The Nature Conservancy
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Early REDD Implementation Fund Overview

Summary

A growing number of countries support the need for a phased approach to REDD funding that includes a readiness phase, an early implementation phase, and a full implementation phase based on ex-post payments for performance. While the structure for the first and third phases is fairly clear, the design of the middle phase is somewhat ambiguous in current U.S. climate legislation and international negotiations.

The existing proposals require that most of the early implementation funding be provided ex-post, i.e. after emissions reductions (or proxies for emissions reductions) have been achieved and verified. This approach appears to assume that private investment will provide the upfront capital for early implementation, based on the promise of a future market. However, the private sector is unlikely to make major investments in early stage REDD implementation due to the considerable delivery, reversal, regulatory, legal, market and political risks involved in this unproven sector. The resulting lack of early upfront REDD funding could severely inhibit the development of the REDD industry.

A publicly-supported Early REDD Implementation Fund could address this challenge by providing and supporting early stage upfront capital investments in REDD implementation, employing a variety of well established financial instruments to reduce risk, build confidence, and 'prime the pump' for long-term market investments. One example of such a fund is the Forest Investment Program under the Climate Investment Funds implemented by the World Bank and other Multilateral Development Banks. Laws and policies on REDD finance should be designed to support such efforts that provide upfront investment capital for REDD implementation.

The Challenge

There is growing recognition of the need for tropical forests to make a significant contribution to national and global emission reduction goals over the next decade. Deforestation and forest degradation release 15-20% of global greenhouse gas emissions annually, destroy more than 13 million hectares a year, threaten the livelihoods of Indigenous Peoples and forest-dependent communities worldwide, and harm biodiversity, ecosystems, and the services they provide. Substantial emissions reductions from the forest sector are critical to success and stable, substantial, and effective incentives are urgently needed to achieve these goals. For example, to halve emissions by 2020 would represent roughly 3 billion tons in annual emissions reductions by 2020, at a cost of approximately $45 billion annually (assuming a cost of $15 per ton).

Reducing deforestation and degradation will be a major challenge however, as countries have been working for decades to stem the tide of forest destruction with limited success. Significant new incentives are needed to address the multiple and diverse drivers of deforestation in countries with varying degrees of capacity. Many countries have called for a flexible, phased funding approach to support the implementation of REDD that utilizes diverse but complementary incentives, including:

i. Readiness funds to support development of baselines, monitoring approaches, and planning;

ii. A major investment of public funds over the next decade to capture early opportunities and promote the development of a REDD market; and

iii. A market or performance-based phase where emissions reductions would be sold *ex post*, either as offsets to capped entities or as emissions reductions to governments.

The payment structure of the first and third phases is fairly well defined in domestic and international policy dialogues. The second phase is not as well defined. In this brief, we describe options and recommendations for designing the second phase.

Existing Proposals

Many existing proposals include up-front funding for the first phase, but require that most of the funding for the second phase be *ex post*, i.e. after the emissions reductions have been achieved and verified. For example:

- The U.S. House Bill includes set-aside provisions estimated to generate $3 to $5 billion annually which can be used for a) up-front funding for readiness activities[1] and certain policy and enforcement activities and b) *ex post* compensation for REDD implementation that achieves verified emission reductions.
- The International Working Group on Interim Finance for REDD original draft proposal includes €2 to 2.5 billion for readiness activities and "enablers" (systems, infrastructure, certain policy reforms) and €8 to 15 billion of *ex post* performance payments for REDD implementation.
- The World Bank Forest Carbon Partnership Facility includes a readiness window of approximately $3 million per participating country, and a Carbon Fund which will purchase emissions reductions *ex post* from participants.

