

Carbon Partnership Facility

Information Memorandum

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PARTICIPATION IN THE CARBON PARTNERSHIP FACILITY IS HIGHLY SPECULATIVE. PROSPECTIVE PARTICIPANTS SHOULD CAREFULLY REVIEW THIS INFORMATION MEMORANDUM, INCLUDING THE RISK FACTORS THAT APPEAR IN CHAPTER 7.

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List of Abbreviations

CCX	Chicago Climate Exchange
CITL	Community Independent Transaction Log
CO ₂	carbon dioxide
CPA	CDM Project Activity
ETS	Emission Trading Scheme
EU	European Union
EUA	European Union Allowance
EU ETS	European Union Emissions Trading Scheme
GIS	Green Investment Scheme
HFC	hydrofluorocarbon
IDA	International Development Association
IETA	International Emissions Trading Association
IFC	International Finance Corporation
IPCC/AR IV	Fourth Assessment Report of the Intergovernmental Panel on Climate Change
ITL	International Transaction Log
JPY	Japanese Yen
LoA	Letter of Approval
LULUCF	Land Use, Land-use Change and Forestry
METI	Ministry of Economy, Trade and Industry of Japan
OECD	Organization for Economic Cooperation and Development
PCF	Prototype Carbon Fund
PDD	Project/Program Design Document
QELROs	Quantified Emission Limitation and Reduction Objectives
REDD	reduced emissions from deforestation and forest degradation
RGGI	Regional Greenhouse Gas Initiative
UN	United Nations
UNEP	United Nations Environment Programme
US	United States
US\$	United States Dollars
VAT	Value Added Tax
WCI	Western Climate Initiative

Measures

tCO ₂ e	one metric ton of Carbon Dioxide Equivalent
GtCO ₂ e	one Giga-ton of carbon dioxide equivalent
MtCO ₂ e	one million ton of carbon dioxide equivalent

PART I GENERAL INFORMATION

Capitalized terms used in this Information Memorandum have the meaning provided in the Definitions section of the Instrument Establishing the Carbon Partnership Facility, contained in Part II of this Information Memorandum, or as otherwise defined in the text of this Information Memorandum. For ease of reference, a list of other abbreviations is also included.

CHAPTER 1 INTRODUCTION

According to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change (2007), warming of the climate system is “unequivocal.” The impacts of projected changes in the world’s climate are expected to be far-reaching and most pronounced in poorer countries, adversely affecting virtually all aspects of social and economic life. These impacts may put in jeopardy years, if not decades, of gains in past and future human development. The World Bank’s overall mission of reducing poverty and promoting long-term development is therefore inextricably linked to climate change and efforts to alleviate it. Action will require development of policy, regulatory, fiscal and financial instruments across sectors to provide countries with effective incentives to reduce GHG emissions. It will also require the development and deployment of a broad mix of low-carbon technologies and the expansion of mitigation options, together with technological innovation and deployment.

The current international policy framework which supports climate change mitigation and carbon finance is driven by the Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC) and the European Union Emissions Trading Scheme (EU ETS). While these agreements have successfully led to the development of a vibrant carbon market, neither framework structure includes clear provisions to support measures for tackling the broad range of emission sources at the scale and duration required to address GHG mitigation globally. With the first commitment period of the Kyoto Protocol ending in 2012, and discussions between the Parties to the UNFCCC on a long-term framework for the post-2012 period not expected to conclude before 2009 at the earliest, there is a period of uncertainty regarding the future international climate regime.

Moreover, the short-term, compliance-driven buying interests in the current market do not sufficiently support large, cleaner investments in energy and infrastructure that have long-term Emission Reduction (ER) potential. The current project-by-project approach under the Clean Development Mechanism (CDM) and Joint Implementation (JI) of the Kyoto Protocol incurs high transaction costs and is unlikely to generate the kind of

transformation in emission-intensive sectors that large-scale programs can produce. This challenge along with the lack of regulatory framework has created a limited demand for post-2012 carbon assets.

It is in this context that the World Bank, prompted by a range of stakeholders from developing and developed countries, proposed the creation of the CPF. It was determined that the World Bank's role in scaling up and catalyzing carbon finance to mitigation programs that are strategic and entail transformational interventions in various sectors in the post-2012 period would have a greater chance of success if it engaged both Buyer and Seller Participants using a partnership model. As a result, the World Bank's Board of Executive Directors approved the creation of the CPF in September 2007.

The CPF is designed to develop ER Programs and support ER purchases over long periods both before and, primarily, after 2012. Its objectives and business model are based on the need to prepare large-scale, potentially risky investments with long lead times, which require durable partnerships between Buyer and Seller Participants. It is also based on the need to support long-term investments in an uncertain market environment, possibly spanning several market cycles. The CPF is intended to be adequately flexible to accommodate changing needs and interests from a large variety of Buyer and Seller Participants, thus preventing a proliferation of carbon funds to meet special interests. For the first time in one of the World Bank's carbon funds, the new Facility will employ a governance structure that features the balanced participation of Buyer and Seller Participants. Governments, be they as representatives of Host Countries or Donors to the companion program preparation fund, will also directly participate in the governance of the Facility in an advisory capacity. Closer collaboration and partnership between all parties in the carbon market is expected to make carbon finance an even more effective tool in climate change mitigation and development, and to provide a unique opportunity at the operational level for parties involved to exchange views and discuss issues of mutual interest.

