UNEP GEF THE WORLD BANK

PROCEEDINGS OF
A Regional Conference Sponsored by UNEP/GEF and The World Bank

CLIMATE CHANGE MITIGATION IN ASIA AND FINANCING MECHANISMS

GOA, India, 4 to 6 May 1998

SECTION III

DOCUMENTS AND PRESENTATIONS FROM THE WORLD BANK

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DOCUMENTS

Carbon Offset Team
Environment Department

THE WORLD BANK

THE WORLD BANK PROTOTYPE CARBON FUND
Mission & Objectives

The mission of the PCF is:

"to promote a global market in greenhouse gas (GHG) emissions reductions that serve our client countries' development needs."

The objectives of the PCF are:

- to supply high quality offsets at a competitive price in an emerging market, and

to seek to provide buyers and suppliers of offsets with a fair deal from their own perspective and a share of the value-added.

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THE KYOTO PROTOCOL
Implications For The Carbon Offset Market

The Kyoto Protocol, agreed in December 1997, sets quantified carbon emission limitation and reduction commitments for OECD countries and countries with "economies in transition"(EITs). These Parties agreed that they would reduce their overall emissions of (six) greenhouse gases (GHG) by, on average, 5 percent below 1990 levels in the commitment period 2008 to 2012. The European Union, U.S. and Japan agreed that, for them, such reductions should be targeted at 8, 7 and 6 percent, respectively.

The Protocol allows for the transfer of emission reductions between countries. Industrialized countries (Annex 1) may finance GHG reductions outside their own borders in order to obtain emissions reductions credit towards their obligations, with a view to limit the costs of complying with their commitments. Such transfers can take place between Annex 1 countries and with the majority of countries with EITs. Certified emission reduction units involving developing country Parties can only take place under the Clean Development Mechanism (CDM). The modalities of the CDM and other JI provisions have yet to be elaborated.

The key requirements for enabling a carbon offset market include the following:

- Commitment among the industrialized countries to binding emissions reductions, compelling the obligated countries to search for the least-cost emission reduction opportunities;
- Existence of relatively high marginal costs of abatement of carbon in the industrialized countries and low marginal costs of abatement in the non-OECD countries;
- A framework for the industrialized countries to purchase carbon offsets from the EITs and/or developing countries and then to receive "credit" for these offsets achieved outside their borders towards their own reduction obligations;
- Verification of offsets by an established authority in order for them to be valid and marketable.

The Kyoto Protocol has created a framework for the establishment of a carbon offset market. However, some of the details of the modality for operationalisation of the offset market, notably the latter two points, remain to be defined. These modalities will be discussed during the Subsidiary Body on Scientific and Technological Advice process leading to the next Conference of the Parties in November, 1998.

The figure below provides the results of a market survey carried out by the Norwegian consultancy firm, ECON. This survey illustrates a large potential market for carbon offsets. The numbers are indicative of the potential size of the market, and are meant to be illustrative. When the Kyoto Protocol enters into force, we may be looking at a market outlined in the "Middle Scenario" with moderate commitments and extensive geographical coverage, possibly including developing countries and EITs, but with perhaps 3 to 5 years delay in the market development beyond the dates referred to in this table.

Potential Market Scenarios

(Volume transactions in 1996 US$ billions)

	2000	2005	2020
High Global Coverage Strong commitments	1	16	60
Middle Extensive Geographic Coverage Moderate commitments	1	8	30
Low Central and Eastern European Countries; Weak commitments	1	3	10

The Kyoto Protocol facilitates the development of a carbon offset market and provides the necessary incentive to move forward with the development of the products of the Global Carbon Initiative.

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Excerpt for James D. Wolfensohn's Note to the World Bank's Development Committee Meeting April 3, 1998

"In my address to the United Nations General Assembly last June, I announced that the Bank stood ready to launch a Carbon Fund should the Parties to the UN Framework Convention on Climate Change find this useful. The objectives of such a Fund would be to supply high quality carbon offsets to industrialized countries through investments in emissions reductions activities in developing countries and Economies in Transition at prices which are fair to both buyer and seller. A unique feature of the Prototype Carbon Fund is that the price of carbon offsets would be negotiated between the buyer and the seller with the Bank as the intermediary. This will ensure that developing country sellers will receive untied cash revenues from largely private sector sources as well as the cost of the cleaner technology in the energy, industry or transport sectors.

Since that announcement, the Bank has assembled five counties and twelve large private companies as potential contributors to the Prototype Carbon Fund to the order of $80-120 million. A Feasibility Study has been completed and is under review. The Board is expected to review establishment of the Prototype Fund in late May, 1998. I hope very much that we will make significant progress on this issue over the next six months."

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Why Participate in the World Bank's Prototype Carbon Fund?

