Forest Carbon Partnership Facility

Update on the pricing approach

Seventh Meeting of the Carbon Fund (CF7)

Paris, France

June 24-25, 2013

Background: PC policy guidance on pricing methodologies

- Pricing should be fair and flexible, be kept as simple as possible and protect both parties from extreme price fluctuations.
- The ERPA price should be a combination of fixed and floating portions, where feasible
- The ERPA price should be determined by negotiations between the CF Participants, as buyer, and the ER Program entity, as seller, based on their respective willingness to pay or to receive payment. This negotiation process should be informed by relevant information such as market surveys or transaction benchmarks
- The ERPA price negotiation process offers an opportunity for non-carbon benefits to be taken into consideration, although there would be no systematic quantification of non-carbon benefits for pricing under the Carbon Fund.

Follow up actions from CF 6

- Cost analysis and financial viability can be important considerations for Sellers as part of ‘informed negotiations’
  - FMT requested to present the REDD+ Cost Assessment Tool and discuss how capacity building efforts should be organized
  - Covered under separate agenda item (5a)
- Carbon Fund could consider setting up a price range (minimum and maximum price) which would help REDD Countries design their ER Programs and seek other sources of financing
- CFPs need to further elaborate their strategy regarding Advance Payments
  - The FMT was requested to explore tools and insurance mechanisms that may secure Advance Payments

Pricing approach

- Two possible approaches discussed at CF6:

1. Setting a fixed price, negotiated per ERPA, that would
   - provide enough incentive for ER Programs to either continue emission reduction activities or undertake new ones, and
   - pilot a performance-based payment system for Emission Reductions in a cost effective manner

   AND/OR

2. Establishing a mechanism whereby, in case a REDD market develops and the benchmark price of REDD+ ERs surpasses a floor price, the pricing approach could
   - become variable, within a band (i.e., between the floor price and an agreed ceiling price)
   - allow for the buyer and the seller to share the downside and the upside risk (i.e., gradually recover the ERs accrued to the buyer while prices were below the floor or the ERs accrued to the seller while prices were above the ceiling
   - allow for automatic revisions of the floor and ceiling prices in case the market price reaches a significant, unexpected level (i.e., a “sunset clause”)

Pricing approach

- At CF 6 it was agreed that, under current conditions, fixed pricing is preferred
- Decision on having fixed and/or variable pricing will depend on conditions at the time of ERPA negotiations and the possibility of having a relevant price reference to which a floating portion could be indexed
- Consideration of setting up a minimum and maximum price (price range) although the possibility of using a single fixed price across all ERPAs was also mentioned
  - Minimum and maximum price can also act as floor and ceiling if variable pricing approach would still be considered

Topics for discussion on pricing

- Do CFPs want to discuss setting a maximum and minimum price?
  - Are CFPs willing to express their willingness to buy at a maximum and minimum price?
  - What kind of information is required to determine maximum and minimum price?
  - If ERPA price negotiation process offers an opportunity for non-carbon benefits to be taken into consideration (with no systematic quantification of non-carbon benefits for pricing under the Carbon Fund), should the maximum and minimum price consider non-carbon benefits or should this be considered separately depending on the specific ER Program?
- What are the circumstances under which CFPs might want to revisit the use of fixed and/or variable pricing for ERPAs?
  - If this is based on changing market circumstances, would this affect existing ERPAs with a fixed price?

Tools and insurance mechanisms that may secure Advance Payments

- FMT initiated discussions with Multilateral Investment Guarantee Agency (MIGA)
- MIGA is the part of the World Bank Group that provides non-commercial guarantees (insurance) for cross-border investments into developing countries
- Minimum length of a guarantee is three years

Main points from discussions with MIGA

- Insurance that MIGA could provide is against 'breach of contract'
  - Protects against losses arising from the government's breach or repudiation of a contract with the investor
- MIGA can only provide guarantees if the Fund operates on a 'commercial basis'
  - This would limit the guarantees to pre-payments made by Tranche A only
  - MIGA is reviewing CF documents to assess if the Fund meets this condition
- Fund needs to be willing to pursue legal action (which includes arbitration) against counterpart and payment is only made if legal action fails
  - Fund needs to invoke the dispute resolution mechanism (e.g., an arbitration) set out in the ERPA
  - If, after a specified period of time, the Fund has been unable to obtain an award due to the government's interference with the dispute resolution mechanism (denial of recourse), or has obtained an award but the Fund has not received payment under the award (non-payment of an award), MIGA would pay compensation.

Indicative costs of MIGA guarantee

- Non binding indicative quote for breach of contract cover in Costa Rica:
  - Approximately 0.80-1.10 % /per annum of the guaranteed amount
  - Specific for Costa Rica based on current country risk assessment
  - Subject to due diligence and management approval etc
- Assuming a 20% Advance Payment on a $60 million ERPA:
  - The guaranteed amount is $12 million for both Tranches or around $1.46 million for Tranche A only
  - Annual costs for Tranche A would be between $11,680 and $16,060 per annum
  - Unclear yet if MIGA would ensure such a small amount looking at due diligence and transaction costs

Topics for discussion

- Guarantees: should the FMT further explore the possibilities of using MIGA guarantees for securing Advance Payments by Tranche A, based on the conditions discussed?
- Pricing approach more generally: see slide 6

THANK YOU!

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