Forest Carbon Partnership Facility (FCPF) Operating Arrangements under the Carbon Finance Mechanism Issues Note

February 9, 2011 (revised)[1]

The current Issues Note highlights technical aspects of the Carbon Fund. This note is based on the original Information Memorandum of the FCPF that was discussed in the design phase of the FCPF in 2007-2008.[2] Each section of this Issues Note corresponds to a section of the original Information Memorandum, which it amplifies or clarifies.

The bulk of this Issues Note was discussed during the design phase of the FCPF in 2006-2008, and reflects inputs from meetings of entities interested in the Carbon Fund (in Washington, London, Frankfurt, Bonn and Cancun) held over the course of 2009-2010, in Participants Committee meetings (PC4, PC5, PC6 and PC7), and exchanges with Indigenous Peoples and civil society in Washington and Accra. This Issues Note also takes into account the Cancun Agreements, specifically the outcome of the work of the Ad Hoc Working Group on long-term Cooperative Action under the UNFCCC, as presented in Cancun in December 2010.[3]

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[1] The Issues Note version of December 22, 2010 contained an error in Section 11, which has been corrected in this version.

[2] The Information Memorandum was first issued in December 2007 and revised in June 2008 prior to the start of operations of the FCPF. It has been available in English, French and Spanish on the FCPF website at http://www.forestcarbonpartnership.org/fcp/node/14.

[3] The outcome of the work of the Ad Hoc Working Group on long-term Cooperative Action is available at http://unfccc.int/files/meetings/cop_16/application/pdf/cop16_lca.pdf.

1. Emission Reduction Definition

The Carbon Fund will deliver Emission Reductions (ERs) from activities that reduce emissions from deforestation and forest degradation, conserve forests, promote the sustainable management of forests, and enhance forest carbon stocks in developing countries (REDD+) to the Carbon Fund Participants. The ERs are all the rights, titles, and interests attached to a tonne of ER.[4]

2. Emission Reduction Creation

A REDD Country Participant will be eligible to submit an ER Program for consideration for a potential Emission Reductions Payment Agreement (ERPA) with the Carbon Fund.

The process will be as follows, noting that the various steps are not necessarily sequential:

1. A REDD Country Participant (through its authorized representative, e.g., its national REDD+ committee or responsible institution) submits an ER Program to the FMT, using the ER Program Idea Note (ER-PIN) template;
2. The FMT verifies that the proposed ER Program meets the following requirements:
    a. The ER-PIN template has been duly completed;
    b. The entity submitting the ER Program is from an FCPF REDD Country Participant and authorized to submit the ER Program. If an ER Program is submitted by another entity than the national government, the FMT verifies that the submitting entity is authorized by the national government;
    c. The proposed ER Program meets the ER Program selection criteria described in Section on Types of Emission Reductions Programs below, or as determined by the Carbon Fund Participants;
3. The FMT liaises with the REDD Country Participant to clarify any issues and obtain a commitment giving the Carbon Fund right of first refusal over the ER Program or a part of the Program's ERs for a given period of time;
4. If the proposed ER Program meets the requirements listed in point 2 above and the Carbon Fund has acquired right of first refusal, the FMT submits the ER-PIN to the Carbon Fund Participants and posts it on the FCPF website;
5. The Carbon Fund Participants may request the FMT to establish an Ad Hoc Technical Advisory Panel (TAP) to assist them in reviewing the ER-PIN;
6. The Tranche Participants make their decisions regarding inclusion of the proposed ER Program into their portfolio (see Structure and Governance Section below), taking into account the TAP's ER-PIN review and other relevant comments;
7. If the ER Program is included in the portfolio of either Tranche, the Participants in that Tranche approve a budget allocation for the preparation of a carbon finance transaction based on the ER Program;

[4] It is important for the Trustee to ensure that the ERs acquired by the Carbon Fund are free of dispute and the legal title to the ERs is transferred to the Trustee in accordance with the ERPA. However, the definition relates to the ERs only. In particular, it does not entail any rights, titles or interests to land and territories. A similar definition is used in other Carbon Funds managed by the World Bank, e.g., the BioCarbon Fund.

