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# PRESENTATION ON NATURAL CAPITAL VALUATION

**High-level Roundtable on Mainstreaming Natural Capital into Decision-Making**

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Ladies and Gentlemen,

Natural capital is an economic term for biodiversity and ecosystem services. It provides a link between nature and capital, highlighting the fact that expenditure must be incurred to sustain the natural conditions of production and compensate for having depreciated the existence of biodiversity and ecosystem services.

Natural capital approach seeks to explore economic solutions to the continuing loss of biodiversity and ecosystem services as all the drivers of such loss can find their root causes in the prevailing economic system. The international community has thus far focused its interventions on mitigating and removing the direct pressures on biodiversity and ecosystem services. These direct interventions are absolutely imperative and must be scaled up by several magnitudes. But the ultimate solution to biodiversity loss rests with successful transformation of our economic system that will be embedded with natural capital.

Natural capital is a relatively new term and needs to be appropriately interpreted and well understood. The term first appears in Agenda 21, which stated: "A first step towards the integration of sustainability into economic management is the establishment of better measurement of the crucial role of the environment as a source of natural capital and as a sink for by-products generated during the production of man-made capital and other human activities."[1]

Subsequently the United Nations Statistics Division defines natural capital as natural assets in their role of providing natural resource inputs and environmental services for economic production. Natural assets are assets of the natural environment, and consist of biological assets (produced or wild), land and water areas with their ecosystems, subsoil assets and air[2]. Natural capital is generally considered to comprise three principal categories: natural resource stocks, land and ecosystems. All are considered essential to the long-term sustainability of development for their provision of "functions" to the economy, as well as to mankind outside the economy and other living beings[3].

The definition of natural capital by the financial sector is more focused on biodiversity and ecosystems. For the purpose of the Natural Capital Declaration, natural capital refers to the stock of ecosystems that yields a renewable flow of goods and services. It provides the ecosystem

[1] United Nations (1992). Agenda 21, adopted by United Nations Conference on Environment & Development, Rio de Janerio, Brazil, 3 to 14 June 1992
[2] United Nations (1997). Glossary of Environment Statistics, Studies in Methods, Series F, No. 67, United Nations, New York
[3] United Nations (2003). Handbook of National Accounting: Integrated Environmental and Economic Accounting, United Nations, New York

products and services that underpin our economy and provide inputs and direct and indirect benefits to businesses and society in general[4].

Recognizing natural capital will bring challenges to economics, ecology and many other disciplines. Economics has traditionally ignored the role of biodiversity and ecosystem services in the production function. Only labour, human-made capital and land are considered as factors of production. As biodiversity and ecosystem services used to be abundant and resilient, their contribution to development and prosperity has been free and not accounted for. This is not a surprise. One school of economics even advocated that all surpluses are created only by labour. Many schools of economics, however, do recognize the productive contribution of capital.

But the good old days of abundance and resilience has already been over, perhaps without notice of most economic actors.

In 1992 summer, the North West Atlantic Cod biomass fell to 1% of its earlier level[5], following overfishing since the late 1950s. Canada's federal government declared a two-year moratorium, ending the region's 500-year history with the North West Atlantic Cod, and provided emergency support with the projected cost of $920 million[6], with no significant recovery so far. For those interested, I would recommend reading "The Mortal Sea by Jeffrey Bolster".

The North West Atlantic cod is not an isolated case. The Millennium Ecosystems Assessment concluded that among 24 ecosystem services, only four have shown improvement over the last 50 years, fifteen are in serious decline, and five are in a stable state overall, but under threat in some parts of the world[7]. From the Congo Basin, Africa to Borneo, Asia to Amazon Basin, South America, many ecosystems are approaching their tipping points – where they will not be able to recover or take very long time to recover to a level that can meet human needs again[8].