The proposed World Bank Prototype Carbon Fund (PCF) is intended to achieve carbon and other greenhouse-gas emissions (GHG) reductions while simultaneously supporting long-term efforts to create a sustainable carbon trading market.

In December 1997, the U.N. Framework Convention on Climate Change adopted further standards and goals for real reductions of GHG emissions around the world. To comply fully with this evolving international agreement, the OECD countries as well as the Economies in Transition (EIT) need to reduce their GHG emissions quickly. By 2010, in the absence of concerted efforts, the EIT as a region may exceed their allowable emissions by over 15 million metric tons of carbon. Similarly, western Europe may exceed their emissions allowances by over 150 million tons, and the United States and Canada by 220 million tons.

The PCF is expected to foster international cooperation in achieving reductions, providing a vehicle for international participation and furthering internationally accepted guidelines. Moreover, the PCF is intended to introduce a high-quality, reliable product into an untested market for GHG emission reduction credits among countries.

The PCF is expected to be a useful and attractive option to its participants because it is intended to:

1. Practice sound management rooted in the World Bank/PCF knowledge base and experience in project development and GHG-related project support.
2. Pool contributions and projects to achieve risk diversification, and
3. Pursue a conservative strategy based on strict criteria for qualifying projects and emissions reductions.

By striving to achieve recognition by future international authorities of recorded reductions, the intention of the PCF is to mitigate the risk that credit for early reduction activity would be lost.

The PCF is also intended to address uncertainty over pricing of GHG reduction credits. Based on reductions related to total project cost and stated in US$ per ton of carbon, prices currently quoted range from under one dollar to over $500. In response, the PCF is developing a carbon purchasing plan intended to achieve reasonable costs for achieving reliable, certifiable, permanent reductions, thereby attempting to balance goals of quality and sustainability of the product with goals of minimizing the burden to the project development process.

The Advantages of Working with the PCF

- ❑ The World Bank/PCF presents a highly-qualified management group.

The PCF staff and World Bank resources behind it include some of the most knowledgeable and experienced individuals in the carbon emissions reduction field. Combined with the project development and management expertise of the World Bank, the PCF presents a unique skill-set for the launch and operation of the fund, including:

- Ability to monitor the status of host-country capacity, including national mechanisms to achieve and record reductions; in some cases, the World Bank would contribute to building those capacities;
- Ability to deal with technical issues of GHG emission reductions, such as:
  - conformity with international protocols;
  - baseline determination and analysis;
  - additionality issues;
  - other social and economic development benefits;
  - project-level reductions assessment.

- ❑ The World Bank/PCF has readily-accessible project information, both in and outside of the World Bank Group.

In identifying potential projects, the PCF will be able to draw from the flow of projects in the World Bank Group. In addition, alliances may be formed with other multilateral, bilateral and private sector lending and development agencies to find more projects at different stages of technical and financial completion. This would provide the PCF with more opportunities to manage the risks associated with its activities. The PCF may also look beyond its own project pipeline for projects, seeking to assure compliance with and promotion of international protocols.

- ❑ The World Bank/PCF presents risk mitigation benefits.

The PCF's structure and operations are intended to help mitigate general and specific risks associated with early activities relating to carbon emission reductions. By pooling resources, participants would spread the risk of non-delivery of reductions among a larger number and differing types of projects. The PCF management, in coordination with participants, would determine the level of project diversification among regions, projects, and types of reductions regarding international protocols.

Similarly, strict project criteria are intended to increase the likelihood that the CIF's recorded reductions are real in relation to national mechanisms in place or under development. It is hoped that a conservative approach of applying strict standards to early efforts would reduce the likelihood that they will not be formally recognized by international authorities.

- ❑ The World Bank/PCF expects to successfully combine commercial and development goals.

The PCF is designed to combine commercial and development objectives of both creating and taking a position in a new market for trading emission reduction credits. Participants in the PCF will be increasing understanding of the kind of rules of the game, including the standards, processes and procedures the Parties to the Convention/Protocol would agree and which will ultimately drive the market. At the same time, the carbon reductions achieved by the PCF's activities are designed to carry forward into such a market when it begins, providing at that time real and cost-effective solutions to the problem of meeting mandatory requirements or taxes.

This document is not intended to solicit participation in the proposed World Bank Prototype Carbon Fund (PCF), but merely to provide to interested parties general information concerning the intended scope of the PCF. Moreover, the legal framework for the PCF is still under development, and the above description serves only as a conceptual outline of the intended activities of the PCF as currently envisaged.

Any decision to participate financially in the Carbon Fund should be made only upon a detailed examination of the PCF and the underlying international framework, the terms, conditions, and guidelines of the PCF, and the risks involved in a financial participation in the PCF.

