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State of the Forest
Carbon Markets 2012

Executive Summary

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Cover by Melissa Tatge.

Executive Summary



Over the last three years, projects that address the relationships between carbon and forests have moved from the sidelines of international climate action to center field. Forestry's recent advancements are the product of decades of ongoing collaboration among market and environmental experts seeking to strike an ideal balance between forestry projects' market risks and shared benefits.

Market dynamics in 2011 demonstrated that these efforts have never been more pivotal, or complex, as forest carbon projects mature – and find themselves positioned squarely in the midst of some of today's most challenging policy debates.

This year, a record number of forest project developers and secondary market suppliers from around the world shared data about their projects and transactions. This third annual State of the Forest Carbon Markets tracks, reports, and analyzes trends in these responses. This information is primarily based on data collected from respondents to Ecosystem Marketplace's 2011 forest carbon project developer's survey, combined with data from the 2012 State of the Voluntary Carbon Markets report.

The data and analysis that follow cover forest carbon activity in compliance carbon markets – including the Kyoto Protocol's Clean Development Mechanism (CDM), the New Zealand Emissions Trading Scheme (NZ ETS), the New South Wales Greenhouse Gas Reduction Scheme (NSW GGAS) and British Columbia's (BC) Carbon Neutral Government directive – as well as voluntary carbon markets including voluntary Over-the-Counter (OTC) market and country-specific voluntary programs worldwide. In total, we captured responses from 140 project developers or project proponents in the primary forest carbon market and 35 suppliers in the secondary market. Respondents represented 215 individual forest carbon projects, half of which transacted credits in 2011 – totaling **451 projects analyzed in all survey years**.

Market Overview: Value Hits New Heights While Volumes Vary by Market

In 2011, forest carbon project developers reported the highest overall value ever attributed to the global marketplace for forestry offsets – **totaling \$237 million**. While values increased 33%, transaction volumes declined 22% from 2010 record volumes to 26 MtCO₂e transacted in 2011. Around 12% of market value was driven by existing and emerging domestic marketplaces like the regulation-driven BC Carbon Neutral Government scheme and Australia's carbon price mechanism. The volume and value of these programs is largely consolidated in the "other" category in Table 1 due to their small number of respective respondents.

The international market for temporary credits from afforestation and reforestation (A/R) projects under the **CDM reported unprecedented value** creation in 2011, owing to the high volume of credits contracted ahead of the end of the Kyoto Protocol's first compliance period. Conversely, volumes fell primarily for offsets contracted over the counter in the international marketplace to voluntary buyers pursuing carbon neutrality or preparing for compliance programs.

Of the value reported in 2011, 26% (\$62 million) represented actual payments to projects in the same year ("pre-pay" or spot contracts). Another \$105 million committed in contracts last year was reportedly due upon credit delivery – some of this value contingent upon project developers' ability to actually deliver.

Volume contracted in 2011 represents a small proportion of surveyed projects' **total potential reductions** – estimated to be between 504 and 1,073 MtCO₂e between the start of their crediting period and 2050. It is also a fraction of the volume of credits developers say they need to sell – at prices that vary by individual project scenarios – in order to get projects off the ground (literally) and maintain project activities. For project activities that are under development or already in implementation, developers value their projects' near-term needs at between \$2.2 and \$5.4 million over an unspecified timeline.

Last year, projects managed to obtain prices that were double the 2010 average, seeing a **market-wide average price** of \$9.2/tCO₂e in 2011. Once again, the pricing incentives or requirements of domestic-only markets factored highly in the increased average price, and may not represent the price or value attainable by projects in the international marketplace. Overall, this price is the aggregation of hundreds of diverse prices that vary greatly by project standard, location and other environmental and social co-benefits – ranging from less than \$1/tCO₂e to over \$100/tCO₂e in 2011.