**Depreciation**

Despite the fact that natural goods and services have increasingly become either fully depleted or declined to the extent of depletion or not renewed at a rate that can keep pace with human exploitation or destruction, neither mainstream economic theories nor prevailing economic systems have realized that natural capital is an input in the production function, and needs to be maintained or returned to its pre-production state. Like other capital goods, natural goods and services are not significantly consumed in the production process but depreciate. Unlike other

[4] United Nations Environment Programme (2013). The NCD Roadmap: Implementing the four commitments of the Natural Capital Declaration, May 2013
[5] Hamilton, Lawrence, and Melissa J. Butler (2001). "Outport Adaptations: Social Indicators through Newfoundland's Cod Crisis." Human Ecology Review 8.2 (2001): 1-11
[6] 1993 Report of the Auditor General of Canada, Chapter 15 - Department of Fisheries and Oceans - Northern Cod Adjustment and Recovery Program
[7] Hassan, Rashid, Robert Scholes, Neville Ash (ed.) (2005). Ecosystems and human well-being : current state and trends: findings of the Condition and Trends Working Group, Island Press
[8] Convention on Biological Diversity (2010). Global Biodiversity Outlook – third edition, Montreal, Canada

capital goods, biodiversity and ecosystem services are largely unique, and thus often cannot be replaced or substituted.

The process of depreciation of natural capital is different from that of other capitals, as nature can decelerate or accelerate the pace of depreciation of natural capital. This may be demonstrated as follows:

Considering a simplistic equation for conventional capital: book value of a community/firm = original cost − traditional depreciation. When natural capital is considered, it will become: book value of a community/firm = original cost – traditional depreciation +/- natural capital depreciation)

If natural capital can be fully renewed or even enhanced, its depreciation rate is zero or even plus and the book value of a society/firm can be greater by adding the enhanced values of natural capital. In the case that natural capital is only half renewed in the production process, the value of natural capital is lost by half and the book value can be significantly lower than if natural capital is not considered. In this case, residual values are also different as there are tipping points for natural capital – when natural capital reaches certain tipping points, ecosystems will lose the capacity of recovery or take much longer time to recover fully, and natural capital is thus considered totally destroyed. Once reaching tipping points, the book value of a society/firm is discounted substantially.

Economics suggests appropriate allowance provided for recognized depreciation of fixed capital but natural capital is not within the picture, leading to no chance for capital renewal and enhancement. As the serious depreciation of a large number of ecosystem services is still not reflected in the global accounting system, the cost of maintaining and sustaining biodiversity and ecosystem services is mostly not provided for in any capital planning.

**Ownership**

The case of the North West Atlantic Cod fishery is believed to provide a good example of the phenomenon known as the Tragedy of the Commons[9]: what is in the individual's best interest is not always in the best interest of a society as whole. From the perspective of the individual participating in the fishing industry, maximizing their catch was in their best interest; however the past absence of ownership stewardship of the fisheries resources brought the ecosystem past its threshold.

Economist Ronald Coase stated that if trade in an externality is possible and there are sufficiently low transaction costs[10], bargaining will lead to an efficient outcome regardless of the initial allocation of property. This is now known as the Coase theorem, which describes the economic efficiency of an economic allocation or outcome in the presence of externalities. In the case of natural capital, however, property rights have not been assigned in some developing countries or

[9] Hardin, Garrett (1968). "The Tragedy of the Commons", Science 162 (3859): 1243–1248.
[10] Coase, Ronald (1960). "The Problem of Social Cost", Journal of Law and Economics 3 (1): 1–44.

the assignment of property rights has been subject to changes, sometimes through political turmoil, with a large proportion of ecosystem services generated from public territories whose ownership and stewardship are often not well defined.

There can be good stewardship of natural capital under different ownership arrangements, as shown in table 1. When the ownership is not well defined, conventional practices may help secure the provision of natural capital. But most likely natural capital under unclear ownership is left to abandonment, and susceptible to overexploitation and misuse.

Table 1. Relationship between ownership and stewardship

| Natural capital | Public ownership | Private ownership | Unclear ownership |
|---|---|---|---|
| Missing stewardship | Multiple causes | Lack of public policy | Lack of care |
| Good stewardship | Efficient public sector management and market | Efficient market solution | Mainly due to conventional practices |

Private ownership of natural capital is still limited globally, and its status of stewardship depends on efficient markets and well-designed public policies. Like for other capitals, appropriate public policies are essential to ensure the efficiency of market solution, including correcting market defects. But poor public policy and enforcement often undermines the efficiency of market solutions to the provision and sustaining of natural capital.

