

Forest Project Protocol: PIA Comments

June 11, 2009

Introduction.

Thank you for the opportunity to comment on draft Project Implementation Agreement of the Forest Project Protocol (“PIA”). We appreciate the choice that CAR has made to open the PIA for public comment, as the form of the PIA is a critical issue that will determine the breadth and depth of landowner participation in the new protocol.

Approaching the topic from an investors’ perspective, we have the following comments on the current PIA draft, listed in summary form and then subsequently described in greater detail:

1. Owners of timber rights should have access to carbon markets, in addition to full fee simple property owners (*Recital D and §8*).
2. The on-site access rights of the Reserve should be expressly limited to at most twice per calendar year for cause unless the Forest Owner is in breach (*§4*).
3. The PIA should only be binding upon current holders of property interests that could be reasonably expected to significantly affect obligated reductions (*§5*).
4. The Reserve’s consent to transfers and assignments that satisfy the terms of the Agreement and the FPP should be non-discretionary (*§5(a)*).
5. Forest Owners should not be liable for Forest Owner Obligations subsequent to proper assignment and transfer under the terms of this Agreement and the FPP (*§5(a)*).
6. Large forest landowners (e.g. >100,000 acres in total forest land holdings) have different financial constraints and should have flexibility in subordinating future encumbrances to the PIA (*§5(e)*).
7. Forcing immediate binding arbitration for any dispute is unreasonable and an incremental dispute resolution system should be created (*§6(a), §12*).
8. The Reserve cannot retain access to legal and equitable remedies while compelling binding arbitration on both parties (*§6(d)*).
9. The Reserve should have no discretion to prevent early termination of projects when such termination meets the requirements of this Agreement and the FPP (*§7*).
10. Replace mandatory binding arbitration with access to courts of law (*§12*).
11. Redraft the excessive indemnity provision to prevent unreasonable exposure of landowners (*§13*).
12. Amend consequences for intentional reversals and early termination:
 - a. Forest Project CRTs should not be required;
 - b. CAR should not determine whether Forest Project CRTs are obtainable;

New Forests Advisory Inc

Location

601 Montgomery Street
Suite 665
San Francisco, CA 94111

Contact

Phone: (415) 321-3300
Fax: (415) 321-3330

Website

www.newforests-us.com

- c. There is no reason to require Improved Forest Management projects to purchase more CRTs to terminate a project than Reforestation and Avoided Conversion projects – the same replacement rate should apply to all Forest Projects;
- d. The replacement rate should be 1:1 and Forest Owners should be required to replace CRTs sold with allowances issued under a compliance federal or state cap and trade system should one exist.

Recital D and §8: Owners of Timber Rights Should Have Access to Carbon Markets

Recital D, due to incorporation into the agreement by §1 of the PIA, essentially requires the Forest Owner to represent and warrant that he/she “is the . . . sole owner *in fee simple* of that certain real property located in . . .” (emphasis added). The requirement that property subject to a forest carbon project be owned in fee simple was not included in the Forest Project Protocol, and we suggest that it is inappropriate to limit forest carbon projects under CAR to owners of forest land in full fee simple. Many individuals and entities owning forests in California and other states own forest through holding “timber rights,” technically *profits a prendre*, a type of extractive easement. So long as their timber rights extend for the duration of the proposed project, these individuals should not be arbitrarily prevented from accessing carbon markets. They may not be able to claim certain carbon pools if they only own the standing live timber, but there are no grounds from preventing them from creating carbon projects under the new Forest Project Protocol.

We suggest amending Recital D to state that: “The Forest Owner is the: (i) [sole owner in fee simple of that certain real property/for the Term of this Agreement, sole owner of all interests in all trees located on that certain real property] located in”. Furthermore, we suggest amending §8 of the Agreement to state that “. . . the Forest Owner is the [sole owner in fee simple of that certain ~~the~~ Property and holder of all interests in ~~the all~~ trees located on the Property, including without limitation, a fee, easement or leasehold interest/for the Term of this Agreement, sole owner of all interests in all trees located on that certain real property]”.

§4: Monitoring Rights of the Reserve Should be Expressly Limited

Many landowners have expressed very reasonable reservations about signing a document that would enable a nonprofit and all its agents to have access to their property at will with only five business days notice for a period of 100 years. After all, it is impossible to know who will control the Reserve in 75 years and what the character of the organization will be at that point, and it would be unwise to allow such unfettered access to a corporate body that may choose to significantly increase the burden imposed by that access right in the distant future for reasons unforeseeable to us now. Furthermore, five business days notice may cause difficulties for Forest Owners who do not live on or near their property.