8. The Trustee sends a Letter of Intent notifying the submitting country of the Tranche Participants' intention to consider the ER Program or a part of the Program's ERs for a potential ERPA with the Carbon Fund;
9. The FCPF Participants Committee, based on the information available (Readiness Package and other relevant information such as readiness progress reports and the ER-PIN itself), and possibly using the assistance of a TAP, assesses whether the submitting country has made sufficient progress towards REDD+ Readiness[5] to enter into an ERPA with the Trustee of the Carbon Fund;
10. The World Bank performs its due diligence as required by the applicable Operational Policies and Procedures, including on environmental and social aspects, and in accordance with the standard internal procedures[6]. The World Bank also advises the submitting country on ways to improve the quality of the ER Program during design and/or implementation, as appropriate[7];
11. The REDD Country Participant continues to develop the ER Program, based on inputs received from various parties, as appropriate, and submits its final ER Program document to the FMT;
12. Based on the Pricing/Valuation Approach and the General Conditions for ERPAs, which will have been adopted by the Participants Committee, the Trustee drafts an ERPA for this particular ER Program, which is sent to the submitting REDD Country Participant and the relevant Tranche Participants. To the extent possible, the Tranche will only commit to paying for a fraction of the ER potential of the ER Program, leaving room for other interested entities to participate in one or several separate transactions. This (these) separate transaction(s) could include Participants from either Tranche looking to negotiate an additional, separate ERPA;
13. The REDD Country Participant and relevant Tranche of the Carbon Fund come to an agreement on the terms of the ERPA;
14. The REDD Country Participant or its approved entity and the Trustee of the Carbon Fund sign the ERPA;
15. The REDD Country Participant or its approved entity implements the ER Program and reports on performance, in particular ERs generated, on an annual basis or at a frequency to be agreed;
16. In the absence of an international or other compliance regime, as applicable, an independent reviewer approved by the Participants Committee assesses the country's performance report;
17. The Trustee supervises that the ER Program is in compliance with the applicable Operational Policies and Procedures and ERPA provisions, in accordance with the applicable carbon finance guidelines;
18. Based on the independent reviewer's verification report, and subject to applicable Operational Policies and Procedures and ERPA provisions being complied with, the Trustee of the Carbon

[5] This assessment must be available before an ERPA is signed, and earlier if possible. The Readiness Package and readiness progress report are documents produced as part of the Readiness Fund processes. For countries that intend to undertake sub-national REDD+ activities, this assessment considers the country's approach to ensuring that these sub-national ER Programs are consistent with the country's existing or emerging systems (please see Section on Types of Emission Reductions Programs below).

[6] These include the internal World Bank Carbon Finance Operational Processing and Review Guidelines, Guidelines on Due Diligence Aspects of Carbon Finance Operations and the Guidelines on Supervision of Carbon Finance Operations.

[7] The World Bank may provide advice to the REDD Country Participant early on based on the ER-PIN but must have concluded its due diligence before an ERPA is signed.

Fund makes payments to the REDD Country Participant or entity designated in the ERPA, in accordance with the ERPA provisions; and

19. The Trustee of the Carbon Fund accounts for the ERs delivered to the Tranche of the Carbon Fund and allocates a *pro rata* share of ERs to each Tranche Participant through the World Bank's Carbon Asset Registry System.

The availability of Carbon Fund documents is determined in accordance with the World Bank's Access to Information Policy.

3. Types of Emission Reductions Programs

It is an objective of the FCPF Carbon Fund that it will be able to review a diversity of ER Programs depending on country circumstances and preferences. Interventions might range from forest policies, measures and investments (such as community forestry or forest law enforcement) to non-forest policies measures and investments (such as land tenure reforms or intensification of agricultural activities in buffer zones). An ER Program might include a variety of different interventions leading to ERs. It is also important to highlight that drivers of deforestation and forest degradation are often located outside of the forest sector such that not only policies and measures in the forest domain are relevant to achieve the desired benefits.

