fpep
Forest Policy and Environment Programme

Forestry Briefing 14

December 2007

The implications of carbon financing for pro-poor community forestry

Cecilia Luttrell, Kate Schreckenberg and Leo Peskett

The emergence of new financing mechanisms associated with the rise of carbon markets brings potential for increased investment in forestry. This paper explores the implications of these mechanisms for community forestry and suggests ways in which such finance may contribute to the pro-poor outcomes of community forestry. The paper also provides an opportunity for those working on the design of carbon financing mechanisms to draw on the experience of community forestry in structuring appropriate benefit systems. The main focus of the discussion is on 'Reducing Emissions from Deforestation and Forest Degradation' (REDD).

REDD has the potential to act as a pro-poor influence in the regulation and distribution of benefits associated with community forestry PHOTO by Cecilia Luttrell

Policy conclusions

1. Carbon financing offers the potential for new forms of financing for community forestry.
2. The primary aim of carbon financing is to offset emissions and not to guarantee pro-poor development. Therefore ensuring these new forms of financing maintain or augment pro-poor outcomes of community forestry present some challenges; it requires some attention to the design and process of both the funding mechanisms and the institutions surrounding community forestry.
3. Forestry schemes associated with REDD are likely to involve a different funding and governance structure from existing schemes funded under CDM or the current voluntary market. The coordinated approach of REDD presents the potential for the increased redistribution of benefits and alignment with local government structures.
4. Clarification of the legal and ownership status of carbon is important to ensure security of contracts and the accurate prediction of returns. Related to this is the need for resolution of the legal status (private or public good) of community forests and their products.
5. The transaction costs of carbon forestry are likely to be high; therefore the matching of benefits to the transaction costs and operational requirements is advisable.
6. The way in which benefits or incentives from carbon financing are targeted is of relevance for poverty outcomes. Benefits may be more effectively targeted through the provision of community services or employment opportunities than through direct financing.
7. The high level of technicality in the carbon market will require community producers to work with intermediaries more than is the case with the marketing of other forest products. To foster positive relationships with intermediaries, information about the nature of the market and the opportunities offered by carbon financing should be made available in an accessible manner.
8. Attention to the development of oversight mechanisms over the carbon value chain is important due to the potential high returns and the international nature of the financing; this is likely to involve inputs from civil society.

Forest Policy and Environment Programme

FPEP conducts independent policy-opriented research on tropical forestry issues, seeking to inform policy change in ways which improve the livelihoods of the forest-dependent poor, whilst also securing the long-term future of forest resources.

odi
Overseas Development Institute

Introduction

Carbon offset credits are tradable units which can be bought and sold in carbon markets. They can be purchased by individuals or organisations or governments from schemes (including but not only forestry schemes) that claim to reduce greenhouse gas concentrations. Currently the trading of forestry carbon offsets can occur through two types of mechanisms

1) The Clean Development Mechanism (CDM), which was negotiated under the Kyoto Protocol and is internationally regulated and follows a set of standard procedures;
2) Voluntary markets where trading takes place outside the Kyoto Protocol.

Forestry has not been popular under the CDM due to high transaction costs and other restrictions. To date, most funding for forestry has occurred through voluntary markets. More recently, there has been increasing international debate over the potential for 'Reducing Emissions from Deforestation and Forest Degradation' (REDD) and the imminent implementation of some pilot schemes with multilateral funding. The REDD mechanism would involve payments for the maintenance of carbon stocks in forests through the avoidance of deforestation or the reduction of degradation (Peskett et al 2006a). One of the main differences, in terms of outcome, between REDD and CDM, is scale. REDD is envisaged to operate with rewards accruing nationally or sub-nationally. This is in contrast to the CDM, and most of the voluntary schemes, which operate on a smaller scale and are project based.

What are carbon investors looking for?

In order to create carbon credits, several components are required. These include:

- The need to prove that the activity is additional to 'business as usual' (additionality);
- The project will not cause negative carbon impacts elsewhere (leakage);
- That reductions are permanent;
- The ability to account for reductions and to report that the above have been achieved.