The bulk of global natural capital remains with public sector ownership, and thus is dependent upon effective public sector management. The continuing loss of biodiversity and ecosystem services can thus find its root causes in the over-reliance on effective public sector management. Unlike in the case of private stewardship where public policies can exert decisive influences, public stewardship of natural capital can only rely on self-corrections, often by self-reorganization/reform and/or external influences. Several countries in Africa and Asia have experimented public sector decentralization and privatization in order to improve the efficiency of providing natural capital.

**Return**

Since the contribution of natural capital is not recognized in the economic system, the rate of return to natural capital has been set as zero, and this level of return of course does not encourage either private sector or public sector to invest in national capital, leading to the continuing deterioration of the global status of biodiversity and ecosystem services. The truth, however, is still not told in full.

When the quality of drinking water in New York City had fallen below standards required by the U.S. Environmental Protection Agency (EPA) in early 1990s, authorities had a choice between investing $1-1.5 billion in natural capital to restore the polluted Catskill Watershed and constructing a water filtration plant at the estimated cost of $6-8 billion plus the $300 million

annual running costs[11]. Assuming the same or even better level of human satisfaction arising out of the two options, the cost saving implies that the return to natural capital investment in this case is six times higher than the alternative.

The failure to appropriately consider the rate of return of natural capital can seriously misguide decision making. If the resultant gross domestic products are used as reference for decision making, constructing a water filtration plant appears to lead to higher presentation of gross domestic products, and thus can become the first choice of those who prefer higher economic growth.

**Macroeconomic effects**

Recognizing natural capital calls for a paradigm shift in macroeconomic analysis as macroeconomic contributions of natural capital have not thus far been integrated into macroeconomic policy consideration.

National accounting for total capital contribution needs to take into account natural capital. The past few years have already witnessed considerable progress in advancing the integration of natural capital into national accounts so that depletion and enhancement of natural capital can be appropriatly documented and communicated. In United Kingdom, the Office for National Statistics set out a roadmap for the development of natural capital accounts within the UK Environmental Accounts[12], and the Natural Capital Committee has developed a framework for defining and measuring changes in natural capital that will consider the eight broad habitats of the country[13].

Attacking cyclical unemployment is a top priority of macroeconomic management. Natural capital continues to offer the largest job reservoir in many countries. During the Great Depression in the United States, a major part of President Franklin D. Roosevelt's New Deal was the Civilian Conservation Corps (CCC), which employed some 3 million young men to perform jobs related to the conservation and development of natural resources in rural lands owned by federal, state and local governments[14]. A similar program is being implemented in India.

Economic growth is sustainable only if natural capital is taken into account appropriately. A United Nations Environment Programme research concluded that a green transformation of key sectors, including agriculture, fisheries, forests, tourism, water and waste management, transport,

[11] Chichilnisky, G. and G. Heal (1998). Economic returns from the biosphere. Nature 391: 629-630
[12] Office for National Statistics (2012). Accounting for the value of nature in the UK: a Roadmap for the development of natural capital accounts within the UK Environmental Accounts, December 2012
[13] Natural Capital Committee (2014). Towards a Framework for Defining and Measuring Changes in Natural Capital, Working Paper 1, March 2014
[14] Salmond, John A. (1967). The Civilian Conservation Corps 1933–1942: a New Deal case study

energy, manufacturing, buildings can produce a higher growth in gross domestic products (GDP) and GDP per capita[15].

National fiscal regimes can be aligned with natural capital consideration. Several countries have already established Green Fiscal Commission to advise and advocate environmental fiscal reform, including greening tax system, introducing environmentally-related taxes, removing environmentally perverse subsidies, and developing environmental goods and services. Brazil and Portugal have integrated biodiversity indexes in their intergovernmental fiscal transfer schemes[16].

Income distribution with consideration of natural capital may be improved as natural capital is closer to the poorer. Indigenous and local communities have historical comparative advantage in the conservation and sustainable use of biodiversity and ecosystem services[17].

International trade system may also be impacted by the consideration of natural capital. There must be a level playing field for all kinds of capital, including natural capital. Natural capital has thus far not featured in any international or regional trade agreements, while many trade treaties have unintended consequences on the provision and treatment of natural capital.

The consideration of natural capital invites considerable rethinking of international finance, including development cooperation financing. A great portion of natural capital brings benefits at all levels, particularly at the global and regional levels, and this global and regional feature of externality provides the justification for a more vigorous structured system to finance global and regional public goods[18].