Assuming the target capitalization level of approximately $200 million, which was authorized in September 2007 by the World Bank's Board of Executive Directors, the Carbon Fund intends to support about five ER Programs undertaken by FCPF REDD Country Participants that have achieved, or made considerable progress towards, REDD+ Readiness. The final number of ERPAs entered into by the Carbon Fund will depend on capitalization, preparation and transaction costs, the number of ERs expected to be generated by each ER Program, portfolio diversification and the learning value provided by individual Programs.

REDD Country Participants may, on a voluntary basis, submit an ER Program to the Carbon Fund with a view to entering into an ERPA.

The following criteria will apply to the selection of ER Programs into the portfolio of the Carbon Fund. The ER Program will need to demonstrate the following characteristics:

1. Be submitted by the governments or government-approved entities of countries that are FCPF REDD Country Participants, i.e., countries that were selected into the Readiness Mechanism of the FCPF;
2. Be based on performance, i.e., payments for ERs relative to an agreed reference emission level (REL) and/or forest reference level (FRL)[8]. Although the Carbon Fund might provide some advance payments for future ERs (see Section on Risks and Risk Mitigation below), it will not provide finance for investments. Programs such as those supported by the Forest Investment Program (FIP), the Global Environment Facility (GEF), the Congo Basin Forest Fund, the UN-REDD Programme, the World Bank, other multilateral and bilateral initiatives, government resources, private investments, are increasingly providing specific funding possibilities to fill the REDD+ financing gap of the readiness and investment phases. The Carbon Fund may cooperate with and piggy-back on programs under these initiatives. Also, the expectation of future incentive payments that comes with a signed ERPA may in some cases be used to access up-front financing

[8] The reference emission level (REL) is the amount of gross emissions from a geographical area estimated within a reference time period; the forest reference level (FRL) is the amount of net/gross emissions and removals from a geographical area estimated within a reference time period.

from other sources than the Carbon Fund, e.g., through monetization of, and access to credit based on, expected future ER deliveries;

3. Generate high-quality and sustainable ERs (including environmental and social benefits, and minimization of the risk of non-permanence)[9];
4. Be consistent with emerging compliance standards under the UNFCCC and other regimes, as applicable;
5. Be based on transparent stakeholder consultations;
6. Use clear and transparent benefit-sharing mechanisms with broad community support, so that REDD+ incentives are used in an effective and equitable manner with the objective to further tackle deforestation and forest degradation. In some cases, the national government can be the best actor to enact and implement the necessary policy changes and regulations. But many changes will also require the involvement of indigenous peoples, local communities and the private sector, in which case these stakeholders or rights-holders would expect to partake in the REDD+ activities and the corresponding carbon revenues (or alternative financing or support) in recognition of their contributions. In other cases, indigenous peoples, local communities and the private sector would be the primary actors implementing the ER Programs and thus expect to be the principal beneficiaries of ERPA payments. These arrangements will have to reflect the assessment of the drivers of deforestation and forest degradation. Adequate governance and financial management arrangements for a transparent benefit sharing will need to be in place prior to the effectiveness of the ERPA; and
7. Generate learning value by testing and demonstrating different approaches that are proposed by REDD+ countries, and learn from them in order to inform the international community on their feasibility.

For sub-national ER Programs, these should also:

8. Be undertaken at a significant scale, e.g., at the level of an administrative jurisdiction within a country or at the national level, in line with the proposed national REDD+ management framework;
9. Be consistent with the (emerging) national REDD+ strategy and recognized as such by the appropriate national authority;
10. Demonstrate capacity to measure and report on ERs. The system should be consistent with the (emerging) national REDD+ MRV system;
11. Be consistent with the national REL/FRL, or with the national approach establishing the REL/FRL;
12. Be integrated in a national institutional framework that will manage and coordinate sub-national programs; and
13. Provide for an assessment of and measures to minimize the risk of displacement of emissions (leakage), reversals (non-permanence) and other relevant risks.

[9] Additional work may be required in a number of areas to achieve greater clarity on what constitutes a 'high-quality' ER. In particular, clearer carbon accounting principles for sub-national ER Programs seem necessary.

