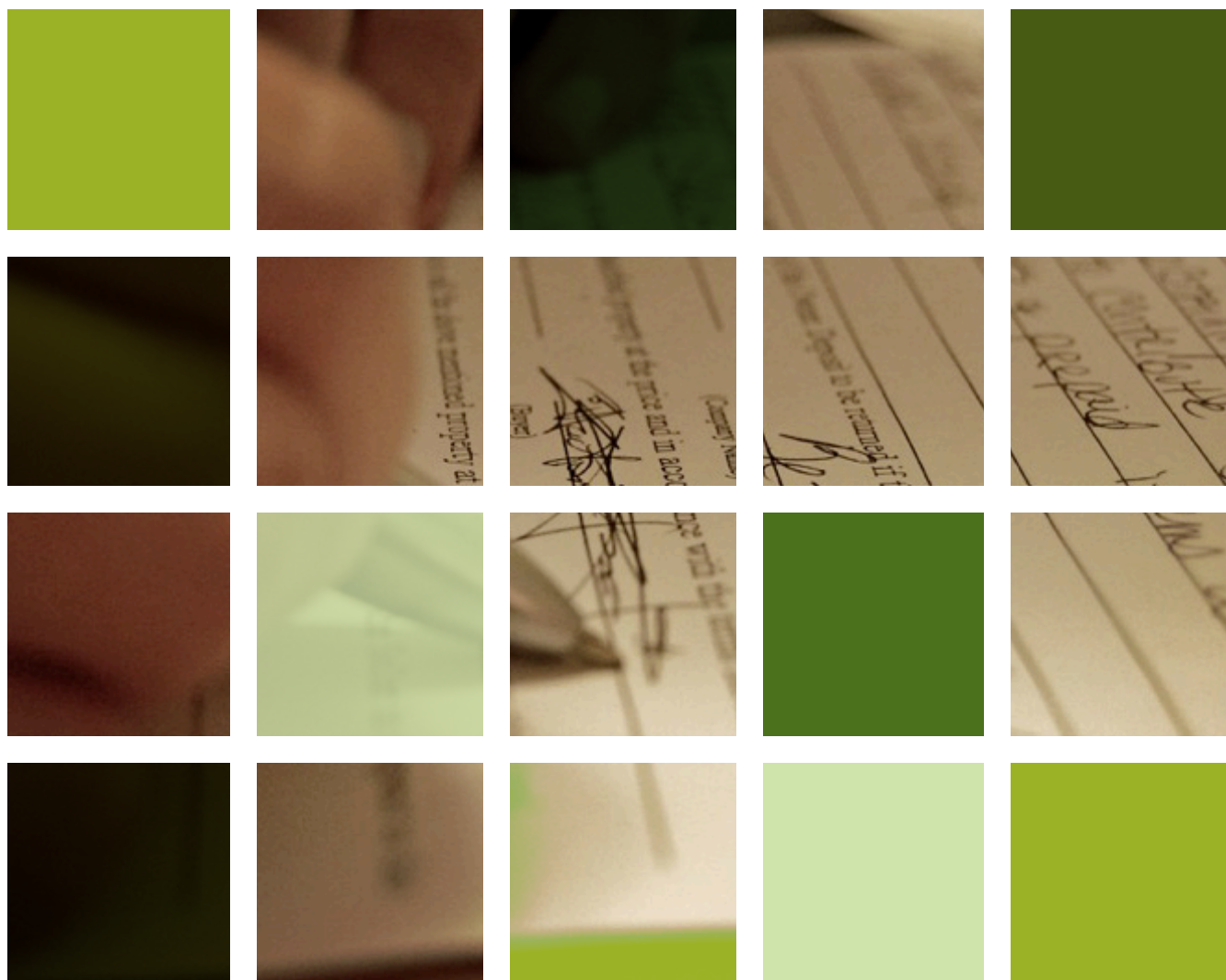


Building Forest Carbon Projects

Legal Guidance



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Building Forest Carbon Projects

Legal Guidance

Legal and Contractual Aspects of Forest Carbon Projects

Slayde Hawkins

Forest Trends

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Established in 1995 by Jacob Olander and Marta Echavarria, EcoDecisión is based in Quito, Ecuador, and works throughout Latin America with a broad array of clients and partners, including international and national non-governmental organizations, businesses, and government institutions.

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Building Forest Carbon Projects



2011

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Other documents in this series, referred to throughout this document, include:

Step-by-Step Overview and Guide

Jacob Olander and Johannes Ebeling

REDD Guidance: Technical Project Design

Joerg Seifert-Granzin

AR Guidance: Technical Project Design

Johannes Ebeling and Alvaro Vallejo

Carbon Stock Assessment Guidance: Inventory and Monitoring Procedures

David Diaz and Matt Delaney

Community Engagement Guidance: Good Practice for Forest Carbon Projects

Tom Blomley and Michael Richards

Business Guidance: Forest Carbon Marketing and Finance

Phil Covell

Social Impacts Guidance: Key Assessment Issues for Forest Carbon Projects

Michael Richards

Biodiversity Impacts Guidance: Key Assessment Issues for Forest Carbon Projects

John Pilgrim, Jonathan Ekstrom, and Johannes Ebeling

Acronyms

AFOLU	Agriculture, Forestry and Other Land Use
AR	Afforestation and reforestation
CCB	Climate, Community & Biodiversity [Alliance or Standards]
CDM	Clean Development Mechanism
ERPA	Emissions reduction purchase agreement
FPIC	Free, prior, and informed consent
GHG	Greenhouse gas
IFM	Improved Forest Management
NGO	Non-governmental organization
NTFP	Non-timber forest product
PDD	Project Design Document
REDD	Reducing Emissions from Deforestation and Forest Degradation
REDD+	Reducing Emissions from Deforestation and Forest Degradation, conservation of forest carbon stocks, sustainable management of forests, and enhancement of forest carbon stocks
UNFCCC	United Nations Framework Convention on Climate Change
VCS	Verified Carbon Standard

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1. Introduction

Forest carbon projects raise a range of complex legal issues. Project proponents need to ensure that they are in compliance not only with all legal requirements regarding reforestation, forest management, or conservation activities, but also with laws and regulations governing title to carbon, financial transactions, taxation, commodity trading (e.g., in the U.S. and Europe), and revenue management, in addition to offset development protocols and regulations. As sellers of carbon credits, project proponents¹ need to be aware of all the nuts and bolts of generating and transacting this product, and they need to manage associated risks, liabilities, and costs. Legal issues arise at every stage of project development, as shown in Figure 1. This chapter explores some of these issues, describes questions that are likely to arise, and highlights when expert legal advice will be needed. Specifically, it covers:

- Key regulatory issues for forest carbon projects, including carbon ownership;
- Project governance and fund management considerations;
- Key components of forest carbon purchase agreements; and
- Efficient allocation of legal expenditures throughout different stages of the project development cycle.

