the ETS.
10/01/2007	EC	COM/2007/2	Lists options as including policies and economic incentives, need for pilot studies – no mention of REDD
23/01/2008	EC	COM/2008/0016	A proposal to amend the ETS. Finds that forestry and agricultural offsets are not measurable, reportable and verifiable. Measures to slow deforestation should be supported by a Global Energy Efficiency and Renewable Energy Fund, supported by allowance auctioning proceeds.
23/01/2008	EC	SEC/2008/85/3	The EC's impact assessment of their ETS proposals does not mention forests or deforestation.
30/06/2008	EC	COM/2008/645/3	Proposes a performance-based Global Forest Carbon Mechanism with auctioning revenue. Pilot REDD for credits, purchased by member governments. By 2020, limited private sector REDD crediting. Recommends to not include LULUCF in third phase of ETS, and not to allow any REDD credits in the ETS until at least 2020 because of monitoring, reporting, verification, and liability problems.
30/06/2008	EC	SEC/2008/2619/2	The Impact assessment of the EC's deforestation communication finds that the "preferred option until 2020" is strengthening existing policies and institutions and establishing a performance-based Global Forest Carbon Mechanism with auction revenues. Linking REDD with markets should be tested. Severe supply-and-demand imbalances would result from allowing REDD credits in the ETS. Notes potentially high rents earned by sellers. Forest credits after 2020 may be considered as a complementary tool in the ETS if "liability and balanced supply/demand are respected."
04/12/2008	Council	Conclusions on Deforestation	The Council notes the EC's Global Forest Carbon Mechanism idea, but does not fully endorse it. The Council invites the EC to assess the implications of REDD credits for partial government compliance and supports the inclusion of AR post 2012. The Council expresses openness to REDD credits for ETS compliance in the medium to long term if methodological issues are addressed.
19/11/2008	France for EU	EU Submission on REDD for Poznan	With "deep commitments" for Annex I parties, the EU is willing to consider public financing and carbon markets to support REDD activities in developing countries. Substantial public funding will be needed whatever the chosen approach.
12/2008	EP	Climate & Energy Package	Parliament's endorsement of the EU package, including plans for 50% of auctioning proceeds to go to mitigation and adaptation including avoided deforestation. If an ambitious international target is agreed in Copenhagen, then the EC will submit an assessment of forest carbon to inform ETS decisions in context of Copenhagen agreement.
28/01/2009	EC	COM/2009/39	Need a 50% cut in deforestation by 2020 and 100% by 2030. GCFM to raise EUR 1 billion between 2010 and 2014.

\*EC refers to the European Commission here, and EP to the European Parliament.

Note: The fund proposed in COM (2008) 645 remains the only option considered for raising forest protection finance. However, the EU's Climate and Energy Package directs the Commission to reconsider its approach after Copenhagen.

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sinks in parties' quantified emissions limitations and reductions objectives. This recommendation suggests disunity because its effectively not a recommendation: countries would not ratify a protocol without knowing basic carbon accounting parameters (Fry, 2002).

Article 3 of Kyoto limited the domestic LULUCF activities that Parties could count towards commitment as afforestation, reforestation, and deforestation since 1990. However, the discussions over baseline and monitoring methodologies and possible limits to offsetting with domestic sinks occurred after commitments were agreed. Continued polarization contributed to the collapse of COP 6 in the Hague (Boyd et al., 2008). By COP 7 (2000), deforestation was dropped from the CDM, and EU negotiators invented a system of temporary crediting for afforestation and reforestation projects in order to circumvent perceived non-permanence. The potential demand for temporary credits has not been tested. With strong EU support, the COP ruled that Annex I countries may only offset up to 1% of their base-year emissions annually with tCERs and ICERs<sup>vi</sup> accrued from afforestation or reforestation CDM projects (UNFCCC, 2001). The decision was set up to expire after the first commitment period (Graichen, 2005), however, the Commission has proposed to continue strict limits on these credits post-2012 (COM/2008/645).

Much of the logic and politics behind the current REDD debate is carried over from Kyoto LULUCF negotiations. The next section reviews stated reservations and political explanations for the EU position.

### 3. Official EU Reservations

The EU officially opposed avoided deforestation in the CDM because of concerns about baseline setting, leakage, permanence and additionality (Fry, 2008). These concerns, in addition to more recent worries about carbon market impacts, constitute most of the European Commission's current argument against REDD.

