Forest Carbon Partnership Facility

Certain Implications of Methodological Framework on ERPA General Conditions

FCPF Carbon Fund Meeting (CF8)

Paris, December 8-9, 2013

Overview

I. **Process of Methodological Framework & Endorsing ERPA General Conditions**

II. **Certain Issues of Methodological Framework**

1.1 **Transfer of Legal Title to ERs**

- Implications on FCPF ERPA General Conditions

2.1 **Reversal Management Mechanism**

- Implications on FCPF ERPA General Conditions

III. **Discussion**

I

Process of Methodological Framework &

Endorsing ERPA General Conditions

Time	Action
March 26, 2012	FCPF Carbon Fund (CF) **established Carbon Fund Working Group (CFWG) to develop a Methodological Framework (MF)** at CF3 (March 24-26, 2012 in Asuncion, Paraguay)
June 29, 2012	PC12 **endorsed guiding principles on the MF for REDD** per PC Resolution (Santa Marta, Colombia)
October 2012 & March, 2013	Meetings of the **CFWG on the MF** in Brazzaville and Washington DC
March 21, 2013	PC14 **endorsed ERPA Term Sheet** per PC Resolution requesting **first draft of the ERPA General Conditions (GCs) by PC15** (June 30-July 1, 2013 in Lombok, Indonesia) with the initial objective of **endorsement of ERPA GCs at PC16**
June 21-23, 2013	Meeting of the **CFWG on the MF** in Paris
June 24-25, 2013	CF7 meeting in Paris to **discuss remaining issues of ERPA GCs**
June 28, 2013	**Pre-PC15 Workshop** (Lombok, Indonesia) on **ERPA GCs**
June 30-July 1, 2013	**Presentation of first draft of the ERPA** GCs at PC15 (Lombok, Indonesia)

Time	Action
October 26-28, 2013	Meeting of the **CFWG on the MF** in Oslo
December 5-6	Meeting of the **CFWG on the MF** in Paris
December 8-9	CF8 meeting in Paris; **approval of the MF**
December 12, 2013	**Pre-PC16 Workshop** (Geneva, Switzerland) on **Implications of MF on ERPA GCs**
December 13-15, 2013	PC16 (Geneva, Switzerland)
January-March 2014	**Revision of the first draft of the ERPA GCs**
March/April 2014	CF9 meeting
April-June 2014	**Commenting & Review Period** for PC members/Observers regarding the revised first draft of the ERPA GCs (potentially with videoconferences)
June 2014	PC17; **endorsement by PC of ERPA GCs**

II (1.1)

Methodological Framework

- Legal Title to ERs -

Transfer of ‘Title to ERs’ (1)
- Methodological Framework -

WHAT IS ‘TITLE TO ERs’?

- Means full legal and beneficial title and exclusive right to ERs contracted for under the ERPA.
- ‘Title to ERs’ relates to ERs only. In particular, it does not relate to any rights, titles or interests to land and territories.

HOW TO DEMONSTRATE ABILITY TO TRANSFER TITLE TO ERs?

- The ability to transfer Title to ERs may be demonstrated through various means, including:
  - reference to existing legal and regulatory frameworks,
  - sub-arrangements with potential land and resource tenure rights-holders (i.e. any agreements, contracts, or other arrangements between the Program Entity and one or more relevant potential rights-holder(s), including those holding legal and customary user rights),
  - benefit sharing arrangements under the Benefit Sharing Plan.
- ER Program respects (legal and customary) land and resource tenure rights of potential rights-holders, including indigenous peoples.

Transfer of 'Title to ERs' (2)
- Methodological Framework -

WHEN DOES THE PROGRAM ENTITY HAVE TO DEMONSTRATE ITS ABILITY TO TRANSFER TITLE TO ERs?

- The Program Entity has to demonstrate its ability to transfer Title to ERs at the time of ERPA signature or, at the latest, at the time of transfer of ERs to the Carbon Fund under the ERPA.
- The MF requires the ER Program to provide a description in the ER Program Document of the implications of the land and resource regime assessment for the Program Entity's ability to transfer Title to ERs to the Carbon Fund.

WHO DETERMINES THE PROGRAM ENTITY'S ABILITY TO TRANSFER TITLE TO ERs?