Although this chapter aims to be comprehensive in its discussion of the major legal aspects of both the carbon transaction and the underlying project activity, the discussion is necessarily kept general, and there will be many important points in the context of a specific project that are not addressed here. Project proponents and others should therefore not rely upon the information provided in this chapter for legal advice but should obtain professional legal guidance in their respective host countries.

Figure 1. Illustrative Legal Questions for Forest Carbon Project Proponents
Grouped by project stage; see Step-by-Step Overview and Guide.

1. Idea & preliminary assessment	<ul style="list-style-type: none">• What is the host-government's position on private REDD+ projects and on carbon projects more generally?• Do the project participants have a legal right to engage in planned forestry or conservation activities?• Are there regulations, legal precedents, or upcoming legislation regarding forest carbon rights, revenue sharing, levies, or national registration procedures?
2. Project planning & design 3. Formal project development 4. Project implementation strategy	<ul style="list-style-type: none">• What government agencies have authority/jurisdiction?• What licenses, permits, or approvals will be required? What type of contractual arrangements are needed (or most suitable) to secure project development rights?• How will roles and responsibilities be allocated in terms of: Communications with third parties? Project planning and management? Fund management?• How will claims on carbon credit ownership be settled? What are compensation arrangements for project inputs and relinquishment of land-use rights?

¹ In this series, the term “project proponents” is used to refer to those individuals or organizations generally responsible for the overall organization, management, and legal representation of the forest carbon project. “Project developers,” on the other hand, is used to refer specifically to entities tasked with the technical design aspects of the project as required by the carbon and/or co-benefit standard(s).

5. Financing/forward sale of carbon credits	<ul style="list-style-type: none"> • What are likely tax consequences? • What is the carbon credit price, and how is financing structured? • How are project, political, and change in law risks allocated between the project and the buyer?
6. Approvals, validation, registration 7. Implementation 8. Verification & issuance	<ul style="list-style-type: none"> • Do participants have required licenses, permits, and approvals? • Is there legally valid proof of authorization for any party to speak or act on behalf of another party? • How can relevant contracts reduce risks of under-performance and under-delivery of carbon credits?

2. Regulatory Issues

Regulatory issues refer to the project’s compliance with applicable laws and regulations. Key regulatory issues are discussed in this section in terms of three overarching questions:

- Do intended forest carbon sellers have sufficient rights to land and trees in the project area as well as rights to the environmental attributes of project activities (i.e., GHG benefits/emission reductions)?
- What government bodies have regulatory authority over the project area or the planned project activities, and what legal requirements apply?
- What taxes may be payable as a result of project activities and carbon sales?

2.1 Rights in Land, Forest, and Carbon

In order to legally perform project activities and transact in carbon credits, project participants must have sufficient rights both to the land and forest in the project area, as well as to the GHG benefits resulting from project activities.

2.1.1 Rights in Land and Forest

Project participants who have insufficient rights in the project area cannot guarantee that underlying project activities will continue as promised, resulting in risks to carbon credit generation. Carbon standards generally require compliance with applicable national and local law as a pre-condition for validation and verification, meaning that project participants must be able to perform project activities lawfully on project lands. At a minimum, project participants must have (for the entire project crediting period):

- Use rights sufficient to perform the project activities (such as planting trees), and
- The right to exclude or prohibit incompatible uses.

This minimum level of ownership or use rights will be required by any carbon credit validation and verification standard. Depending on the project and regulatory context, different sets of rights may be available to fulfill this requirement. Note that land law is overwhelmingly local in character, and there is a bewildering variety of tenure and land use arrangements between and even within countries. Concepts of ownership, use rights, and leasing do not have uniform meanings from one place to another. Prospective buyers and sellers will be well-advised to develop a clear understanding of the nature and hierarchy of land rights in a particular host country before beginning project activities or contemplating a forest carbon transaction.

While local circumstances and implications will vary widely, the following discussion provides a generalized overview of different bundles of rights that may exist in a given country. Some potential implications for forest carbon rights as a function of these land tenure and use rights are also pointed out; however, carbon rights are discussed in more detail in the subsequent section.

Formal private ownership of land, supported by clear, documented title, represents the broadest set of rights in land and includes rights to use, enter, sell, mortgage, lease, or give away. Formal private ownership is likely sufficient to support forest carbon project activities and a claim to carbon credits, absent any laws or regulations to the contrary. However, formal private forestland ownership may not exist, or may play a very limited role, in a given host country. Moreover, private ownership rights are often limited by rights of entry and use by neighboring communities as well as public rights over certain environmental resources.

Another set of rights includes the **right to use** and/or **right to enjoyment**, i.e., the right to derive benefit from property owned by another person or entity. For example, a usufruct is a legal right under civil law that grants rights

Prospective buyers and sellers will be well-advised to develop a clear understanding of the host country's land rights at the early stages of project development.

to use and enjoyment, so long as the property is not damaged by such use and enjoyment. A usufructuary right typically encompasses the rights to use and derive benefits from any renewable resource on the property, including benefits from agriculture, timber and non-timber forest products (arguably including carbon), livestock, and even rental payments.

More limited use rights are also common. For example, the right may be granted to live on the land and to use it for subsistence, but not commercial, purposes. Or, the landholder may have the right to, e.g., harvest non-timber forest products, but not trees, or to enjoy above-ground benefits (e.g., from agriculture or silviculture), but not below-ground benefits (e.g., from ore, oil, or gas).

Tenancy rights, such as those obtained via a lease, allow the rights holder to enter and occupy land or facilities, but do not necessarily permit the use of land or enjoyment of benefits (other than possession) derived from the land. The precise contours of tenancy rights vary extremely widely, ranging from a simple right to occupy land for a short period of time to a secure long-term leasehold with all the attributes of ownership. The latter is an alternative that may infer comparable rights to private ownership in some countries where formal private ownership is a limited possibility for forestlands.

Regardless of the formal classification of tenure or use rights, project proponents need to understand what "bundle of rights" current landowners or users may have in a given context, whether those rights are strong enough to support the deal (e.g., in terms of longevity, rights of transfer and mortgage, exclusivity, autonomy in decision-making over land and natural resources use), and whether there are other parties that also have claims to the same area. Further, they must assess the consistency of actual enforcement of formal rights in the political framework and judicial system (see below). For further discussion about ownership and use rights in land and trees, see Calmel et al. (2010).