As well as these minimum technical requirements, buyers are most interested in investments which have a low risk profile. Types of risk from an investor's perspective can be grouped into:

- Project risk (i.e. the risk of failure);
- Regulatory risk (such as the effect of the EU Emissions Trading Scheme not allowing forestry credits to be traded over the past few years);
- Governance risks (in-country difficulties for project developers in running projects).

The high priority that carbon investors place on low levels of risk does not immediately rate community forestry as an attractive investment option, for reasons of both tenure and scale. Private tenure is typically seen as one means of controlling risk, as liability responsibilities are clearer than in a collective situation. As a result, investors may impose additional requirements on community forest user groups such as the need for financial plans or guarantees to mitigate higher perceived risk. Such requirements can generate high transaction costs. These are more easily overcome in larger scale 'production' systems than in small-scale pro-poor ones. However, not all community forest enterprises operate on a small scale. In contrast to private smallholder forestry, the 'shareholder-enterprise' model of some community forestry user groups (seen for example in Mexico [Klooster, 2000] and Guatemala [Nittler and Tschinkel, 2005]) does present the potential for economies to scale which may be able to absorb these risk-mitigating requirements.

Can carbon and poverty objectives be combined, or is this overloading the mitigation agenda?

The primary aim of carbon financing is to offset emissions and not to bring about pro-poor development. Apart from certain niche markets, the voluntary market is unlikely to be driven primarily by poverty reduction goals. Not only are voluntary markets heavily oriented to supply-side interests, but the high costs of pro-poor strategies present a disincentive to the involvement of the poor. For many of those involved in voluntary projects, the addition of a 'socially responsible' element represents an unwelcome additional constraint on what is primarily a market-based instrument. This tension has implications for standard setting in the voluntary market – specifically, the question of whether impact standards should merely guarantee that projects 'do no harm' or should go further to ensure that projects deliver positive development benefits (Peskett et al., 2007).

In terms of REDD, it is as yet unclear whether the mechanism will contain any kind of obligation for development outcomes to be met. In principle, sovereignty issues may make any such international stipulation difficult. In addition, the dominance of the international conservation lobby in the debate raises the question over the degree to which production forestry will be permitted under REDD. One lesson from the experience of community forestry is the importance of poverty reduction as an explicit objective from an early stage if pro-poor outcomes are to be attained. Attempting to graft on poverty reduction to other objectives (for example, conservation, sustainable forest management) is unlikely to satisfy any constituency.

Increasing financial investment to forestry alone does not necessarily result in pro-poor outcomes. The fear that poor people may be actively disadvantaged by community forestry initiatives might also apply to carbon forestry. Poverty outcomes from community

forestry vary according to a variety of structural and process factors (Schreckenberg et al., 2007; Moss et al., 2005), and a number of these factors are relevant to understanding how carbon finance may affect the pro-poor outcomes. These include the need for:

- Ownership and tenure;
- Benefit-sharing mechanisms and levels of equity;
- Transaction costs;
- The role of intermediaries; and
- Institutions appropriate for the value of forest products.

Clarity over ownership and rights to benefit from carbon

One of the main challenges in carbon forestry is that of formulating international contracts over a product which has an ambiguous legal definition, and is governed by various legal standards which are firmly under national sovereignty regimes. The importance of clear and secure rights over the benefits is a strong theme in the literature on community forestry, and would seem also to be a requisite for pro-poor outcomes in carbon forestry. However, lack of secure rights is one of the major uncertainties facing buyers and producers in the carbon market, and this represents something of a countervailing force.