4. National vs. Sub-National Implementation

Whether to implement REDD+ at a national or sub-national level is the sovereign decision of each country and should take into account several factors, including:

- National forest law and regulations, which specifies who manages, owns, or has rights to, forest land, timber and non-timber forest products, and other forest services and amenities, including the carbon in the biomass and in the soil, and what institutions or political entities are responsible for land-use planning and/or forest law enforcement;
- Lessons from existing forest policies and programs with respect to the sustainable use of forest resources and biodiversity conservation;
- Current drivers of deforestation and degradation, and the current actors of protection against deforestation and degradation;
- Who could effectively reduce deforestation and forest degradation given the proper legal framework and economic incentives;
- Formal and customary property and user rights;
- The need to respect and rely on traditional, including indigenous, knowledge about and practice in forest use and conservation, and to respect the rights of indigenous peoples and local communities; and
- Arrangements for benefit sharing through centralized or decentralized mechanisms.

To the extent feasible, the Carbon Fund's procedures with respect to sub-national ER Programs, in particular the question of how to account for ERs generated by sub-national programs, should be consistent with emerging policy guidance in the UNFCCC, and other national/regional bilateral regimes, as appropriate.

5. Risks and Risk Mitigation

The Carbon Finance Mechanism faces several risks, each of which could affect its performance, but which in the view of the FMT can be mitigated:

- **Financial Risk to the Carbon Fund:** There is a risk that any advance payments made by the Carbon Fund do not lead to the generation of ERs by ER Programs.

  Mitigation of Financial Risk to the Carbon Fund: In principle the Carbon Fund would pay mostly on the delivery of ERs generated by the ER Programs. Advance payments will have to be agreed on a case-by-case basis by the Carbon Fund Participants. However, the same principle of payment on delivery becomes a risk to the REDD Country Participant who undertakes ER Programs and may not be compensated for them in case they do not perform, and may actually deter the country from investing in the first place. This underscores the need for balancing risks and incentives carefully, which may entail the use of some upfront payments, possibly in association with guarantees provided by the REDD Country Participant.

- **Financial Risk to the ER Program**: There is a risk that the ER Program is not fully funded, which prevents it from starting or reaching its full potential. There is also a risk that Program finances (including the revenue sharing mechanism) are poorly managed, which harms the Program's sustainability.

Mitigation of Financial Risk to the ER Program: To cover the investment capital needs, the Carbon Fund intends to rely on other initiatives, including government-sponsored programs, private sector investments, and internationally funded programs, e.g., by the Forest Investment Program (FIP), GEF, UN-REDD Programme, World Bank and other multilateral funding and bilateral initiatives. To assist with the distribution of benefits and sharing of revenues, these topics will be a focus for the Readiness Fund, so that the ER Program under the Carbon Fund will be able to build on Readiness achievements.

- **Delivery Risk:** The performance and impact of the Carbon Fund depends on the performance of the ER Programs from which it will acquire ERs. The delivery risk can be classified in two sub-categories: (i) the ability of the ER Program to effectively reduce emissions and deliver those to the Carbon Fund; and (ii) the ability to credibly measure the ERs generated. If the ER Programs fail on either count, the Carbon Fund will not receive delivery of the expected ERs and will not disburse its capital according to plan.

  Delivery Risk Mitigation: (i) The 'non-effectiveness risk' can be reduced by adopting measures that increase the likelihood that contracted ER volumes will indeed be realized, in particular by: (1) applying tight selection procedures so that only the most promising ER Programs are included in the portfolio, that are fully funded and where good governance is in place; (2) applying conservative estimates of the ER potential of any ER Program; and (3) contracting for only a fraction of the ER potential of any ER Program.

  By reducing the quantities contracted, measures (2) and especially (3) tend to reduce the total ER value to the REDD Country Participant, which is a risk in itself for the delivery of ER. Hence the delivery risk ought to be mitigated without removing the incentive that the ERPA provides to the REDD Country Participant to deliver.