Although the CPF has the benefit of building on precedents established by the current commitment period of the Kyoto Protocol, efficient and cost-effective, market-based instruments require further development. "Learning by doing" approaches will be an essential aspect of the Facility as it moves from individual projects to programmatic approaches, including developing methodologies needed for such approaches. It should be noted that, while following this learning-by-doing philosophy, the World Bank will be guided by national policies and negotiating positions; the World Bank is not party to the UN climate negotiations. However, as the Facility is being designed to develop and test elements of the carbon market, methodologies, pricing and programmatic approaches developed by the Facility may contribute to the shaping of international agreements being negotiated.

In terms of structure, the CPF is set up as a partnership between Buyer and Seller Participants. It will be comprised of two trust funds:

- (i) The Carbon Asset Development Fund (CADF) funds the administrative costs of the World Bank of establishing and operating the Facility (including Program

development, supervision and ongoing ER Verification), as well as provides grants and otherwise supports technical assistance and capacity building to Seller Participants, to Host Country governments or to entities authorized by the Host Countries for the development of Programs, and creation of an enabling environment for the generation of ERs.

- (ii) The Carbon Fund receives Contributions from the Buyer Participants to purchase ERs generated by Programs and other payments required as per the Emission Reduction Purchase Agreements (ERPAs).

The CPF would target long-term investments that have a significant potential to mitigate emissions in the future. To do this, the CPF would purchase ERs well beyond 2012. For Programs that also generate pre-2013 assets, these assets may be purchased by the CPF and/or one of the World Bank's current carbon funds. The CPF is open for all types of activities that (i) reduce greenhouse gases, (ii) are suitable for scaling up, i.e., can be replicated as part of a program, and where (iii) CPF involvement would enable or add value to the proposed Programs. Programs may be financed or co-financed by the World Bank, the IFC, and other international financial institutions and funds or entirely by the Seller Participants themselves. Examples of the types of Programs that could be included in the CPF portfolio include, among others, the following: power sector development, energy efficiency, oil and gas sector, waste management, transportation, and urban development programs.

Contributions to the Carbon Fund would be achieved through a tranching process, whereby capital is raised and allocated in several steps. The Carbon Fund became operational on May 15, 2010, with First Tranche commitments of €100 million, and acceptance by the Trustee of at least three Seller Participants. The CADF became operational on January 14, 2009, when €5 million in Donor Contributions was reached. The First Tranche of the Carbon Fund will be closed from further Contributions on December 31, 2010, or when Contributions from Buyer Participants to the First Tranche of the Facility reach a level that is deemed appropriate by the Trustee, whichever is earlier. For the First Tranche of the Carbon Fund, Contributions from Buyer Participants of at least €20 million for each Buyer Participant which is a non-Annex I Country and €35 million for any other Buyer Participant are required.

The CPF seeks to generate ERs that may be recognized assets under different regulatory systems, notably under the UNFCCC, as well as to pilot approaches to ERs where the regulatory framework is absent or evolving or where methodologies can be improved. As parties to the UNFCCC move forward on designing a future climate regime, the CPF would adjust to new rules as they are adopted and seek to ensure that carbon assets are developed for compliance in the relevant regime(s). The CPF would develop and test new approaches that depart from narrow, project-by-project methodologies (many of which were successfully developed by the existing World Bank carbon funds), including sectoral and other cross-cutting methodologies applicable to programs where the main interlocutors are likely to be national governments or large public and/or private sector entities. The World Bank's experience and expertise in the area of baseline and monitoring methodologies will assist it in leading this dialogue and pilot related actions.

In fact, it is one of the most important areas where the World Bank can add value. These new approaches would allow scaling up the mitigation and development impact of carbon finance.

The CPF concept has been discussed extensively with interested governments and the public and the private sectors for more than a year, with increasingly intensive and detailed consultations held within the last nine months. Continued dialogue and information sharing with relevant stakeholders (even those that are not directly participating in the Facility) will be required to sustain and strengthen the partnership approach and to ensure its experiences and “global public good” outputs get widely disseminated. In addition to Host Country governments and Donors, the CPF governance structure allows for the IBRD as Trustee of the Facility and in consultations with Buyer and Seller Participants, to invite any entity that would be considered important for meeting the objectives of the Facility to become a Partner. Such entities could potentially include international organizations and research and development institutions.

Given the complexity of the issues involved and the long-term nature of the ERPAs to be entered into under the Carbon Fund it is expected that the CPF could potentially operate well beyond 2020. Various Tranches of the Facility would have a separately defined lifetime – for example, the First Tranche is proposed to purchase ERs up to 2022.