Most standards, including the Verified Carbon Standard (VCS), also require forest carbon project participants to give evidence that they have "control over the project area." This means that project participants must be able to ensure that project activities can continue at least for the formal lifetime of the project and at least for the minimum duration required by the certification standard (e.g., 20 years under the VCS). Demonstrating control over project area, along with establishing clear title to GHG benefits (see below), may be challenging for a number of potential carbon projects, and this issue should be flagged early on in legal due diligence assessment.

Beyond constituting a minimum requirement of validation, the level of land and use rights in the project area is a crucial dimension of project risk. In general, the clearer, more extensive, and more secure project participants' rights are, the lower the risk to project performance and the potential for disputes and competing land use claims. For example, the VCS considers several aspects of ownership and use rights in the project area in determining the project's risk rating (VCS, *AFOLU Non-Permanence Risk Tool*, 2011):

- If land ownership and access/use rights are held by different entities (for instance, where the project proponent holds a concession on government-owned land), there is a *slightly* negative impact on the project's risk rating.
- If there are disputes over or overlaps of access/use rights, there is a *moderately high* negative impact on the project's risk rating.
- If there are disputes over land tenure or ownership in more than 5% of the project area, there is a *high* negative impact on the project's risk rating.

The existence of clear and secure rights in the project area reduces project risks and, in addition, provides direct financial benefits under the VCS by reducing the percentage of carbon credits that must be held aside in the non-permanence risk buffer.² Of course, evaluating risk in practice is a much more complex and nuanced undertaking than it appears in this simple illustration. In addition, the political stability of the host country (another VCS non-permanence risk category) is a crucial aspect in terms of actual security of land rights, and it will be vital to develop a good understanding of how consistently land-use regulations are applied and how well tenure and property rights are enforced, including through recourse to court action.

2.1.2 Carbon Rights

In addition to land ownership or use rights, the project proponent must have the right to GHG benefits and carbon credits generated from project activities. These may or may not be directly linked to land tenure and use rights in a given project and host-country context. Uncertainty over a seller's legal right to carbon revenues or authorization to enter into sales contracts will jeopardize (or preclude) project validation and financing. While the relevant rights of use may be explicitly granted by law or regulation, most countries do not currently have a legal framework in place that explicitly allocates carbon rights. Instead, carbon rights must be inferred from existing law, taking into account the specific project context.

Many countries differentiate between ownership of trees that are planted versus those that are naturally regenerated. Planted trees are usually considered "industrial fruits," with strong rights associated with the person or entity that has established them, while naturally-regenerated trees are commonly considered "natural fruits," and the associated rights more closely linked to the owner of the land or to the government.

For GHG benefits, the VCS requires clear "proof of title" of the project proponent's "right of use" of GHG benefits generated by the project (VCS, *VCS Standard*, 2011).³ Similarly, the CCB Standards require project proponents to "demonstrate that the project proponents have clear, uncontested title to the carbon rights, or provide legal documentation demonstrating that the project is undertaken on behalf of the carbon owners with their full consent"

² See REDD Guidance for a more detailed discussion of the non-permanence risk buffer.

³ Right of use means the "unconditional, undisputed and unencumbered" right to claim the project's GHG reductions or removals (VCS, *Program Definitions*, 2011; pers. comm. with VCS Association, June 10, 2011). Types of rights of use that are acceptable under the VCS include (i) a right established by law or regulation; (ii) a right stemming from the ownership of the process that generates the emission reductions or removals; or (iii) a contractual right to emission reductions or removals (rights assigned by the project owner to the investor, for example).

(CCBA 2008, 21). The legal due diligence assessment should establish early on whether there are likely to be significant hurdles in establishing such clear title to GHG benefits. This is a key consideration towards a project's feasibility and may even be vital to securing initial interest of private investors or buyers (see Step-by-Step Overview).

Because forest carbon credits are closely tied to land and natural resources, rights to credits are often considered part of project participants' rights in land, forest, and natural resources in the project area. However, carbon rights may be considered to belong to the entities responsible for generating GHG benefits by reducing carbon emissions or increasing carbon sequestration relative to the baseline. For example, an entity that provides capital for project development or project activities, or an entity that relinquishes use rights that would lead to emissions under "business as usual" could claim rights to the carbon credits thereby generated. It is therefore important to analyze not only who holds rights to lands, forests, and natural resources in the project area, but also who will undertake and fund the various activities necessary to transform carbon stocks into actual GHG benefits additional to the baseline scenario.

Given the potential for multiple claims to carbon rights, it is essential for project participants to set up an explicit contractual agreement, ideally with all potential claimants, regarding which entities may claim and commercialize

A formal government endorsement of a project or the agreed allocation of land and carbon rights can be useful for any project.

carbon benefits, and, if applicable, which stakeholders forgo potential claims in return for money or in-kind compensation (see also Section 3).

Regardless of the specific project context and stakeholder inputs, some governments may claim that ecosystem services belong to the people as a whole, and therefore that any ecosystem services transactions must pass through the central government, which acts on behalf of the people. International discussions between

countries (UNFCCC) and states (the Governors' Climate and Forests Task Force) have potentially bolstered such policy approaches by favoring jurisdictional forest carbon accounting. In any case, large areas of natural forestland in many developing countries are formally state property. As a result, the relevant government body may have to approve of any carbon transactions linked to these forests and either transfer its rights to project proponents or participate itself in the forest carbon transaction on behalf of the State.

Where the law does not explicitly allocate carbon rights, a careful examination of applicable law and regulation (including customary law and legal precedents) will be necessary to determine whether these rights can be considered to legally belong to the person that holds rights in land and forest in the project area, to the government, or to some other person or entity. Where the legal framework does not provide this clarity, private negotiation and written agreements between all potential claimants of carbon rights can greatly enhance legal certainty.

In general, where carbon rights are inferred from existing law rather than explicitly allocated, they remain relatively insecure and susceptible to legal challenges or changes in government policy, enforcement, and interpretation. Inferred rights could also be eradicated or diminished by new law or regulation, a particular risk as many countries are expected to formulate new rules for forest carbon rights and project development in the near future. Project proponents therefore must remain vigilant about legal and policy developments. In any case, a formal government endorsement of a project and/or the agreed allocation of rights in respect to a project are likely to be very useful for any project, even one implemented on private lands. Considering the evolving policy discussions towards a regulatory REDD+ market (under the UNFCCC or regional markets), such a formal endorsement could indeed be essential to securing the project's viability.

Finally, it is important to obtain clarity not only on the rights to the GHG benefits created by a forest carbon project, but also on the **right to transfer carbon credits /GHG benefits** once they have been generated by a project. Though it may seem evident that the owner of carbon credits would have a right to commercialize and sell these, this is not

necessarily the case in every jurisdiction. In the same way as one would ascertain rights to land tenure and use and GHG benefits, discussed above, existing regulations and legal precedents should be evaluated to ascertain carbon credits transfer rights.