The question of who owns carbon reductions has not been much debated at the international level and where it has, it has been assumed that the answer will be determined by pre-existing laws in the country concerned. In strict legal terms this is obviously the case, though it leaves unanswered the issue of equity. Tenurial uncertainties under REDD have the potential to create additional difficulties. These may include the danger that customary rights will be violated in the interests of inward investment; the risk of abusive contracts perhaps of a long-term nature; and land speculation by investors to the detriment of the community interest (Griffiths, 2007). Evidence from a number of existing carbon forestry projects points to the dangers of communities allowing themselves to become locked into unfavourable legal agreements, unaware of the risk of low returns, legal obligations, penalties and high technical requirements (Boyd et al, 2007).

At the same time, the experience from community forestry warns that formalisation is not always a positive step for pro-poor outcomes. For example, in Cambodia, the legalisation of community forestry has, in some cases, resulted in more restriction than the informal agreements that preceded them. Similarly, in the case of joint forest management in tribal areas of Orissa, effective indigenous systems have been lost with the formalisation of the process by the state. In Cameroon there are only four forms of legal entity under which community forests can be registered, none of which is designed for community forestry (Oyono et al., 2006).

The right to commercial benefit: carbon as a private or a public good?

One issue which will be increasingly relevant as the potential for returns from forest carbon increases, is the nature of the right to benefit from carbon mitigation. A crucial factor in determining the pro-poor outcome of community forestry is the nature of the rights under which forest products fall. The right to collect or benefit from forest products does not necessarily imply full ownership. This distinction is important in terms of the activities which are legally permitted; in many instances of community forestry, for example, commercial exploitation is forbidden or discouraged through high taxation. Such proscriptions reflect the unresolved legal status of forest resources (i.e. whether community forest resources remain a national public good). If they are still to be considered national public goods, the right of community forestry users (rather than more distant users) to make a profit from commercial use is undermined. Such dilemmas are clearly pertinent to the case of carbon financing of community forestry activities.

In practice, such problems may not be immediately apparent, but there may be value in addressing them at an early stage. In the first stages of community forestry in Nepal for example, only degraded lands were handed over to communities and there was little need for a discussion about the right of communities to benefit commercially. The spread of community forestry to the higher value areas of the Terai (i.e. the more productive alluvial plains) was accompanied by the imposition of taxes on surplus timber sold. This policy decision imparted a clear message that forest resources were perceived as a public good, a decision which led to heavy public debate and legal action by FECOFUN, the Nepal community forestry user group-federation. Similarly, in New Zealand (from 2002 to 2007), the government retained ownership over carbon benefits from plantations on both public and private land, resulting in a high financial disadvantage to forest owners and forest carbon investors (Peskett and Harkin, 2007). There is also a risk of 'double standards' being applied (Larson and Ribot, 2007), where community forest user groups are only given rights for non-commercial use, while rights for commercial use of the same resources are given to companies or local government. The high potential returns available from carbon financing may add to this tension and there is a need for clarity in policy over the right to commercial benefit before investments are made.

Benefit-sharing mechanisms: targeting the poorest

Resolution of the debate over who has the right to 'own' carbon is crucial for determining the level at which decision making over benefit sharing will

take place. It is not yet clear at what level REDD will operate, but it will probably involve a degree of centralised control (discussed in Peskett and Harkin, 2007). This would have a number of implications for pro-poor outcomes. These include:

- How revenues will be channelled to producers;
- How carbon baselines and targets will be devolved to producers; and
- Whether the government will play the role of the seller, will rather act as a buyer from a sub-national devolved payment system, or simply as regulator and/or broker.

The way in which benefits or incentives are targeted is a concern for the welfare of forest dependent poor because of the wide coverage that schemes are likely to have. The experience of community forestry raises some questions and provides some insights into aspects which need to be considered in assessing what form of benefit sharing is most accessible to the poorest:

- Nature of benefits: whether cash or in-kind benefits are of more value? In some cases employment opportunities associated with community forestry may be more beneficial to the poor than direct access to the product.
- Beneficiaries: Whether distribution to a community level is preferable over distribution to the individual? There are many examples of community forestry funds being used for community services but there are also examples where the poorest do not gain access to such services.
- Distribution of benefits: Whether benefit distribution should be equal or equitable? Unless specific action is taken to ensure the needs of the poor are taken into account, they may not be able to utilise equal access rights, e.g. in Nepal many poor people cannot make use of their timber allocation because they cannot pay advance permit fees (Iverson et al., 2006). As a result some community forest user groups are moving towards equitable allocation, a more needs-based approach that provides households with different levels of products they can actually use.