This Information Memorandum provides an overview of the main operational aspects of the CPF and is constructed as follows: Part I sets the CPF in context, describes the proposed governance and operational arrangements for the Facility, and discloses the risks involved. Part II consists of the Instrument; and Parts III, IV, V and VI, respectively, contain the model Buyer and Seller Participation Agreements, Partnership Memorandum of Understanding (to be signed by Partners of the Facility) and Administration Agreement (to be signed by Donors making a Donor Contribution to the CADF). For ease of reference, Parts II, III, IV, V and VI are provided under a separate cover.

CHAPTER 2 BACKGROUND

2.1 The International Climate Change Regime

2.1.1. The UNFCCC and the Kyoto Protocol

The international regime providing the backdrop for the World Bank's establishment of the Facility derives from the UNFCCC and the Kyoto Protocol. The UNFCCC was adopted in 1992. Its ultimate objective is the "stabilization of greenhouse gas concentrations at a level that would prevent dangerous anthropogenic interference with the climate system."

The Kyoto Protocol was adopted in December 1997 and entered into force on February 16, 2005. In contrast to the UNFCCC, it provides for specific Quantified Emission Limitation and Reduction Objectives (QELROs) to be met by the countries listed in UNFCCC Annex I. Annex I Countries include developed countries and those with Economies in Transition. The Annex I Countries that have ratified the Kyoto Protocol have agreed to reduce their greenhouse gas emissions by an average of approximately 5% below their 1990 levels, over the first commitment period from 2008 through 2012.

2.1.2. Mechanisms of the Kyoto Protocol

The Kyoto Protocol provides that Annex I Countries can meet some proportion of their QELROs through three market-based mechanisms ("Kyoto Mechanisms"). The detailed modalities for implementing these mechanisms have been developed during their implementation, but their underlying principles are described in the Kyoto Protocol. These three Kyoto Mechanisms are:

- (i) "Joint Implementation" or JI, which consists of the transfer, on a project-by-project basis, of Emission Reduction Units (ERUs) among Annex I Countries under Article 6 of the Kyoto Protocol;
- (ii) The "Clean Development Mechanism" or CDM, which allows the transfer of Certified Emission Reductions (CERs) to Annex I Countries from projects located in non-Annex I Countries under Article 12 of the Kyoto Protocol.
- (iii) "International Emissions Trading," which allows the trading of Assigned Amount Units (AAUs) and other Kyoto Protocol credits (including CERs and ERUs after they have been generated by a project) among Annex I Countries under Article 17 of the Kyoto Protocol. "Assigned Amounts" refers to the quantity of GHGs a Party to the Kyoto Protocol is allowed to release in the global atmosphere as calculated on a yearly basis in Annex B of the Protocol.

The first two mechanisms, which generate CERs and ERUs, are “project-based,” in that they enable Annex I Countries to purchase ERs from projects which reduce or sequester GHG emissions in non-Annex I Countries (CDM) or Annex I countries (JI). Each individual CER, ERU and AAU equates to one metric ton of Carbon Dioxide Equivalent (tCO₂e) abated.

2.2 The World Bank and Carbon Finance

More than a decade ago, the World Bank began its involvement in building the carbon market and prototyping carbon finance operations. After years of analytical work and participation in the UNFCCC Activities Implemented Jointly program, the World Bank launched its first public-private partnership, the Prototype Carbon Fund (PCF), in April 2000.

The PCF was established with US\$180 million in capital, with the participation of 17 companies and 6 governments. In many respects, the PCF has been the pioneer of the global carbon market, developing methodologies and piloting transactions years before the Kyoto Protocol entered into force. Over the past eight years, carbon finance activities at the World Bank have grown from the PCF to include ten more carbon funds and facilities with a total capitalization of more than US\$2.2 billion.¹ These funds cater predominantly to parties seeking to comply with obligations in the first Kyoto commitment period (2008–2012).

At the early stages of the World Bank’s engagement in the carbon market, the World Bank’s objective was to catalyze the nearly non-existent international market for GHG ERs. The World Bank recognized that the carbon market could result, over the longer term, in considerable financing for developing countries to increase the efficiency of their energy industries and improve their environment. Yet institutional hurdles created substantial risks for both potential sellers and purchasers of ERs.

When the Kyoto Protocol came into force in February 2005, the demand for GHG ER credits expanded considerably. Many Developing Countries and Countries with Economies in Transition have become actively engaged in carbon finance, but others have not yet been able to benefit. The World Bank’s role in the carbon market has been three-pronged:

- (i) To ensure that carbon finance contributes substantially to sustainable development, beyond its contribution to global environmental efforts;
- (ii) To assist in building, sustaining and expanding the international market for GHG ERs and its institutional and administrative structure; and

¹ The World Bank carbon funds and facilities include the Prototype Carbon Fund, Netherlands CDM Facility, Netherlands European Carbon Facility, Spanish Carbon Fund, Italian Carbon, Community Development Carbon Fund, BioCarbon Fund, Danish Carbon Fund, Umbrella Carbon Facility, the Carbon Fund for Europe and the Forest Carbon Partnership Facility.

