INFO BRIEF

Engagement of Private Sector in REDD+ Cross River State

INTRODUCTION

Considerable investment is needed to realise the climate change mitigation potential of forests. Investment is needed both up-front for capacity building and preparatory work as well as on an ongoing basis for implementation, which entails compensation for opportunity costs as well as the costs of sustainable forest management.

However, there is a huge funding gap between what is needed to effectively address deforestation and available public funds. Investment at the desired scale is unlikely to come from governments alone. Hence active investment from private sector investors is essential, including financial institutions (FIs) – both banking and non-banking. Private sector involvement and finance are not only important to tackle the funding gap itself; the speed at which the private sector can mobilize finance at the required scale is important as well.

For the effective participation of the private sector in the REDD+ programme investments in enhancing standing forests and creating new forests, it is paramount that policymakers (i) offer avenues and formats for the private sector to invest and engage in the protection, rehabilitation and creation of forests; (ii) increase the financial competitiveness and attractiveness of forest-based climate mitigation investments and (iii) reduce the investment risks involved. It is the potential for future profit that drives present investments, and the level of expected profit must be high enough to compensate for expected risk. An investment scheme that compensates for the actual costs incurred only without accounting for investment risk is unlikely to attract private investment. Furthermore, changes in financial incentives

KEY MESSAGES

- For successful financing, need to **improve the investment environment i**ncluding: good governance, supportive policies and institutions, clear land tenure, a stable macroeconomic environment and a well-designed REDD+ strategy backed by a well-designed national forestry policy
- Insurance, pension funds, and the stock exchange are a **source of long-term financing** which is crucial for REDD+ success.
- **Key political risks** that FIs will need to face when investing in REDD are: international policy risk, eligibility risk, government implementation risk; market risks, such as a low price for REDD+ credits and carbon market-specific regulatory risks and other more general business risks such as natural events, country and social risks.
- Clear and undisputed **land tenure and ownership rights** are not only a condition for equitable participation of local communities in REDD+ activities, but a key condition for the involvement of the broader private sector and the mobilisation of private finance and investment in REDD+ activities.
- The **key roles that the private sector, including FIs, can assume** in REDD+ include: investing own equity, fund managers, lenders, and insurance providers.

are needed to discourage commercial activities that lead to forest loss and stimulate activities and initiatives that promote the sustainable use of forests. Besides providing investment funds, the private sector must be mobilized so that the drivers and root causes of deforestation and forest degradation are addressed.

Whilst the REDD+ programme presents new business opportunities for the private sector, participation of the private actors has been slow due to the high perceived levels of risk and a general lack of awareness of the opportunity. However, with the right incentives, the private sector and financial institutions can effectively participate in the REDD+ programme to both reduce their negative impacts on forests and provide investment finance towards REDD+ activities. This **policy brief provides an analysis** of the opportunities, risks and roles of the private sector including FIs in the REDD+ programme.

DEFINING PRIVATE SECTOR ACTORS

The private sector covers a wide spectrum of actors from those living a subsistence lifestyle to highly profit-focused commercial enterprises. Given the level of diversity of private sector actors, it is necessary to identify and cluster the private sector into groups that are most relevant to REDD+. Three key private sector groups can be identified as follows:

- Those involved in the production and sale of verified emissions reductions (VERs): This group can include project developers, technical service providers, financiers and VER buyers.
- Those linked to the drivers of deforestation and degradation: Actors in this category will include producers of raw materials, suppliers, manufacturers, traders, retailers, consumers, financiers and technical service providers
- Those involved in harvesting non-timber forest goods: These can be considered as important forest stewards who do not drive forest loss.

MAKING REDD+ MORE ATTRACTIVE FOR THE PRIVATE SECTOR

The private sector in Nigeria benefits from deforestation in the following areas: agricultural commodities (especially yam, cassava, rice, maize, plantain & banana, cocoyam, oil palm, cocoa, and pineapple), fire wood & charcoal, unsustainable timber harvesting, mining & quarrying and infrastructure. The economic use of forests can be shifted to a more holistic and sustainable green growth approach through:

- Increasing efficiency in the sectors that drive deforestation (e.g. higher land efficiency in agricultural production, greater exploitation of already deforested land, shifts from conventional agriculture to agro-forestry and a greater focus on tree crops)
- Enhancing land efficiency in the production of conventional forest products, such as timber, charcoal, fibre and other non-timber products; and

Private actors, investors and financial institutions need to rethink their behavioural patterns and change the way they exploit forests. The required change can be realized through an effective

Key Private Sector Actors Impacting on Deforestation and Forest Degradation in Nigeria