**What is the role of Convention in mainstreaming natural capital valuation into national development and financial planning?**

Unlike the ecosystem approach which was officially adopted by the Conference of the Parties, there is not yet a systematic natural capital agenda established under the Convention on Biological Diversity. However, many elements of the natural capital approach have been very well advanced under various programs. The concept of natural capital was introduced into the Convention process in the earlier years. For instance, it was mentioned that to facilitate communication and to assure that natural capital can be incorporated into national accounts, each Party could develop a national index of natural capital (NCI). The index would use a single figure to express an aggregation of multiple state indicators, expressed as a percentage. NCI would be the product of quantity and quality of ecosystems[19]. Another document pointed out that the major challenge in the long term is to establish a highly aggregated Natural Capital Index

[15] UNEP (2011). Towards a Green Economy: Pathways to Sustainable Development and Poverty Eradication (Green Economy Report)
[16] See: https://www.cbd.int/financial/fiscalreform/
[17] This point is well captured in Article 8(j) and 10(c) of the Convention on Biological Diversity
[18] Kaul, Inge (1999). Global public goods: international cooperation in the 21st century, edited by Inge Kaul, Isabelle Grunberg, Marc A. Stern, New York, Oxford: Oxford University Press
[19] See the document UNEP/CBD/SBSTTA/3/9 (10 July 1997)

next to the current Social Capital Indices and Economic Capital Indices to assure appropriate information in the national and supra-national decision-making process aiming at sustainable development[20].

**Monitoring ecosystems in physical terms**

Based on the ecosystem approach, the scientific body of the Convention has elaborated a number of programs to promote better understanding of, and monitor the status and the trends concerning, coastal and marine ecosystems, agrobiodiversity, forest ecosystems, inland water ecosystems, mountain ecosystems, dryland and sub-humid ecosystems, and islands biodiversity. The Global Biodiversity Outlook, soon in its fourth edition, was designed to provide a global documentation on the status and trends in biodiversity and ecosystem services. The CBD work in this regard was informed by the Millennium Ecosystem Assessment, and will benefit from the Intergovernmental Panel on Biodiversity and Ecosystem Services.

**Exploring ecosystems in monetary terms**

Appropriate valuation of natural capital is a very important first step towards realizing the productive contribution of natural capital. Nevertheless, valuation needs to be demand-driven in order to be embedded into decision making. True values are determined by forces of both supply and demand of natural capital, not by estimation of either supply side or demand side alone. It is as important to explore valuation mechanisms as to improve valuation methodologies. The Economics of Ecosystems and Biodiversity (TEEB), promoted by the G8 and UNEP and more recently by several countries, has provided a major push for the economic valuation of biodiversity and ecosystems.

The first sentence of the Convention is about the intrinsic value of biological diversity and of the ecological, genetic, social, economic, scientific, educational, cultural, recreational and aesthetic values of biological diversity and its components. This recognition of biodiversity values has subsequently featured in many decisions taken by the Conference of the Parties. In addition to the various biomes-based programmes of work, the work streams on access and benefit sharing, financial resources and mechanism, business engagement, protected areas, and incentive measures all call for undertaking valuation of biodiversity and ecosystem services and related capacity building. The examples of economic valuation of biodiversity and ecosystem services have been observed in over 60 percent of countries, at the national level assessment and project or site-specific level[21].

The Strategic Plan for Biodiversity 2011-2020 contains several targets related to biodiversity values. Target 1 states that people should be made aware of the values of biodiversity. Target 2 underscores that biodiversity values will have been integrated into national and local development and poverty reduction strategies and planning processes and are to be incorporated into national accounting, as appropriate, and reporting systems. Target 19 indicates that

[20] See the document UNEP/CBD/SBSTTA/3/Inf.13 (22 July 1997)
[21] See: https://www.cbd.int/financial/values/

knowledge and the science base relating to biodiversity values are improved, widely shared and transferred, and applied.

**Developing mechanisms**

Although the valuation approaches for biodiversity and ecosystem services at the project/site level have been reasonably developed, mechanisms for enabling their application are still under development. In most cases, decision-making at the household and firm levels is focused on the measurement of the direct and indirect use values and not on the non-use and option components of total economic value of biodiversity and ecosystem services.