- (iii) To further strengthen the capacity of developing countries to benefit from the emerging market for ER credits.

Thus, the World Bank and other international development institutions have had the opportunity to promote the use of carbon finance as a tool to increase energy efficiency, build sustainable forest management, and improve land practices in agriculture - all while setting up a cost-effective mechanism to address climate change. Going forward, and as part of its *Development and Climate Change: A Strategic Framework for the World Bank Group*², the World Bank aims to have greater impact on climate change mitigation and poverty alleviation through, inter alia, the use of carbon finance by: (i) supporting long-term investments to promote transition to low-carbon economies; (ii) shifting from a project-by-project approach to programs of investments; (iii) systematically integrating carbon finance into public and private investment decisions; (iv) incorporating and mainstreaming carbon finance into World Bank lending and other operations, ensuring complementarities with other financing instruments (Climate Investment Funds³, Global Environment Facility⁴, etc.); and (v) expanding carbon finance to regions and sectors that do not currently participate. To help achieve these objectives, the World Bank has created two new facilities, namely the CPF and the Forest Carbon Partnership Facility. The latter aims at piloting financial incentive mechanisms to reduce emissions from deforestation and forest degradation (REDD), and became operational in June 2008.⁵

2.3 State and trends of The Carbon Market

Each year the Carbon Finance Unit of the World Bank publishes a report on the “State and Trends of the Carbon Market.” The 2010 report, which provides the most recent assessment, can be found at the following link:

http://siteresources.worldbank.org/INTCARBONFINANCE/Resources/State_and_Trends_of_the_Carbon_Market_2010_low_res.pdf.

² For further information on *Development and Climate Change: A Strategic Framework for the World Bank Group*, please refer to <http://go.worldbank.org/HZ77KYCI90>.

³ For further information on the Climate Investment Funds, please refer to <http://go.worldbank.org/58OVAGT860>.

⁴ For further information on the Global Environmental Facility, please refer to www.gefweb.org

⁵ For further information on the FCPF please refer to www.carbonfinance.org/fcpf

CHAPTER 3 ORGANIZATIONAL STRUCTURE

The Facility is comprised of two trust funds: (i) the CADF and (ii) the Carbon Fund.

3.1 Carbon Asset Development Fund

The CADF will cover the World Bank's costs for administrative, management and Program preparation and supervision functions for the CADF and the Carbon Fund, and provide financial support to Seller Participants, Host Country governments and entities authorized by the Host Countries for the development of Programs and, to a limited extent, focused assistance to the above parties in creating an enabling environment for the generation of ERs.

Once a program proponent signs a Seller Participation Agreement, it may apply for a CADF grant to assist with program preparation expenses, notably preparation of the Program Design Document (PDD) and the monitoring plan, and, if applicable, costs incurred by the Seller Participant in the development of a new baseline and monitoring methodology. A Host Country government or other authorized representatives and any other entities as may be invited by the Trustee of the CADF may also apply for a CADF grant at the time of signing a Partnership Memorandum of Understanding with the Trustee of the CADF, and as the case may be, Trustee of the Carbon Fund for the purposes of upstream identification and development of ER Programs or work on the enabling environment.

The Trustee will also use CADF property to pay or reimburse itself or any other person for costs and expenses incurred in the development, implementation and supervision of Programs and the general management and administration of the Facility. Such costs would include (i) management of the Facility including the Program pipeline and ERPA portfolio; (ii) expenses associated with Demands for Payment; (iii) accounting and reporting, external audits; and (iv) costs of ongoing Program supervision and ER verification and accounting for carbon assets received and distributed.

The CADF is funded by a charge from Buyer Participants, by Contributions from Donors and from investment income.

The IBRD in its role as Trustee for the CADF is responsible for administering the CADF funds, entering into CADF Grant Agreements with Seller Participants and Host Country government Partners, or, as appropriate, with other entities in accordance with the CADF eligible uses, supervising the CADF grants, providing reports, accepting Donor participation in the CADF and managing Contributions to the CADF. Given the expected lifetime of the First Tranche of the Carbon Fund, the current expectation is that the last disbursements from the CADF would be made in 2024; however, the CADF is likely to continue to operate beyond 2024 if additional Tranches of the Carbon Fund are established.

3.2 Carbon Fund

The Carbon Fund receives Contributions from Buyer Participants with the main objective to purchase ERs generated by the Programs and is used for ER-related payments only (e.g., purchase of ERs, options/option premiums, advance payments, etc). It entails the trusteeship functions of (i) administering Buyer Participants' promissory notes and making draw-downs, (ii) making payments for carbon assets as per the ERPAs and supervising the ERPAs, and (iii) administering and forwarding carbon assets.

The Carbon Fund may have several Tranches, each with a discrete set of Buyer Participants and Portfolio Selection Criteria. Buyer Participants may participate in more than one Tranche and the Portfolio Selection Criteria for each Tranche may cover several sectors and technologies or be more narrowly focused.