2.2 Other Host Government Regulatory Issues

During early stages, a project proponent will need to answer several legal questions:

- What laws apply to project activities?
- Which national and local government bodies have (or claim) authority over the project area or project activities?
- What is required to comply with legal requirements and gain necessary approvals or permits?

The first place to look for legal requirements that may be applicable to a project is the host country's framework environmental and forestry laws and regulations. Other areas that may be relevant include laws on land and natural resources (including mining, oil, and gas), agriculture, planning and infrastructure development, and indigenous peoples. Depending on the host country, national laws and regulations may be readily available on the Internet or at a library. In addition to statutory law, legal precedents established by court decisions (known as "common law") are also important in many countries and are likely to be significantly more difficult to find and interpret. It will also be important to identify applicable local laws and regulations, which may impose new or additional requirements beyond what is required nationally. Applicable local laws and regulations are likely to be harder to identify, particularly from abroad.

Crucially, it is not enough to identify applicable legal requirements – it is also necessary to understand how they are interpreted and enforced at national and local levels. Even where legal requirements appear clear and straightforward, they may be interpreted in unexpected ways, impose conflicting requirements, or be inconsistently enforced. Similarly, many of these laws and regulations were not written with forest carbon projects in mind, potentially resulting in gaps, inconsistencies, or other problems that might adversely affect a forest carbon project. Local counsel experienced in relevant land and natural resource issues is essential to avoid risks to the project from noncompliance.

Government bodies most likely to have authority over a forest carbon project include environment, climate change, agriculture, and forestry agencies, as well as the office or entity serving as that country's Designated National

It is not enough to identify applicable legal requirements – it is also necessary to understand how they are interpreted and enforced at national and local levels.

Authority under the UNFCCC. In some cases, multiple agencies may have, or believe they have, jurisdiction over all or part of a project. Overlapping areas of authority can result in redundant or inconsistent governmental oversight and create risks for project developers.

When seeking to obtain government approval, it is important to remember that anti-bribery laws in the buyer or investor's country limit what can be given or promised in exchange for official support. The U.S. Foreign Corrupt Practice Act, for example, forbids U.S. businesses from buying credits from a project that relied on bribes or other corrupt practices to secure host government support, such as by transferring something of value to a foreign official. Anti-corruption laws may exist within the host country as well as in jurisdictions where the project developer may seek to sell credits. Anti-bribery laws do not forbid sharing credits or profits with a government body (as opposed to an individual) or promising to

provide community benefits in connection with project activities. However, these laws are important to keep in mind when structuring benefit sharing agreements with the host country government.

2.2.1 Permits, Licenses, and Certifications

Where required by national and local law, the project proponent will need to acquire permits or licenses for certain activities, and to ensure that any supporting entities are registered with the national or local government. The technical requirements for other land use activities may be a useful starting point for forest carbon projects, and official guidance documents and other materials for these other activities may be more readily available. A permit or license may be needed, for example, for:

- Tree harvesting;
- Exploitation of non-timber forest products, potentially including ecosystem services; or
- Agricultural (or agro-forestry) activities.

In many places, there is a risk that different government departments will issue contradictory permits covering the same location. For example, one department could authorize a forest carbon project, while another department grants a permit for mining activities within the project area. These risks must be addressed on a case-by-case basis, depending upon the specific risks and the protective measures available to the project proponent.

The project proponent may also be required to carry out an environmental impact assessment. This can be a useful exercise, in particular for reforestation and forest management projects (see Biodiversity Impacts Guidance), but it is likely to be costly. It is worth inquiring whether certain formal legal requirements can be waived for small-scale or community-based projects. Sustainable forest management certification (for example, from the Forest Stewardship Council) may also be desirable or necessary.

Note that there may also be limitations and restrictions in relation to the purchase of land by foreign investors, and this should be determined early on if the project design involves land purchase (e.g., for tree planting).

Potential sources of more information include:

- “Ease of doing business” assessments, which focus on specific countries and evaluate the ease of: starting a business, getting credit, registering property, paying taxes, trading across borders, enforcing contracts, dealing with construction permits, closing a business, protecting investors, and employing workers. The World Bank, for example, provides a Doing Business Guide for many countries and is a good place to start when assessing the availability and feasibility of property or title registration in the host country.
- Publications or guides from the relevant government body
- An experienced local lawyer or consultant

Broadly speaking, legal due diligence verifies that a project is in compliance with all applicable laws and has the necessary permits, licenses, certifications, and approvals.

2.3 Tax Implications

The tax consequences of a forest carbon project are another legal issue that must be taken into account, and failure to do so may mean the difference between profit and loss. Underlying project activities – in particular, timber harvests and sales – may be subject to taxes or government fees. The same applies to the carbon credit transaction.

The primary taxes to watch out for include:

- **Sales and value-added (VAT) taxes.** These taxes are very common and are charged when a good, service, or piece of property is transferred. They are based on the value of the good, service, or property.
- **Personal or corporate income taxes.** Income taxes are also very common and may be based on the financial income or profit of persons, corporations, or other legal entities. Personal and corporate income taxes are likely to be subject to different rates and regulations. Income is defined and taxed differently in different countries and may be taxed at different rates based on whether it is active (i.e., wages from work) or passive (i.e., interest on investments). Carbon revenues and other revenues from project activities, such as those derived from timber sales or eco-tourism, may generate taxable income.
- **Property taxes.** These are charged to a property owner, based upon the value of the property. In parts of Latin America, property taxes are an important revenue-raising mechanism for local governments. In comparison, the incidence of property taxes in Africa is much lower.
- **Duties or tariffs.** Duties or tariffs are taxes on the value of imported or exported goods. A project that involves the export of timber, non-timber forest products, or agricultural goods is likely to incur tariffs.
- **Carbon revenue taxes or fees.** One new issue for project participants involves targeted taxes that apply specifically to revenues from carbon credit sales, above and beyond corporate income taxes. Some countries, including China, levy a tax on all CDM credits, and other countries are considering similar measures. The role of the state in most forest carbon projects, the magnitude of potential revenues, and the increasingly politicized nature of the REDD+ debate in many countries make this a critical emerging issue.

The applicability and impact of these and other taxes depend to a large degree on the circumstances of the particular project. For example, a project proponent that is a private for-profit enterprise may face very different tax obligations than a community enterprise or NGO. A formal tax analysis, conducted after the completion of project planning (i.e., when the structure of the project and relationships between the parties are clear), will help project proponents structure carbon transactions so as to minimize tax liability while ensuring that the project is in full compliance with tax law.