We therefore strongly recommend that the §4 be amended to state that “The Reserve and its agents, including, without limitation, any ~~and all~~ accredited third party verifiers approved by the Reserve, shall have the right to enter the Property at reasonable times and from time to time to monitor and verify the Forest Owner’s compliance with this Agreement and the Forest Protocols provided that (i) the Reserve gives fifteen (15) business days written notice to the Forest Owner in accordance with Section 10 and (ii) the Reserve adheres to ~~the~~ reasonable health and safety practices while on the Property and (iii) such entries to the



Property shall be limited to at most two (2) times per calendar year, unless the Forest Owner expressly waives this limit through a written instrument or the Forest Owner has been declared in breach of this Agreement and has not initiated dispute resolution proceedings contesting such breach.”

Furthermore, §4 should require the Reserve to demonstrate proof of liability insurance to Forest Owners to limit their liability when providing the Reserve and its agents access to their property.

§5 and §5(a): The PIA Should Only be Binding Upon Holders of Property Interests that Could Significantly Affect Obligated Reductions

Section 5, “Transfer of this Agreement”, opens by stating that “All of the provisions of this Agreement shall be binding upon the Parties hereto and their successors, assigns *and any other party* holding a right, obligation, title, possession or interest in the Property, including without limitation a fee, leasehold, deed, mortgage, or easement interest (the “Interest”)” (emphasis added). This sentence creates two primary issues. First, one right holder in a property cannot bind other right holders in the same property to a contract they do not sign absent some prior agreement to that effect. Simply stating that this Agreement is binding on other holders of property interests in a property will not make it so. Nevertheless, under the substantive intent of this language, a fee or timber right owner who desires to create a carbon project under the FPP would have to secure the express agreement of all holders of any property right to the Property to be bound by all of the terms of the PIA – even entities that own mere utility easements, right of way easements, the right to hunt or fish on the property, and so forth.

Second, securing the agreement of a minor property right holder would require their acceptance of significant liability under the PIA and the FPP. A hunting club that owns an easement to access property for hunting or a neighbor who owns the right to drive across the property on a particular road would seem very unlikely to agree to be bound by “[a]ll of the provisions of this Agreement” and the many potential liabilities that would entail. This language as drafted is simply not sensible. We suggest that the first paragraph in Section 5 be amended to state that “All of the provisions of this Agreement shall be binding upon the Parties hereto and their successors, ~~and assigns. and any other party holding a right, obligation, title, possession or interest in the Property, including without limitation a fee, leasehold, deed, mortgage, or easement interest (the “Interest”).~~”

Similarly, section 5(a) states in part that “Any Forest Owner shall not transfer, assign, delegate or convey any Interest in the Property or any Forest Owner Obligation unless: (1) the party receiving the Forest Owner Obligation or Interest in the Property (the “Assignee”) agrees to assume all of the Forest Owner Obligations unconditionally without modification or amendment”. This section prevents transfers of property interests in the property subject to the PIA that do not ensure that the Assignee assumes all of the Forest Owner Obligations. Once again, consider the situation where a Forest Owner wishes to transfer a simple right of way easement to a neighbor. It is manifestly unreasonable to propose that the neighbor should assume all Forest Owner Obligations, including indemnifying the Reserve and all of its agents for any liabilities in any way connected with the PIA (see §13 of the Agreement), simply for the right of driving her car across the Forest Owner’s property.



We suggest that §5(a) be amended to read: “The transfer, assignment, delegation or conveyance of any Forest Owner Obligation or any Interest in the Property that could reasonably be expected to significantly affect Obligated Reductions shall be void unless: (1) the party receiving the Forest Owner Obligation or such Interest in the Property (the “Assignee”) agrees to assume all of the Forest Owner Obligations unconditionally without modification or amendment [. . .] was fully executed. For the avoidance of doubt, the real property interests described in California Civil Code §801(1), (2), (3), (4), (6), (7), (8), (11), (12), (13), (14), (15), (16), (17), and (18) in addition to other similar servitudes and the right of receiving water from the Property, shall all be deemed to have no significant effect upon Obligated Reductions and are therefore beyond the scope of this Section 5(a).”

Please note that the term “Obligated Reductions” is used many times in the FPP and is not defined in the FPP’s glossary. We suggest supplying a definition.