#### *Baselines and MRV*

If accurate baselines cannot be constructed, the integrity of emissions reductions through REDD would be in jeopardy. The magnitude of leakage would also be difficult to estimate (Schwarze et al., 2002). Furthermore, monitoring, reporting, and verifying (MRV) reductions in deforestation is technically expensive, and requires competent forest inventory institutions in each country (Wertz-Kanounnikoff and Verhot, 2008). However, since the Kyoto discussions, national forest monitoring systems have become a reliable and feasible goal for most countries and historical satellite data is complete enough to construct adequate baselines from 1990s activity (DeFries et al., 2005).

Baselines are important scientific and political concerns. For instance, Brazil would support historical baselines (currently only for setting up a fund), while countries with historically lower rates or little current deforestation, such as Gabon, may support something like Guyana's proposal of an 'economically rational' baseline that compensates for local opportunity costs of conservation (McKinsey & Company, 2008). National baseline negotiations could thus entice participation by offering countries initially liberal baselines (Andersson et al., 2009). Compensating countries with high forest cover but low deforestation rates, such as Gabon, Belize, or Suriname, is crucial to preventing international leakage (da Fonseca et al., 2007).

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### *Leakage*

Reduced emissions from deforestation only mitigate climate change if those emissions are not displaced to a different area. Though difficult to estimate without much evidence, the potential scale of REDD leakage is substantial (Murray, 2009). National level monitoring – “wall-to-wall coverage” – prevents intra-country leakage (DeFries et al., 2007: 387). But preventing international leakage requires complete participation from all relevant countries (Germany, 2007). For this reason, the added value given to sinks in Annex-I countries may provoke inter-annex leakage through increased harvesting pressures in non-Annex-I developing countries (Niessen et al., 2002). The EU’s concern with leakage is tied with technical MRV concerns, because MRV limitations may make full participation difficult in the short term. Less than full participation creates leakage problems in a market-based approach, although a performance-based fund would not necessarily fare any better. And leakage is not just a forestry problem – industrial project-based reductions are also prone to leakage (Chomitz, 2002).

The most profitable deforesting industries, including logging, soya farming and oil palm production, are prone to international leakage but also will be among the last causes of forest conversion targeted by REDD, as most conversion can be stopped at lower opportunity costs (Ebeling and Yasue, 2008).

### *Non permanence*

How to adjust or correct for potential non-permanence remains controversial. An EU submission to SBSTA noted that “non permanence is not an issue when possible reversals are compensated” (Germany, 2007). Permanence risks can be dealt with through insurance, full buyer liability, discounted or temporary crediting, or by applying a risk buffer, as employed by the Voluntary Carbon Standard. Indeed, it was EU (and Brazilian) negotiators who devised the complicated CDM AR system of long crediting periods and temporary crediting to ensure permanence.

### *Market flooding*

The European Commission’s climate unit head wants “to see real emissions reductions in Europe,” and believes that fungible REDD credits “would flood the market.” since global emissions from deforestation far exceed the ETS demand (Runge-Metzger, quoted in Tollefson, 2008). REDD trading will and is intended to reduce the costs of hitting any carbon flow target. The concern about an excess supply of cheap REDD credits may eventually dissipate with increasing carbon demand from tighter caps and US participation, but this has not begun to happen. Overall energy research and development required to achieve stabilization would probably be reduced by forest carbon crediting. For a given stabilization target, Tavoni et al (2007) find that a REDD market substantially lowers mitigation costs but also reduces investment in energy research and development. However, the Eliasch Review (2008) found that if the EU ETS set supplementary limits at 50% or less for non-EU credits (including from REDD), the EU carbon price would still be driven by the cost of domestic action and thus remain high. The evidence against market flooding has prompted the Commission’s newly emphasized concern that REDD credit-generators will earn excess profits if carbon prices are high.