Table 1: Volume, Value, and Prices in the Forest Carbon Markets (Primary & Secondary Markets)¹

MARKET	HISTORICAL	VOLUME		VALUE		AVERAGE PRICE	
		2010	2011	2010	2011	2010	2011
Voluntary OTC	76.4 M	27.8 M	16.7 M	\$157.8 M	\$172 M	\$5.6	\$10.3
California /WC pre-compliance	2.0 M	0.5 M	1.6 M	-	\$13 M	-	\$8.1
CCX	2.9 M	0.1 M	0 M	\$0.2 M	-	\$1.2	-
Voluntary Total	81.4 M	28.4 M	18.3 M	\$158 M	185 M	\$5.6	\$9.2
CDM/JI	15.3 M	1.4 M	5.9 M	\$6.3 M	\$23 M	\$4.5	\$3.9
NSW GGAS	6.3 M	2.3 M	-	\$13 M	-	-	-
NZ ETS	0.9 M	0.2 M	-	\$0.3 M	-	\$13	-
Other / Unknown	1.9 M	0.4 M	1.5 M	-	\$29M	-	\$19.7
Compliance Total	24.5 M	4.4 M	7.3 M	\$25.0 M	\$52 M	\$4.6	\$7.2
GRAND TOTAL	105.9 M	33 M	26 M	\$177 M	\$237 M	\$5.5	\$9.2
<i>Primary Market</i>	<i>95 M</i>	<i>32 M</i>	<i>21 M</i>	<i>\$143</i>	<i>\$143 M</i>	<i>\$5.5</i>	<i>\$8.1</i>
<i>Secondary Market</i>	<i>11.3 M</i>	<i>1.2 M</i>	<i>4.9 M</i>	<i>\$4.8 M</i>	<i>\$54.7 M</i>	<i>\$7.6</i>	<i>\$12.1</i>

Source: Ecosystem Marketplace. Notes: Based on 965 observations in 2011; >1,000 total historical observations. "Other" category includes markets with fewer than three data points. *2008-2010 values for the NSW GGAS market should be considered conservative due to limited market price data.

As seen in Table 1,¹ **primary transactions** (project developers' initial contracts) led the marketplace and, overall, pricing behaved according to market principles – increasing as credits moved through the value chain from developer to secondary market players to end users. Within this trend, however, we find that in the voluntary markets, developers sold the largest volumes directly to end users at below-average prices, and a smaller volume into the secondary markets at slightly above-average prices. Suppliers say this goes a long way toward explaining why contracts between developers and secondary market offset providers – still the forest carbon market's single largest source of private sector demand – fell by more than half in 2011.

A range of sectors – public, private and non-profit – develop forest carbon offset projects. Last year saw an uptick in the volume of credits contracted from government- and NGO-led projects. This trend speaks to the emerging relationship between national or bilateral activities to reduce emissions from deforestation and forest degradation (REDD+), and the NGOs that funders appear to be tapping to carry out or coordinate project-level REDD+ pilots.

Afforestation and Reforestation Projects Firmly Planted at the Top

Even as projects that reduce emissions from deforestation and forest degradation (REDD) consumed the greater part of international climate actors' attention, contracted credit volumes from **afforestation/reforestation** (A/R) projects reached new heights – whether or not one includes the large CDM A/R market. The bulk of these transactions involved credits contracted to purely voluntary corporate buyers and were many years in the making. The median start date reported for A/R project crediting periods indicates that the largest number of project activities were initiated at least five years ago.