§5(a): Reserve’s Consent to Qualifying Transfers Should Be Non-Discretionary

Paragraph 6 on page 3 in Section 5(a) begins “If any Assignor transfers, assigns, assumes, delegates or conveys any Interest in the Property or Forest Owner Obligation, the Assignor shall not be released from any Forest Owner Obligation unless the Reserve gives written consent releasing the Assignor from the Forest Owner Obligations, which consent shall not be unreasonably withheld.” This sentence in effect provides the Reserve with leverage to ensure that the required procedures are followed for assigning Interests in the Property. However, this language would grant the Reserve unreasonable discretion to block assignments or transfers that meet the criteria specified in the PIA – if an assignment or transfer meets the requirements set out in the PIA, the Reserve’s release of the Forest Owner from applicable Forest Owner Obligations should be required and ministerial rather than discretionary. The “consent shall not be unreasonably withheld” language would be cold comfort to a landowner forced to dispute a “reasonableness” claim by the Reserve before binding arbitration in Los Angeles. If a transfer or assignment fails to meet the requirements of the PIA, the Reserve can declare a breach and initiate remedies or resolve the dispute before arbitration if necessary – this is enough protection for the Reserve’s interests. We therefore recommend that this sentence be amended to read that “If any Assignor transfers, assigns, assumes, delegates or conveys any Interest in the Property or Forest Owner Obligation, the Assignor shall ~~not~~ be released from any Forest Owner Obligation unless only if the Reserve gives written consent releasing the Assignor from the Forest Owner Obligations, which consent shall not be unreasonably withheld. said transfer, assignment, assumption, delegation or conveyance satisfies all of the applicable conditions and terms of this Agreement.”

§5(a): Forest Owner Should Not Be Liable for Forest Owner Obligations Subsequent to Proper Assignment or Transfer

Paragraph 6 on page 3 in Section 5(a) also states that “Notwithstanding any consent by the Reserve that releases any Assignor from any Forest Owner Obligation, the Assignor shall remain obligated to and liable for any Forest Owner Obligation, which arose during the time that the Assignor held an Interest in the Property or was subject to or liable for any Forest Owner Obligation.” Consider a hypothetical Forest Owner who



transfers land subject to the PIA to a new owner. The transfer is in accordance with the terms of the PIA and the new owner assumes all of the Forest Owner Obligations. This sentence, however, would seem to force the original Forest Owner to retain liability for all obligations that arose during the period of her ownership of the Property when it was subject to the PIA, including (for example) maintenance of obligated reductions for CRTs that she sold – when she now has no control over the Property. Should she continue to be liable for a wildfire started by a new owner, or for illegal clearcut logging initiated by the new owner? Clearly not.

We therefore recommend deleting this sentence.

§5(e): Future Encumbrances Should Be Subordinate to a PIA on Most, But Not All Projects

Section 5(e) states that “Forest Owner shall ensure that any deed, mortgage, lien, lease, or other encumbrance on or affecting the Property that arises subsequent to the Effective Date of this Agreement shall be subordinate to this Agreement.” First, we approve that subordination of encumbrances is limited to future encumbrances under the current language. Approaching current lien holders and convincing them to subordinate to a PIA would inevitably require payments that would render carbon projects uneconomic for many forest landowners with a significant mortgage.

Second, the ability to subordinate future encumbrances to an existing PIA will depend significantly upon the aggregate landholdings of the Forest Owner. Small to medium-size forest owners will very likely be able to convince a bank to subordinate a future mortgage to the PIA, so long as the loan to value ratio is not too high. This has been the case in the past with conservation easements. Large industrial forest owners, however, often mortgage portions of their land holdings to access secured credit on relatively short time periods. The scale of such financing is significantly different than the scale of mortgage financing on small and medium-size properties. The same banker who might be willing to subordinate a US\$1M loan to a PIA given a low loan to value ratio on a small property would very likely be unwilling to subordinate a US\$100M loan to a PIA on a large property, even at a similarly low loan to value ratio. Having more at stake increases risk aversion. Furthermore, large secured credit facilities are often syndicated, with multiple banks holding portions of the loan. The landowner thus faces the prospect of needing to negotiate with multiple lenders rather than a single lender over subordination, which would likely prove prohibitive.