Box 1. Key Resources for Regulatory Issues

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3. Project Governance and Fund Management

Any forest carbon project that involves multiple participants, for example, some combination of individuals or organizations contributing to project development, implementation, and management, in addition to land owners or local communities and forest carbon credit sellers, should formalize the roles and responsibilities of these parties in writing. Specifically, written agreements should cover at least (1) project governance and operating procedures, roles, and responsibilities; (2) procedures and authorization for centralized management of project funds; and (3) rights to carbon credits and benefit-sharing.

It is important to agree on these matters ahead of time and in writing in order to reduce the risk of misunderstandings, confusion, and dispute during later stages of project development. While there may be a trade-

Forest carbon projects involving multiple participants should formalize the roles and responsibilities of each party in writing.

off between comprehensiveness and transaction costs, such contractual agreements can be quite simple. At a minimum, they need only show that the parties agree on who is to play what role in technical project development and implementation of project activities, the responsibilities involved, and a clear authorization for any grant of authority (e.g., to invest project funds into activities, negotiate with buyers or investors, liaise with the government, or enter into carbon sales contracts). More complicated agreements will address a larger number of contingencies.

As a general rule, private contracts like those described above do not need to be filed with an official entity but are effective once signed by all the parties. However, enforcement of these contracts in a host country, particularly against local entities, will depend on that country's legal system and, by extension, its government.

Benefit-sharing is a particularly important issue. For reasons of fairness and efficacy, it will often be necessary to distinguish between the rightful (legal) owner of carbon rights and the legitimate recipient of carbon revenues. For example, formal rights to forest carbon in a country may be held by the government and could be transferred (perhaps in exchange for a share of revenue) to an investor who finances a project that reduces deforestation by smallholder farmers. In this case, even if the applicable legislation does not infer any carbon rights to the farmers, it will be vital to incentivize and compensate local communities for changing their baseline behavior, or to compensate other actors that provide inputs that are essential to the generation of GHG benefits and attendant commodities.

Written agreements should include strong transparency requirements and should provide for access to information and documents by project participants. Copies should be kept in a central location (with the entity or individual in charge of project governance) and should themselves be easily available for viewing by all projects participants and supporting entities.

3.1 Project Governance

It will be important for project participants and supporting entities to agree early on in project development regarding:

- The roles and responsibilities of each party with respect to underlying project activities (such as sustainable timber harvesting, ecotourism, agroforestry, etc.);
- The roles and responsibilities of each party with respect to technical carbon project development (including analyses and writing contributing to the PDD as well as project monitoring) and the carbon credit transaction;

- Procedures for inclusive, transparent decision-making and dispute resolution; and
- Revenue sharing between project participants, with local communities, and/or with the government.

One or more informal memoranda of understanding (MoUs) or letters of intent regarding the above aspects should ensure that each of the parties has a full understanding of the planned undertaking and agrees to its terms. More formal agreements may or may not be necessary to (1) assure buyers and investors that robust, binding project governance procedures are in place, (2) obtain carbon credit or environmental or social benefit certification, and (3) provide added assurances to project participants themselves and avoid conflicts in cases of complex stakeholder relationships.

Importantly, agreements should also provide for what happens if a party fails to fulfill its responsibilities as promised. Such provisions may be especially important where a failure by one party can jeopardize carbon revenues for all participants and, potentially, lead to project failure (see Community Engagement Guidance).

Among numerous project participants, it can quickly become impractical to obtain the consent or signature of each one whenever needed and to coordinate external communications, e.g., with supporting entities, standards bodies, buyers, and investors. Therefore, project participants may want to officially form an organization, consortium, or business entity. Even where no appropriate organizational form is available, individual project participants should specifically grant authority to one or several persons to act on behalf of the group. In many cases, the representative person or entity should be the same as the project proponent (or its authorized representative) identified to the VCS or CCBA, although international investors may prefer that a local project participant deal with local authorities while reserving the right of being a project proponent and main contact point with carbon standard bodies.⁴

Good, transparent project governance, with robust procedures to resolve disputes and facilitate participatory collective decision-making, can be expected to reduce the cost to sellers of administering the project and will contribute to the project's success. It may even reduce the project's non-permanence risk, and the associated buffer discount under the VCS, if it facilitates the inclusion and cooperation of local communities and encourages government endorsement of the project. Drawing up a detailed organizational diagram can be very helpful in clarifying the roles and responsibilities of different stakeholders and establishing what agreements will be needed.

3.2 Fund Management

Centralized fund management is particularly important as the number of parties and/or complexity of the transaction increases. For more complex payment arrangements, centralized fund management will be a necessity – for example, where there are numerous project participants, when a trust account is used, or where payments owed to various parties must be “netted” before money changes hands.

Project proponents that wish to set up an escrow account, trust fund or other independent fund to receive and disburse project revenues will do so by contracting directly with a financial institution. Once again, strong transparency provisions are essential in order to avoid the risk of improper use of funds and to maintain trust among various sellers or project participants. The entity in charge of fund management should give regular accounts to other parties on revenues raised and expenditures made, potentially including explanations of unforeseen developments (e.g., a change in carbon prices).

⁴ A project proponent may authorize another entity to interact with the VCS registry on its behalf via a “communications agreement” that is signed by all parties and submitted to the VCS registry administrator (VCS 2011, 27).

4. Negotiating Carbon Sales Agreements

Negotiating and drafting carbon transaction agreements is likely an aspect of project development with which project proponents have less experience. Legal advice should be sought to properly analyze the particular circumstances and needs of the project and to clarify central questions of risk, liability, and cost implications of a particular agreement. Sellers may want their own legal counsel to be present during negotiations with buyers and investors.

It is important to keep in mind that buyers' lawyers have a fiduciary obligation to negotiate the best possible deal for their own clients and cannot be expected to take into account sellers' interests. Familiarity with the key issues and agreements likely to arise on the part of sellers and project developers will help these parties to plan appropriately, select the right legal advisor, and ask the right questions, thereby saving time and money over the long run. Key provisions to consider when negotiating and drafting a forest carbon purchase agreement are outlined below.

Sellers may want their own legal counsel to be present during negotiations with buyers and investors. Buyers' lawyers have a fiduciary obligation to negotiate the best possible deal for their clients.

4.1 Key Ingredients of Purchase Agreements

The most widely used type of agreement for transacting carbon credits is a **purchase agreement**, also known as an emissions reduction purchase agreement (ERPA). A purchase agreement deals with the sale of verified or certified emissions reductions – i.e., carbon credits generated by the project and verified or certified to the chosen standard.

Purchase agreements may deal with carbon credits that have already been issued or with credits that have yet to be generated. A **spot purchase agreement** is an agreement to buy carbon credits that have already been issued and are delivered to the buyer immediately. There is little risk to the buyer in this type of transaction and therefore prices tend to be higher. In comparison, a **forward purchase agreement** is signed before carbon credits are issued. Because the buyer bears some of the risk of project failure or underperformance, or of delays in the generation and delivery of credits, prices are likely to be lower under forward purchase agreements.