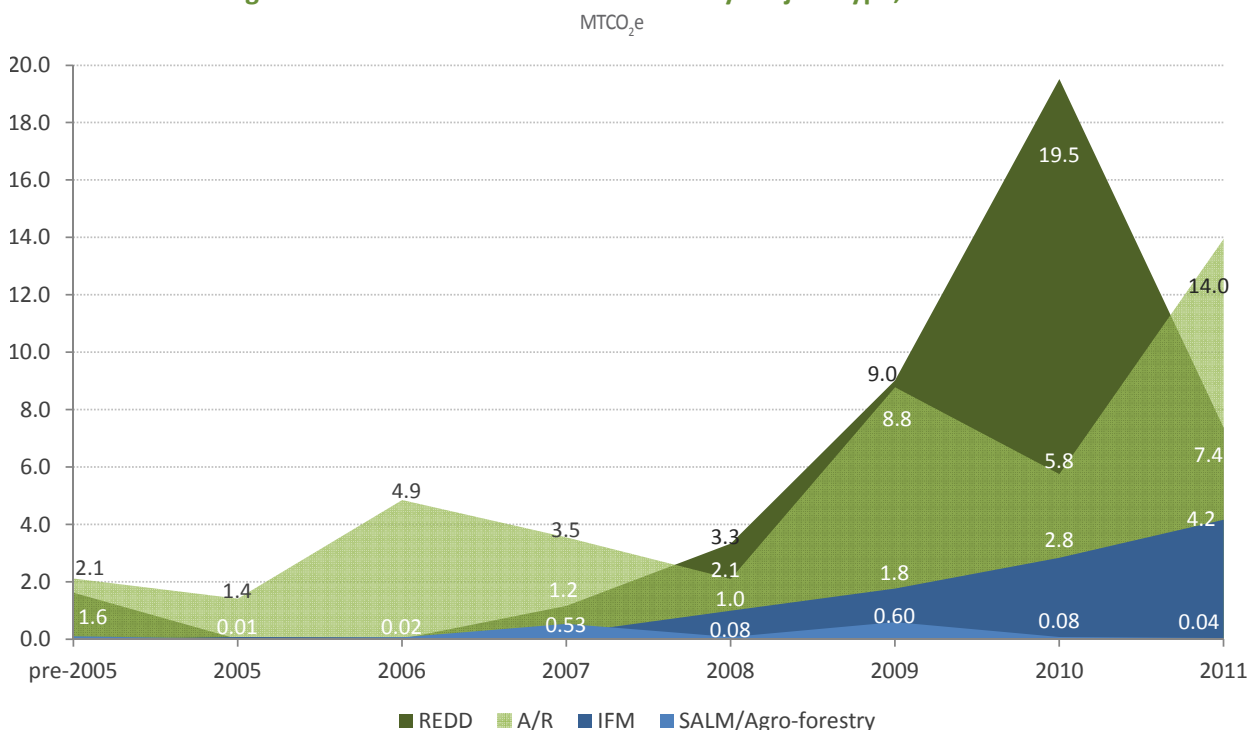
Behind A/R, **REDD** credit transaction volumes fell by 62% last year as projects came to terms with the unexpected complexities and costs of newly available methodologies; decreased demand from recession-constrained European buyers; and the intricacies of tenure, community building and evolving policy environments that characterized global challenges to REDD project implementation and finance in 2011.

Despite encountering a morass of political and market uncertainties, REDD project developers forged ahead with several market breakthroughs in 2011, seeing the **first REDD credits verified and issued** to the Verified Carbon Standard (VCS), new approaches to crediting projects in the context of jurisdictional programs – and a trend toward identifying complementary revenue streams to help stabilize projects' financial resources in times of lean market demand and to enhance REDD's contribution to adaptation and sustainable livelihoods.

Improved Forest Management (IFM) projects were the preferred project type feeding into North America's compliance markets, which pushed IFM credit volumes to a new level in 2011. Last year also saw the first glimpse of credits from **Sustainable Agricultural Land Use** (SALM) projects which – like IFM – see increased uptake due to the strong business case for adopting more sustainable land management practices. A smaller volume of credits was transacted from agro-forestry projects, though these activities were reported within A/R, REDD and managed forest project areas – and credited as one of these categories.

¹ Volumes not tied to a price were multiplied by each marketplace's average price and added to its total. This change in methodology means that annual total values may differ from previous reports.

Figure 1: Historical Transacted Volumes by Project Type, All Markets



Source: Ecosystem Marketplace. Notes: Based on 603 observations in 2011; 731 total historical observations.

Sustainable Forestry and Agriculture the Most-Used Approaches to Avoid Deforestation

REDD, IFM, A/R and SALM/agro-forestry each encompass a variety of activities within their project areas. For REDD projects, activities that help to avoid the projects' drivers of deforestation ran the full spectrum available tools, the most popular being **improved forest management, smallholder to commercial scale sustainable agricultural practices**, as well as introducing sustainable energy alternatives to wood fuel and A/R activities. REDD projects exemplify what developers point to as an emerging trend to view project types more holistically rather than as discrete activities. REDD+ projects often incorporate A/R, IFM and sustainable agriculture – and sometimes small scale energy alternatives – that are simply credited under the umbrella of “REDD+” but in fact impact a much larger land area than is currently recognized.