Carbon Offset Team
Environment Department

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How will the Prototype Carbon Fund work?

The following text describes the current thinking for the design and operation of the prototype Carbon Fund (PCF or Fund). Although this design process is quite advanced , the Bank Group is still refining Fund design and reviewing implementation arrangements with Participants, other stakeholders and the Bank's Executive Directors.

The legal framework for the PCF would be similar to that of a World Bank trust fund, with the Bank receiving a fee for acting as administrator of the PCF. The Fund would be structured similar to a closed-end mutual fund. The size of the PCF would be within the range of US$100-120 million, based upon contributions from a prospective twelve to sixteen participants, both public and private. The Bank would enter into one trust agreement subscribed to by each of the participants. At the time of the closing, the Fund management (i.e. the Bank) will ask participants to provide promissory notes or irrevocable stand-by letters of credit for the amount for which they subscribe. Payments into the Fund will be made by installments based on a pre-determined schedule, and will be held in a trust fund account. Each participant will hold shares in the PCF, and will be entitled to a corresponding percentage of the aggregate carbon emission reduction units produced by the Fund.

The Bank will make its investments in projects on the basis of "Project Selection Guidelines" which will be developed in consultation with the participants and hosts. Once a project is selected, the Bank, as administrator of the PCF, would enter into an agreement with the relevant host country government and a separate agreement with the project sponsor. The agreement would specify the amount to be paid to the host and to the sponsor for the carbon offset, as well as the procedures for withdrawal of the funds.

The negotiated price of the carbon offset would implicitly cover the cost of additional emissions reductions measures over the baseline, as well as a margin representing equitable benefit sharing of the gains from the carbon offset trade between the investor and the host. Initially, disbursements would be made to the project sponsor to finance the cost of the adjustment to the baseline project to generate emissions reductions, or “carbon offsets”. Subsequently, the balance of the amount would be withdrawn and disbursed against the delivery of carbon offsets as they are generated over the life of the offset project. The quality of the offsets and the delivery of payment for the offsets will be determined by the processes of certification and verification carried out by an external auditor. Fund Management expects that the negotiated outcome on offset price will provide the necessary incentives for the host countries and project sponsors to undertake the projects and achieve the estimated unit carbon offset costs.

After verification of the carbon emissions reductions or sequestration, the Fund will facilitate issuance of credit-worthy carbon offset certificates to the participants on pro-rata basis. It is expected that participants would then have the following choices: use their carbon certificates to cover international or national obligations in lieu of domestic reductions, or sell the certificates in the emerging carbon offsets market.

A pipeline of PCF carbon offset projects is under development in both Economies in transition and the developing countries, supported to an important extent by the National Strategy Studies program. The Fund Management expects to have 2-3 projects from the World Bank pipeline identified and ready for implementation upon signature of the trust fund agreements. In the longer run, the PCF is expected to draw on a combination of projects from the WB pipeline, International Finance Corporation pipeline and third parties, such as the Multilateral Development Bank, and other multilateral, bilateral and private sector agencies. Early indications are that the world demand of carbon offsets through flexibility mechanisms may amount to 500 million tones of carbon annually during the first budget period (2008-2012).

Fund participants accept the risk that the Bank cannot guarantee that the UNFCCC Conference of Parties/Meeting of Parties to the Kyoto Protocol will authorize certification of the carbon offsets generated by the PCF, and the Bank does not intend to guarantee participants that any carbon offsets will be obtained in return for their contribution. The Fund manager will, however, exercise due diligence to ensure that the projects meet "good practice" in the determination of project baselines and certification and verification of emissions reductions achieved below the baseline. Moreover, the Bank will procure the services of independent certification companies to certify the baseline and verify the carbon emission reductions.

Significant progress has been made with the design of the proposed PCF and it is soon to be discussed with the Bank’s Board and potential fund participants. Final details of whether and how to proceed, and of design and operation will be determined in the course of these reviews.

Carbon Offset Team
Environment Department

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Summary Report Brief
Carbon Investment Fund Consultative Group Meeting For Investors
World Bank Headquarters, Washington, DC
September 29 and 30, 1997

Introduction

The World Bank has established the Global Climate Initiative (GCI) to investigate the potential of market mechanisms to reduce global greenhouse gas (GHG) emissions and to support environmentally sustainable growth for developing countries. In this context, the Bank is exploring the establishment of a Carbon Investment Fund (CIF) as one such market mechanism. All efforts made towards the GCI and the establishment of the fund will be consistent with the decisions of the UN Framework Convention on Climate Change (UNFCCC) and does not attempt to preempt the Conference of the Parties. The CIF will provide a mechanism whereby buyers and sellers of carbon offsets can efficiently invest in a pool, or fund, of carbon investments. This mechanism will act as a market intermediary by obtaining funds from investors (industrialized countries and private sector entities in industrialized countries with binding emissions reduction obligations -- if agreed to in the Kyoto Protocol) and investing these funds in projects which would result in carbon emissions reductions in low-cost countries (primarily EITs or developing countries -- if permitted in the Kyoto Protocol).

