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REDD Financing: Different Approaches for Different National Circumstances

Recent analysis indicates that both market and non-market financial flows can play key roles in REDD. Market-based approaches can be important in compensating nations for reducing GHG emissions from deforestation and degradation; non-market funds can create incentives for maintaining large stocks of existing forests and help with 'REDD Readiness,' when nations build capacities for robust and credible national-level market-based REDD programs.

In the basket of financing tools, market-based REDD has the potential to generate significantly greater financial flows than fund-based approaches. Two misconceptions about market-based REDD have hindered its acceptance in some policy circles. First, some think that market-based REDD would function like an offset and not lead to absolute reductions.

- In fact, if allowances in a market-based REDD system are awarded *post facto*, when national-level reductions below a historical average are achieved and proven to be real, measured and verified, such reductions are not offsets. The majority of emissions in many developing countries come from deforestation, so in those countries, REDD has the potential to achieve national-level reductions comparable to those achieved under a cap. Such REDD allowances should be fully fungible on the global market.

Second, some think a market-based approach would not benefit local or indigenous peoples.

- In fact, if the rules are well written, a cap-and-trade system that includes market REDD can channel benefits to local people and local projects. A new global framework should include guidelines to maximize local benefits in a market-based REDD approach. Governance, national and local capacities, and transparency are factors that affect national abilities to implement REDD whether the compensation system is fund-based or market-based.

As a result of these misconceptions, non-market approaches to finance REDD, like "market-funded," "dual-market," or "voluntary donation," that lack fully fungible allowances, are sometimes believed to retain the advantages but avoid the risks of a market mechanism. These approaches incorrectly assume non-market REDD could set and enforce REDD rules that a market-based system could not.

Benefits of a Market-Based Approach

Expansion of agriculture and industrial resource extraction, including oil and gas extraction, mining, industrial logging, cattle ranching, soy and oil palm plantations, and biofuel expansion, drive deforestation because the economic benefits of deforestation outweigh the benefits of forest protection. A market-based REDD system could re-align economic incentives to make a tree more valuable alive than dead:

Market-based REDD can lead to virtuous cycles of greater developing country participation, deeper Annex I targets, and greater absolute global emission reductions. A market-based REDD system offers the chance to welcome important major emitting developing nations into a global carbon market when they achieve voluntary national-level emission targets. In addition, introducing REDD allowances in the market would decrease compliance costs, enabling industrialized nations to take tighter caps and leading to additional atmospheric benefits.

When nations agree to national-level reductions below historical baselines using a market-based approach, there is an absolute/net gain for the environment. Allowances will only be generated *post facto*, after emissions from deforestation have been reduced below historical baselines. These would be national level reductions and not project-based offsets. Unlike project-based offsets, in which additionality is hard to prove and emissions can

increase indefinitely, a market-based REDD approach can reduce absolute global emissions, delivering substantial atmospheric and biodiversity benefits.

Market-based REDD offers a long-term reliable source of funding that can help ensure permanence and absolute reductions. Because allowance prices are expected to increase with time, economic estimates indicate that resources for market-based REDD are likely to increase over time and generate sufficient funds to overcome the opportunity costs of the activities that drive deforestation.

Market-based REDD decreases compliance costs, but does not 'flood the carbon market,' allowing industrialized nations to take deeper caps. A recent study by EDF economists estimates that allowing use of REDD credits for compliance lowers the projected price of GHG allowances by roughly 13%.¹ However, while it would reduce the cost of compliance, it would not lead to a crash in the price of carbon. Even if no regulatory limit were placed on the use of forest carbon credits and if forest carbon credits throughout the developing world became available within the next five years, in a global carbon market, the price of GHG allowances would still be roughly \$16/tonne in the year 2012, rising to \$40/tonne by 2030. While these numbers reflect a global market model, even when the assumptions are based on the current EU ETS, allowing REDD credits would still depress the price by only 13%, reducing the current ETS price from 28 Euros to 25.5 Euros and reducing a future price of 40 Euros to 34.8 Euros. These prices are high enough to ensure the viability of critical low-carbon technologies, such as renewable energy sources and CCS. If industrialized countries were to limit the amount of REDD credits they could trade under their caps, some market benefits would be lost, and capping the demand for REDD could limit the potential for reducing deforestation globally.

The ability to bank allowances for the future is the crucial factor in sustaining prices at a moderate level. Banking increased environmental protection and economic efficiency in the US SO₂ program, and, in the EU-ETS, EU power companies and banks are already purchasing allowances today for 2013 and 2014. Allowing REDD in the compliance market will send the right signals to invest in preventing deforestation.

Problems with an Exclusively Non-Market Approach

With the funding magnitude required for REDD, exclusively non-market REDD or a REDD program in which REDD allowances only become fungible if set aside from an overall national cap in an Annex I nation would not likely generate funds at a level needed to reduce deforestation. Demand for public financing for a wide range of concerns continues to rise. Many of these demands cannot be addressed through the market. REDD presents a unique opportunity to use the market to strongly counter the economic pressures favoring deforestation and to reduce absolute emissions.

A REDD fund would not likely provide a reliable, long-term source of funding. A voluntary fund would be at risk of drying-up, especially during slow economic growth. An allowance set-aside risks reduced funding through changes in allowance allocation or auction amounts, jeopardizing the permanence of forest protection if funding no longer exceeds the opportunity costs of other land uses.

Publicly funded REDD credits do not decrease compliance costs, a necessary precursor for some of the biggest emitters to take tighter caps. Industrialized countries must take tighter caps, which, for many of them, will require more cost-containment options.

Similar to market-based REDD, non-market REDD investments that fail, create leakage, or do not account for reversals will increase net global emissions. However, market-based REDD would benefit from the discipline imposed by a competitive market-place, in which investors search for real, measurable, and verifiable reductions because they have value in the carbon market. Both fund and market-based REDD should be required to show that reductions are real, transparent, and measurable; economic compensation reaches those who work to protect forests; and leakage, permanence, and (for projects) additionality are addressed.

Please visit www.edf.org/AccraClimateTalks or for more information.

¹ Pedro Pirus Cabezas and Nathaniel Keohane. "Reducing Emissions from Deforestation and Degradation in Developing Countries (REDD): Implications for the Market." Environmental Defense: 22 May, 2008.
http://www.edf.org/documents/7975_REDDandCarbonMarketAnalysisReport_EDF_0508.pdf