

**Carbon
Accountability
Programme**



carbon insolvency

UK forest carbon: the case for cover







While we have adequate arrangements to manage financial insolvency, we do not have a meaningful framework for dealing with carbon insolvency, in which promised future delivery of carbon benefits does not occur because the delivery organisation has failed.

Due to the ultra long-term nature of forest carbon offsetting projects it is expected that at least some organisations will fail before the full carbon benefit of a project is delivered.

Organisational 'life insurance' associated with forest-project quality standards is, we believe, a vital step towards confidence in forest carbon offsets from afforestation projects.

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International carbon markets

At the COP 15 global climate negotiations later this year forests will move to centre stage as efforts are made to reduce the causes and impacts of global climate change. This is understandable; it is estimated that land use change, including significant elements of forest destruction, accounts for about one fifth of global greenhouse gas emissions – roughly the same as the global transport system. So far forests have not featured as strongly as many would like in climate change agreements despite general acknowledgement that their potential benefits go beyond mere abatement of climate change; important co-benefits include broader ecosystem services as well as the hard-to-quantify value of biodiversity.

The growing international carbon offset market has tempted a number of new enterprises into attempting to create additional forest cover, with varying levels of success. In order to finance the relatively high capital cost of forest projects many forest-based credits have historically been sold as ‘future carbon’, credits that promise of future delivery of sequestration. Today future carbon is now somewhat poorly regarded within the credit trading markets as risky and most credits are sold ex-post, that is after verified sequestration has occurred. Nevertheless afforestation linked to the value of sequestered carbon is still a feature of the broader offset landscape in the UK, largely conducted under private treaty.

UK forest carbon projects

Commonly domestic UK projects are put together to satisfy individual stakeholders, typically companies, whose primary driver is a PR-driven need to demonstrate meaningful social and environmental contributions. Companies following this line, usually after extensive due diligence, become financiers to a risky start-up project that depends fundamentally on the future delivery of (primarily) a carbon benefit. While not producing ‘credits’, nevertheless new forest can be claimed by companies as effectively ‘offsetting’ their emissions, and even sold to the public. Such endeavours provide vital additional finance to create new forests, which in the UK are a marginal proposition even when developed for commercial exploitation.

UK afforestation as a climate change mitigation project is complex ultra-long term and generally relatively small scale. Such projects also have unique features when compared to other abatement programmes. A primary difference between afforestation and say, a technology-based greenhouse gas abatement project is the length of the project cycle. In a technology based project, results can be achieved over somewhat restricted timescales well suited to the normal career cycle of the implementing executive. Reductions in GHG emissions, assuming an adequate baseline and suitable metric, can be demonstrated over 2-5 years post-implementation. Afforestation projects, on the other hand, take decades to mature and begin net sequestration.

Not only does this put the benefit of afforestation projects well beyond the reach of the normal executive performance-based reward system, but there is a second, key issue: these timescales are beyond the typical lifecycle of an organisation. In the UK, 40% of start-ups stop trading within four years¹; in the US, statistics demonstrate that 70% of start ups fail within 10 years². This is particularly relevant in the context of COP 15. During the last year, at least 20 carbon offset providers have failed, despite the industry as a whole weathering the economic turmoil somewhat better than (say) many venerable financial institutions. We can be certain that if a deal on forestry is reached at Copenhagen many new organisations will want to try to create financial value both within established offset trading markets and under private arrangements.

¹ UK VAT figures show that 58% of businesses founded in 1995 were still registered after four years. This figure was 59% for 1996; 60% for 1997; 59% for 1998; 56% for 1999; 60% for 2000; 61% for 2001, averaging 59.6%. Please note this data is economy wide and that a company can deregister and still trade however this is rare.



The concern which we wish to highlight and which discussions with industry participants suggest is a valid concern is that inexperienced new businesses will be started with the good intention of developing afforestation projects with due attention to co-benefits. But we expect that over the course of the next 20 years some and perhaps many of them will fail and become insolvent. While we have adequate arrangements in place to manage financial insolvency, we do not have a meaningful framework for dealing with *carbon* insolvency, in which the promised long-term future delivery of carbon benefits does not occur because the resources and infrastructure to make it happen have disappeared.

What redress exists, is it adequate

Of course it is true that some players may be large enough to be able to isolate these problems to a particular entity or geography, and others may be diverse enough to have a mixture of forest and non-forest projects which can to some extent provide a degree of self-insurance. However we would suggest that the nature of forest projects demands a high degree of specialisation and that this situation would not be typical for domestic UK arrangements.

It is also true that generally sequestration projects of this kind have buffers or reserves, in order to provide against the risk that a *particular* project owned by a *particular* organisation may under-perform. In such circumstances, project reserves can be drawn on, or in extremis, a successful project from the same portfolio can be used to deliver the benefit offered by a failed project. This assumes a certain size of organisation, which may at least for a period, remain no more than an aspiration. And it does not help us if the entire organisation fails, since then there is no-one to do the trading off.

We know that there are generally contractual obligations on landowners to replace any carbon that has been lost through catastrophic failures, e.g., forest fire or pest invasion; and in the UK, felling is controlled by licences requiring restocking. But in the event of organisational failure, where will the re-instatement funds come from? In the event of insolvency or bankruptcy minimising loss to financial creditors will be the advisors priority and any means of escaping from such restoration obligations would be sought. Neither is it helpful to place a reliance on covenants, which depends critically on the impact of the loss of forest (or its non-growth) on a neighbour. This anti-nuisance constraint seems a rather light-weight and ineffective means of redress.