  (ii) The 'inability-to-measure risk' will depend on the standards set for each ER Program. The standards might be different for each ER program and the Carbon Fund will have to adjust the requirements for MRV to the ER Program conditions and elaborate, where needed, an action plan to further develop the MRV capacity of the ER Program up to a satisfactory level.

- **Reversal (Non-Permanence) Risk:** Once the Carbon Fund has received delivery of the ERs and paid for them, there remains a risk that the carbon will be released back to the atmosphere due to future disturbances, which might eliminate previously achieved climate mitigation benefits.

  Reversal (Non-Permanence) Risk Mitigation: Permanence can never be fully guaranteed in the context of land-use change and forestry activities, including REDD+. Nevertheless, some measures may help to mitigate this risk. Fundamentally, the Carbon Fund will seek to acquire ERs from programs for which there is a high level of buy-in from people on the ground, including indigenous peoples and local communities, and where there is good governance, including confirmation of a sound relevant legal framework and good capacity and commitment to enforcement of law. These factors would increase the likelihood that the program is sustained in the long term and the title to the ERs is stable (e.g., local land tenure and titling disputes reduce the stability of ER titles). In addition, the use of reserves (buffer accounts), where a certain portion of the ERs generated by an ER Program could be set aside and maintained as a buffer for possible losses to the carbon asset, can reduce the non-permanence risk if the reserve is set at the appropriate level. The buffer could either be managed by the REDD Country Participant, or be managed at the program level.

- **Displacement (Leakage) Risk**: In the case of sub-national implementation, the risk of leakage represents one of the most important risks to the environmental integrity of an ER Program. A REDD+ activity may simply lead to the pressure on forests being displaced to a different location, with a net lower, zero or even negative effect in terms of emissions. This may apply in particular to drivers of deforestation and forest degradation that are mobile, e.g., logging, but also conversion to agriculture. It has been noted that while domestic leakage may be contained and eliminated, cross-border leakage may still exist and require international cooperation. However, international leakage is not addressed in the context of the climate negotiations (for REDD+ or other mitigation actions).

Displacement (Leakage) Risk Mitigation: Leakage cannot be controlled entirely. It will be important to identify the drivers of deforestation and forest degradation, which will help monitor, quantify and address leakage, including through the establishment of reserves (buffer accounts). In addition, as noted above regarding the risk of non-permanence, the Carbon Fund will seek to acquire ERs from programs for which there is a high level of buy-in from people on the ground, including indigenous peoples and local communities, and where there is good governance, including confirmation of a sound relevant legal framework and good capacity and commitment to enforcement of law.

- **Social Risk:** Indigenous peoples, in particular, fear that the injection of carbon revenues, especially into political systems where their rights are not secured, may cause social disruption or even conflicts.

  Social Risk Mitigation: Participation in the Carbon Fund will be strictly voluntary and will ensure the full and effective participation and consultation of indigenous peoples and local communities. No country participating in the FCPF Readiness Fund will be forced to enter into an ERPA with the Carbon Fund. Moreover, ER Programs should be designed and implemented so as not to cause any disruption of rights or livelihoods to indigenous peoples and local communities, including in the way that benefits may be shared. ER Programs should seek to strengthen rights and livelihoods, as such achievements would actually enhance the performance of ER Programs and permanence of associated ERs.

- **Political Risk**: Government does not have a long-term commitment to REDD+, e.g., it does not establish an adequate MRV system or strategy implementation framework or does not implement relevant policy decisions in the context of REDD+.

  Political Risk Mitigation: The ER Program must be embedded in the readiness process and endorsed by the national authority, which will increase ownership and accountability for the selected ER Program.

- **Regulatory Risk**: Regulatory risks exist for both sellers and buyers. Although there is substantial progress in the international negotiations, the rules and modalities of REDD+ are far from agreed. Only a fully agreed regulatory framework would provide complete certainty to the recipients/sellers and donors/buyers on procedures, principles and standards for REDD+ Programs. Even when the regulatory framework is well known, its implementation may create risks for participants, as has been experienced in the context of the Clean Development Mechanism under the Kyoto Protocol.