If carbon financing is to benefit the poor then the same three questions will need to be addressed.

Addressing transaction costs

The ability of any project to benefit the poor is also linked to the level of transaction costs. Because of capital constraints, high transaction costs tend to be anti-poor. Transaction costs need therefore to be properly factored in, avoiding over-optimism regarding the extent to which the poor can benefit from initiatives without external protection or support. Should carbon forestry have high costs relative to the returns, there could well be little gain to the communities.

A heavy requirement for verification is one factor that pushes up transaction costs. Skutsch (2005) argues that this can be overcome by use of appropriate, low-cost methods such as self monitoring by communities. The community forestry literature offers the same conclusion and emphasises the need to match transaction costs and organisational requirements to the benefits available.

The role of intermediaries

Carbon financing can offer high returns but the downside of this is high risk for small-scale producers. Any payment which is based on an international market is sensitive to external price fluctuations. This uncertainty, coupled with the inaccessibility of information about the carbon markets and the need for a high degree of knowledge in terms of the technicalities of the issue, will require carbon forestry producers to work with intermediaries and brokers to a larger extent than is the case with timber or NTFP production. Common themes in the community forestry literature are the dependency created by reliance on external players for operational capital, the danger of unfavourable relationships between intermediaries and producers, and the capture of excess profits by the intermediaries. At the same time, there is a body of experience which stresses the importance of intermediaries in accessing otherwise inaccessible markets and providing expertise, equipment and credit upfront (te Velde et al., 2006). Intermediaries are likely to have a particularly crucial role in carbon financing, given the need for heavy upfront investment (intermediary networks may need to be developed to provide this upfront capital), as well as the knowledge intensiveness of the process (for example, about marketing and prices, and the need for progressive policy change). Thus, whatever the risks, the involvement of intermediaries can hardly be avoided. To ensure positive relationships with intermediaries, information about the nature of the market and the opportunities offered by carbon financing should be made available to all interested parties, and in an accessible manner.

Matching institutions to changing forest values

The rise in forest 'value' that carbon financing may bring increases the risk of elite capture and hence the need for robust local institutions to ensure that the benefits are legitimately distributed. The experience of community forestry shows that unless accountable institutions are in place, an increase in the value of forest 'products' can lead to corruption. Legislation and procedures which may have been developed in one area or context may need fine-tuning before they can be applied in a different one, even within the same country. Thus, many of the procedures applied in the Middle Hills area of Nepal are not appropriate in the Terai, due to the way in which institutional structure has developed to deal with low value subsistence products and not to mediate the problems associated with the potentially high returns from timber production. Civil society oversight is likely

to be particularly crucial to ensure accountability up and down the value chain. Such oversight may be even more important in the case of carbon forestry due not only to the high value of the commodity, but also to the international nature of the financing and the technicality of the debate.

Conclusions

So what does this mean for the potential of carbon financing for pro-poor community forestry? The CDM has not proved the panacea which many hoped for, and the scale of the benefits that voluntary market financing can bring are as yet unclear, particularly in relation to development benefits. REDD is as yet untested in this area.

The opportunity which REDD offers for increasing the pro-poor outcomes from community forestry is that it represents a very different funding and governance structure from existing carbon financing mechanisms. The degree of central coordination which is likely in REDD offers some advantages: the manner in which community forestry has developed in most countries is through projects (often delinked from local government) that are intended to coalesce into national programmes. In many cases it is only at this point of coalescence that crucial issues such as benefit redistribution, alignment with government structures and replicability are addressed. A high level of central coordination from the outset should allow for such issues to be taken on board at an earlier stage. REDD therefore has the potential to act as a pro-poor influence in the funding, regulation and distribution of benefits associated with community forestry. Recent experience would however warn of the need for a pro-active approach if equity goals are not to be marginalised.