The First Consultative Group Meeting was assembled to provide potential investors in the first fund with the opportunity to voice their particular concerns and suggestions related to the specific design issues of the fund, with the understanding that these discussions and the establishment of the fund are contingent upon the decisions made in Kyoto. The meeting was opened by Ismail Serageldin, Vice President, Environmentally and Socially Sustainable Development, World Bank and Andreas Raczynski, Director, Technical and Environment Department, International Finance Corporation (IFC). Ken Newcombe, Global Manager, New Products and Partnerships chaired the meeting.

Synopsis of Investor's Guidance

Fund Structure and Operation

- A clear call was recognized for a straightforward objective with a common sense of purpose which includes a competitive price, but more importantly certainty of the delivery of quality carbon offsets and securing a fair share of the value-added ensuring both suppliers and investors that their needs are being met in the process of the development of the fund;
- the fund will be structured as a closed-end mutual fund;
- the minimum contributions to the fund will remain at $10 million USD for government investors and $5 million USD for the private sector;
- initial investors will be able to participate in the development of a secondary market;
- no commitment can be made now in terms of the management fee, but it will be transparent and consistent with the services provided;

Investment Strategy

- The fund should not take too many risks with technology, but must be sure it is environmentally proven and socially acceptable technology which will efficiently generate carbon offsets.
- the design issues of operations are sensitive to the UNFCCC guidance and policies;
- the fund will invest in project-based carbon offsets;
- the Bank should not take a monopolistic position;
- the fund should explore the perspectives of third-party offset deals with bilaterals, companies and investors in an effort to create a broader capacity for the market to grow;
- the Bank will invest in the Economies in Transition given the allowance for crediting in the Kyoto Protocol. However, the dialogue will continue with the developing countries to explain the initiative and will expand as is allowed by the upcoming Kyoto Protocol.

Risk mitigation strategies

- Although steps should be taken prior to Kyoto, some decisions and parameters will have to be decided after Kyoto;
- given the relatively small fund and given the uncertainty of the outcome at Kyoto it will be difficult to meet the carbon offset delivery needs of all the investors. The design consultant will be asked to respond to this issue in the Feasibility Study;
- in terms of financial additionality, the concern that those supplying the offsets are assured that the funding for these projects are over and above official development assistance and GEF contribution was recognized;
- offsets will be converted into certificates which are verified by a third party on an annual basis;
- incentive measures will be required to motivate the supplier to ensure that the project performs at the design level;

- sovereignty risk may be mitigated through arrangements with Multilateral Investment Guarantee Agency;
- portfolio diversification will eliminate exogenous risk factors;
- most of the projects will come from the Bank Group's own portfolio and pipeline, which will benefit from the required mechanisms of the Bank Group, such as supervision, quality assurance and monitoring and evaluation;
- highly credible project baselines are important.

Carbon Offset Team
Environment Department

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Final Report of the Second Consultative Group Meeting for Carbon Fund Participants
Interlaken, Switzerland
January 29-30, 1998

The Second Consultative Group Meeting was held to provide potential participants of the prototype Carbon Fund (CF) an opportunity to discuss the Fund design and operation. The objectives of the meeting were to solicit input on the key design parameters of the CF; to provide a basis for decisions on a commitment to participate in the CF; and to respond to participants' concerns and interests. The meeting was attended by representatives from the public and private sectors, almost all of which had signed a Memorandum of Understanding (MOU) with the Bank to confirm their interest in participating in the first CF subject to certain provisions. The following issues were discussed during the meeting:

The Kyoto Protocol and its implications for the CF

The participants consider that the Kyoto Protocol (KP) significantly advanced the potential for successful CF operations. At the same time the participants expressed a concern that there is still room for different interpretations of the KP, which may have unpredictable impacts on the CF. Among these, special attention was provided to the following:

- The KP does not resolve issues concerning a compliance mechanism;
- The KP does not address an offset banking provision including a starting date for Joint Implementation (JI) within Annex 1 countries (article 6);
- The operational modalities for 'certified emission reductions units' under the Clean Development Mechanism (CDM) (article 12) require further detail; and
- there is uncertainty about ratification and entry into force of the Protocol.

The participants re-emphasized the difference between an emission trading approach and project-based Joint Implementation (JI). Many participants were of the view that JI within Annex I countries could be eligible for credits in the pre-budget period. There were different interpretations of the CDM provision in the KP. On balance however, participants felt that the CF could potentially operate under the CDM, subject to UNFCCC guidance. Participants recognized that the Kyoto Protocol suggests that the CDM allows for "crediting" of certified emission reductions from the year 2000. Many participants would like to include projects in developing countries in the project portfolio, if consistent with the CDM.