- **Subsistence Agriculture**: Predominantly rural farming communities in most parts of the state.
- **Commercial Agriculture:** Key agricultural value chains in Cross River include oil palm, other commercial crops, e.g. cocoa, pineapple, rubber, and cashew. Key private sector actors in CR: Oil Palm - Wilmar Ltd (large scale); Real Oil Ltd (SME); and Pineapple (Dansa Foods Ltd)
- **Fuelwood consumption:** All rural communities & some urban largely for domestic use and/or limited commercial activities in the urban areas such as cooking for events, functions, etc.
- **Logging & timber extraction**: Despite the subsisting ban on logging in CRS, this has persisted. Due to the subsisting logging ban, no organized private sector actors in CR
- **Energy producers:** MSMEs, etc. engaged in charcoal production for domestic use and export to markets in the Middle-East & Eastern Europe – increasing demand = more high value trees being cut down. No organized private sector actors in CR
- **Mining / Quarrying:** Various solid mineral mining by SMEs/large companies. In the past 17 years, 29 companies (38 including those named below as road construction contractors) have engaged in solid mineral mining activities – especially limestone quarrying – in Cross River: L.C.C. Company; Expanded Mining Nig. Ltd.; HZ Blazer Co.; Saturn Co; Mark-Sino Co; Win-Xin Co.; Two Brothers Co.; Uranus Co.; S&V Nig. Ltd.; Faith Plant Global Ltd.; H&K [Power/Racon] Co.; Crushed Rock Nig. Ltd.; Predeco Nig. Ltd.; Thejan Nig. Ltd.; Piccolo Nig. Ltd.; Sactone Nig. Ltd.; Ideke Nig. Ltd.; Prod Nig. Ltd.; Genec Nig. Ltd.; Ding Zheng Ltd.; Star Advantage Co.; Wings of Heaven Co.; Japaul Mine Co.; Enerco Co.; Xin-Xin Co.; SK Touch Co.; Lafarge Holcim Cement Co. Ltd. (formerly UNICEM before its takeover by Lafarge); Rufus Ventures Ltd.; Zing Zheng Co.
- **Infrastructure development**: Real estate development; road construction, etc. undertaken to drive economic development and facilitate access to markets – policies of government. Companies that have been involved in road construction in the past 17 years in Cross River are: Arab Contractors Nig. Ltd., RCC Construction Co. Ltd., Hi-Tech Nig. Ltd., Zenith Construction Nig. Ltd., Sematech Nig. Ltd., CCECC Nig. Ltd., Julius Berger Nig. Ltd., Gitto Construction Ltd., Setraco Nig. Ltd. (all also have been involved in varying degrees in quarrying activities in the state)

REDD+ funding mechanism which, in addition to finding new sources of investment, can reshape the way forests are currently exploited. This means the REDD+ programme should offer the private sector actors financially competitive alternatives to current land-use and deforestation patterns. Only then will the private sector truly shift their behavioural patterns and unlock the skills and resources needed to achieve the desired REDD+ targets.

The **design of a REDD+ funding mechanism** will play a crucial role in creating monetary value for forest-based ecosystem services (including the sequestration and stocking of CO2) that currently remain undervalued. Only when these ecosystem services are attributed an appropriate monetary value, and there is willingness and ability to pay for these services, will the sustainable management of forests result in revenue streams which are attractive for private sector actors and investors. This way the drivers of deforestation and forest degradation will be addressed with a shift towards more sustainable paths of forest utilization.

REDD+ FINANCING NEEDS

There are two basic needs for REDD+ financing in Nigeria: (i) financing up-front capacity building; and (ii) financing on-going emissions reduction costs.

I. Financing up-front capacity building:

Nigeria must fulfil minimum readiness requirements, such as putting in place infrastructure for monitoring emissions reduction, clarifying land tenure and strengthening institutional capacities for law enforcement. The Nigerian forestry sub-sector and the relevant government (public sector) bodies and environment-focused NGOs and CBOs are quite conversant with environmental and REDD+ issues. However, the private sector counterparts generally have limited levels of awareness of REDD+ issues. A few banks and non-bank financial institutions, such as insurance companies, have incorporated environment and REDD+ friendly practices in their businesses (e.g. once-off tree-planting activities under their CSR programmes; and conducting business plan EIAs prior to lending).

II. Financing on-going emission reduction costs:

The costs of emission reduction activities are in two categories: a) sustainable forest management costs and b) opportunity costs. **Sustainable forest management costs** refer to the costs of implementing the policies and measures (PAMs) inside and outside the forest sector that are needed to reduce forest emissions. **Opportunity costs**, arise from foregone profits from deforestation or the costs of adopting more sustainable forest use.

SOURCES OF FINANCE

Financing for REDD+ can come from various sources, including: 1) federal and state government budgets; 2) revenue from the sale of forest products and services; 3) and private-sector investment.

Public-sector. The public-sector plays an important role in financing. Firstly, it can encourage private-sector investment with incentives such as grants, tax relief and subsidised loans. Secondly, it is responsible for providing a policy and institutional environment that supports private-sector investment. Public-sector financing of REDD+ can include "ring-fencing" budget allocations; earmarking taxes for forestry; investment tax credits or exonerations, public-private partnerships or revenue sharing arrangements; provision of targeted REDD+ subsidies, subsidized interest, and payments for environmental services. The public sector can play concrete roles in the development of payments for environmental services. They can provide the appropriate policy and institutional framework to support implementation, they may be important buyers of many ecosystem services; and they can act as catalysts for private-sector investment in such schemes.