Cecilia Luttrell is a Research Fellow with the Forest Policy and Environment Programme (FPEP) at ODI. Leo Peskett is a Research Officer with FPEP. Kate Schreckenberg is a Research Associate at ODI.
For correspondence please contact:
c.luttrell@odi.org.uk
l.peskett@odi.org.uk
k.schreckenberg@odi.org.uk

References

Boyd, E. M., Gutierrez and M. Chang (2007) *Small-scale forest carbon projects: adapting CDM to low-income communities*, Global Environmental Change Volume 17: 2.

Griffiths, T. (2007) 'Seeing RED? Avoided Deforestation and the Rights of Indigenous Peoples and Local Communities', FPP, Moreton-in-Marsh, UK.

Iversen, V., Chhetry, B., Francis, P., et al.(2006) *High value forests, hidden economies and elite capture: evidence from forest user groups in Nepal's Terai*, Ecological Economics, 58(1): 93-107.

Klooster, D. (2000) *Institutional Choice, Community, and Struggle: A Case Study of Forest Co-Management in Mexico*, World Development, 28(1): 1-20.

Larson, M. and Ribot, J. (2007) *The poverty of forestry policy: double standards on an uneven playing field*, Sustainability Science 2:189–204.

Moss, C., Schreckenberg, K., Luttrell, C. and Thassim, L. (2005) 'Participatory Forest Management and Poverty Reduction: a review of the evidence'. Report prepared for the ARPIP Start-up workshop, Nairobi

Nittler, J. and Tschinkel, H. (2005) 'Community forest management in the Maya Biosphere Reserve of Guatemala: protection through profits', USAID and SANREM, University of Georgia.

Oyono, P. R., Ribot, J. C. and Larson, A. M. (2006) *Green and Black Gold in Rural Cameroon: Natural Resources for Local Governance, Justice and Sustainability. Environmental Governance in Africa*, Working Paper Series 22, World Resources Institute, Washington, D.C., USA.

Peskett L, Brown D and C Luttrell (2006) *Can payments for avoided deforestation to tackle climate change also benefit the poor?,* Forest Briefing Paper no.12, Overseas Development Institute, London.

Peskett, L, Luttrell, C. and Iwata, M. (2007) *Can standards for voluntary carbon offsets ensure development benefits?,* Forest Briefing Paper no.13, Overseas Development Institute, London.

Peskett, L. and Harkin, Z. (2007) *Risk and responsibility in REDD*, Forest Briefing Paper no. 14, Overseas Development Institute, London.

Ribot, J. (1996) *Participation Without Representation: Chiefs, Councils and Rural Representation*, Cultural Survival Quarterly. Fall 1996.

Schreckenberg, K., Luttrell, C., Zorlu, P. and Moss, C. (2007) 'A way out of poverty? A review of the impacts of PFM on livelihoods', Keynote paper, First National Participatory Forest Management Conference, Kenya 6-8 June.

Skutsch, M. (2005) *Reducing carbon transaction costs in community based forestry management*, Climate Policy 5:433–443,

Te Velde, D.W., Rushton, J., Schreckenberg, K., et al. (2006) *Entrepreneurship in value chains of non-timber forest products*, Forest Policy and Economics 8(7): 725-741.

Overseas Devlopment Institute

111 Westminster Bridge Road, London SE1 7JD

Tel +44 (0)20 7922 0300

Fax +44 (0)20 7922 0399

Email forestry@odi.org.uk

Forestry Briefings Series

Series Editor:

David Brown

Administrative Editor:

Francesca Iannini

Forestry Briefings present objective information on important development issues. Readers are encouraged to quote or reproduce material from them for their own publications, but as copyright holder, ODI requests due acknowledgement and a copy of the publication.

This and other Forestry Briefings are available from www.odifpep.org.uk