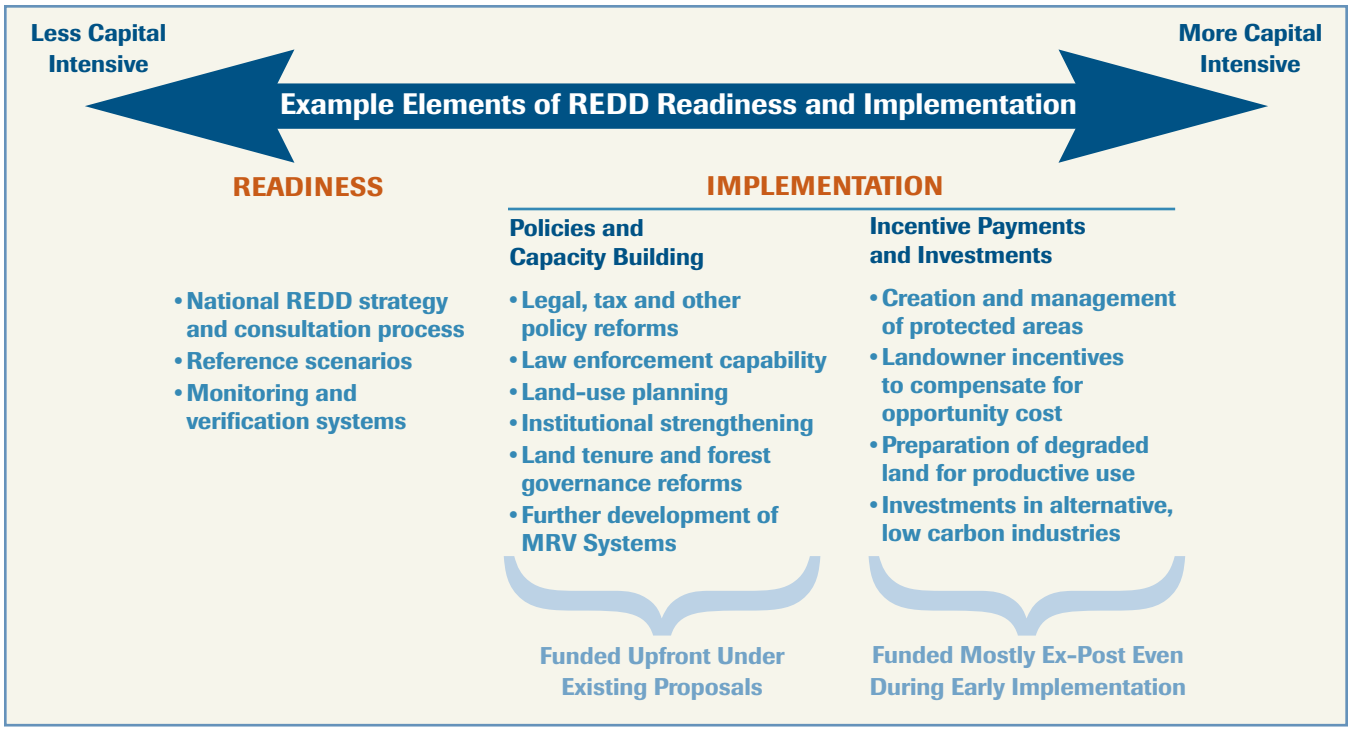
Under these proposals, governments would receive funding up-front for readiness and selected policies and capacity building. There could also be a strong incentive to implement further investments in REDD from the potential *ex post* demand for emissions reductions or proxy outcomes. However, the countries would need to attract very large amounts of up-front capital to fund most of the REDD implementation—the period between readiness and sale of ex post tons of emissions reductions (sometimes called the "missing middle").

Key REDD implementation needs that would not be covered upfront by the existing proposals include the substantial investments needed beyond policies and capacity building, such as financing mechanisms to expand and strengthen protected area systems, incentives to landholders to compensate for the opportunity cost of not clearing land, identification and preparation of degraded land for productive use, and capital to promote low carbon development strategies as an alternative to traditional forest-intensive industries. Definitions of "readiness" and REDD implementation vary, but the following diagram presents some examples drawing from several recognized sources.

Private capital is often identified as the primary source to fill this "missing middle" gap. However, given the considerable risks involved in REDD investments in the early stages of the industry, it is unlikely that private capital will provide the billions of dollars annually that is needed to get REDD off the ground. Key risks that private investors will be challenged to accept before REDD programs and risk management mechanisms have been demonstrated include the following:

- Delivery risk
  - Ability of program sponsors to effectively reduce emissions
  - Ability to control leakage to other locations
  - Ability to credibly measure emissions reductions, net of leakage
  - Ability to generate emissions reductions at or below market prices
- Reversal risk
  - Ability to sustain emissions reductions over the long term

[1] H.R 2454, as passed by the House provides for up-font payments for the development of measurement, monitoring, and verification capacities; leakage prevention activities; development of governance structures; enforcement; efforts to combat illegal logging; and incentives for policy reform. Payments for national and subnational deforestation reduction activities (including pilot activities) must be made ex-post.



- Legal risk
  - Legal rights to the emissions reductions generated
- Regulatory risk
  - Acceptance of verified emissions reductions in compliance markets
- Market risk
  - Volumes and prices demanded by the market (for capped entities, cost of buying allowances relative to investing in offsets)
- Political / policy risk
  - Long-term government commitments to REDD policies and programs

A growing number of corporations and investors are starting to consider investments in experimental REDD projects, but will be cautious in the initial years about investing the hundreds of millions of dollars per company that will be required to implement REDD at scale. Public funding sources could also be available to fill this gap, for example the Amazon Fund in Brazil. However, the Amazon Fund has approximately $140 million (with commitments up to $1 billion subject to performance), relative to an annual need, according to McKinsey and Company, of $8 billion annually to implement REDD in Brazil

Early REDD Implementation Fund

To address this gap, The Nature Conservancy proposes an Early REDD Implementation Fund to provide up-front funding for REDD implementation using established financial mechanisms to manage key risks and accelerate private and public investment, thereby catalyzing the path to a REDD market. The source of funds for the Early REDD Implementation Fund would be public funding, such as the set-aside provisions of cap and trade programs or contributions to a global REDD funding mechanisms as contemplated by the International Working Group on Interim Finance for REDD. The funds could be invested in multiple ways. Following are several options for consideration.