Achieving significant carbon sequestration or avoided land use emissions through forest carbon offsets will require involving the industrial forest sector. If the Reserve wishes to make this Protocol accessible to large forest landowners, it must offer some flexibility around subordination of future encumbrances to the PIA. We suggest two options for creating such flexibility for landowners with more than 100,000 acres:

- 1) Allow subordination of the PIA to the new encumbrance, but increase the buffer withholding rate for that Forest Owner by an appropriate amount to reflect the increased risk of reversal should the Forest Owner go bankrupt or default on the senior lien and the property transfer involuntarily to the lien holder with the PIA nullified.
- 2) Creating an option to subordinate the PIA to new encumbrances if doing so would not unreasonably increase risk of reversal or breach of the PIA. The Reserve would have to develop a multi-factor test to assess increased risk of reversal due to subordination of the PIA.



Regardless, without creating some form of flexibility on the subordination issue for large forest landowners, the FPP is likely to have limited impact “on the ground.”

§6(a) and §12: Create an Incremental Dispute Resolution System

Section 6(a) enables the Reserve to declare a breach of the Agreement in its “sole and reasonable discretion”; the forest Owner then has 30 days to cure. No provision is made for negotiations over reasonable disagreements as to the existence and extent of an alleged breach. If the Forest Owner wishes to challenge a determination of breach, he or she must initiate binding arbitration proceedings in Los Angeles.

This hawkish, one-sided dispute resolution procedure has been a material concern for many of the landowners with whom we have spoken. We would recommend creating an incremental dispute resolution system. If the Reserve or the Forest Owner alleges a breach, the Reserve and the Forest Owner should have 10 business days to discuss the matter and try to reach agreement on the presence or absence and extent of a breach of contract. If no agreement is reached, CAR should create an internal appeals process to appeal the decision if it was the Reserve that alleged breach. If disagreement continues to exist after a decision via the internal appeals process, the Parties may proceed to a court of law or binding arbitration. The location of such arbitration or the venue for the lawsuit should be the decision of the party who did not allege breach of contract. CRT sales could reasonably be frozen throughout the dispute resolution process.

§6(d): The Reserve Cannot Retain Legal and Equitable Remedies While Compelling Binding Arbitration

Section 6(d) states that “Notwithstanding anything to the contrary herein . . . the Reserve shall have the right to: (i) seek all remedies available at law or in equity for any breach of this Agreement or the Forest Protocols subject to Section 12”. Section 12 states that any dispute must be submitted to binding arbitration in Los Angeles, and that “the decision of the arbitrator shall be the exclusive remedy for any Dispute, final, conclusive and binding upon the Parties.” Furthermore, if a Party pursues a Dispute by any method other than arbitration (e.g. pursues legal or equitable remedies in a court of law) then “the responding Party shall be entitled to recover from the initiating Party all damages, costs, expenses and attorney fees incurred as a result of such action or proceeding.”

If the Reserve proposes a contract that compels binding arbitration as the only mechanism of dispute resolution, and provides that damages awarded pursuant to any other claim in an alternative forum must be compensated by the plaintiff, it makes no sense to reserve all remedies available at law or in equity. We suggest deleting §6(d)(i).

§7: Project Termination Meeting the Requirements of the Protocol Should Not Be at the Reserve’s Discretion

Section 7 states that termination of the Agreement is impossible unless “the Forest Protocols specifically provide for the termination of this Agreement and/or the Forest Protocols, in which case this Agreement will terminate, at the Reserve’s option.” The Forest Protocols and this PIA under the June 2, 2009 proposal specifically provide for early termination of the Project, provided that a certain number of CRTs are retired.



If the Forest Owner follows the provisions of the Forest Project Protocol in an early termination of a project, the Reserve should not have the discretion to decline to terminate the PIA.

We therefore suggest the following language for §7: “No breach of this Agreement or the Forest Protocols shall entitle either Party to cancel, rescind, or otherwise terminate this Agreement unless (i) the Forest Protocols specifically provide for the termination of this Agreement and ~~/or the Forest Protocols~~ (ii) **all terms and conditions of the Forest Protocols and this Agreement for early termination of the Forest Project and this Agreement have been met**, in which case this Agreement will terminate, ~~at the Reserve’s option.~~”