While it might be possible to deal with the issue we raise contractually, our understanding is that contracts do not, in general, provide for the transfer of ownership of projects in the event of such a failure; indeed, to whom would they be transferred? A competitor? The carbon benefit buyer, whose expertise lies elsewhere? One organisation that we spoke to has stated that it is prepared to consider how to deal with this in its own contracts, as a result of our raising this concern.

The standards that are available in the market focus on projects, but as this discussion illustrates, the issue is much deeper. Reliance on current standards alone will not provide an adequate insurance to organisational failure and any resulting 'carbon insolvency', even where reciprocal buffers or shared risk pools are created (although this will undoubtedly help). We think that there are some lessons that could be learned from another industry, in which promises of future benefits are made.

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2 Illusions of Entrepreneurship: The Costly Myths that Entrepreneurs, Investors, and Policy Makers Live By. Scott Shane, 2008. Again this data is economy wide. <http://smallbiztrends.com/2008/04/startup-failure-rates.html>

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Lessons from others

When the UK travel package tour industry first began its expansion, it was characterised by many small players trying to succeed in a complex and competitive market. Some failed, either while holidaymakers were abroad – leaving them with no means to get home – or before they got to go away. The industry created a voluntary scheme to try to prevent the reputations of the best being sullied by such events, in which an insurance bond was required from each participating provider to ensure that – if they were to go insolvent – the benefits promised could be delivered (even if that meant a refund), administered through a trust company. The trust company provided the means by which the necessary administrative arrangements could be executed. It is this administrative mechanism which is so far absent in relation to carbon insolvency.

We know the travel industry arrangements today as the ATOL (Air Tour Operators Licence) and best advice today is to always use an ATOL bonded provider. The size of an operator's bond depends on a number of factors, including its profitability, size, anticipated future activity, track record and the quality of its management. How the bond is calculated and provided is therefore complex, but while it provides a useful comparison, the calculation is in any case is less the issue: the onus is placed on the provider to have adequate insurance in place to cover the possibility of its own failure. The ATOL logo signifies that the relevant insurance is held, and provides a measure of confidence to the end purchaser that they will get what they have paid for.

For forest carbon determining an appropriate value bond is a technically achievable objective, and could be based (for example) on the volume of forward carbon under contract, less the volume actually delivered to date. The promised volume of carbon is both quantifiable (based on the arrangements that the seller has with the buyer) and capable of valuation (because we now have an increasingly liquid carbon market). To reduce the cost of the premium the bond would not need to cover the costs of replanting trees on the same site but could buy and retire offsets on the open market.

Bonds are used elsewhere to deal with environmental issues, for instance in order to ensure that environmental restoration takes place after degradation occurs as a result of business operations³. And yet, curiously, the idea has not yet surfaced in relation to climate change, a far greater environmental threat than any other that we face. We think it is time that it should. In fact, we know of at least one forest project developer which operates in exactly this way: a percentage of turnover is invested in insurance projects elsewhere in order to provide a 'belt and braces' level of delivery assurance. This is in addition to project buffers, and remarkably similar to the underlying idea of the ATOL bond. We think this best practice approach should become the norm.

3 Asian Development Bank: <http://www.adb.org/water/topics/dams/dams0915-15.asp>; for further discussion of the role of mandatory insurance, see <http://www.law.duke.edu/shell/cite.pl?12+Duke+Envtl.+L.+&+Pol'y+F.+293>



The value of a bond

In practice, the bond could be implemented voluntarily, ideally as a condition of use of one or more quality standards and associated with a readily identifiable logo.

Our research with market players has supported our view that a project accredited by a standard that includes ATOL-like insurance would provide significantly greater consumer confidence and therefore attract a price premium from those companies choosing to mitigate climate change through afforestation projects.

The industry should (and based on our research, would) welcome the opportunity to create a barrier to entry that protects incumbents from weak and high risk competitors, while creating opportunities for robust well capitalised organisations to enter the market. They should also welcome the price premium that would be expected from this additional level of delivery assurance.

In our view, the bond should be held by any participant offering forest based projects for sale, whether to an organisation or the general public. It would be necessary for the industry to create an appropriate authority such as a trust company to manage affairs in the event of a failure. While ATOL is solely UK-based, there is no reason in principle why a voluntary scheme could not have a global reach.

Members of the public purchasing offsets through other organisations – like airlines - would benefit from knowing at a glance that every possible risk is being addressed, and those partnering to offer such offsets would benefit from the clear reputation premium such assured projects would provide. Companies entering into private bargains would benefit from reduced costs associated with due diligence, and the knowledge that they can tell their stakeholders that the projects in which they invest are designed to stand the test of time, reducing the risk associated with investment and gaining persuasive evidence that the initiative is more than low cost lip-service.

Conclusion

Dissatisfaction with the quality of forest based projects, particularly in the eyes of the public, has grown over the last few years. Nevertheless there is a broad recognition that forests are vital to the climate change debate, either as source or solution. Robust and quality afforestation projects are desirable, which must be provided through enterprises that can guarantee their permanence. The length of the project cycle presents risks which are not present in many other kinds of climate change mitigation project. Mandatory organisational 'life insurance' associated with forest project quality standards is, we believe, a vital step towards confidence in forest offsets.

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Carbon Accountability Programme

We promote accountability in environmental claims to improve business and personal confidence in low-carbon products and markets.

Our work will help businesses to be confident that their green choices are effective and rewarded

Our findings will help consumers have confidence in the actions they take to reduce carbon

Our partnerships with business and NGOs will help to develop carbon accountability solutions with consistency and transparency

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