- It will be the responsibility of the Program Entity to demonstrate its ability to transfer Title to ERs to the Carbon Fund.
- Whether or not, or to which extent, the Program Entity has succeeded in demonstrating such ability will be assessed by the Carbon Fund on the basis of the information provided by the Program Entity. [If needed, the Carbon Fund may, as part of its assessment, request additional external legal advice.]

II (1.2)

Implications on FCPF ERPA General Conditions

- Legal Title to ERs -

Transfer of 'Title to ERs' (1)
- Implications on FCPF ERPA General Conditions -

A. PRIOR TO ERPA SIGNATURE

- If, as a result of the Carbon Fund's assessment of the information provided by the Program Entity (**Seller**), the Carbon Fund determines prior to ERPA signature that the **Seller did not, fully or partially, demonstrate its ability to transfer Title to ERs**, the initially anticipated ERPA **Contract ER volume may be reduced** accordingly (with such ERs for which the ability to transfer Title to ERs could not be demonstrated at ERPA signature potentially being included in a Call Option).

- In addition, the Seller and the Bank, as trustee of the Carbon Fund (**Buyer**), may **agree on additional steps** for the Seller to become able to demonstrate its ability to transfer Title to such ERs at the time of ER transfer (with such progress potentially becoming a milestone for any interim advance payments).

- However, if prior to ERPA signature the amount of ERs for which the Seller cannot demonstrate its ability to transfer Title to ERs is **significant**, **ERPA signature may be postponed** until the Seller can demonstrate its ability to transfer Title to ERs to an increased amount of ERs.

Transfer of 'Title to ERs' (2)
- Implications on FCPF ERPA General Conditions -

B. PRIOR TO ER TRANSFER

- Under the FCPF ERPA, **Seller has to represent and warrant** to Buyer every time ERs are transferred to the Carbon Fund (whether as part of the ERPA Contract ER volume or a Call Option volume) that it has transferred, or has the authorization to transfer, Title to ERs free of any third party rights or encumbrances.
- If the Seller's ability to transfer unencumbered Title to a portion of ERs is still **unclear** and/or is **contested** by any third party or group, the following procedures could apply:
  - Transfer of unclear or contested ERs is suspended.
  - Buyer may allow Seller to clarify its ability to transfer Title to all verified ERs and/or have the contesting third party's allegations regarding Title to the Contested ERs assessed and resolved within a specified time period (potentially by using a grievance redress mechanism under the ER Program).
  - **If Seller can clarify its ability to transfer Title** to all verified ERs within that specified time period, transfer of the ERs will be allowed to proceed.
  - **If Seller cannot clarify its ability to transfer Title** to all verified ERs within that specified time period, Buyer may **refuse transfer of the affected ERs**. As a result, **no payment for such affected ERs** would become due.
  - In the latter case, Seller may have its ability to transfer Title to such affected ERs clarified by the time of the next transfer of ERs.

Transfer of 'Title to ERs' (3)
- Implications on FCPF ERPA General Conditions -

C. AFTER ER TRANSFER

- If any third party or group (**Contesting Party**) contests Seller's Title to any transferred ERs (**Contested ERs**), the following procedures could apply:
  - Unless Seller is able to have Contesting Party's allegations regarding Title to the Contested ERs assessed and **resolved within a specified time period** (potentially by using an available grievance redress mechanism under the ER Program), Buyer may request **external legal counsel** to assess whether or not the allegations by Contesting Party **appear (prima facie) to have merit** under domestic law. For this potential activity, Carbon Fund may have to set aside a cost reserve to cover any such related future expenses.
  - During this assessment process, any pending or scheduled **transfer of Contested ERs would be suspended**.
  - If such assessment concludes that Contesting Party's **allegations have no merit**, the Contested ER transfer process would be allowed to proceed.
  - If such assessment concludes that Contesting Party's **allegations do have merit**, any pending or scheduled transfer of Contested ERs would continue to be suspended and the Contesting Party's alleged failure to transfer Title to the Contested ERs would be deemed as an **Event of Default**.

