

“enhancing the profitability of climate-friendly technology”

This is the first annual report of the World Bank’s Prototype Carbon Fund, which covers the period from the fund’s inception in 2000 to the time of publication in September 2001.

The audited PCF financial statements for fiscal year 2001 (July 1, 2000 to June 30, 2001) are being published but under separate cover.

An online version of this report and the PCF financial statements are available at the PCF website (www.prototypecarbonfund.org).

NOTES

All \$ = U.S. dollars.

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letter from the World Bank



Climate change is one of the most serious environmental issues facing the world today, and developing countries will suffer the most damage. Poor people will be at an even greater disadvantage. The World Bank believes that climate change concerns are central to development itself.

Alleviating the crippling effects of climate change on poorer countries will require private as well as public investment. Efficient market-based mechanisms are crucial to lowering the costs of climate change mitigation and to channeling private capital to cleaner technologies and more socially and environmentally sustainable development in our client countries.

The Prototype Carbon Fund (PCF) demonstrates the Bank's commitment to catalyze the development of these market mechanisms in order to help developing countries benefit from carbon finance.

I am grateful to the companies and governments that are participating in the Fund, to the countries who host the PCF's emission reduction purchase transactions, and to the many stakeholders that have provided support and guidance. All have enabled the countries engaged in the United Nations Framework Convention on Climate Change's (UNFCCC) Kyoto Protocol negotiations to take advantage of the PCF's learning by doing. All have helped open the eyes of the private sector working in developing countries to the opportunity of carbon finance to enhance the profitability of cleaner climate-friendly technology.

More broadly, the Kyoto Protocol is leading the way in addressing environmental problems of global scale and significance. Its pioneering of market-based mechanisms demonstrates how markets can begin to internalize global environmental externalities and work for sustainable development.

In the next twelve months the PCF will commit the great majority of its capital and expand the learning experience to about a dozen new projects which will generate emissions reductions. I will be following these developments with great interest and wish those participating in this business every success.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ian Johnson', written in a cursive style.

Ian Johnson

Vice President and Head of Network

Environmentally and Socially Sustainable Development

World Bank





letter from the chairmen

The world has faced the fact that emitting carbon dioxide and other greenhouse gases is no longer free, and stabilizing their concentrations in the atmosphere and minimizing future emissions is critical. Using the tools and instruments provided by the UNFCCC, the PCF promotes the preparation of projects to achieve these objectives, and to enhance the capacity of all parties involved through a learning by doing process.

Today's society is conceived as an interlinked world where governments, business, and communities work together to find viable solutions to current challenges. PCF has demonstrated that this sense of interaction among the different parties involved in Clean Development Mechanism (CDM) and Joint Implementation (JI) projects is not a mere expression of desire, but a reality.

The ongoing uncertainty of the climate change negotiation process was heightened during the last year. The PCF proved able to meet the challenge by becoming a reference for public and private institutions interested in the emission reductions market. The PCF is a unique platform to discuss matters related to CDM and JI. It brings together host and participant country representatives, as well as private sector investors and technical experts from the PCF team, provides the opportunity to exchange views and advances the knowledge base for both mechanisms.

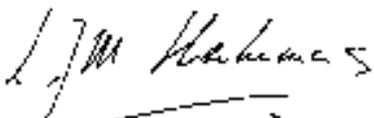
The PCFplus program was created to respond to the capacity building needs of the host countries through three different tools: the PCFplus fellowship program; PCFplus outreach and training activities; and PCFplus research, which analyzes the technical challenges of project development, carbon markets, and the relationship between CDM and sustainable development.



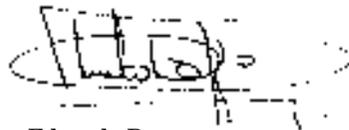
“finding viable solutions to current challenges”

The evolution of the carbon market presents a new challenge for the PCF. Taking into consideration the nature and limitations of the fund, we can count on the PCF team’s creativity to find answers to the new questions formulated by an increasing number of active and knowledgeable participants and hosts and the public-at-large.

It is important to recognize the efforts and commitment of the PCF team, which shows an extraordinary level of professionalism. We would also like to express our gratitude for the help and support provided by our colleagues in the Participants’ Committee and Host Country Committee, with whom we remain committed to quality work and increased co-operation in the further development of the Prototype Carbon Fund.