Forest Carbon Projects Impact 18 Million Hectares Historically

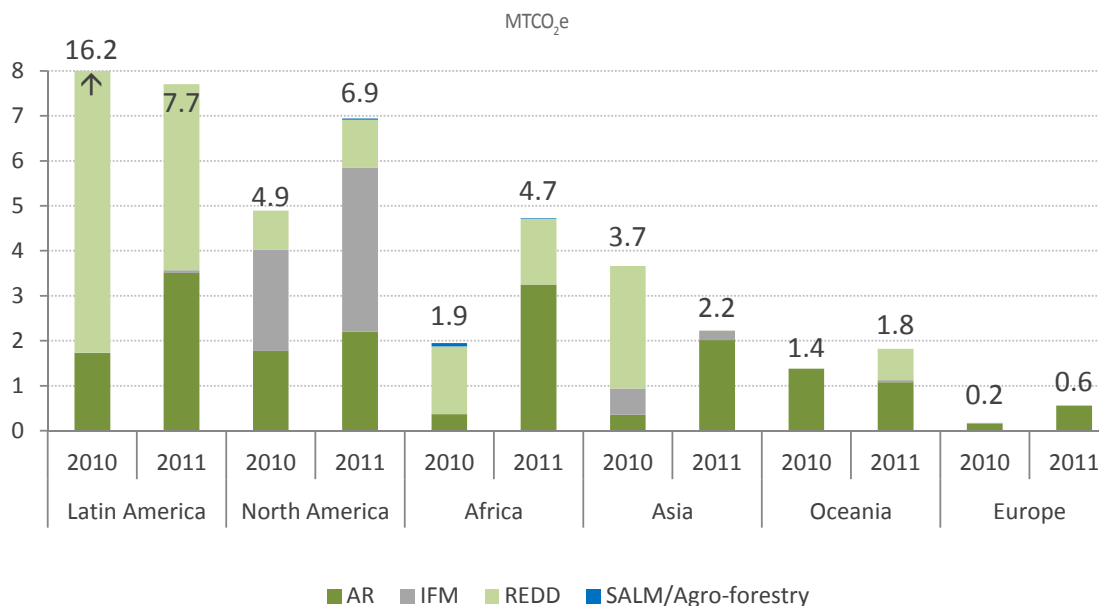
Forest carbon credits are each tied to land areas that feature unique environmental conditions and tenure arrangements. In the pursuit of risk mitigation and simplified project documentation, the largest number of projects that successfully contracted credits were situated on private land (70 projects contracting 11 MtCO₂e) – though the largest growth in volumes was seen among project areas featuring **collective or customary land rights**. The extent to which this designation also confers ownership of the carbon stock to community smallholders varies by country location. Another 3 MtCO₂e of credits were generated on government-owned public lands, where some project developers have worked in tandem with under-resourced domestic conservation agencies to define, implement and monitor adherence to formal land use plans. The smallest volume of credits was generated from projects that went the route of obtaining land or conservation concessions, owing their low uptake to legal and administrative complexity.

Worldwide, projects that successfully contracted credits in 2011 were situated on 5 million forested hectares – 4.2 million ha of which was attributed to REDD projects. Combined with the areas impacted by historical projects that did not contract credits in 2011, forest carbon project developers reported their activities affect a total of 18 million hectares. Including historical projects that did not contract credits, the vast majority of this broader land area is also attributed to REDD projects (14 million ha), which as mentioned above support a wide variety of activities within their formal project boundaries.

Americas Retain Top Status for Forest Carbon Offset Supply

Supply of forestry credits varies highly by region. The volumes of credits contracted is not only a function of forest resources or threats but also the region's policy environment. Again in 2011, developers reported the largest volume of credits contracted from projects based in **Latin America and Caribbean countries (LAC)**. The region reported the highest concentration of projects and inroads made to domestic voluntary market development. LAC countries nevertheless saw volumes fall 52% as developers encountered many of the challenges inherent to REDD projects, as well as country policies that tended to focus their efforts in 2011 on climate and forest measures other than those that directly incentivize project-level activities.

Figure 2: Transacted Volume by Project Location (Region) and Type



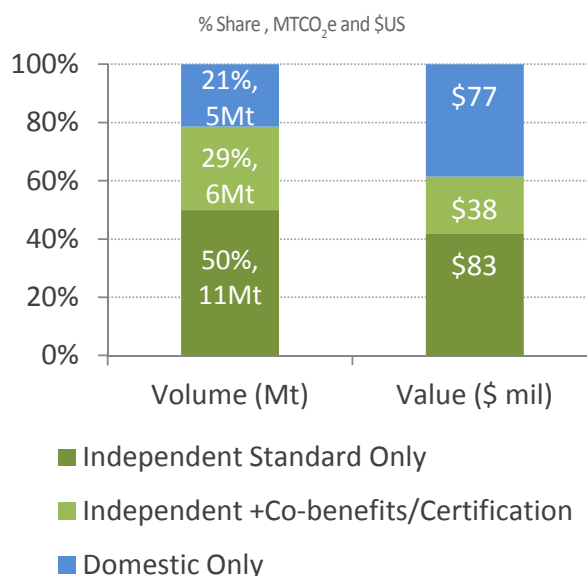
Source: Ecosystem Marketplace. Note: Based on 828 observations.