Transfer of 'Title to ERs' (4)
- Implications on FCPF ERPA General Conditions -

C. AFTER ER TRANSFER (*continued*)

- Such Event of Default would trigger an **Action Plan** process under which Seller and Buyer would agree on a **plan to cure the Event of Default** during a specified time period (e.g. by way of having Seller and Contesting Party agree on including the Contesting Party in the Benefit Sharing Plan in return for an express assignment of Title to the Contested ERs from the Contesting Party to the Seller).
- If Seller and Contesting Party **succeed in curing the Event of Default** in accordance with the Action Plan, the dispute related to the transfer of Title to the Contested ERs would be deemed to have been resolved and no further action would be deemed necessary.
- If Seller and Contesting Party **fail to cure the Event of Default** in accordance with the Action Plan, Buyer decides whether to enter into a new Action Plan with Seller (if deemed promising) or to exercise the following remedies:
  - [*If a buffer reserve is established for this purpose:* Request the release of an amount of ERs deposited in a buffer reserve (equivalent to the amount of Contested ERs) from the buffer reserve and transfer of such ERs to a registry account nominated by such Contesting Party.]
  - Exclude the relevant area of land from the ER Program Accounting Area.
  - If the amount of such Contested ERs equals or exceeds [x]% of the ERPA Contract ER volume, terminate the FCPF ERPA.

II (2.1)

Methodological Framework

- Reversal Management Mechanism -

Reversal Management Mechanism (1) - Methodological Framework -

WHAT ARE 'REVERSALS'?

- Means a situation where the cumulative monitored and verified ERs are less than the currently transferred ERs, i.e., at any point in time more ERs have been transferred than is warranted by the underlying reported and verified results of the ER Program.
- Reversals can occur through various events such as, among others, fire, logging, storms, conversion to agriculture etc.

HOW CAN AN ER PROGRAM ACCOUNT FOR REVERSALS DURING THE TERM OF THE ERPA AND BEYOND?

- An ER Program has to undertake an assessment of the anthropogenic and natural risk of Reversals that might affect ERs during the ERPA term and assess, as feasible, the potential risk of Reversals after the end of the ERPA term.
- An ER Program also has to demonstrate how effective ER Program design and implementation will mitigate significant risks of Reversals identified in the assessment to the extent possible, and will address the sustainability of ERs, both during the ERPA term and beyond.

Reversal Management Mechanism (2) - Methodological Framework -

HOW CAN ER PROGRAMS MANAGE THE RISK OF REVERSALS?

- ER Programs need to have in place a **reversal management mechanism** (e.g., buffer reserve or insurance), that is:
  - ➢ Substantially equivalent to the reversal risk mitigation assurance provided by an ER Program CF Buffer (see below), and
  - ➢ appropriate for the ER Program's assessed level of risk, to fully cover Reversals that may occur during the ERPA term.
- While the MF provides for some flexibility on what a reversal management mechanism may look like, the MF envisions an ER Program-specific buffer reserve (**ER Program CF Buffer**), to be managed by the Carbon Fund, as the **default mechanism**.

WHICH RISKS WOULD BE COVERED BY AN 'ER PROGRAM CF BUFFER'?

- Risks of **Reversals** (intentional and un-intentional)
  - ➢ Provided that Seller is in full ERPA compliance
- In addition to the ER Program CF Buffer, additional buffer reserves may be provided to manage risks related to uncertainty and Title to transferred ER

Reversal Management Mechanism (3)
- Methodological Framework -

HOW DOES AN 'ER PROGRAM CF BUFFER' WORK?

- In the event the ER Program CF Buffer is the (chosen/default) reversal management mechanism, a certain amount of ERs generated under an ER Program (**Buffer ERs**) would be deposited in the ER Program CF Buffer.
- Such Buffer ERs would **not be transferred to the Carbon Fund**.
- If a **Reversal occurs** during the ERPA term, an amount of **Buffer ERs** equivalent to the amount of transferred ERs affected from such Reversal event will be **cancelled**.
- The **amount of Buffer ERs** to be deposited into the ER Program CF Buffer would be based on a **reversal risk assessment** and be assessed **on a case-by-case basis**, but would **range from 10-40% of ERs** generated, verified and transferred to the Carbon Fund at each time of ER transfer.
- In addition to the risk of Reversals managed through the ER Program CF Buffer, **additional buffer reserves** may be established to cover additional risks related to **uncertainties** and/or, if established for this purpose, **disputed Title to transferred ERs**. Such coverage may require an additional amount of ERs to be deposited in such additional buffer reserves (potentially based on a separate risk assessment).

