



# Seeing the Forest for the Trees: Carbon Forestry's Potential Ready to be Realized

Between discussions leading up to climate talks in Copenhagen and pending U.S. legislation, increasing attention (and capital) is being devoted to forest carbon projects. Amid all the ruckus, **Brannen McElmurray** of Evolution Markets Financial Services sorts out the landscape and the investment opportunities.

*Notwithstanding the slow adoption of forestry projects as part of the international carbon offset framework, forestry should play an increasingly important role in global carbon markets. Given that deforestation accounts for approximately 20% of global CO2 emissions, the topic is worthy of all the scrutiny and debate this brings. After a look at the likely methodologies for creating carbon offsets, forestry projects have the potential to generate predictable and significant volumes of carbon offset credits over time. These projects also are expected to produce credits at a lower cost relative to most other project types. The twin attributes of high volumes of credit production over time and a low unit cost have captured the attention of both compliance buyers and financial players looking to invest in the carbon offset arena. Despite the central role that forestry-related projects could play in emission reduction programs, their role has been limited to date. Issues related to politics, permanence of the emission reductions, and a lack of infrastructure to efficiently and effectively monitor project performance have all contributed to relatively slow adoption within the international carbon markets, including the EU ETS. A healthy skepticism persists yet forestry remains a highly debated and important offset category in the design of a future US carbon compliance scheme. This Executive Brief examines how forestry plays into the current international carbon markets, its likely role post-Kyoto, and its potential significance in a U.S. cap and trade regime.*

## How Big a Role for Forestry?

Forestry projects have been controversial from the start due to fundamental disagreements on how climate change should be mitigated. The opposition lines up like this: some environmental groups fear that investments in forestry activities will distract from fossil fuel replacement efforts due to the vast mitigation potential of forestry projects. In addition, several European countries are concerned that investment flows would be directed abroad because of the limited forestry project opportunities within Continental Europe.

This sentiment is highlighted in the history of forestry-related project development under the Clean Development Mechanism (CDM). As of November 2001, afforestation and reforestation (AR) projects were the only accepted verifiable forestry projects under CDM. Unlike emission reductions projects where detailed regulations were developed, no specific rules were set for projects in this sector, which allowed the energy, energy efficiency, methane capture sectors to grab an early lead in CDM project market share.

In December 2003, rules and modalities were finally agreed upon, and a year later, in December 2004, there was the first call for project submissions. However, the path forward was hardly smooth. The initial methodologies submitted were all rejected. Only in late 2005 was the first methodology approved. Due primarily to the complicated requirements, only one forestry project had been validated by the CDM Executive Board by February 2008, versus more than 900 registered projects overall.

Since early 2008, however, forestry has grown to the third largest sector in terms of the number of methodologies approved. There are currently eighteen approved methodologies (eleven of which are large-scale) which equal 10.53% of all CDM methodologies approved to date. Registration of actual projects has not kept up with the increase in available methodologies. Currently, only afforestation and reforestation projects are accepted as CDM activities, and as of October 2009, only 8 projects are registered (1 afforestation and 7 reforestation).

Investor interest has tracked the growth in forestry projects. Initially, the World Bank's funds were the primary buyers for forestry credits. However, since the methodologies have become more accepted and standardized, additional investors have entered the market. Buyers from both Southern Europe and Japan's public and private sector are becoming more interested in forestry offsets. U.S. investors – including emitters, institutions, and trading houses – are increasingly looking at the sector to deploy capital.

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Why all the attention? Forestry provides both the scale (large amounts of tons potentially delivered) and relatively attractive pricing. This rising interest in international forestry bodes well for the role of forestry in a post-Kyoto world.

## The Past, Present and Future for Forestry

As it stands, Kyoto Protocol structures forestry activity on a project level. Managing these activities on an individual project level has several challenges, including additionality, permanence, leakage and adverse selection. Currently, the universe of potential forestry projects is limited because AR activities are the only accepted project types. Notably, neither emission reductions from forest conservation nor carbon removal from improved forest management are currently eligible under the CDM.

To address the shortcomings of the project-based approach, there are suggestions for a system of national inventory accounting where nations maintain records of their total carbon stock. This stock is then analyzed according to a preset baseline to determine the offset credits that can be redeemed, or debits that must be covered in the permit market. To avoid the difficult task of forecasting future stocks, international negotiations determine the reference stock. However, such comprehensive schemes may limit the incentives for private project developers and limit the sector to inter-government dealings. With this approach gaining favor in international circles, private investors have been reluctant to engage with certain nations where weak institutions, corruption, and/or powerful special interest groups might limit progress.

In order for forestry projects to attract significant amounts of private capital, the process for credit generation will need to be transparent, enforceable, and executable within a reasonable time frame. In addition, the policy path for REDD is far from clear as most of the current international discussions have focused on developed nations funding directly to host nations for REDD activities. Private investors should protect themselves from the possibility that REDD is exclusively a foreign aid game.

## U.S. Stands Up for Forestry

While much of the international community slowly gains confidence in forestry as a credible source of carbon offsets, the U.S. is showing signs of a quick and full embrace.

Comprehensive legislation to curb greenhouse gas emissions is winding its way through the U.S. Congress, and by all accounts the carbon offset scheme envisioned in both the House and Senate bills envisions a major role for domestic and international forestry credits. Both pieces of legislation set up a dedicated system for generating carbon offsets from a variety of forestry project types, including afforestation, reforestation, forest management, and, importantly, avoided deforestation (or REDD – reducing emissions from deforestation in developing countries).

Already within the U.S. market, organizations such as the Climate Action Registry (CAR) have issued new protocols to address the role of forestry – although not without their own measure of controversy. CAR recently issued its IFM 3.0 protocol, which provides a glimpse of a project type that may yield significant volumes of carbon offsets domestically. However, it remains to be seen whether the restrictions on landowners required under IFM 3.0 will be acceptable, or, more particularly, what price landowners will need to agree to restrictions on their land use. To make it more acceptable to landowners, the protocol does provide several unique safety valves – particularly around intentional reversals, which would give the landowners the ability to opt out of their delivery obligation at replacement cost of the undelivered credits.

As the market digests the implication and practical implementation of the new CAR methodology, another standard continues to drive international carbon forestry investment. Most buyers seem to place the greatest value on a combined Voluntary Carbon Standard (VCS) and The Climate, Community & Biodiversity Alliance (CCBA) accreditation. Investors in VCS + CCBA projects point to the robust carbon crediting methodology and the accredited sustainability and community benefits. Increasing acceptance of this combined standard by the NGO community – and increasing levels of investment – has led to an anticipation that these standards will ultimately be accepted by a U.S. standards body whether that be EPA or another organization.

## Where to Place Your Bet

Most observers agree that forestry represents a large potential investment opportunity within the carbon offset sector. Will such a bullish sentiment translate into transactions and value creation? In our view, projects structured to maximize credit production volume at low unit production costs while mitigating the political and regulatory risks will be of the highest value. Project types such as IFM in the U.S. and AR/REDD internationally, particularly Latin America, should be well positioned for carbon investment as interested parties position themselves for a compliance framework that most consider a matter of when than if.

**For more information on carbon credits from forestry projects or to explore investment opportunities, please contact Evolution Markets Merchant Bank carbon finance specialists at +1 646.200.7700 or the Evolution Markets Global Carbon Markets Team at +1 914.323.0265 or +44 (0) 20. 7264.4550.**

### Sources:

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