The CF and its Market Environment

Many participants expressed interest in the development of a secondary market, and the possibility of selling CF credits in this market. The majority of participants recognized the importance of stimulating the development of a secondary market in the long run. However, governments and private sectors revealed different priorities on the timing of such efforts. Some participants suggested that the Bank maximize its efforts to create a market value for CF credits. Most governments stressed that creating a credible instrument in the primary market that delivers high quality offsets should have priority.

Certification and Verification

The participants expressed a strong wish that the CF maximize the probability of recognition of CF credits under a future regulatory framework. Many participants endorsed the importance of high quality of offsets, with implied higher transaction costs of certification, monitoring and verification. The participants want the Bank to contribute to the creation of generally accepted principles of certification and verification. A clearer definition of the terms certification and verification was requested by many participants, including a clarification on how they relate to the approval process of offsets under the Convention/ KP.

Management Fees and CF cost structure

The Bank presented a theoretical profile of estimated CF operating costs, including costs of monitoring and verification of projects. The cost structure presented was generally accepted as an indicative benchmark, although participants demanded a more detailed analysis of the various components.

Relations with Participants

There was considerable discussion around differing views of the governance structure for the CF, and participants roles and responsibilities in it. This concerned the extent to which participants should oversee, and provide guidance to, or even control CF operations. Participants proposed the establishment of a Participants Committee (i.e. investment committee) with options for representation and specific powers, roles and responsibilities to be presented to them for further review. Participants suggested that the Bank proposes a governance structure to be discussed in the next Consultative Group meeting.

Relations with Hosts and Project Selection Criteria

There was some debate about the geographical focus of the Fund. Many participants would like to include projects in developing countries in the project portfolio, if consistent with the CDM. One investor viewed selecting projects in developing countries as premature, and preferred to await project identification until regulatory frameworks for such projects have been further developed. Most participants showed interest in including some land-use projects in the portfolio. These projects have to be considered carefully, and should be fully consistent with Convention/Protocol provisions. Third party deal flow should be considered as well. There was some discussion about an acceptable price range for carbon offset projects: a range of $20-30 per ton carbon was mentioned in this respect. It was emphasized by several participants that additionality should not be defined too narrowly, i.e. not only in financial terms but in technology and environmental terms.

Carbon Offset Team
Environment Department

THE WORLD BANK

Summary of the
First Consultative Group Meeting for the Prototype Carbon Fund
Potential Host Countries
Meydan Hotel Danube, March 25-26, 1998, Bratislava, Slovak Republic

Introduction
The World Bank is exploring the development and establishment of a Prototype Carbon Fund (PCF). This Fund would facilitate exchanges of emission reduction units under the provisions in the Kyoto protocol, which provide for such exchanges between countries with emission reduction commitments (Joint Implementation or JI) and between a country with a emission reductions commitment and one without (the Clean Development Mechanism or CDM). The PCF will pool funds from governments and companies in countries with commitments and invest them in emission reductions in economies in transition (EITs) and developing countries. The PCF is developed in strict adherence to UNFCCC rules and decisions.

Participants from Czech Republic, Hungary, Latvia, Poland, Russia, Slovak Republic, Ukraine, and Uzbekistan met in Bratislava to discuss the World Bank proposal for a Prototype Carbon Fund (PCF). This was the first of a series of meetings with potential host countries for carbon offset investments under the Fund. The purpose of the meeting was to

- Understand CF design and operation, and discuss the potential benefits for host countries;

- Discuss the role of host countries and the nature of agreements for governments and project sponsors;

- Seek feedback on key requirements for effective implementation of CF operations.

The meeting of the consultative group was hosted by the Government of the Slovak Republic, who also chaired the meeting jointly with the World Bank.

The group discussed and provided guidance on a number of issues of importance for the further development of the PCF. The main elements of the discussions, and the participants guidance under the various agenda items, are outlined in the following paragraphs.

The Kyoto Protocol and its implications
The participants welcomed the World Bank's contribution to exploring how the Kyoto Protocol could be implemented. It was indicated that the World Bank could contribute to a better understanding of the implications of the Protocol. There is still

considerable uncertainty regarding three of the flexibility mechanisms in the protocol, namely JI, the (CDM) and emissions trading. In the EITs, it is imperative that instruments for JI and emissions trading instruments are developed and applied in a mutually consistent manner. The role of sinks in meeting the objectives of the Kyoto Protocol needs to be addressed. Further, adequate rules for baseline determination need to be developed before COP4.