Prices in forward purchase agreements vary significantly depending on the project specifics, in particular its development status and risk profile. Forward purchase agreements are generally much more complex because they must address project risks and establish a long-term relationship between the buyer and the project proponent. As discussed in the Business Guidance of this series, there are a number of significant advantages to forward purchase agreements, particularly from the project developer's or seller's perspectives, including predictable revenue streams, and potentially significant technical and financial support for formal project development, or even up-front funding for project activities.

Project proponents may also seek to commercialize carbon credits through a **brokerage agreement** with a carbon market intermediary. The broker does not actually buy the project's carbon credits but rather finds buyers and matches them with the seller, often according to pre-defined conditions (including a target price). The broker typically receives a percentage of the transaction value as fee for its services, which can include settlement services and advice in addition to finding buyers at the most favorable terms for the project. A separate purchase agreement will then be signed between the individual buyer and the project, often facilitated by the broker.

Selling future credit volumes raises some challenging issues, including:

- Price and timing of deliveries and payments;
- Allocation of risk and liabilities relating to under-generation of credits;
- Allocation of project development transaction costs; and
- Provisions dealing with default and remedies.

These issues are outlined below. Other provisions in a purchase agreement typically include a section describing the project area and project activities, provisions addressing contract duration, delivery of carbon credits, representations and warranties, costs and taxes, reporting and monitoring obligations, validation and verification, communication with third parties, confidentiality, termination, notices, amendments, governing law, assignment and novation, survival, definitions, and other miscellaneous provisions. For further guidance on these issues see the CERSPA template agreement and supporting documents available in Box 2. For more detailed guidance on forest carbon ERPA clauses, see Hawkins, et al. (2010).

It will be important to remember that most clauses are negotiable. Sellers or project developers can compare a buyer's draft agreement to other existing agreements to get an idea of which clauses are commonly negotiated. Various template agreements developed for use under the Clean Development Mechanism of the Kyoto Protocol showcase a variety of approaches.⁵

4.2 Price and Timing of Payments

For obvious reasons, the price to be paid and timing of payments are central issues for a forest carbon transaction. The key considerations in this regard include:

- Setting the price, using a fixed price vs. an indexed or floating price,
- Differentiating prices by credit tranches or seniority, and
- The timing and procedure for advance payments, if any.

The carbon price that is attractive to the buyer and seller is linked to a variety of factors, such as which side takes on certain costs and liabilities and when payments occur. Apart from these factors, however, the market price for credits will have a major impact on the price that will be acceptable to the buyer, while the cost of the underlying project activity will limit the scope of negotiation for the seller.⁶ See the Business Guidance of this series for further considerations, including advantages of fixed vs. floating prices, upfront vs. on-delivery payments, and sale to one vs. several buyers.

Setting the price and timing of payments has important implications for other aspects of the purchase agreement. For example, significant upfront payments under a forward purchase agreement expose the buyer to the risk that credits ultimately will not be generated. Accordingly, the buyer may require that the purchase contract stipulate additional benefits (such as a lower overall price or a right of first refusal to additional credits beyond the contract term or

⁵ A selection of template ERPAs developed for use under the CDM are available at: http://www.katoombagroup.org/regions/international/legal_contracts_cdm.php.

⁶ Plan Vivo deals with the issue of credit production costs in an interesting way. Project activities (typically tree planting) only commence once a buyer has been found at a minimum price deemed necessary by sellers (usually small farmers), and once the buyer has deposited a sufficient minimum amount into an escrow account.

amount) and safeguards (such as a degree of oversight over project activities or penalties in case the seller does not perform its obligations).

4.3 Allocation of Risk and Delivery Liabilities

Much of the length and complexity of a purchase agreement is due to the fact that the parties must allocate diverse risks among themselves. The underlying concern is that credits will not be delivered as expected, for example because:

- The project underperforms (e.g., is less effective than expected at reducing deforestation);
- The project does not meet third party validation or verification requirements, or fewer credits than expected are issued;
- Events outside of the control of project participants disrupt project activities;
- A change in host-country law adversely affects the project; or
- Credits are issued but are not delivered to the buyer by the project proponent as promised.

Efficacy dictates that risks be allocated to the party best able to control them. Alternatively, equity concerns call for an allocation of risks based on each party's ability to bear them. In reality, both considerations must be negotiated in context.

In general, and particularly for small-scale projects, the purchase agreement does not provide for the buyer to be reimbursed for carbon project development support costs (e.g., for PDD development, external validation or registration costs) in case of project underperformance. The buyer therefore generally bears the risk of non-delivery to the extent that he or she expended money to support project development. Advance cash payments, however, may carry an entitlement to reimbursement under particular circumstances, e.g., where the seller misses specific project development milestones defined in an ERPA or defaults on delivery. Such an entitlement would normally be tied to specific collaterals.

A different case exists where the project performs adequately and credits are issued, but the project proponent refuses to deliver credits as foreseen in the ERPA. In this case the buyer may be entitled to reimbursement or even damages, as discussed under "Default and Remedies" below.

Project underperformance is a major risk in the forest carbon context, as future carbon credit flows from project activities tend to be highly uncertain and difficult to predict at the outset. To mitigate the risk that unpredictable circumstances will cause the project proponent to be in default under the agreement, many forward ERPAs are structured as unit-contingent contracts, i.e., buyers commit to buying and sellers are obliged to deliver all or some of the carbon credits generated by the project only if credits are indeed generated by the project. Where delivery is non-guaranteed, buyers will normally have the right to terminate the ERPA (but not claim damages), and the ERPA may specify that this right may only be exercised after, for example, two consecutive under-deliveries.

Where sellers feel confident about their ability to generate and deliver a certain number of credits, they may instead decide to execute fixed volume ERPAs, which oblige them to either deliver the agreed volume of carbon credits at the agreed delivery dates, or to compensate the buyers if they fail to do so. This latter approach is only advisable where the significantly increased risk assumed by the seller is sufficiently compensated through higher carbon credit prices.

Project underperformance can also result where project activities are disrupted by events outside of project participants' control (so-called "force majeure" events or "acts of God"), or where a project is undermined by a change in law. The purchase agreement may provide that the affected party must give notice of the occurrence of a

force majeure event or change in law, and generally must show that it took reasonable steps to minimize delay or damages caused by foreseeable events. If these conditions are fulfilled, the affected party's failure to perform is excused, and that party is not considered to have violated its obligations under the agreement. However, termination of the agreement generally is an option if the disruption is severe, in recognition of the fact that an unforeseen event may significantly reduce or eliminate benefits for both the buyer and the seller.