On the basis of demonstrated demand, the Trustee will open Tranches for Contributions – that is, nominate an Opening Date, Operational Date, a Closing Date, the necessary level of minimum Contribution for participation, CADF Charge, Seller Contribution Credit (SCC), and the proposed Portfolio and Program Selection Criteria for Programs from which the ERs would be purchased for that Tranche. It is the intention of the Trustee to maintain each Tranche of the Carbon Fund as a separate trust fund and to maintain and account for the assets, liabilities, and ER credits of each Tranche separately. The final disbursements from the First Tranche of the Carbon Fund are expected to be made by December 31, 2024.

While the Trustee of the Carbon Fund will seek to mitigate under-delivery of ERs under the ERPAs, the Trustee will not enter into legal commitments that exceed the capital available in the Carbon Fund or that would provide for delivery of ERs after the termination date of the relevant Tranche. The Trustee of the Carbon Fund shall only enter into ERPAs for each Tranche up to the capital available in that Tranche after the deduction of the applicable CADF Charges. The Trustee of the Carbon Fund shall furthermore only enter into ERPAs for each Tranche in the holding currency in which the Tranche is denominated. For example, all ERPAs for the First Tranche would be denominated in Euro.

3.3 Buyer Participants

Participation as a Buyer in Tranches of the Carbon Fund would be open to governments, as well as public and private sector entities located in countries which are parties to the UNFCCC and which are approved by the Trustee. Buyer Participants would contribute to a particular Tranche of the Carbon Fund and each Buyer Participant would enter into a Buyer Participation Agreement with the Trustee of the Carbon Fund and CADF, setting out the terms and conditions of its participation in that Tranche of the Facility.

The World Bank will review the potential private sector Buyer Participants to determine their eligibility for participation in the Carbon Fund on the basis of an ad hoc questionnaire that provides background on the activities and financial status of the potential private sector Buyer Participant.

3.4 Seller Participants

Participation as a Seller of ERs would be open to public and private entities from Developing Countries and Countries with Economies in Transition. Seller Participants of the CPF would commit to develop one or more Programs and to sell a portion of the ERs generated by the Program to the Buyer Participants in the Carbon Fund. Seller Participants would apply for participation in the Facility by submitting a Program Idea Note (PIN) describing one or more potential Programs for review and approval by the Trustee. The Trustee would decide whether or not to accept the participation of the prospective Seller Participant, based on the review and approval of the PIN. Approved Seller Participants would enter into a Seller Participation Agreement with the Trustee of the Carbon Fund and Trustee of the CADF, setting out the terms and conditions of participation in the Facility. The Seller Participant's proposed Programs would be allocated to a Tranche or Tranches of the Carbon Fund in accordance with Portfolio and Program Selection Criteria.

In addition, as noted above, each approved Seller Participant may request a CADF grant to assist with Program preparation activities such as preparing the carbon asset related documentation.

3.5 Partners and Donors

The CPF will also include Partners and Donors that will participate in the governance of the Facility in an advisory role. Partners would include Host Country governments or their authorized representatives that have entered into a Partnership Memorandum of Understanding to work in partnership with the Trustees to identify and develop Programs, and any other entities as may be invited from time to time by the Trustees (in consultation with the Buyer and Seller Participants and existing Partners and Donors) to become Partners in the Facility. Prospective Partners may include, for example, representatives of relevant international organizations and civil society organizations.

The success of the CPF and its impact on the future of the carbon market will depend on appropriate policies and measures implemented by the Host Country governments, as well as on the negotiation outcomes in the UN context and in other international fora, as well as on the development of regional regimes. Involvement of Donor and Host Country governments as well as other Partners in the Facility will therefore enable the partnership to benefit from the inputs of those that are closely engaged in the formulation of future policies relevant to the activities of the CPF, be they in countries where ER Programs will be undertaken or at the global level in the context of shaping the evolving international climate change policy framework.

3.6 Facility Governance Structure

The Facility will be managed by an IBRD team and headed by a World Bank appointed Facility Coordinator. Buyer and Seller Participants will have joint representation in the CPF governance structure which is shared by the whole Facility and includes an Annual Meeting of all Participants, Partners and Donors, and a Partnership Committee. The Trustee may, when deemed necessary, establish separate consultative groups or other governance structures for the purposes of advising the Trustee on specific Tranches, types of Programs or asset classes.

The Annual Meeting will be an opportunity for Participants, Donors and Partners to share information and experience on the Facility and its Programs and provide broad guidance to the Trustee on how to further develop the Facility. At the Annual Meeting the Participants, Donors and Partners also elect representatives from among their respective constituencies to sit on the Partnership Committee. In addition, the Annual Meeting may review specific decisions made by the Partnership Committee with respect to the CPF Pricing Approach.