Private-sector. In most countries, the private-sector is the main source of financing for forestry and the amount of financing and diversity of investors has increased rapidly in recent years. Direct investment currently accounts for most private-sector investment in forestry, but indirect investment products - such as forest and land investment trusts and funds - are increasing in importance. Funds focusing on socially responsible and green investments are another source of private-sector finance that is expanding and these funds might invest in some types of forests. In addition, the development of mechanisms for the payment of environmental services may increase the financial returns from sustainable forest management and stimulate more investment in the sector.

ROLE OF THE PRIVATE SECTOR IN REDD+ FINANCING

A feature of the REDD+ programme is that it needs an upfront investment in climate change mitigation activities whilst the returns to investment are realized in the distant future. The revenue support will originate from developed countries with mandatory emission reduction requirements, while the investment needs are likely to be met from Nigeria. FIs can play a vital role in providing the required investment funds.

For any private sector investment proposition, it is essential that the risk-adjusted returns should be greater than the risk-adjusted costs. Therefore, one of the most important success factors for the REDD+ programme will be the level of demand and price of carbon credits by governments, industry, individual consumers, and FIs-who with sufficient demand, will play various roles to move capital from developed to developing countries through brokerage and trading functions. They can also bring forward capital in time through forms of debt and equity investment and reduce risks through off-take agreements, guarantees and insurance.

REDD+ PROGRAMME FINANCING ALTERNATIVES

I. *INVESTORS AND & FUND MANAGERS*

FI Own Equity- Financial institutions can invest their own equity directly into forestry projects, or into forestry project development companies or forest funds. Forestry projects can generate a given level of carbon credits per year to finance conservation and community projects. FIs can then purchase the carbon credits at pre-agreed prices.

FI as Fund Managers- The funds can be invested through Public-private partnerships (PPPs); Community-private-public partnerships (CPPPs); REDD+ fund management for the voluntary carbon market; Forestry funds; National Environmental Funds; and Conservation trust funds. Through the PPPs, the public-sector contribution can attract the private sector to invest in REDD+ projects. Through the PPPs, each dollar invested by the government will be leveraged by private sector investment.

Forest or Green Bonds- Issuing 'forest' or green bonds for financing REDD+ activities will offer institutional investors an attractive investment opportunity. The Federal Government of Nigeria (at national or state level) or a multilateral institution could issue forest bonds to mobilise funds to be disbursed as loans. To be attractive, the green bond loans will need to be on better terms than non-green bond loans or loans accessed under normal, commercial borrowing market circumstances.

Securitization- Provide up-front financing for REDD+ projects. With securitisation (versus themed bond issuance) investors buying 'asset-backed securities directly 'invest' in the asset or group of assets financing loan repayment. The secured bonds can be packaged by the investors or project sponsors in a flexible, decentralised, disperse and needs-driven basis

II. *LENDERS*

Credit lines and project Financing- Bank credit/loans (public and private), including micro-finance and targeted grants (public banks). Banks and other lenders may be involved in lending to forest companies, leveraged funds or individual projects on a non-recourse basis, where the returns and expected cash flows are commensurate with their lending criteria. Many different sorts of debt instruments can be offered, from conventional 'senior' debt secured over assets such as land or a future stream of carbon credits, to more innovative 'mezzanine' products such as convertible loans which can revert to equity.

Micro-Finance-Micro-payment and micro-credit infrastructure. Important for setting up a sustainable, long-term framework for making small compensation payments to thousands of smallholder farmers & SMEs dependant on the forests. Forest protection efforts will depend on extending small amounts of credit to smallholders to help them establish alternative livelihoods that do not involve deforestation or forest degradation.

INVESTORS, INSURERS & GUARANTORS

Insurers- Insurance products and long-term financing. Insurers improve the viability of forestry projects by providing insurance products to cover different types of risks such as natural events and REDD+ specific risks. Insurance and pension fund premiums can be an important source of long-term financing under REDD+.

Guarantees- Unconditional performance guarantees. Limited guarantees (cover specific events, are limited by time and/or capped at a certain amount). Guarantees are a valuable tool for mitigating risks and encouraging FI involvement in REDD+. Guarantees can cover several risks and are especially useful for managing government-related risks (such as government implementation risk and country risk).

Risks and risk mitigation options to make forest-based mitigation more attractive to FIs

There are numerous constraints that limit the participation of the private sector and financing of REDD+ activities. For example, many of the benefits of sustainable forest management do not generate direct revenues for forest owners and managers- hey have no incentive to produce the full range of benefits from forests and instead focus on production of timber and a few other marketed products. The complexity and generally higher costs and perceived risks of sustainable forest management compared to other land uses (including unsustainable forest practices and the expansion of land under agriculture) is also a major constraint. The high up-front investment costs and long-time duration for return on investment as well as the lending policies favour short-term loans with low risks. Also, interest rates are often higher than growth in the value of forests when timber is the only marketed output. These economic constraints are often compounded by policy, legal and institutional constraints such as: weak institutions, a lack of policy co-ordination across sectors; unresolved land tenure issues; and weak governance, as well as a lack of technical capacity

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