World Bank Carbon Finance Business Implementation Note No. 2

Vision for the Ten Year Horizon

In July 1999, the Executive Directors of the World Bank approved the establishment of the Prototype Carbon Fund, which began operating in April 2000. This decision was an historic milestone in the Bank's work in climate change, and formally launched the carbon finance business. In January 2003, senior management approved a comprehensive carbon finance strategy for development of the carbon finance business as a core element of the Bank's development assistance, endorsing integration of carbon finance in regional operations and close alignment with Bank country assistance. In reviewing implementation of this strategy and in light of prospective rapid growth it was felt useful to articulate a vision of World Bank Carbon Finance Business for the next ten years.
The mission of the Bank's Carbon Finance Business (CFB) is "to catalyze markets for climate change mitigation and sustainable development". This mission is consistent with the Bank's mission of sustainable development and poverty alleviation and with the energy access and poverty alleviation focus of the Millennium Development Goals.

The **Vision** for the Bank's role in carbon finance for the ten year horizon is for a business that is diversified in its activities to ensure that the carbon market and carbon trade supports sustainable development and poverty alleviation while providing a cost effective means of addressing climate change. This means that the CFB in ten years will have improved balance between intermediation for buyers and acting as an agent for borrowing countries to help them develop and market emissions reductions directly. Over the next ten years direct private sector intermediation in North-South carbon trade will increase substantially, facilitated by the Bank wherever feasible through capacity building partnerships and risk mitigation instruments. Hence, Bank purchases through own-managed carbon funds will focus increasingly on market segments not covered by the private sector, expanding the reach of the carbon market to countries, sectors of economic activity and technologies not benefiting from privately intermediated trade, and strengthening the contribution of carbon trade to sustainable development and poverty alleviation.

Consistent with this vision, the key activities of the Bank's CFB in this period will include:

- Acting as an agent for borrowing countries with large pools of potential emissions reductions to facilitate trade on terms which support market liquidity and stability and optimize sustainable development locally;
- focusing Bank-intermediated origination and trade on extending carbon finance to local communities and the rural poor, and smaller poorer countries;
- linking carbon finance to large-scale programmatic lending in infrastructure alongside Bank lending assistance where feasible, laying a foundation for a climate-friendly infrastructure for long term growth;

- building capacity in the OECD, within Governments and the private sector, to effect trade with borrowing country clients on terms that maximize sustainable development;
- developing risk mitigation instruments and strategic alliances with the private sector to increase private sector intermediated trade.

Looking Back

In launching the Prototype Carbon Fund, the Bank and key stakeholders recognized the importance of markets for global public goods to internalize in carbon-intensive goods and services the cost of global externalities of unsustainable economic growth. However, no such markets existed even after the Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC) was adopted in 1997. The first step in developing this market was therefore to demonstrate that demand existed for this global public good of greenhouse gas emissions reductions ("carbon") and that carbon assets could be produced and traded with all the attributes of other tradable commodities, i.e. sufficient uniformity in project classes, prospect of replicability and high volumes in trade, and manageable risk and uncertainty.

Fundamentally, to date, the role of the Bank through its carbon finance business has been one of market maker. In order to catalyze a market in greenhouse gas emissions reductions, or carbon, first we had to demonstrate there were buyers on a significant scale. The Prototype Carbon Fund (PCF) demonstrated that demand existed while facilitating learning-by-doing through first-of-a-kind activities in every part of carbon asset creation and management. However, PCF positioned the Bank as much a "buyers agent" as in its traditional role of representing the interests of its borrowing countries. This "dual agent" role required careful management to mitigate conflict of interest and promote equitable benefit sharing in carbon trade.

Looking Forward

A fully diversified CFB supporting carbon trade for sustainable development and poverty alleviation market development requires greater emphasis than exists at present on the role of the Bank (i) as a sellers agent, (ii) as a provider of market know-how for both buyers and sellers by sharing the lessons we have learned to date, and (iii) in mitigating risk and uncertainty for purely private market transactions by private sector entities in the OECD and borrowing countries. With phase one - the market making phase - drawing to a close, this transition in relative emphasis of CFB activity will take place in two additional phases. The three phases of the Bank's role in carbon finance are described below.

Phase I: Making a Market (2000-2004). This phase has been characterized by mobilizing capital for carbon purchases for "learning-by-doing" in first-of-a-kind transactions to achieve Kyoto-compliant greenhouse gas emissions reductions. The business objectives of this phase were to inform the design of the regulatory and incentive system globally and nationally, to benchmark carbon asset creation and trade under the Clean Development Mechanism (CDM) and Joint Implementation, and then to address distributional inequities in market development as these became clear. The Bank-managed carbon funds with OECD corporate and government shareholders have dominated this phase, starting with the PCF and Netherlands Clean Development Facility, and moving to the Community Development Carbon Fund (CDCF), BioCarbon Fund (BioCF) and, finally, additional OECD country funds to help OECD governments and private sectors and the UNFCCC maintain momentum in addressing regulatory issues in defining and registering tradable assets for compliance purposes, and increasing awareness of the potential impact of carbon trade and carbon finance on sustainable development. While initiatives to position the Bank as an agent for host countries in presenting portfolios of carbon assets to the emerging market were always foreseen, tangible and practical opportunities only emerged in 2004 for operational launch in 2005 in Economies in Transition States and in China.

Phase II: Diversification – (2005-2009): This phase will be characterized by diversification away from the heavy emphasis on market development on behalf of OECD shareholders to include a significant role as agent of Bank borrowing countries, helping them to develop assets for trade through their own vehicles. In addition, the Bank will seek to create opportunities to manage risk and build capacity for a greater direct private sector role in carbon trade between the OECD and Bank borrowing countries under the flexible mechanisms of the Kyoto Protocol or successor frameworks, and for the European Emissions Trading Scheme. As these initiatives succeed, increasingly the Bank will focus on addressing barriers to market development, extending the reach of the carbon market to countries, sectors of economic activity, and technologies, yet to benefit from carbon finance, and to maximize the convergence between carbon trade and sustainable development and poverty alleviation locally, such as through the CDCF and BioCF which are designed to enable smaller and more rural poor communities to benefit from carbon finance. Efforts to build a credible volume of transactions in the CDM will be maintained through Bank-managed funds, and will also expand to build capacity in the OECD, in governments as well as the private sector through alliances and strategic partnerships, through trade fairs and other international fora and internships and fellowships in carbon finance, complementing anticipated growth in carbon finance technical assistance for public and private entities through the Bank's ongoing CF-Assist program.

Phase III: Consolidation (2010-2014). In this phase the Bank will consolidate around a fully diversified business with Bank-managed funds as well as instruments to facilitate direct selling by borrowing countries. The focus of new Bank-intermediated carbon purchase instruments in this phase will be firmly on expanding the frontiers of the market where carbon finance would not reach without Bank assistance in managing risks and transaction costs, such as the poorer smaller countries and uncharted high development potential market segments, such as carbon sequestration and improved land management, and targeting carbon finance for poverty alleviation. The Bank will also continue to meet demands from client countries in capacity building and technical assistance through CF-Assist, increasingly directed as support to local private sector capacity building in all aspects of carbon trade.