Each Participant at the Annual Meeting would have one vote, except when electing its constituency's representatives to the Partnership Committee, at which time the Buyer Participants' and Donors' votes would be proportional to the level of their financial Contributions to the Facility. Partners and Donors shall act as advisory parties and observers with no voting rights, except when electing their representatives to the Partnership Committee.

The Partnership Committee will always have an equal representation of Buyers and Sellers and it would be established once there at least three Buyer Participants and three Seller Participants in the Facility. The Partnership Committee would be comprised of up to fifteen (15) members among which three to six members would represent the Seller Participants; three to six members would represent the interests of the Buyer Participants; one member would represent the Donors as a non-voting member; and two members would represent Partners as non-voting members. In order to ensure representation of both public and private Buyer Participants in the Partnership Committee, the participation of public and private sector Buyer Participants would be drawn based on a pro rata distribution of their aggregate Contributions to all the Tranches of the Carbon Fund. Members of the Partnership Committee representing the Buyer Participants and the Seller Participants would each elect one of its members to serve as a chairperson every year, thereby having one Buyer and one Seller Participant co-chair the Partnership Committee.

The Trustee may revise the composition of the Partnership Committee upon the opening of subsequent Tranches. Each voting member of the Partnership Committee would be entitled to cast one vote and a majority of the voting members of the Partnership Committee would constitute a quorum for the meetings of the Partnership Committee. Except as otherwise provided in the Instrument, every matter submitted to a Partnership Committee meeting would be decided by consensus. If consensus cannot be reached, the decisions would be taken by a two-thirds majority of the votes cast at that meeting.

3.7 Role of the Partnership Committee

The Partnership Committee would be the main decision-making body of the Facility and provide guidance to the Facility Coordinator on broad policy issues and on the operation of the Facility. Specifically, the Partnership Committee would:

- (i) provide views to the Trustees for the purpose of setting priorities for carbon asset creation e.g. in terms of technology, balance of regions/countries, etc;
- (ii) provide operational guidance, including on the Portfolio and Program Selection Criteria which have already been established;
- (iii) endorse a CPF Pricing Approach (see Section 5.6 below for further discussion of the Pricing Approach and the role of the Partnership Committee in endorsing it);
- (iv) endorse the General Conditions to be used for ERPAs;
- (v) in the absence of International Rules on an applicable regime, advise on the selection of the Independent Third Party auditors to review rules and methodologies to vet the environmental integrity and credibility of the carbon assets; and
- (vi) endorse the acceptance of those entities, other than Host Countries governments and their authorized representatives, proposed by the Trustees to become a Partner in the Facility.

3.8 Role of the Trustee, Reporting and Management Team Structure

The IBRD, in its role as Trustee of the CADF and the Carbon Fund, would be responsible for managing the administration and trust fund related aspects of the CPF, including receiving and administering the participations in the CPF, managing draw-downs, providing reports, and procuring audits. IBRD, as Trustee of the Carbon Fund, will also be responsible for entering into ERPAs with Program entities and making payments to those entities under the terms of the ERPAs. Neither Buyer nor Seller Participants have the right to remove the Trustee.

The Trustees will prepare an annual CPF Progress Report for the benefit of the Buyer and Seller Participants, Donors and Partners.

A senior level Facility Coordinator will be appointed by the World Bank and will be responsible for the day-to-day management of the operations of the CPF, including managing the annual business cycle for the Facility and reporting to CPF Participants. The Facility Coordinator will use the services of the World Bank's Carbon Finance Unit (CFU), which is responsible for the management of other IBRD-managed Carbon Funds, and report to the Manager of the CFU.

A CPF Operations Team Leader will be responsible for overseeing the selection and development of Programs, management of the pipeline and portfolio of Programs and the negotiation of the ERPAs. The CPF Operations Team Leader will manage and draw on a

team of carbon finance specialists in the CFU's Operations Team and members of the country teams working in the World Bank's Regional Vice Presidencies on key themes and sectors covered by the various Tranches of the Carbon Fund and their portfolios. The CPF Operations Team Leader will also be responsible for leading the sectoral dialogue with government counterparts in individual Host Countries.

Further, CPF implementation will be supported by the CFU's Policy and Methodology Team and its Team Leader. The Policy and Methodology Team is responsible for supporting the CFU in all matters related to regulatory guidance on ERs, follows the UNFCCC regulatory process, and contributes to bottom-up rule-making for project investments, in particular under the CDM and JI. This includes development of new methodologies, analyzing the policy context, and, in cases where approved methodologies can be used, ensuring that Programs conform to the methodology requirements.

In addition to the Operations Team and Policy and Methodology Team, the CPF management team will be able to draw on the other functional teams within the CFU that cover Fund Management, Resource Management, Communications and Financial Operations. The CFU currently has about 60 staff.

Furthermore, the CPF management team will draw on specialist staff within the World Bank, including for project technical review and appraisal; country, sector and technology expertise; advice on safeguard policies; economic and financial analysis; training; knowledge management; legal services; research, marketing; and Participant, Donor, Partner and Host Country relations.

