DOUBLE DIPPING IN THE CARBON MARKET: IS IT A VALID CONCERN?

Jim Rinehart July, 2008

The interface between conservation and financial components of a forest investment is the working forest easement. In the context of a transaction, the market determines the value of the property and the difference between pre-easement and post-easement investment value defines the cost of conservation. This relationship can be seen as a co-investment, with each “partner” investing in the property attributes most important to their core objectives. The line of demarcation between these property attributes is the conservation/working-forest easement – the financial partner is free to operate commercially up to the easement, while the conservation partner “owns” the social rights on the other side. The partnership is made efficient through the dynamic tension created by the easement.

The developing market for carbon offsets has blurred the line. Offsets are a “forest product” much as logs or recreational leases, but who owns them? With the easement in place, on which side of the line do they fall? The argument has been made that since under the California Climate Action Registry (CCAR), an easement is necessary for carbon reserves to be registered, the easement, in effect, creates the reserve and thus the owner must relinquish carbon rights along with other rights acquired by the easement.

While containing a degree of apparent logic, in fact this argument is incorrect.

A TYPICAL TRANSACTION

The basic premise to be applied is that the landowner should be paid fully for the value he relinquishes, as determined by appraisal – no more and no less.

By way of example, assume that market value for a given property is $10 Million – a willing buyer will buy it for that and a willing seller will sell it. In the co-investment described above, Conservation determines the course of management by defining the level of conservation desired. In this example, let’s say that Conservation wishes to extinguish development and subdivision rights and that the property must be managed under FSC standards. Assume that this creates a permanent increase in standing inventory of 10% over and above what would have resulted by management constrained only by regulation. Except as constrained by the easement, the financial partner, as owner of fee title, is free to manage the property to the fullest extent with respect to all of its residual values. The financial partner is willing to manage the property subject to the easement, but finds that under the easement conditions, he/she can pay only $6 Million and still achieve a market rate of return. It still takes $10 Million to buy the property, so Conservation must contribute $4 Million to make the deal work.

An easement is a legal lien on a property that runs with the title for as long as it is effective. The landowner no longer owns the rights to the activities that the easement restricts, and it is the responsibility of the easement holder to monitor management to be certain easement constraints are met. As with any commercial transaction, the price paid for the easement is determined by negotiation between easement holder and landowner – if Conservation declines to pay what the landowner demands, the landowner may decline to sell the easement, may lower the price, or adjust the conditions. When a public agency provides the funding to acquire an easement, its cost can be no more than market value as determined by competent appraisal. Through this mechanism, the agency is assured that public funds are not used to subsidize private enterprise. In fact, even where no government funding is involved, where the easement buyer is a tax exempt 501(c)3 NGO, under IRS Private Benefit constraints, price is constrained by appraisal or the NGO risks losing its tax-exempt status.

CARBON TRANSACTION

Assume the conditions are the same as described above, with Conservation paying $4.0 million to acquire the management restrictions constrained by the easement. In this case, however, assume that the 10% increase in standing inventory creates certified carbon offsets that might be sold in a carbon market, should such a market develop. Because the easement constrains harvest, the only potential economic value in the marginal inventory is carbon. Although the landowner has no plans to sell the carbon currently, he wishes to retain these rights. The easement agreement does not state that carbon rights, or any other potential values that may or may not develop, are retained by the landowner, although it does list the specific constraints of the easement that the landowner agrees to abide by. The sale price agreed to by the landowner and the conservation organization is in consideration only of these specific constraints.

In securing funding for the easement, the conservation organization is required by the State funders to provide an appraisal that estimates the fair market value of the easement. Appraisal guidelines define such value as market value in an unconstrained condition less market value constrained by the easement. The appraiser is instructed to consider all observable components of value.

- **Scenario 1. No Specific Carbon Sale is Contemplated.** In this case, the landowner contemplates no specific sale of carbon, although he wishes to retain the right to sell carbon in case a sale opportunity should occur. The appraisal supports the $4.0 Million easement sale agreed to by the NGO and the landowner. The appraisal attributes no value to potential carbon assets as no carbon value is reflected by the market. Nonetheless, the State argues that because the easement has created the opportunity to sell carbon, the carbon rights are attached to the easement and the landowner has no right to sell them.

  Who wins the argument?

  Landowner: "Wait a minute! I don't want to sell the carbon rights and you're not paying me for them! I can make more money by selling logs and subdividing my property."

  State: "The carbon sale wouldn't have been available without our easement, so you didn't have them to begin with."

Landowner: “The carbon is in the trees and I own the trees. All I gave up was the development rights and I’ve committed to FSC. It’s my carbon. Tell you what. Pay me another $50,000 for the easement and I’ll do it.

State: “The appraisal doesn’t support that price.

Landowner: “Then no deal!”

In fact, the price paid for the easement must equal the forgone return from timber management or subdivision in order for it to be economically efficient for the forest owner. If it is not, the owner is subsidizing the easement, a “donation” for which he is not paid and for which he receives no tax deduction. The retention of carbon rights by the landowner helps make up the difference.

In this case, the landowner wins the argument but everyone loses. The property is ultimately subdivided, the State misses an opportunity to place voter mandated funds, and the public looses the opportunity for conservation. In fact, the State has overstepped its bounds by requiring a restriction that it did not pay for.

- **Scenario 2. The Landowner Contemplates a Voluntary Carbon Sale**. In this case, prior to selling the easement, the landowner anticipates that he can sell carbon credits and actually talks to a carbon buyer who expresses interest at a price yet to be negotiated if he can complete his easement. This time, the State funds the easement sale for $4.0 Million, acquiescing on carbon because the appraisal discerned no carbon value in the market place. When the easement closes, the landowner completes the carbon sale for $50,000.

  Did the landowner receive more than he should have for the easement?

  Again, the basic principal to be applied is that the landowner must be paid fully for the value relinquished, as determined by appraisal, and no more. In fact, the appraisal has determined the value of the easement to be $4.0 million and that is what the landowner was paid. The fact that the landowner was able to sell carbon after the transaction closed has no bearing on the matter, as the carbon value was indiscernible by the documented standards that the State applied. The landowner has met his commitment to the easement and having done that, is entitled to whatever revenues are available.

  It is interesting to note that the next landowner may have a more difficult time making the same case. With this carbon sale, a transaction has occurred that may in the future be discernable by appraisal. Thus the post-easement value of the property may appraise higher the next time as the carbon value show up in the appraisal.

  Seen differently, first-movers in any developing market take substantially higher risk than those who follow later and are thus due a higher return to compensate them for the risk. Frequently, pioneering risk ends in failure and the potential for “windfall” returns serve to induce the development of new markets. In the above case, were the State to insist on disallowing the sale of carbon by the property owner, the taking of such risk would be discouraged and the development of a carbon market would be jeopardized.

While appealing on the surface, in fact the argument that the easement creates the carbon and the landowner has no right to it is incorrect and can apply only if the easement specifies that the landowner must relinquish rights to sell carbon, assigns value to it, and pays for it as agreed by the landowner. To do otherwise discourages the development of the very market that the State wishes to encourage.

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