4.4 Allocation of Project Development Transaction Costs

In addition to the agreed price for carbon credits, the buyer may be responsible for paying some or all of the transaction costs associated with carbon credit generation. Transaction costs can be significant (see Business Guidance), so which party bears them is likely to influence the price. External transaction costs include obtaining third party validation and verification as well as credit issuance and registration fees. Internal transaction costs, which may include the cost of writing the PDD and even monitoring costs, may also be allocated in a purchase agreement.

It appears to be relatively common for a forest carbon buyer to pay at least some transaction costs (a form of up-front payment, sometimes coupled with in-kind technical project development support). This makes sense where the project lacks the capital to cover these costs and where the buyer has specialized experience with handling these types of issues, e.g., through frequent interactions with validators or registries. However, the increased cost and risk to the buyer will be compensated with a lower carbon credit price.

4.5 Default and Remedies

As distinct from events of project underperformance where neither party is considered to be at fault, a party *is* considered to be at fault in certain situations. In such cases of “default” or “breach,” the other party can access contractual remedies. Purchase agreements usually address default and remedies in detail, describing what can be considered a breach of agreement and outlining the remedies that are available to the non-breaching party.

First, the agreement must define what constitutes an “event of default,” or a breach of (as opposed to a minor or de minimis deviation from) the contractual terms. Because an event of default triggers contractual remedies, minor or insignificant breaches should not be included in the definition.⁷ Events of default commonly include:

- Failure to support or ensure implementation and operation of the underlying project as described in the purchase agreement, or an annex to the purchase agreement;
- Bankruptcy of a party, or any event that causes a business entity party to dissolve;
- Having made a non-trivial false statement of fact in the purchase agreement – what is known in legal terms as “material breach of a representation”;
- Failure to deliver carbon credits as promised, if that failure is not excused by force majeure, change of law, or other provisions;
- Failure to make payment when due, if that failure is not excused by force majeure, change of law, or other provisions; and
- Failure to comply with validation, verification, and monitoring obligations.

⁷ One common way to do this is to use the term “material” alongside certain events of default. For example, instead of providing that a misrepresentation is an event of default, the parties can specify that it must be a “material misrepresentation.” Similarly, the phrasing of the parties’ obligations is commonly used to limit what will be considered default, for example by providing that a party will use “reasonable efforts.”

The agreement may describe specific remedies that will be available in case of breach. The parties can also specify that contractual remedies are the only remedies available for an event of default or that contractual remedies are in addition to any provided by law, i.e., via a lawsuit. The former approach adds certainty and predictability, while the latter is more protective of the non-breaching party, but also potentially more costly.

Specific remedies that may be provided in case of a default by **either party** include:

- Termination of the agreement or designation of an early termination date;
- Exclusion from a planned subsequent transaction; and
- Monetary damages for the non-defaulting party.

Potential remedies for default by the **seller** include:

- Liability for replacement credits; and
- Payment withholding by the buyer.

Potential remedies for default by the **buyer** include:

- Recovery of credits already transferred; and
- Recovery of outstanding payments.

There may be a “cure period” available for an event of default, providing an opportunity for the defaulting party to fix the problem.

The specific remedies available in case of default may depend upon the severity or willfulness of the default and the circumstances of the contracting parties. The possibility of claiming monetary damages, for example, can be limited to cases of intentional default or gross negligence.⁸ One common difficulty that arises is the protection of the buyer against seller default in cases where small-scale sellers are unlikely to have the resources to pay monetary damages or buy replacement credits. In such cases, it will be important to consider whether seemingly small remedies could provide an adequate deterrent or whether traditional remedies are necessary.

In any case, the costs of enforcing a remedy can be significant, especially if a court case is involved, and may be greater than the value of the remedy. This is an important consideration because some mechanisms that are used in other contexts to control the cost of obtaining a remedy (like “step in rights” and letters of credit or other financial guarantees) are not well-suited to the forest carbon context.⁹ Many agreements require that disputes between the parties be resolved via arbitration according to agreed procedures. While arbitration is not necessarily a lower-cost option compared to a lawsuit, it can be set up to limit costs as much as possible. Mediation may also be required as a first phase that feeds into arbitration.

⁸ See, for example, Section 10.03 Buyer Remedies for an Event of Default, in CERSPA (2009). “Gross negligence” is a legal term of art that is often used to describe either willful misconduct, or conduct involving reckless disregard of a real risk of harm.

⁹ “Step in rights” allow a buyer to take over administration of a project in certain cases of seller default, thereby enabling the production of credits and avoiding potentially high enforcement or collection costs. However, due to the context-specific nature of forest carbon projects, the specialized local expertise that is needed, and the overlap between forest carbon projects and tenure issues, step in rights are probably not appropriate for most forest carbon agreements. Letters of credit or other financial guarantees provide that a third party institution will pay certain sums to the non-breaching party if a breach occurs. This can ensure that the non-breaching party gets monetary damages or compensation even if the breaching party is bankrupt or refuses to pay. However, financial guarantees are expensive and are not often used in the forest carbon context.

It is important to note that the provisions outlined in this chapter make up only a part of a purchase agreement. They will affect and be affected by other provisions not mentioned here. Project proponents are therefore encouraged to consider the resources below for further information and to consult with a specialized lawyer.

Box 2. Key External Legal Resources

CERSPA Initiative. Certified Emissions Reductions Sale and Purchase Agreement (CERSPA Template). Version 2.0, <http://www.cerspa.com>, 2009.

Hawkins, S. et al. 2010. Contracting for Forest Carbon: Elements of a Model Forest Carbon Purchase Agreement. Forest Trends: Washington, DC. Available at: http://forest-trends.org/publication_details.php?publicationID=2558.

Katoomba Group. *Katoomba Group-Legal Initiative: Online PES Contract Management Center*. http://www.katoombagroup.org/regions/international/legal_contracts.php (accessed April 2011).

5. Investing in Legal Advice Efficiently and Strategically

Legal issues – and costs – will arise throughout the project process, particularly during early stages. Some issues will require the help of a specialized lawyer, while others will not. The cost of consulting with a lawyer can be significant but can be well-invested at the following stages:

- At the idea and preliminary assessment stage, legal advice will be needed to assess project participants' rights in land, forest, and carbon and outline strategies for obtaining needed government approvals.
- During project planning and design and project implementation strategy, help will be needed to set up robust project governance and fund management structures that serve the needs of project participants, satisfy regulatory requirements of the host government, and assure buyers and investors.
- If a forward sale of carbon credits is used, legal assistance will be needed at the project financing stage to negotiate and draft one or more purchase agreements. Many buyers tend to insist on ERPA's being governed by laws other than those of the seller or project location, e.g., English law (many carbon buyers and intermediary firms are based in England). It may be advisable to seek legal advice from lawyers experienced in these laws. Furthermore, as the sale of carbon credits is still a relatively exotic area of law it may be advisable to seek advice from lawyers specialized or at least experienced in this area.