North America and **Africa** both posted increased market share in 2011, resulting from very different demand drivers. In North America, both supply and demand were split between purely voluntary action and compliance/pre-compliance demand from British Columbia and California-facing market players. In **Africa**, 97% of credits were sold to voluntary buyers in the EU. In **Asia**, volumes fell but developers reported significant technical developments on the ground, while volumes from projects in **Australia and New Zealand** got a boost over 2010 as developers made their way to the starting line for the Australian carbon price mechanism via the Carbon Farming Initiative (CFI) offset program.

VCS and CDM Vied for Ranking as Most-Used Independent Standard

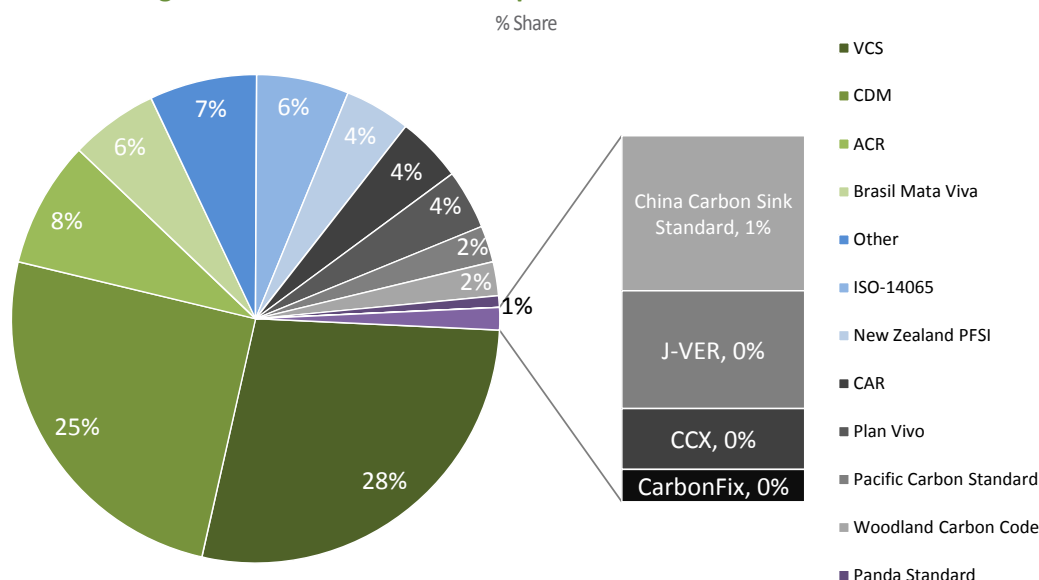
In 2011, the **VCS** retained its top spot among independent standards that offer methodologies for a variety of project types and regions, capturing 28% of overall global market share for carbon accounting standards with 6.5 MtCO₂e transacted. In contrast to 2010 when the vast majority of VCS credits stemmed from REDD activities, this year's survey also tracked large volume contracts from VCS A/R and IFM projects. Behind VCS, **CDM** methodologies underpinned a record volume of credits sold to international compliance buyers. **American Carbon Registry** (ACR) forest carbon project offsets also transacted at record volumes in 2011. Though ACR projects were primarily US-facing in 2011, ACR also saw several international projects under development to the 2011 release of its first internally applicable REDD methodology.

Figure 3: Market Share by Standard Type, 2011



Source: Ecosystem Marketplace. Note: Based on 1,260 observations.