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## 4. Broader Considerations

While concerns about system integrity are a genuine source of EU reservations about forest carbon markets, there are other potential explanations of the EU position that warrant consideration. Other potential explanations might be grouped in three categories. First, the self interest of states and blocs and their nation states is likely to help explain particular negotiating positions, just as the particular interests of powerful lobby groups are likely to affect the negotiating position of particular nation states. Here, institutional factors may influence the power of various agendas in EU bodies. Second, historical considerations are relevant, such as the extent to which nation states have committed to international law, or are compelled by sovereignty principles. Third, the manner in which relevant scientific facts and beliefs are constructed varies from one state to another, depending upon the power of the scientific and policy making elite and the education and values of citizens. Each of these perspectives is likely to help in understanding the positioning of different players, including the EU. We briefly examine the first two.

### *Interests and political economy*

The European Commission is responsible for pursuing the interests of Europe as a whole, and not individual member states, although one Commissioner is appointed by each member state. This contrasts with the Council and Parliament which represent governments and citizens, respectively. The Commission thus has a unique (but not complete) buffer from voters and state interests and lobbies. However, the Commission has a strong interest in the success of European policy, and continued global perceptions of progressive European leadership and consensus building. In part because the third phase of the ETS will be directed by the Commission and not member states, interest in protecting the integrity of the ETS are likely to be especially acute.

The Commission's mandate to serve European interests also affects which pressure groups have influence in Brussels. Not surprisingly, non-governmental organizations (NGOs) with supranational agendas are a dominant lobby and integrated in the policy process, often informally (Jung et al., 2007). Consistent with the Commission's position, most major European and Europe-based environmental NGOs are vehemently opposed to trading REDD credits in the ETS (e.g. Greenpeace Europe, Friends of the Earth International, Climate Action Network Europe, and others). The NGO pressure against market-based REDD originates primarily from interest in keeping the European carbon price high, in order to facilitate domestic industrial emissions reductions. REDD trading has been perceived to threaten that price.

Commissioner turnover is low and an internal policy reversal on REDD is unlikely. However, the current policy trajectory may not be entirely resilient to external shocks. An indication of the potential for policy turbulence may be the recent political crisis concerning which industries or countries should be given free, rather than auctioned, emissions allowances during Phase 3. The Commission's proposal for the EU Climate and Energy package included 100% auctioning. Germany, Poland, and even Italy at one point hinted or threatened to veto the package because of anticipated costs to industry. This is especially troubling for poorer and coal-powered Eastern Europe. Dramatic negotiations ended with a final package approved by the EU Summit and Parliament which stipulates an 80 percent free allocation to power companies, and a 100 percent free allocation to sectors with 'significant risk of leakage.' The Commission is now tasked with proposing how to administer the free allocations, which it initially opposed.

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Competitiveness concerns among industries and governments led to massive free allocation for Phase 3 (this also happened during Phase 1). Similar pressures could conceivably emerge and force ETS inclusion of REDD. The Council, which formally holds executive authority but confers it unto the Commission, may sway towards favoring REDD inclusion if cost-conscious Prime Ministers and Finance Ministers enter a negotiating space usually run by environment ministers. The Climate and Energy Package also interestingly directs the Commission to reconsider REDD policy in light of what is agreed at Copenhagen.

### *Ethics and Sovereignty*

The EU prides itself on progressive global leadership and consensus building. Ethical concerns about local implementation and indigenous rights led some to believe that the EU took the moral high-road by opposing avoided deforestation in the CDM (Boyd et al., 2008). Further moral justifications against REDD trading might be considered from a ‘historical materialist’ perspective (Paterson, 1996). By stopping the commodification of sovereign natural resources for international trade, the EU may see itself as rectifying inequitable global power structures, or attempting to broker the relationship of the US and developing world to that end. Brazil, and also Peru, DRC and others have expressed sovereignty concerns with REDD markets and the internationalization of forest resources.

The EU position could be viewed as consistent with these Parties, and also soft international law, which has a clear history of recognizing forests as a sovereign resource of states (see, for example, the 1992 and 2007 Forest Principles both following Principle 21 of the Stockholm Declaration). However, the Commission does not highlight sovereignty arguments to justify its position. And in reality, European trade policy does not afford such reverence for developing-country sovereignty. For example, EU development aid is conditioned on market liberalization through economic partnership agreements (European Commission, 2005), which may impede developing-country economic sovereignty, even if ‘saying no’ is technically possible (De Vos, 2002). A performance-based fund may be seen as requiring similar conditionality.<sup>vii</sup>

### **5. EU Outlook Post-Kyoto**

Indications from the European Commission, Parliament and Council currently point strongly towards exclusion of REDD from compliance trading until 2020. This is driven by the official reasons discussed above (concerns about baselines and MRV, leakage, non-permanence, and market flooding) and wider reasons of EU political economy, interests and other considerations. The upshot is that while pilot initiatives may generate some REDD credits for government compliance, a flourishing REDD market is not an expected short-term outcome.