  Regulatory Risk Mitigation: One of the FCPF's main strength lies in the fact that the regulatory frameworks of REDD Country Participants will be relatively well known (these frameworks should have been well detailed in relevant Readiness documents). This will entail the REL/FRL, monitoring system, benefit-sharing mechanisms, etc. This demonstration of relevant regulatory requirements will reduce the element of surprise for Carbon Fund Participants relative to regulatory developments in REDD Country Participants. In addition, all ER Programs to be supported by the Carbon Fund need to be endorsed by the REDD Country Participant's national government and need to be consistent with the national framework, which will increase the political ownership of the ER Programs. Regarding the eligibility of FCPF ERs in a future REDD+ compliance framework, the Trustee cannot promise or hold out any expectation related to compliance value for the Carbon Fund's ERs. Moreover, the FCPF cannot and does not intend to interfere with the UNFCCC COP negotiations, including related to REDD+. Nonetheless, concrete experiences garnered by REDD Country Participants and Donor Participants alike in the FCPF may inform the design of REDD+ regimes in the UNFCCC and national jurisdictions.

As the FCPF starts its operation without the availability of compliance standards and/or broadly agreed methodologies for carbon accounting, a series of questions would need to be answered on how to proceed in the absence of externally set rules. While the FCPF will foster the experimentation by countries with different accounting methodologies, some orientation is needed to reliably and transparently quantify ERs generated under the programs that the FCPF will support. In order to address these questions, the FCPF will transparently discuss these questions with the Participants to try to help to guarantee satisfactory results.

6. Non-Carbon Values

It is inherent in the REDD+ types of activities that ERs will vary in quality and benefits, particularly when it comes to non-carbon values.. Some ER Programs may offer, in addition to climate change mitigation benefits, significantly higher non-carbon values (what is also referred to as 'additional benefits' from a climate change mitigation point of view, e.g., livelihoods and benefits) compared to ERs generated by other mitigation programs, in particular for local people and the local environment. How the FCPF may help create, monitor and value additional benefits is a matter largely for the Participants Committee to determine. It is recognized that REDD+ is, first and foremost, a climate change mitigation instrument, and that it should not be expected to solve all the problems arising in forests, including loss of biodiversity, poverty, insecure land rights, etc. However, ER Programs should not cause any harm to people and the environment and, instead, should help to improve social and environmental issues, for such improvements will likely also foster the primary goal of climate change mitigation. For example, REDD+ activities could seek to preserve or improve livelihoods for local communities (e.g., by securing customary property or user rights to their forest land, and their land's timber and non-timber forest products) and use ER revenues to finance programs that would help forest communities to protect their immediate environment. In many cases, unless poverty is reduced and governance is improved, the real driver of deforestation and degradation will not be altered, and few if any REDD+ benefits will be sustained over time. REDD+ could also enhance biological diversity by protecting and restoring natural habitat (e.g., by concentrating ER Programs on biodiversity hot spots).

REDD+ may offer a case of synergy between the climate change mitigation and adaptation agendas. A stronger resilience of ecosystems may entail a greater capacity for climate change adaptation, hence REDD+ may also enhance adaptation to climate change.

Especially in the early days of incentive payments for REDD+, when limited resources are available, the FCPF will seek to give priority to ER Programs that exhibit strong additional benefits for only a marginal increase in costs, if any at all, as those ER Programs tend to have lower performance risks. In this respect, some of the ER Programs selected by the Carbon Fund may be designed to achieve cost-effective ERs while also creating additional livelihood benefits, such as more secure land tenure rights or improved living conditions for indigenous peoples. This would require that indigenous peoples and local communities be properly consulted, that they fully and effectively participate in REDD+ design and implementation, in some cases that their rights be regularized, and that they be able to benefit from incentive payments.