The emerging instruments, such as payment for ecosystem services, biodiversity offset mechanisms and market for green products, have provided opportunities for translating welfare economic value of biodiversity and ecosystem services to exchange value. Technically speaking, their application means a clear physical measurement of ecosystem services and ecosystem assets, dynamics of ecosystems and changes in flows of ecosystem services, as well as establishing valuation of ecosystem services and ecosystem assets as well as their future values.

Under the strategy for resource mobilization adopted in 2008, Parties decided to undertake several explorations, including:

- Promotion of schemes for payment for ecosystem services
- Consideration of biodiversity offset mechanisms
- Exploration of opportunities presented by environmental fiscal reforms including innovative taxation models and fiscal incentives
- Exploration of opportunities presented by promising innovative financial mechanisms such as markets for green products, the activities and financing of biodiversity friendly business and project.
- Integration with the development of new and innovative sources of international development finance
- Consideration of biodiversity when developing any funding mechanisms for climate change
- Enhancement of access and benefit-sharing initiatives and mechanisms

It has already been observed that half of the CBD membership have some kind of payment for ecosystem services schemes[22], one fifth of the CBD membership have biodiversity offsetting

[22] See: http://www.cbd.int/financial/pes.shtml

mechanisms[23], nearly half of the CBD membership have introduced fiscal reform measures[24], 39% of the CBD membership are known to have measures on markets for green products[25].

The enabling frameworks, such as appropriate legal, policy and administrative measures, for developing and applying these instruments at the national and international levels are still not in place. A number of consensus building and capacity building workshops have been organized under the Convention. The need for safeguards measure is identified in order to maximize the potential of these mechanisms to contribute to the three objectives of the Convention, promote their consistency with international trade treaties and other agreements, avoid undermining unique components of biodiversity, and respect the rights and traditional practices of indigenous and local communities. Governments can play a great role in fostering mechanism creation, for instance through green public procurement and greening taxation and expenditure systems. Governments can also have a role to play in correcting the imperfectness of natural capital market and regulating its volatility.

**How can the Rio and other Conventions coordinate and work together on the issue?**

Natural capital has increasingly appeared on the agendas of international organizations and regional bodies. Both the United Nations and the Breton Woods Institutions are working to develop further a common framework of knowledge and promote application and replication of successful innovations.

The United Nations Statistical Commission in 2012 adopted the first international statistical standard for environmental-economic accounts - the System of Environmental-Economic Accounts (SEEA) Central Framework, and has advanced the SEEA - Experimental Ecosystem Accounts considerably. The SEEA-Central Framework starts from the perspective of the economy and its economic units (including households) and incorporates relevant environmental information concerning natural inputs, residual flows and associated environmental assets. In contrast, SEEA-Experimental Ecosystem Accounting starts from the perspective of ecosystems and links ecosystems to economic and other human activity. Together, the approaches provide the potential to describe in a complete manner the relationship between the environment, and economic and other human activity[26]. The Secretariat co-organized with the United Nations Statistics Division the international conference entitled “Global implementation of the SEEA” to launch the implementation of SEEA and supporting statistics in New York, from 17 to 19 June 2013. A series of related projects and capacity building workshops are organized by the Secretariat, United Nations Environment Programme, Food and Agriculture Organization of the

[23] See: http://www.cbd.int/financial/offsets
[24] See: http://www.cbd.int/financial/fiscalreform
[25] See: http:// (www.cbd.int/financial/greenproducts/)
[26] United Nations Statistics Division Briefings: The System of Environmental-Economic Accounts (SEEA) – Measurement framework in support of sustainable development and green economy policy, and The System of Environmental-Economic Accounting (SEEA) Experimental Ecosystem Accounting

United Nations, Economic Commission for Europe, Economic Commission for Latin America and the Caribbean, Economic and Social Commission for Asia and the Pacific[27].

World Bank also works, through the Wealth Accounting and the Valuation of Ecosystem Services (WAVES) Global Partnership, to implement the SEEA-Central Framework and test out SEEA Experimental Ecosystem Accounts in 8 countries (Botswana, Colombia, Costa Rica, Guatemala, Indonesia, Madagascar, Philippines and Rwanda) as well as Vietnam and Morocco interested in joining, and is in discussion with governments of another 10-12 countries[28].