Sound legal support, particularly at these key points, is vital to laying a firm foundation for project activities, avoiding future legal and non-legal costs, ensuring an adequate share of carbon benefits for sellers and project participants, reducing the risks of dispute and project failure, and creating a level playing field for negotiation. Early planning for legal costs is extremely important, particularly as major legal costs necessarily occur before project financing via a sale of carbon credits.

The costs of obtaining necessary legal support can be substantial and may be over the budgets of small-scale projects. As a result, project participants may feel unable to consult a lawyer as needed. One way to limit legal costs is to seek guidance from project participants that are involved in similar projects in the country. Another is to use resources available from international and national non-profit entities and governmental initiatives to reduce the amount of paid legal advice that is needed. A third is to seek "pro bono" (free or reduced cost) support from a lawyer or firm, a

practice which is encouraged by some law firms for “worthy causes.” Finally, project participants should ask for written fee estimates from various lawyers or firms before selecting one.

Nevertheless, it is important to keep in mind that professional legal advice is a strategic investment. Engaging an experienced lawyer when needed will help project participants avoid costly mistakes and conflicts, and ensure that they receive a fair share of the benefits from the project.

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Glossary

For CDM projects, readers may wish to refer to the official definitions provided in the CDM Glossary of Terms, available at: http://cdm.unfccc.int/Reference/Guidclarif/glos_CDM.pdf.

VCS also provides standard Program Definitions, which are available at: <http://www.v-c-s.org/sites/v-c-s.org/files/Program%20Definitions%2C%20v3.0.pdf>.

Additionality – The principle of carbon additionality is that a carbon project should only be able to earn credits if the GHG benefits would not have occurred without the revenue (or expected revenue) of carbon credits. The same principle of additionality can be applied to social and biodiversity benefits.

Attribution – The isolation and accurate estimation of the particular contribution of an intervention to an outcome, demonstrating that causality runs from the intervention to the outcome. That is, attribution demonstrates that benefits claimed by the project (usually *co-benefits*) have been caused by the project and not another phenomenon.

Baseline – See *reference scenario*.

Biodiversity target – Biodiversity features which the project will target in its efforts to achieve net positive impacts on biodiversity. These will usually comprise High Conservation Values.

Causal model – See *theory of change*.

Co-benefits – Benefits generated by a forest carbon project beyond GHG benefits, especially those relating to social, economic, and biodiversity impacts.

Control – In the context of impact assessment for forest carbon projects, an area that does not experience project interventions but is otherwise similar to the project area. Controls are used to monitor the reference scenario and to demonstrate the attribution of outcomes and impacts to the project.

Counterfactual – The outcome that would have happened had there been no intervention or project – i.e., the final outcome of the reference scenario.

Evaluation – The systematic and objective assessment of an on-going or completed project, program or policy, and its design, implementation, and results.

GHG benefits – Any emissions reductions from reducing carbon losses or emission removals from enhanced carbon sequestration due to the forest carbon project activities.

Impact – The positive and negative, primary and secondary, short- and long-term effects of a forest carbon project. Impacts may be direct or indirect, intended or unintended. Impacts result from a chain of inputs, outputs, and outcomes.

Indicator – A measurable variable that reflects, to some degree, a specific monitoring information need, such as the status of a target, change in a threat, or progress toward an objective.

Inputs – The financial, human, and material resources used for a forest carbon project. Most relevant in discussion of outputs, outcomes, and impacts.

Leakage – The geographical displacement of GHG emissions – or social, economic, or biodiversity impacts – that occurs as a result of a forest carbon project outside of the forest carbon area. Leakage assessments must consider adjacent areas as well as areas outside of the project zone.

Measurement, Reporting, and Verification System – A national, subnational, or project-level set of processes and institutions that ensure reliable assessment of GHG benefits associated with real and measurable emission reductions and enhancement of carbon stocks.

Methodology – An approved set of procedures for describing project activities and estimating and monitoring GHG emissions.

Monitoring – A continuing process that uses systematic collection of data on specified indicators to provide indications of the extent to which objectives are being achieved.

Multiple-benefit projects – Projects that generate sufficient environmental and social co-benefits, in addition to GHG benefits.

Outcomes – The likely or achieved short-term and medium-term effects of an intervention’s *outputs*.

Outputs – The products, capital goods, and services that result from a forest carbon project.

Project area – The land within the carbon project boundary and under the control of the project proponent. (The CCB Standards use distinct language for *project area* and *project zone*.)

Project developer – The individual or organization responsible for the technical development of the project, including the development of the PDD, the assessment of social and biodiversity impacts, monitoring and evaluation, etc. Although the term does not necessarily describe a commercial entity, it often refers to an external company that is contracted to do work on the ground.

Project Design Document – A precise project description that serves as the basis of project evaluation by a carbon standard, commonly abbreviated to PDD. (Alternatively, VCS calls this the “project description,” or PD)

Project participant – Under the CDM, a Party (national government) or an entity (public and/or private) authorized by a Party to participate in the CDM, with exclusive rights to determine the distribution of CERs – equivalent to *project proponent* under the VCS. In the voluntary market, project participant is used more loosely to describe any individual or organization directly involved in project implementation.

Project proponent – A legal entity under the VCS defined as the “individual or organization that has overall control and responsibility for the project.” There may be more than one project proponent for a given project. Carbon aggregators and buyers cannot be project proponents unless they have the right to all credits to be generated from a project.

Project zone – The project area plus adjacent land, within the boundaries of adjacent communities, which may be affected by the project. (The CCB Standards use distinct language for *project area* and *project zone*.)

REDD – A system that creates incentives and allocates emissions reductions from reducing emissions from deforestation and forest degradation.

REDD+ – A system that creates incentives and allocates emissions reductions from the following activities: (a) reducing emissions from deforestation; (b) reducing emissions from forest degradation; (c) conservation of forest carbon stocks; (d) sustainable management of forests; and (e) enhancement of forest carbon stocks.

Reference scenario – An estimated prediction of what will happen in a given area without the project. Reference scenarios may cover land use patterns, forest conditions, social conditions, and/or biodiversity characteristics. Also called the “business-as-usual scenario” and the “baseline.”

Starting conditions – The conditions at the beginning of a project intervention. Also called “original conditions” in the CCB Standards and sometimes referred to as the “baseline” in the field of impact assessment. This can, however, lead to confusion, considering that CCB Standards and carbon standards use the same term to describe the “reference scenario” of a forest carbon project.

Theory of change – The hypothesis, as developed by the project design team, of how the project aims to achieve its intended goals and objectives, including social and biodiversity objectives. This is sometimes referred to as the *causal model*.



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