Previous experience of the CFU and its staff include the management of 11 carbon funds and facilities, representing participation by 24 governments and 66 private sector companies and a total capital value of over US\$2.3 billion as [of August 2010]. With the exception of the Forest Carbon Partnership Facility, the focus of these funds is to purchase project-based ERs for the participants in the funds primarily to enable them to meet their obligations for the first commitment period of the Kyoto Protocol (2008-2012). Through these market-based instruments, the World Bank is helping to address climate change and support the poverty reduction and sustainable development priorities of its client countries. As of August [30, 2010], the CFU had signed 137 ERPAs for a total contracted ER volume of about 207.17 million tons. The portfolio of projects is geographically and technologically diverse, and includes projects in 47 countries in all regions of the developing world. Thus far, approximately 27% of all methodologies approved by the CDM Executive Board (seventy percent of methodologies for forestry projects) have been developed by the CFU and its Policy and Methodology team. The CFU has also been instrumental in promoting the possibility of including programmatic activities in the CDM, which contributed to the adoption of the guidelines on CDM Program of Activities.

3.9 Contributions, Draw-downs and Charges

See also Chapter 6 for further details.

3.9.1. Contributions from Buyer Participants

The Minimum Contribution for an Eligible Buyer Participant in the First Tranche is twenty million Euro (€20,000,000) for each Buyer Participant which is a non-Annex I Country and thirty five million Euros (€35,000,000) for each other Buyer Participant. Subject to the agreement of the Trustee of the Carbon Fund, any Buyer Participant in the First Tranche may elect to participate in an amount higher than the Minimum Contribution by making additional commitments to contribute in increments of one million Euros (€1,000,000).

Each Buyer Participant in the First Tranche will be required to pay its Contribution through the issuance and delivery of one or more unconditional Promissory Notes made payable to the Trustee on demand or irrevocably pre-paying the Contribution.

In the event that at the time the Trustee intends to enter into any ERPA, the Buyer Participant has no rating or does not have a rating of Baa or higher by Moody's Investor Services Limited, or a rating of BBB or higher by Standard and Poor's Rating Services, or a rating of BBB or higher by Fitch's Ratings, the Trustee may, prior to entering into such ERPA, demand that such Buyer Participant (i) prepay that portion of the amount of its Contribution that corresponds to such Buyer Participant's pro rata share of the amount payable by the Trustee under such ERPA, or, (ii) provide an irrevocable standby letter of credit, in form and substance satisfactory to the Trustee, issued from a financial institution acceptable to the Trustee for such amount of its Contribution drawable over the term of the ERPA or such other form of security for such amount as is acceptable to the Trustee.

Each Buyer Participant will be required to pay a percentage of its Contribution (CADF Charge) to fund the CADF within fifteen (15) days after execution of the Buyer Participation Agreement or thirty (30) days after written notice by the Trustee of the Operational Date of the First Tranche, whichever is later. The CADF Charge for each Tranche of the Carbon Fund will be determined by the Trustee and notified in writing to potential Buyer Participants in each Tranche of the Carbon Fund on or before the Opening Date for that Tranche. The CADF Charge for the First Tranche will be nine percent (9%) of a Buyer Participant's Contribution, [paid/to be disbursed] in three equal installments in three consecutive years.

Except for CADF Charges, the draw-downs for the Carbon Fund would be determined by the Trustee based on the requirements to make payments under ERPAs. The Trustee will provide Buyer Participants with Demands for Payment accordingly. Typically, a Demand for Payment would be issued at the beginning of the World Bank fiscal year. Furthermore, if at any time the Trustee expects a potential or actual shortfall in funds available to meet the financial requirements of a Tranche of the Carbon Fund, it may issue an additional Demand for Payment together with a statement explaining the reasons for, and amount of, the shortfall. Demands for Payment from Buyer Participants will be

made on a pro rata basis relative to Buyer Participant Contributions, with Buyer Participants given thirty (30) days notice to deliver the payment to the Trustee.

Buyer Participants will be entitled to prepay up to the entire amount of their Contribution, in advance of any Demand for Payment by the Trustee (Prepaid Contribution). In that case, the Trustee and the Buyer Participant will enter into a separate agreement concerning the Prepaid Contribution, and the Prepaid Contribution will, pursuant to such separate agreement, be held in a multi-donor trust fund managed by the World Bank. Investment income generated by the Prepaid Contribution will be transferred to the CADF in accordance with the separate Prepaid Contribution agreement between the Trustee and the Buyer Participant.

Buyer Participants have the right to withdraw their Contributions to the Facility if no International Agreement is adopted by the parties to that agreement by June 30, 2011. Withdrawal shall not, in any manner, affect the effectiveness or implementation of Programs already approved and the obligations of the Trustee under the ERPAs already entered into between Program Entities and the Trustee of the Carbon Fund. In this event, the Trustee would return to the withdrawing Buyer Participant on a pro rata basis any remaining balance of the CADF Charges that is not committed by the Trustee, including without limitation, with respect to approved Programs, executed ERPAs, Grant Agreements, incurred, committed and estimated costs and expenses in accordance with the Instrument and/or any agreement with any consultant or other third parties.