Status of the Carbon Fund

Participants asked the World Bank to clarify the relationship between the PCF and the emerging schemes for emissions trading. Ownership of the emission reduction units at different stages of the project cycle should be clarified. The Carbon Fund should provide guidelines on baseline determination. The Fund will not carry out certification and verification itself, as this will be done by an independent third parties. The Carbon Fund should broaden its scope to cover all gases in the Protocol.

CF Relationships with Host Countries

Participants reiterated the urgent need for assistance regarding baseline calculations. Selection of financing instruments for project implementation could to some extent be done on a project by project basis, depending on to the character of the project. For example, projects aiming at policy changes, such as demand side management projects, could be suitable under an allowance based trading scheme. Improvements in generator efficiency could be more suitable for financing from the PCF. It was clarified that under the PCF, details of the individual project, such as cost assessment, carbon prices, project duration and financial flows will be determined on a case-by-case basis and are subject to negotiation. The individual investment decision will be made by the PCF fund managers and not contributors.

In addition to CO2, the PCF should include all gases as defined in the Kyoto Protocol. The investments made under the Fund should be geographically balanced. Ideas regarding project selection and project processing should be shared early in the process or developed in cooperation between CF and host countries. There is still considerable uncertainty about the legal framework for projects implemented by JI/CF etc. The real potential for carbon reductions may be smaller than envisaged in some EITs

Carbon Offset Development Guidelines

PCF projects will follow Bank guidelines for project processing. The participants indicated that a wide variety of projects should be included in the PCF portfolio. Cogeneration (industry; power) and demand side management, could lead to large carbon, but there are considerable problems of implementation.

The responsibility for ensuring that the emission reductions from PCF projects come within the Kyoto Protocol targets rests with the host government. Project related risks will be shared between contributors and host governments, based on negotiations. Meeting participants encouraged the Bank to explore the possible use of guarantees and insurance schemes. Participants did not see any conflicts between the PCF and the Global Environment Facility (GEF).

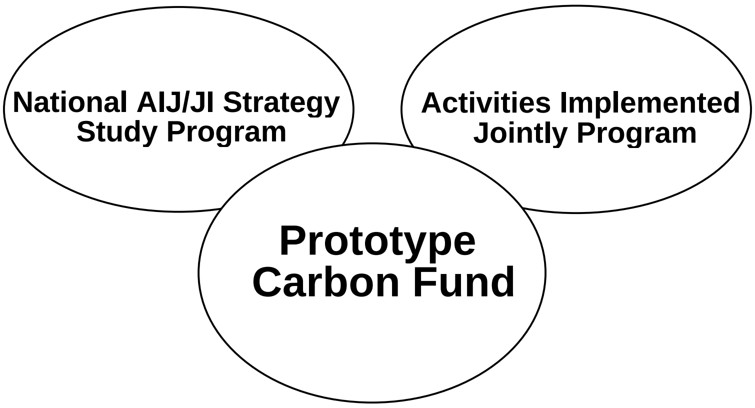
Host Country Responses to outcome of Contributors Meeting

The hosts expressed interest in better understanding the motivation of different groups of CF participants. The CF should clarify how the contributors would share transaction, certification and verification costs. The Fund should support feasibility studies and other preparatory work.

Next Steps

The meeting supported the establishment of an electronic bulletin board to promote interaction and maintain continuity. Assistance for the training of specialized negotiators was requested. The participants were positive to further meetings to discuss the PCF, including a request for joint meetings between host countries and contributors.

World Bank
Carbon Offset Unit



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Financing mechanisms for climate mitigation:
The Prototype Carbon Fund

A Consultative meeting with potential host countries
Goa, India, May 5-6, 1998

Introduction

The second consultative meeting for potential host countries to the Prototype Carbon Fund (PCF) was held in Goa, May 5-6, 1998. The meeting was "co-hosted" with the United Nations Environment Program (UNEP) Collaborating Centre on Energy and Environment at Riso, Denmark. Governments. Experts designated by the invited governments, participated in the Workshop, representing 11 countries in the Asian region. The first part of the meeting was organized by UNEP-Riso and focused on the evaluation of greenhouse gas (GHG) mitigation studies in participating countries. The second part of the meeting focused on financing mechanisms for climate change mitigation, with particular emphasis on the Prototype Carbon Fund (PCF), which is the subject of this report.