The Readiness Mechanism will help reduce trade-offs, and create synergy, between climate change mitigation and the additional goals of livelihood improvement and biodiversity conservation. Furthermore, the question of the valuation of these additional benefits will be addressed. Should tonnes of carbon dioxide equivalent with higher additional benefits receive higher payments than those with lower benefits? Or should different buyers pay for different services – practically, can distinct sources of financing for the different services embodied in REDD+ ERs (e.g., carbon, water, biodiversity and poverty reduction) be bundled together? It must be emphasized that the improvement of livelihoods, consultations with local stakeholders and the inclusion of social groups in ER Programs represent mitigation measures to the delivery risk and may also be financially rewarded in this respect.

7. Valuation/Pricing

Even though emerging precedents under large scale operations might be of interest for the pricing/valuation of ERs, determining a fair value for ERs under the FCPF is difficult given that there are few relevant precedents to draw from, with the exception of a handful of emerging examples at scale. Most 'REDD+ projects' are undertaken for the voluntary market. Those projects often have very different characteristics than, and are therefore difficult to compare with, large-scale national or sub-national ER Programs. To fill this vacuum, the Participants Committee will establish guidelines on how to value ERs under the Carbon Fund. The objective is to arrive at values that:

1. Entice parties to transact ERs from REDD+ and safeguard their respective interests and rights in a reasonable manner;
2. Represent a transparent mechanism that reflects the risk allocation between parties to the transaction;
3. May use both fixed and variable valuation/pricing options that would allow risk sharing to deal with large price fluctuations and provide the comfort of a fixed price component;
4. Reflect the quality of ERs generated by each ER Program, including non-carbon values as appropriate; and
5. Leave room for adjustments later to align with emerging guidelines under the UNFCCC and other regimes, as applicable, and as demand and supply for ERs from REDD+ activities evolve.

If and when the regulatory risk is reduced in the coming years, the value of ERs might change accordingly. Besides sharing in the potential value/price upside, parties to ERPAs may also decide to share the potential downsides.

The Trustee will flesh out valuation/pricing options to help the FCPF Participants and facilitate the adoption of valuation guidelines.

8. Ad Hoc Technical Advisory Panels

Ad Hoc Technical Advisory Panel(s) (TAPs) may be established by the Carbon Fund Participants or the FMT to provide technical review and advice on various aspects of the ER Programs, or the functions of the Fund. The procedures for establishing and managing TAPs shall follow those described in Section 3.8 for the Readiness Mechanism and already tested in the operation of the Readiness Fund.

9. Safeguards

ER Programs that underlie an ERPA with the Trustee of the Carbon Fund will be expected to comply with the World Bank's applicable Operational Policies and Procedures, including the Environmental and Social Management Framework (ESMF) prepared in the context of REDD+ Readiness preparation work, where applicable, either on their own, or as part of a Strategic Environmental and Social Assessment (SESA), in accordance with the applicable carbon finance guidelines.

ER Programs should also comply with the safeguards included in the outcome of the work of the Ad Hoc Working Group on long-term Cooperative Action.

10. Procurement

Payments for ERs by the Carbon Fund will not be subject to the Operational Policy on Procurement since payments to be made under ERPAs will be for environmental services produced by the REDD Country Participant, namely ERs from REDD+ activities, as opposed the procurement by the country of goods, works and services in the future in the context of World Bank financing.

11. Structure and Governance

The FCPF Carbon Fund is designed to be a public-private partnership. In order to encourage private entities' participation in the Carbon Fund, it has been decided to structure the Carbon Fund into two tranches, with segmentation of the Participants, namely between those who wish their use of ERs to be unfettered (unrestricted) and those who have restrictions on the use of their ERs.

Criteria for determining participation in a given Tranche

The Terms of the Participation Agreement will determine to which Tranche a Carbon Fund Participant belongs. To date, the Trustee has signed two types of Participation Agreements – the first one ('restricted') with specific provisions that the Participant's *pro rata* share of ERs must not be used for compliance purposes nor for resale and will be cancelled by the Trustee upon receipt of the ERs from the ER Programs, and the second one ('unrestricted') with standard terms of participation without any restriction on the use of ERs. A potential Participant signing a restricted Participation Agreement would belong to the restricted Tranche, regardless of the source of funding (e.g., Official Development Assistance or other sources). Conversely, a potential Participant signing an unrestricted Participation Agreement would belong to the unrestricted Tranche, again regardless of the source of funding. It is expected that private sector Participants would therefore belong to the unrestricted Tranche. Government Participants would likely make a choice between the restricted and unrestricted Tranche. The unrestricted Tranche will be named "Tranche A", and the restricted Tranche will be named "Tranche B".