Reversal Management Mechanism (4)
- Methodological Framework -

WHAT HAPPENS TO THE 'BUFFER ERs' AT THE END OF THE ERPA TERM?

- **At the latest 1 year before ERPA term ends**, ER Program should have in place a robust reversal management mechanism or another specified approach that addresses the risk of Reversals beyond the ERPA term (**Post-ERPA Mechanism**).
- If Post-ERPA Mechanism is a buffer reserve/allows for the use of buffer ERs, **all or a portion of the remaining Buffer ERs** in the ER Program CF Buffer at the end of the ERPA term are expected to be **transferred to that Post-ERPA Mechanism** (subject to interim MF review(s) and decision by ERPA parties in 2019). If Post-ERPA Mechanism does not allow for the use of buffer ERs, all or a portion of the remaining Buffer ERs in the ER Program CF Buffer will be transferred to a registry account nominated by the Program Entity.
- If **no Post-ERPA Mechanism** is in place 1 year before ERPA term ends, **all remaining Buffer ERs** in the ER Program CF Buffer will be **cancelled**.

Reversal Management Mechanism (5)
- Methodological Framework -

HOW ARE REVERSALS ADDRESSED AFTER THE END OF THE ERPA TERM?

- Taking into account that the **FCPF is scheduled to terminate on December 31, 2020** and **FCPF ERPAs will terminate no later than such date**, the World Bank, as trustee of the FCPF Carbon Fund, can only help address/manage risks of Reversals until the end of the FCPF/FCPF ERPAs.
- **Post-ERPA risks of Reversals**, and thereby the continued permanence of transferred ERs, need to be addressed/managed separately.
- If a **Post-ERPA Mechanism** is in place, such mechanism can help address/ manage post-ERPA risks of Reversals.

II (2.2)

Implications on FCPF ERPA General Conditions

- Reversal Management Mechanism -

Reversal Management Mechanism (1)
- Implications on FCPF ERPA General Conditions -

A. CONDITION PRECEDENT

- Unless a reversal management mechanism is in place at ERPA signature, the establishment of a **reversal management mechanism**, in form and substance satisfactory to the Trustee, would become a condition precedent for the sale and payment obligations under the ERPA to become effective.

B. COVENANTS (GENERAL)

- The Seller would have to:
  - Implement and operate the reversal management mechanism in accordance with **best practices**
  - **Inform** the Trustee if events occur that have the potential to (1) result in a Reversal and/or (2) negatively affect the risk mitigation assurance level provided by such mechanism
  - **Report** on the status of the reversal management mechanism periodically

Reversal Management Mechanism (2)
- Implications on FCPF ERPA General Conditions -

C. COVENANTS ('ER PROGRAM CF BUFFER'-SPECIFIC)

- If an 'ER Program CF Buffer' is the reversal management mechanism, at **each time of ER transfer**, Seller would have to **deposit** an additional amount of ERs (equivalent to between **10-40%** of the amount of ERs generated, verified and transferred to the Carbon Fund) **into the ER Program CF Buffer** as Buffer ERs.
- Buffer ERs are **different from** and **additional to** Contract ERs
- **No extra payment** is required for Buffer ERs
- The ER Program CF Buffer covers **intentional and un-intentional Reversal events**, provided that Seller is in full compliance with its ERPA obligations

Reversal Management Mechanism (3)
- Implications on FCPF ERPA General Conditions -

D. REMEDIES

- In the event of a Reversal event during the ERPA term, any **reversal management mechanism** put in place will be **used** to ensure that the validity of any previously transferred ERs remains unaffected by the respective Reversal event.

- **In case of an ER Program CF Buffer**, an amount of **Buffer ERs** equivalent to the amount of previously transferred ERs that is affected by the Reversal event would be **released** from the ER Program CF Buffer and be **cancelled**.

- If the reversal management mechanism(s) **do not suffice** to ensure the continued validity of all previously transferred ERs during the ERPA term, the Buyer may:

  - Terminate the FCPF ERPA
  - Request payment of any incurred Costs/unrecovered advance payments
  - [Request liquidated damages: e.g. ER unit price X amount of transferred ERs that remain affected by the Reversal event]