The purpose of the meeting was to get feedback from participants on the concept of the PCF and to solicit input on its design issues. In particular, participants were requested to share their views on the following topics:

- Cooperative implementation under the Kyoto Protocol, notably the Clean Development Mechanism
- The concept and design of the Prototype Carbon Fund (PCF)
- The relationship between the PCF and host countries

Political process: The Kyoto Protocol

The World Bank presented an overview of the mechanisms for cooperative implementation in the Kyoto Protocol (KP), notably of the mechanism for emission reduction unit exchange between those countries with binding emission targets (Annex 1), as spelled out in Article 6 of the KP, and mechanisms for certified emission reduction exchange with developing countries under the Clean Development Mechanism (CDM), under Article 12 of the KP. The World Bank emphasized that its proposed Prototype Carbon Fund is based on these two project-based mechanisms for emission reduction exchange ('joint implementation'), which is distinct from the trading mechanism under Article 17 of the KP. The Secretariat of the Convention provided an overview of outstanding issues regarding the Clean Development Mechanism.

In response to these presentations, participants noted that there are many unresolved issues regarding operational modalities of cooperative implementation (JI, CDM, and trading). Some of these outstanding issues may be resolved at the Fourth Session of the Conference of Parties (COP4), to be held in November in Buenos Aires. However, there was a common perception that some issues will be left for further clarification in subsequent meetings. It is questionable whether emission reductions from CDM projects will count from the year 2000 if by then Parties failed to resolve the practical modalities of the CDM. Participants noted that it was not clear from the KP which 'legal entities' are eligible for playing a role in cooperative implementation. These might be entities which are established by national law (public sector institutions or private sector under authority of their government) and/or by international law (such as the World Bank etc.). Such legal entities might be able to assist others in acquiring emission reduction units as an intermediary, but that the Parties to the Convention (i.e. governments) remain responsible. It is entirely a matter of the State Party to determine which entities it authorizes to participate. It is clear that all initiatives for implementing the KPs cooperative mechanisms, whether developed by Parties or by these ‘legal entities’, should conform to UNFCCC/KP guidelines and should operate under these constitutions.

Participants noted that differences between the three flexibility mechanisms of JI, CDM, and emissions trading, require clarification. These mechanisms should be compatible. It is expected that the COP will provide some guidance in this respect. Also, it is not clear from the KP who bears responsibility for monitoring, certification, and verification, including its costs. Most countries felt that there is a need for strengthening human and institutional capacity to participate in these new financial mechanisms, for example, via national focal points. Implementation challenges should not be underestimated in this respect. The importance of existing financing mechanisms, such as the Global Environment Facility, was endorsed.

Prototype Carbon Fund: Concept

The World Bank presented the Prototype Carbon Fund (PCF) and its current status. A separate presentation explained the complementarity between the Global Environment Facility (GEF) and the PCF.

In general, participants were very interested to learn about the PCF. However, participants made clear that some of the design issues require further clarification or development. There was great interest in the nature and extent of the risks involved for host countries, and how these risks can be shared with investors or with others. Risk analysis should also look at system wide effects of PCF projects, including possible market distortions. There was a substantive discussion on the negotiation processes of prices for carbon. In this respect the issue was raised whether the negotiated prices will be adjusted to market price developments over time. Also, participants requested that the World Bank refines its definition of ‘fairness’ of the negotiations and deals, and suggests a process to promote such fairness. The ‘resource rent’ should be shared between the government and project implementing entities to give an incentive for performance.

It was emphasized that technology involved in PCF projects should be “state of the art” technologies that fit in with national development priorities, and are replicable. Again, participants stressed that the PCF must operate under the regulatory framework provided by the UNFCCC/ Kyoto Protocol. Certification and verification of PCF projects should be done by external and independent parties, to ensure its integrity. There is a need for institutional development in host countries required to develop carbon offset projects. Participants emphasized that the Bank should pay due attention to capacity to implement PCF projects.

The relationship between the Prototype Carbon Fund and host countries

One of the presentations of the World Bank explained the nature of the agreements between the PCF and potential hosts. Other presentations covered the criteria for project selection, and the process towards host countries. One conceivable PCF project, a geothermal project, was presented for illustrative purposes.

A substantive part of the discussions focused on the relationship between the PCF and potential host countries. Participants supported the PCF objective of ensuring a fair share of value added to buyers and sellers, but felt that this needs to be elaborated. Both procedural and consequential fairness should be recognized in this respect. In order to avoid concentration of PCF projects in a few countries, the Bank should ensure wide participation in the development of the PCF and in the selection of projects. Some countries might lack of knowledge on procedures to get access to the fund (as experienced in the early development phase of the GEF). To overcome this and to ensure the composition of a truly country- driven project portfolio, there is a need for more information and consultation in individual countries, involving local actors, government constituencies and project developers. Participants stressed that (positive and negative) lessons learned from other financing mechanism, such as the GEF, should not be overlooked in the design and operation of the PCF. The PCF must also share its experiences with other organizations and actors. For carbon offset projects in developing countries, the PCF will have to operate under the CDM and include eventual payments for 'adaptation' as dictated by future decisions on the CDM. Many participants recognized that the PCF will provide valuable opportunities for developing countries to gain operational experience with carbon offset projects, but recognized that its scope is limited (10-15 projects, of which maximum half in developing countries).