§12: Replace Mandatory Arbitration with Access to Courts of Law

Section 12 requires mandatory arbitration in Los Angeles of all disputes pertaining to this Agreement. Arbitration can be capricious, does not necessarily afford the same procedural safeguards as litigation in American courts, and does not necessarily offer a more rapid resolution of disputes than litigation. We would recommend that Section 12 (i) incorporate an incremental dispute resolution process, as described above; and (ii) not restrict access to courts of law for dispute resolution. We therefore recommend deleting the current text of §12 and replacing it with “**The Parties agree that, in the event the dispute resolution procedures specified in Section [x] of this Agreement fails to resolve a dispute, all actions or proceedings arising in connection with this Agreement shall be tried and litigated exclusively in the State and Federal courts located in the County of [X], State of California. The aforementioned choice of venue is intended by the Parties to be mandatory and not permissive in nature, thereby precluding the possibility of litigation between the Parties with respect to or arising out of this Agreement in any jurisdiction other than that specified in this paragraph. Each Party hereby waives any right it may have to assert the doctrine of forum non conveniens or similar doctrine or to object to venue with respect to any proceeding brought in accordance with this paragraph, and stipulates that the State and Federal courts located in the County of [X], State of California shall have in personam jurisdiction and venue over each of them for the purpose of litigating any dispute, controversy, or proceeding arising out of or related to this Agreement.**”

§13: The Indemnity Provision as Drafted is Excessive and Unreasonable

The indemnity provision as drafted in section 13 will be unacceptable to any landowner, large or small, regardless of location or temperament. Leaving this provision unaltered will result in zero uptake of the new FPP. As drafted, this provision would require the Forest Owner to indemnify the Reserve and its agents for a broad range of unacceptable actions. Consider a verifier, agent of the Reserve, who negligently starts a fire on a Forest Owners’ property that spreads to neighboring properties and causes \$10M in damage. Should the Forest Owner indemnify the Reserve for such damage? No. Consider a dispute between the Parties, pursued according to the current section 12 in arbitration. The Forest Owner wins in arbitration and is entitled under §12 to recover its costs and expenses, but in §13 has indemnified the Reserve for any penalties and costs “arising from or in any way connected with this Agreement,” and therefore arguably must pay for the Reserve’s legal expenses even after winning an arbitration dispute!

We strongly recommend amending the language in §13 to limit the Forest Owner’s indemnity to a narrowly defined, reasonable extent.



Consequences for Intentional Reversals Should be Limited to Replacing CRTs Sold and Should be Symmetric Among Project Types

The supplementary document to the PIA draft suggests that intentional reversals must be compensated with CRTs issued by the Reserve to other Forest Projects registered with the Reserve; if unobtainable, as determined by the Reserve, the reversal may be compensated for with other CRTs. Similarly, to terminate a project the Forest Owner must retire CRTs issued to Forest Projects unless unobtainable as determined by the Reserve. For Reforestation and Avoided Conversion projects, the Forest Owner must retire an amount of CRTs equivalent to the number of CRTs issued by the Reserve to that project since the project's initiation. For Improved Forest Management projects, the Forest Owner must retire a higher number of CRTs if the project is terminated within 50 years from its initiation.

First, we recommend that the Reserve not require replacement with Forest Project CRTs and not place itself as the arbiter of Forest Project CRT "obtainability". The only rationales for requiring replacement with Forest Project CRTs are to (a) retain co-benefits or (b) retain a premium price for forest carbon offset tons. While forest conservation goals are undeniably important, CAR and the Forest Project Protocol have climate mitigation goals, not land conservation goals. If the climate is "made whole" through the replacement and retirement of CRTs equivalent to the amount issued to the project, some land use change should be acceptable to CAR.

Conferring economic rents to Forest Project CRT owners by artificially increasing demand for their product should also not be a goal of CAR, and it should not be the judge of whether Forest Project CRTs are obtainable. Should a Forest Owner terminating her project be compelled to buy and retire the last 100 Forest Project CRTs on the market simply because they exist? What if the owner of those CRTs does not want to sell, or will only sell at \$10,000/CRT? CAR will in practice only be able to verify the existence of Forest Project CRTs, not true practical availability. It should therefore not establish itself as an arbiter of availability.

Second, there is no reason to discriminate between Reforestation and Avoided Conversion projects and Improved Forest Management (IFM) projects by requiring IFM projects to purchase a higher number of CRTs to terminate a project. If any forest project terminates, they are all equally likely to do so due to higher returns from an alternate land use. An Avoided Conversion project may, for example, choose to convert the land to housing or agriculture, causing significant reversals. There is therefore no stronger reason to "game" Reforestation and Avoided Conversion projects than IFM projects, and they should therefore all be subject to the same requirements for early termination.

Third, to terminate a project, a Forest Owner should only be required to replace and retire CRTs equivalent to the amount issued to that project. If a federal or state compliance cap and trade system exists that issues allowances, Forest Owners should be required to purchase allowances rather than CRTs to replace CRTs sold from their Project to terminate their projects.