Figure 4: Market Share for Independent and Domestic Standards



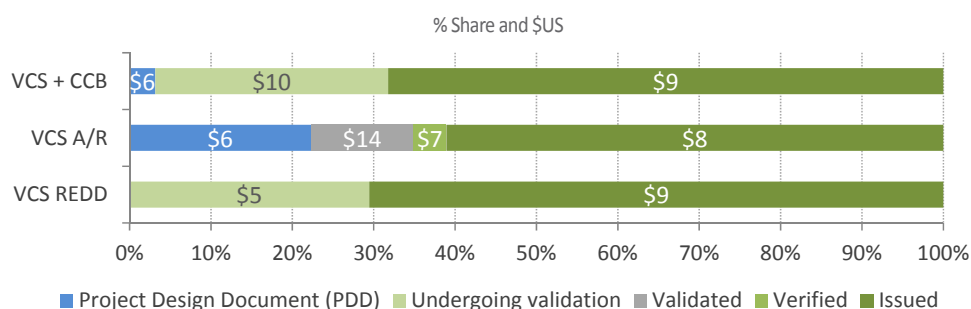
Source: Ecosystem Marketplace. Note: Based on 948 observations.

Meanwhile, the US pre-compliance market was divided between project pursuing early action credits for California's cap and trade scheme through the **Climate Action Reserve's** (CAR) US Forest Project Protocol, versus those projects going straight to compliance protocols available in the state's regulatory text. The regulation protocols are adapted from the CAR protocol but do not require projects to undergo two project assessments – as is the case with projects originally developed under CAR. Purely domestic standards – both voluntary and compliance-facing – were reported being behind 21% of contracted volume and 39% of market value. Some of these programs have already been mentioned – others include New Zealand's Permanent Forest Sink Initiative (PFSI), China's Panda Standard and China Carbon Sink Standard, Japan's Verified Emissions Reduction Program (J-VER), Brasil Mata Viva and the Oklahoma Carbon Program.

Another 29% of credits using independent standards combined their carbon accounting tools with the certification of additional social and environmental benefits through the **Climate, Community and Biodiversity Standards (CCB)** – or were developed within land areas that secured additional certification for sustainable forestry or agricultural land use. Projects in this category achieved higher average prices overall.

With respect to price, most independent standards exhibited a wide range of prices that were determined by various project attributes. Two other important components of credit pricing that can be analyzed alongside the project standard are the project type and the stage the project had achieved at the time of transaction. Figure 5 shows that **VCS REDD project prices** exhibit the most typical pricing pattern rewarding the lower delivery risk associated with issued tonnes. Because of VCS REDD credits' relative "newness" in the marketplace, their pricing became fairly transparent as market players exchanged price observations throughout the year. Otherwise, even prices analyzed at this depth reveal very little in the way of trends due to the opacity and small size of the international marketplace for credits developed to independent standards. The price spreads for credits from standards within compliance and domestic markets were comparably narrower.

Figure 5: Market Share and Price by Popular Forest Project Types, All Markets 2011

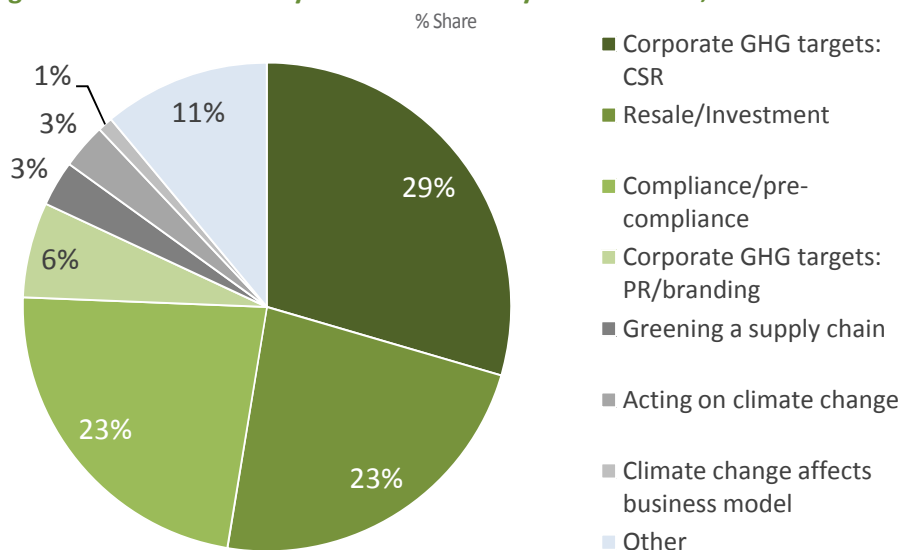


Source: Ecosystem Marketplace. Note: Based on 414 observations.