The Inter-American Development Bank recently approved its Biodiversity and Ecosystem Services Program[29], involving both advisory and direct project support to mechanism development. It has already promoted the systematic incorporation of biodiversity and ecosystem services into sector notes for energy, water and sanitation, transport, natural resources, and tourism as a contribution to the development of new Country Strategies in Paraguay, Belize, and the Dominican Republic, organized capacity building workshops on how to incorporate biodiversity and ecosystem services in the appraisal of Bank infrastructure investments, approved grants for promoting South-South cooperation in managing marine and freshwater ecosystems, developing an innovative Payment for Ecosystem Services scheme for biodiversity conservation in Honduras, and incorporating biodiversity and ecosystem services in the feasibility analysis of a sanitation project in Paraguay[30].

The Natural Capital Declaration, launched during the UN Conference on Sustainable Development under the aegis of United Nations Environment Programme Finance Initiatives in 2012, has been signed by the CEOs of more than 40 financial institutions. The Declaration seeks to integrate natural capital consideration into loans, equity, fixed income and insurance products, as well as in accounting, disclosure and reporting frameworks[31]. The banks subscribing to the Equator Principles agreed in 2013 recognizing the importance of climate change, biodiversity and human rights and believing that negative impacts on project-affected ecosystems, communities, and the climate should be avoided where possible. If these impacts are unavoidable they should be minimized, mitigated, and/or offset.

Multilateral environmental agreements can be politically instrumental in fostering and advancing mechanisms for natural capital. The Clean Development Mechanism (CDM) was initially defined in Article 12 of the Kyoto Protocol, and it allows a country with an emission-reduction or emission-limitation commitment under the Kyoto Protocol (Annex B Party) to implement an emission-reduction project in developing countries[32]. The REDD financing, shortened for

[27] United Nations (2014). Report on the Committee of Experts on Environmental-Economic Accounting, Economic and Social Council, E/CN.3/2014/6, dated 24 December 2013
[28] See: http://www.wavespartnership.org/en
[29] Inter-American Development Bank (2013). Proposal for the Establishment of the Special Program and Multidonor Fund for Biodiversity and Ecosystem Services, 15 February 2013
[30] Communication with Ms. Michele Lemay (Inter-American Development Bank)
[31] UNEP Finance Initiatives (2013). The NCD Roadmap: Implementing the four commitments of the Natural Capital Declaration, May 2013
[32] See: https://unfccc.int/kyoto_protocol/mechanisms/clean_development_mechanism/items/2718.php

"reducing emissions from deforestation in developing countries and approaches to stimulate action" also arose out of the negotiations under the UN Framework Convention on Climate Change[33] and the UNFCCC COP 19 recently approved the rules providing guidance for the full implementation of REDD+ activities.

**What are the potential opportunities and roles of the GEF?**

As the financial mechanism of the Convention, the GEF is well positioned to support financially and technically the development and implementation of the natural capital approach. In its guidance to the financial mechanism, the Conference of the Parties requested the Global Environment Facility to provide financial support for the implementation of the Strategic Plan for Biodiversity 2011-2020 and the Aichi Biodiversity Targets, particularly in the GEF-6 period[34]. In this sense, the GEF is already given the mandate to advance various elements of the natural capital approach.

Broadly speaking, financial and technical support is required in the following areas:

- Capacity building for natural capital valuation at national and regional levels;
- Tools and references on the application of natural capital valuation
- National implementation of the international statistical standard - System of Environmental-Economic Accounts (SEEA) Central Framework and further development of the SEEA Experimental Ecosystem Accounting
- Development of enabling regulatory, administrative and policy frameworks for business-level mechanisms that make use of natural capital valuation
- Demonstration projects on the mechanisms that make use of natural capital valuation

A good number of GEF-financed projects contain elements on valuation of biodiversity and ecosystem services. The GEF has already supported several projects on payment for ecosystem services and biodiversity offset mechanisms. The impact of its support to certification systems is already seen in some markets for green products. Its support to the ratification of the Nagoya Protocol on access and benefit sharing has also begun to yield initial results[35]. This support needs to be substantially scaled up in a more conceptually structured and programmatically coherent manner.

And this is my message to this Roundtable

Thank you.

[33] See: http://unfccc.int/methods/redd/items/7377.php
[34] Decision XI/5 - The financial mechanism
[35] Various GEF reports to the Convention, available at: https://www.cbd.int/financial/gef/reporting/