Investment Strategy

The primary objective of early implementation funding should be to accelerate the generation of REDD emissions reductions by assuming risks of and financing the implementation of REDD activities in areas where the risks are too high to attract private investment, but not so high that success is unlikely. In the arly years of REDD implementation, the majority of the funding will be focused on lower risk countries where the greatest opportunities lie for early implementation, although some portion of funding could be reserved for higher-risk countries to encourage broader participation in a portfolio of investments. Over time, private investment will flow to those countries that have proven to be good investments and early implementation funding for REDD can shift its focus towards riskier countries that are still unable to attract private capital.

In order to target the funding, fund managers should identify which risks are inhibiting private investment in various countries and choose the financing mechanisms (see table below) that will best address the principal risks involved. This should be done in consultation with the private sector to ensure that the Early REDD Implementation Fund will be effective in attracting private capital to REDD. In many cases, it may be appropriate to seek co-investment from the private sector.

Fund mechanisms

An Early REDD Implementation Fund could employ a variety of established financial mechanisms, including:

	Description	Pros	Cons
1. Grant	• Grant of funds with no return to funderreturn to funder	• Simple and effective in advancing implementation	• Limited accountability • No return to funder
2. Equity	• Contribution in exchange for share of emission reductions or revenues generated	• Funder shares in upside	• Complexity with multiple funders and funding time frames • Riskier for funder and higher return required than other options below
3. Sovereign Loan	• Loan based on full faith and credit of national government • Return in currency versus emissions reductions	• Simple and effective for dispersing funds • Manages funder risk • No need to define price per ton	• May be unattractive to forest nations • Funders may want ERs versus currency
4. Non-Recourse Loan	• Loan with recourse only to the REDD project or program • Return in currency versus emissions reductions	• More attractive to forest nations • No need to define price per ton	• Higher funder risk • Funders may want ERs versus currency
5. Forward Contract / Upfront Payment	• Upfront payment in exchange for future delivery of emissions reductions	• Nations get upfront funding, funders get ERs • Simple and transparent • Funder risk	• Need to define price per ton
6. Forward Contract / Payment on Delivery	• Contract to purchase emissions reductions and pay upon delivery (ERPA)	• Low risk for buyer • Covers market risk for forest nations • Simple and transparent	• Forest nations still need to attract upfront capital • Need to define price per ton
7. Option	• Upfront payment in exchange for right of buyer to purchase emissions reductions at a pre-specified price	• Low risk to buyer • Buyer gets ERs	• Magnitudes of upfront funding may be low, depending on strike price
8. Risk guarantees	• Insurance against specific risks, such as policy or political risks, catastrophic events	• Addresses specific risks to facilitate private investment	• Complexity of pricing risk • Can involve significant risk for insurer

An Early REDD Implementation Fund could use a combination of these mechanisms, depending on the objectives of the funders and forest nations, and the needs of private investors to manage risk before committing capital. Note that all of the mechanisms above involve some return to the funder either in emissions reductions or currency, with the exception of the grant.

Forward contracts with up-front payments may be a particularly attractive instrument for **public investments** as they are simple and transparent mechanisms to provide up-front capital in exchange for the emissions reductions desired by many government funders. As REDD is demonstrated through these public investments, private capital will be more likely to flow to these countries. Risk guarantees and forward contracts with payment on delivery could also be critical to address specific risks needed to attract large amounts of private capital.

Fund recipients

The recipients of Early REDD Implementation investment could include a range of actors responsible for REDD implementation, including:

- National governments
- Sub-national governments (e.g. States, Provinces and jurisdictions below these levels)
- Private developers
- Communities
- NGOs

Fund managers

Managing an Early REDD Implementation Fund will require experienced and sophisticated staff. While all these financial mechanisms are well established and commonly used instruments in other markets, appropriately structuring and transacting them does require financial training and experience. Organizations that could potentially manage an Early REDD Implementation Fund include The World Bank Group, which, through the International Finance Corporation makes loans and investments to private companies, through the International Bank for Reconstruction and Development makes loans and provides risk guarantees to governments, through the Multilateral Investment Guarantee Agency provides political risk insurance, and through the Forest Carbon Partnership Facility and other funds invests in REDD activities. Other multilateral development banks, such as the Inter-American Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development have similar capacities. And the U.S. Government has various agencies that may have this capacity, including Treasury and the Overseas Private Investment Corporation.

One opportunity is the Forest Investment Program ("the FIP") under the Climate Investment Funds implemented by the World Bank and other Multilateral Development Banks. The FIP is being created as a vehicle to pilot and scale-up replicable models of REDD implementation. The FIP design includes key elements of the Early REDD Implementation Fund advocated in this paper, including upfront funding for REDD activities and mechanisms to catalyze private sector investment in REDD. Laws and policies, such as the set-aside provisions of U.S. climate legislation and the recommendations of the International Working Group on Interim Finance for REDD, should be designed to support such efforts that provide upfront investment capital for REDD implementation.