Most standards described above utilize a handful of **offset registries** to serialize, transfer and track their credits. In 2011, registries reported record issuance and retirement volumes. The majority of newly issued forestry credits were house on the Markit Environmental Registry, which supports one leg of the VCS registry system and also several other standards including CarbonFix, Plan Vivo and several domestic standards. In 2012, the CDM registry issued the first ever temporary credits (tCERs) from CDM A/R projects in Ethiopia and Brazil.

As seen in the burgeoning number and value of domestic programs, forest carbon project developers have followed the global carbon markets down the path of market fragmentation. This is also apparent in the profiles of forest offset buyers who range from sovereign country-scale buyers seeking tCERs to US-based intermediaries preparing for regional compliance demand to developing country corporates wading into corporate social responsibility commitments via domestic voluntary programs.

Figure 6: Market Share by Private Sector Buyer Motivation, All Markets 2011



Source: Ecosystem Marketplace. Note: Based on 621 observations.

Last year, **European buyers** contracted the largest volumes of credits, to surrender on behalf of their Kyoto Protocol obligations and/or to achieve voluntary aims. They were also the largest source of demand for credits from developing countries, but in 2011 a growing volume of credits from EU-based forestry programs like the UK Forestry Commission's Woodland Carbon Code also went to domestic buyers in their programs' respective countries. Domestic demand was not only relegated to the ranks of developed country buyers, but also saw examples of buyers China seeking Panda Standard or other local program credits, and Latin American exporters greening their end of multinationals' supply chains. As in previous years, buyers in the US were responsible for contracting the largest total volume of buyers in any one country, and primarily sought credits from projects within their own borders.

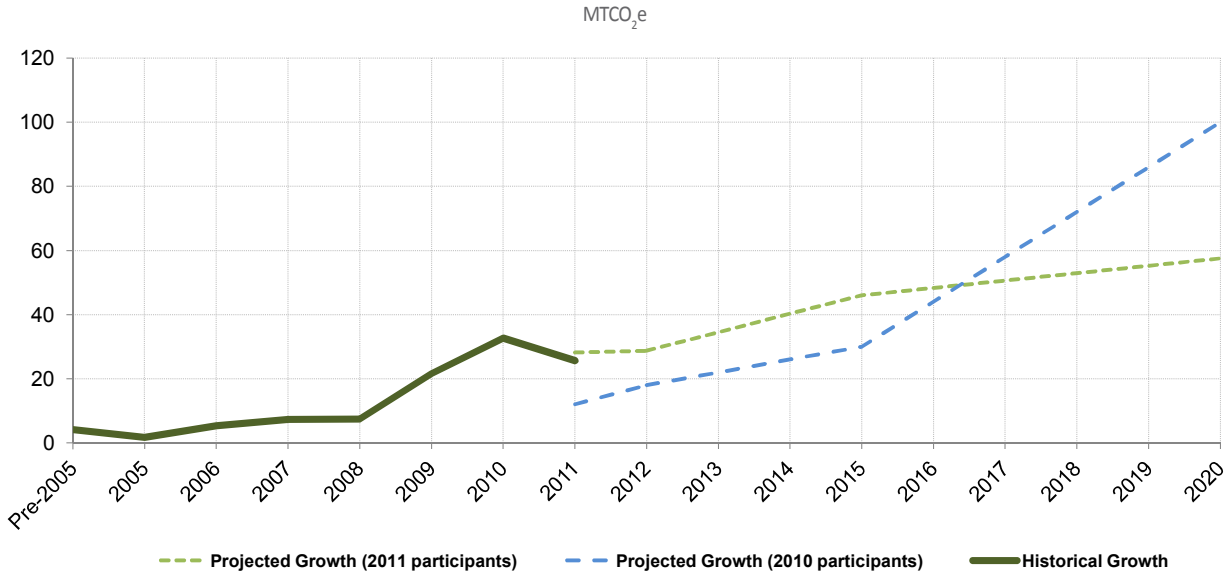
Reflecting the fact that the majority of forest carbon offset transactions occurred in the voluntary markets, the most prominent motivation for transactions is buying offsets in pursuit of CSR targets. Buyers motivated by resale and/or investment contracted another quarter of forest carbon offset volumes. Buyers with an eye on existing or potential compliance markets worldwide – from California to Chile – also contracted credits with the expectation of future regulations or to surrender at the end of Kyoto Protocol's first commitment phase (close of 2012). Other motivations fit squarely in the category of voluntary commitments. This includes "greening" a supply chain or acting on climate change in response to its impact on their business models.