In the meantime, the EU appears likely to pursue a Global Forest Carbon Mechanism. This would be funded by government donations in the short term, and by proceeds from a proposed 5% earmark on emissions allowance auctioning in the medium term. If the earmark for avoided deforestation does come to pass — there are a wide range of other demands on auction revenues<sup>viii</sup> — it might generate over US\$2 billion per year (COM/2008/645/3), which would be an unprecedented level of funding for forest carbon.<sup>ix</sup> All the same, this would still only represent a small first step towards the \$17 to \$28 billion per year price tag on halving deforestation emissions by 2020 (Kindermann et al., 2008).

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Furthermore, the REDD negotiation space is in flux. The US represents a new and significant player in REDD policy, and it is not yet clear whether the EU position will remain invariant in response to REDD policy shifts in the US. For instance, if the US includes REDD in its domestic carbon market, and if this provides a politically attractive (and economically rational) form of cost control, the EU may be spurred to move if the GFCM is not delivering the volume that a market would. Furthermore, events internal to the EU are relevant, as discussed above: eastern European nations are acutely aware of their exposure to carbon prices and of the need to ensure that reliable mechanisms are in place to control costs. Given the increasing importance of the Council of Ministers, and the capability of eastern European member states to shape Council decisions, pressure for a REDD market from within the EU may yet re-emerge.

As such, while the indications support the view that the EU will seek to use a fund-based mechanism to promote REDD, it is still too early to conclude that the EU's opposition to REDD markets will remain robust to events as they unfold.

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## Notes

<sup>i</sup> This is consistent with the findings of the Eliasch Review (2008).

<sup>ii</sup> REDD costs include both opportunity costs and forest protection costs.

<sup>iii</sup> The Commission acts as the executive branch, with one commissioner and cabinet appointed by each member state. The lower legislative body, Parliament, is elected by citizens and the upper body, the Council of Ministers, represents member state governments. The Council retains formal executive authority but confers it unto the Commission. The Council negotiates treaties.

<sup>iv</sup> Article 1.8 of the 1992 UNFCCC defines a “sink” as any process, activity or mechanism which removes a greenhouse gas, an aerosol or a precursor of a greenhouse gas from the atmosphere.

<sup>v</sup> Australia, Canada, Japan, Iceland, New Zealand, Norway, Russia, United States, and Ukraine

<sup>vi</sup> A temporary CER (tCER) is defined in 5/CMP.1, Annex, paragraph 1, to be a CER issued for an afforestation or reforestation project activity under the CDM which expires at the end of the commitment period following the one in which they are issued. A long-term CER (ICER) is also a CER issued for an afforestation or reforestation project activity, but which expires at the end of the crediting period of the afforestation or reforestation project activity. The amount of tCERs issued equals the carbon stock of the whole project, whereas ICERs are only issued for incremental gains in the carbon stock. For this reason, ICERs are not replaced until the project lifetime ends, or between 20 and 60 years, whereas tCERs expire after the next commitment period.

<sup>vii</sup> The Cotonou Agreement, signed in 2000, forms the basis for WTO-compatible economic partnership agreements between Europe and African, Caribbean, and Pacific states. Development aid is conditioned on adherence to the partnership agreement, which requires the removal of trade barriers and tariffs, among other things.

<sup>viii</sup> The calls on auction revenue are many and varied. The Commission (COM/2008/16) has proposed distributing auctioning proceeds to a variety of causes, including at least 20% toward a combination of avoiding deforestation in developing countries, adaptation finance, adaptation research, a Global Energy Efficiency and Renewable Energy Fund, and helping people cope with higher electricity prices. Various other claims – such as CCS support and research and development – are also made on the funds.

<sup>ix</sup> Average Official Development Assistance from OECD and multilateral agency donors from 1996 to 2004 was just US\$ 564 million per year (Tomaselli, 2006). According to the World Bank (2008), forestry ODA has increased and is currently about US\$ 1.9 million per year.