Maurits Blanson Henkemans
Chairman
Participants’ Committee



Eduardo Dopazo
Chairman
Host Country Committee





notes from the fund manager

Dear Friends,

It is my pleasure to share some observations almost 18 months into the PCF's emissions reductions purchase phase. It has been a period full of interesting surprises. I will mention here a couple that were particularly striking and explain how PCF is addressing them. On pages 8–9 we present some of the highlights of our progress in this period.

First, I am struck by the diversity we confront in every part of our business—it is showing no signs of becoming routine. To meet this challenge, PCF is constantly innovating, whether by pioneering ways to define credible baselines, or by structuring innovative transactions to accommodate a country's legal framework. On a daily basis, we build our knowledge of business processes and legal contracts related to the CDM/JI project cycles, creating a rich set of resources that others can adapt to their own projects. This makes our path-breaking efforts all the more important for the private sector entering this new market.

Second, our work with our developing country and transition economy clients has revealed an unforeseen opportunity. In developing our first commercial transaction, we recognized the remarkable educational power of learning by doing. Only when confronted with requests to make long term legal commitments to create and sell this new “sovereign commodity” can governments and local private sectors realize the opportunity to benefit from the CDM and JI.



“the remarkable
educational
power of learning
by doing”

The lesson for the PCF team is that we must provide more than our unique transactional knowledge and funding for a single carbon purchase transaction. We must build strategic coalitions with bilaterals, business associations and development agencies to help host countries efficiently gain the legal, administrative and market capacity they need to compete for a share in the CDM/JI market.

Over the next 12 months we hope to bring this vision closer to reality by developing a technologically and geographically diverse portfolio of highly replicable projects. We expect to complete several pioneering emission reduction purchase transactions in renewable energy and energy efficiency, and create innovative, low-cost transaction structures to efficiently bundle small projects for delivery of carbon finance.



Ken Newcombe
Fund Manager





highlights

COMPLETED OUR FIRST EMISSION REDUCTION PURCHASE TRANSACTION

- Negotiated an emission reduction purchase agreement for the Latvia Liepaja Solid Waste Management Project in accordance with then-current CDM rules (July 2000)

DEVELOPED A STRONG, DIVERSIFIED PROJECT PIPELINE

- Reviewed and registered over 130 Project Idea Notes
- Obtained clearance from PCF participants to prepare 15 emission reduction transactions, covering 6 technologies, 8 countries, and 4 regions, for a total of up to US \$50 million, and developed a pipeline of over 30 projects under active review
- Prepared 10 projects for validation, including several projects in Costa Rica, and projects in Brazil, Chile and Uganda

DISTILLED AND SHARED KEY LESSONS LEARNED ON THE CDM AND JI

- Analyzed the cost burden of CDM transactions, in particular on small projects
- Demonstrated the sufficiency of environmental additionality and conservative and reasonable approaches to establishing baselines for CDM and JI operations
- Demonstrated that carbon finance, even at relatively low prices, can have an important impact on project viability



PIONEERED PROJECT DOCUMENTATION AND STRUCTURING OF PROJECTS

- Developed a Preliminary Validation Manual to facilitate streamlined, systematic, comprehensive approaches to validation
- Completed baseline studies and Monitoring and Verification Plans for several projects
- Pioneered legal structures for JI and CDM projects
- Finalized intermediary agreements to bundle carbon purchase transactions for small renewable and energy efficiency projects in Brazil and Eastern Europe
- Developed a coherent initial approach to carbon pricing, risk assessment and transaction structuring

PROVIDED CAPACITY BUILDING OPPORTUNITIES, AND DISSEMINATED PCF EXPERIENCES AND RESEARCH RESULTS WIDELY

- Launched training in partnership with the World Bank Institute covering basics of carbon finance and project design, and delivered training to 22 country teams
- Increased the number of PCF participating countries to over 30 and created a PCF fellowship program enabling 9 representatives to work in the PCF Fund Management Unit for up to three months at a time
- Launched a research and development program, which completed reviews of carbon market developments, carbon finance for solar photovoltaic operations, and streamlined baselines for small-scale energy conservation projects
- Built an interactive website (www.prototypecarbonfund.org) to disseminate knowledge of PCF's work