Decision making arrangements within a Tranche

Section 12.4 of the Charter envisages that each Tranche will have its own decision making process when agreement cannot be found among all Carbon Fund Participants. The Charter includes a provision on voting arrangements for the Carbon Fund, namely a simple majority, with each Participant casting a number of votes commensurate with the size of its contribution, namely one vote per $1 million in contribution. However, the Charter is silent on decision-making modalities within a Tranche. Therefore, the decision-making arrangements within a Tranche need to be determined by the relevant Tranche Participants.

It will be possible for each Tranche to adopt its own modalities, including voting arrangements. A Tranche can decide to adopt decisions by consensus, by majority votes, or other voting modalities.

Decisions about inclusion of ER Programs in Tranche A will be adopted by consensus or, if consensus cannot be reached, by two-thirds majority of the votes cast by Tranche A Participants, with this vote being tallied on two dimensions, and a decision to move forward on a particular ER Program requiring approval of a two-thirds majority on both dimensions, as follows:

a. Based on allocation of one vote per Participant, a two-thirds majority of Tranche A Participants will need to vote for the ER Program (thus 'protecting' the interests of Participants with a smaller share and putting them on an equal footing with potentially larger Participants); and

b. The vote will also be measured on the second dimension of the share of capital in the Fund. In this case, a two-thirds majority of Tranche A Participants, as measured by one vote per $1 million contribution, will be required to select the ER Program. (This second dimension will protect the interests of larger Participants and also provide some incentive to increase the size of contributions to the Carbon Fund over time.)

This arrangement for Tranche A will require an amendment to the Charter establishing the FCPF.

Tranche B may adopt a decision-making process similar to that of Tranche A for including ER Programs in its portfolio, or it may adopt another arrangement, to be agreed among Tranche B Participants.

Finally, it is up to the Participants in a Tranche to decide whether to set up a Tranche Committee if required to make decisions effectively.

Interaction between the two Tranches

According to the Charter, each Tranche will operate as a separate trust fund, with its own budgeting and accounting, and its own decision-making processes (if the two Tranches cannot come to joint decisions). In particular, each Tranche will sign its own ERPAs with given ER Programs. Nevertheless, although each Tranche would sign separate ERPAs with each ER Program, it should be noted that both Tranches would follow the same quality and due diligence approaches regarding ER Program selection and the ERPAs of both Tranches would follow the same General Conditions. In other words, there would not be a difference in the quality of the carbon assets created for the two Tranches, though it would be up to each Tranche to decide whether to enter into an ERPA with an ER Program submitted to the Carbon Fund and to agree on some specific commercial terms. The relationship and the arrangement between the two tranches with respect to the ER Programs submitted by the Trustee, including ER distribution, need to be further discussed among the Carbon Fund Participants. The allocation of ERs between the two Tranches could be *pari passu* (meaning each Tranche receives the same number of ERs at each delivery) or *pro rata* (meaning that each Tranche receives an amount of ERs that is proportional to its share of fund capital or share of the ERPA). .

To avoid unnecessary administrative costs and maximize learning value, there will not be separate Tranche meetings unless it becomes necessary. The Carbon Fund Participants intend to make joint decisions across the two Tranches whenever possible.

Observers in Carbon Fund meetings

The meetings of the Carbon Fund should be open to the participation of REDD Country Participant observers to ensure transparency and increase learning value. The Tranche Participants would still retain the discretion to decide whether to close the meetings to observers if necessary.

Once the Carbon Fund becomes operational, the Carbon Fund Participants could develop their rules of procedure, which would regulate, *inter alia*, the participation of observers in Carbon Fund meetings.