The World Bank should assist developing countries in researching the long term implications of their participation in the PCF, the CDM and other mechanisms under the Kyoto Protocol. The question was raised whether host countries are better off negotiating directly with the investors. It was suggested by a participant that in the absence of a market it may be more attractive to pool projects in a fund, such as the PCF. Both the development and operation processes of the PCF must be fully transparent. This can be facilitated by an 'electronic discussion' or a newsletter. It was suggested to establish focal points in the World Bank resident missions to facilitate information exchange and the development of PCF projects.

It was widely recognized that host countries should have a stronger role in the development and operations of the PCF. The Bank has made a strategic choice to focus in the early development phase of the PCF on the relationship with potential investors to ensure financial support of carbon offset projects. It was suggested that in the future the Bank could consider to reverse this process and develop a carbon fund that acts as an agent for host countries by seeking investors for a determined portfolio of carbon offset projects. The Bank could also assist host countries in establishing national carbon funds. Bank assistance could include assistance in project selection and development, training, strengthening institutions, dealing with methodological challenges, and in approaching investors.

World Bank interpretation of host country guidance

In summary, the Bank has heared the host countries wish to establish procedural fairness, substantive fairness, and help build institutional capacity. In response to these requests, the Bank proposes the following:

	Bank response
- institutional capacity to develop carbon offsets and understand long term implications of participation in the PCF	The Bank response is three-fold. First, the Bank has established a **National Strategy Study program** to assist potential host country governments in exploring the opportunities and potential benefits from participating in the AIJ (Activities Implemented Jointly) pilot phase and in formulating their own positions regarding AIJ and JI (Joint Implementation). The program also assist developing countries in assessing their role in the CDM, identify potential investment projects and develop national policies regarding the CDM. The objective of each study is to provide the relevant national authorities and other stakeholders with an opportunity to develop and analyze options to better understand the issues and opportunities presented by potential international markets and other financing opportunities for greenhouse gas (GHG) offsets. Second, the Bank will continue **bilateral and regional consultations** with potential host countries. As part of this dialogue the Bank will provide assistance in identifying potential carbon offset projects as part of its regular lending and non-lending activities. Third, within the Bank **global environmental focal points** will be established for each region. These focal points will help match project with the appropriate funding source (GEF; PCF; JI; AIJ).
- capacity to negotiate a fair deal	The Bank has initiated an investigation of how to strengthen the host country capacity to negotiate a deal that is perceived as fair. A collaboration with the Economic Development Institute (EDI) to provide **training** in countries that submitted a project for the PCF is under discussion. The EDI would partner with external (preferably local) reputable institutes to provide such training. The Bank will propose to its PCF Participants that the costs of this training will be included in the project development costs.
- formal role in PCF operations	In the Third Consultative Group meeting for Participants, June 15-16, 1998, the Bank will propose a formal role for host countries in the **governance structure of the PCF**. It will propose to establish a **Host Country Advisory Panel:** Members: host countries with projects submitted (under serious consideration) or approved meet at least once a year, linked up to other events. Mandate includes to review projects under implementation and to assess implications for host countries; and to provide guidance on future operations to ensure procedural and substantive fairness
- role in the development of the PCF	The Bank will continue its **consultations** with developing countries, countries with economies in transition, and external constituencies to solicit input on the PCF development and operations. These include bilateral consultations, regional consultations, and consultative meetings at events, such as UNFCCC meetings. Also, the Bank works towards the establishment of a moderated **electronic discussion group**, that serves as a medium to solicit input on the development and operations of the PCF. This discussion group would be open to all interested constituencies. A similar discussion group exists for Participants to the PCF.
- distribution of investment among countries	The Bank proposes to establish the following project selection criteria with the aim of encouraging wide participation of countries: • a maximum and minimum amount invested in one project; • a maximum investment amount in Annex I countries • maximum limit for investment in in the same country; • a maximum limit of investment in any one technology

	These are, aimultaneously, consistent with the risk diversification goals of the PCF. Also, the Bank will evaluate its role in the carbon offset market
- distribution of resource rent	Participants to the workshop expressed their clear preference for market adjusted prices for carbon offsets over cost-plus pricing. Cost-plus pricing was viewed as undesirable for both efficiency and equity considerations. The World Bank will evaluate mechanisms to link prices to future price developments (indexing).
- institutional capacity to understand implications of the CDM	The Bank will initiate contacts with other organizations, such the United Nations Development Program to survey the feasibility of setting up a capacity building program in this area. Also, several capacity building activities are described in the Environment Strategy for the Energy Sector. (www/......).

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