Project Developers Await Steady Long-Term Growth

Forest carbon suppliers were asked again this year to predict the future of the forest carbon market and the volumes they expect from their own projects. While these predictions are subjective, they provide useful insight into the current temperament of the market and indications of where it might be headed. Developers responding to this question only slightly overestimated the size of the 2011 forest carbon market, predicting 28 MtCO₂e, when 26 MtCO₂e was actually contracted.

Looking ahead, they expect the forest carbon market in the current year (2012) they expect transaction volumes to remain steady and contract an estimated 29 MtCO₂e. This estimate is perhaps the most accurate, as this survey was conducted in the first quarter of 2012 and many ways captures developers’ immediate outlook on prospective transactions. Beyond 2012, and in contrast to 2010 developers’ projections, respondents in 2011 were more conservative about their long-term outlook, anticipating a leveling off of growth after 2015 but no major disruptive events.

Figure 7: Project Developer Predictions, All Markets 2010-2011



Source: Ecosystem Marketplace. Note: Based on 832 observations from 37 developers.

Developers reported that a total of 32 MtCO₂e in reductions that they intended to contract in 2011 but instead carried over into 2012. Had developers contracted all volumes in their portfolios, the total 2011 volume would have been closer to 58 MtCO₂e. Looking ahead, developers anticipate generating another 243 MtCO₂e from new project activities from 2012-2016. The makeup of this volume varies greatly from existing portfolios, where developers expect to double the volume of A/R credits that remained in their portfolios at the end of 2011 – as well to increase their current supply of REDD credits 41 times over (to 182 MtCO₂e through 2016) and IFM credits, which may increase 1 ½ times over their current portfolio volumes.

Marketplace Branching Out in 2012

In the first three quarters of 2012, the landscape for forest carbon markets continues to evolve as different types of actors and project approaches enter the mix – and turn the market’s lens on new ways to measure and monetize forest services. Efforts to “nest” project activities within jurisdictional frameworks – or to trial Free, Prior and Informed Consent procedures – that were mere blips on the radar in 2011, have recently come into clear view. So, too, have innovative approaches to blue carbon, milestones in credit issuance and the start of new compliance markets that all acknowledge forestry’s integral role in the fight against climate change.

Developers report that the new year has also carried over some existing challenges identified in our 2011 data, as the struggle continues for developers to identify fresh sources of offset demand in the international voluntary markets – where new buyers have been slow to step up to the plate in response to extenuating economic circumstances. In response, 2012 has seen some effort to reignite international voluntary demand for offsets through programs like the Code REDD campaign, intended to raise corporate awareness around the critical need for REDD.

Some of the most promising project incentives are entering the market at the domestic level – like the Australian government’s \$250 million fund to kick start purely voluntary domestic activities. As seen with government offset purchase programs in other sectors, this type of action could serve as a successful bridge to compliance market “readiness,” innovation and scaled up project activities – primarily benefitting projects that are literally in the right place at the right time. But if recent events are any indication, “purely domestic” markets for forest carbon maybe expanding their own field of vision, seeing the majority of active and pending regional to national marketplaces now weighing linkages with other regions at various depths and scale. This may in turn push forestry to the

front of the agenda as each program weighs the relative merits of its domestic approach against the use of more fungible independent standards and registries.

At the project level, both our data and discussions with market players reveal a genesis of new structures for developing and financing international forestry projects – as developers demonstrate increasingly sophisticated relationships between forest carbon assets and other agricultural commodity markets; formalize the community role in REDD; and deepen their relationships with the agencies responsible for piloting donor-funded forestry initiatives in hopes of gaining access to that value as it slowly makes its way to projects on the ground.

With one eye on these nascent opportunities and the other on immediate project needs, developers, standards bodies and their stakeholders carry on in their quest to take the forest carbon market to the next level in 2012 – forging new tools for market tracking, and collaborating between standards and with buyers and governments themselves to ensure that forest carbon consciousness is at the heart of the year's key corporate and policy decisions.



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