3.9.2. Contributions from Seller Participants

Seller Participants will be subject to a charge in the form of the SCC, which offsets a portion of the CADF Charges paid by the Buyer Participants. The SCC will be based on a percentage rate to be determined by the Trustee before the opening of each Tranche. The resulting SCC will be deducted by the Trustee from the amount due to the Seller Participant for ERs delivered under the specific terms of each the ERPA. The amount of the SCC for the First Tranche will be two percent (2%).

3.9.3. Contributions from Donors

The Minimum Contribution for a Donor to the CADF is the equivalent of two million Euros (€2,000,000). An Eligible Donor may participate in the CADF through entering into an Administration Agreement with the Trustee of the CADF and shall pay its Contribution to the CADF in accordance with the terms of the Administration Agreement. Subject to the agreement of the Trustee, a Donor may elect to increase its Contribution by making one or more additional Contributions to the CADF at any time during the operation of the CADF provided that the additional Contributions are made in increments equivalent to five hundred thousand Euros (€500,000).

CHAPTER 4 OPERATION OF THE FACILITY

4.1 Emission Reduction Programs

The CPF will focus on the identification and development of programmatic activities which consist of a series of the same and/or associated investment activities for which a common approach or an implementation framework can be developed. Many of the Programs are expected to be identified and developed through the ongoing country and sector dialogue and operations of the World Bank.⁶ Indeed, the CPF puts particular emphasis on integrating carbon finance into the World Bank's lending and other operational programs as a component of the financing package available to implement these programs. In the process it will benefit from the extensive policy and financial support that the World Bank will extend to these programs. Consequently, World Bank country and sectors teams will be closely involved in the identification and formulation of these programs. Such an emphasis does not exclude investments financed by other sources, such as other multilateral banks or private sector institutions.

A Program may be undertaken by a single entity (e.g., a public or private sector company) or by a number of different entities, typically coordinated through a program coordination entity or an implementation agent (e.g., the national government, a national utility, a financial intermediary). Programs may be located in one country, or be developed as sub-regional, regional or even global programs spanning several countries (a Program of potentially multi-country reach could, for example, include promotion of use of an energy efficient technology or appliance or include the construction of energy transportation or power transmission systems). Programs may also support the implementation of national policies and/or regulations.

As applicable, a Program may utilize the CDM Program of Activities framework. However, in the context of the ongoing UNFCCC negotiations on a post 2012 agreement, and as the CDM Program of Activities has some limitations on its applicability (besides being applicable only for CDM eligible countries), a Program may be structured in a broader way to maximize potential for scaling up and replication, and to further explore different approaches to programmatic ER activities.

Similarly, Programs may utilize existing CDM and JI methodologies as appropriate, but in certain cases modifications to existing methodologies or development of completely new methodologies will be needed to reach the objectives of the CPF and to fully utilize and leverage ER generation potential (see Section 5.7 for further discussion on possible methodological approaches).

⁶ In the case of countries that have graduated from the IBRD borrowing country status, and where the World Bank therefore may not have active operations, the Trustee would seek the relevant Buyer Participants' consent prior to approving any PIN.

A Program may, depending on the specifics and needs of a Program as well as the exact role of the coordination entity, lead to one ERPA with the coordination entity or several ERPAs signed directly with several project entities under the Program.

4.2 Emission Reduction Asset Types

The CPF will transact ERs which fall under two broad asset categories:

- (i) The first category includes those that are contracted on a compliance credit basis, e.g., on a CER, ERU or AAU basis. Other compliance grade credits could also emerge depending on the negotiations under the UNFCCC or development of national or regional markets. For ERPAs in this category, the Carbon Fund would typically pay for the ERs upon issuance of the compliance credit (e.g., payment upon issuance of the CERs by the Executive Board). Contracting on this basis could be used in the case of Programs that can utilize an existing, approved CDM methodology.
- (ii) The second broad category includes transactions for which it is not clear at the time of the signing of the ERPA whether the ERs will be acknowledged under any compliance regime - for example due to a new methodology being used that has not (yet) been approved by the regulatory system. For such Programs the Carbon Fund could contract on a Verified ER (VER⁷) basis. Under such VER contracts, payment for the ERs would be made upon Verification of the ERs. In this contract type the Buyer Participant would take more regulatory risk, reflected in the price paid for the ERs. The Trustee of the Carbon Fund would seek to ensure that the Programs and ERs generated are consistent and in compliance with the UNFCCC, any International Agreement and/or any other regime as deemed appropriate by the Trustee in consultation with prospective participants. In other words, the Trustee would make an effort to convert the VERs into compliance grade credits by getting the methodology approved (with adjustments if necessary) or otherwise modify the Program to ensure its alignment with the UNFCCC or another emerging regulatory framework. Some VERs, however, may never get converted into compliance credits.⁸

⁷ The term VER is often also used for a “voluntary ER”; this is not intended here

⁸ In order to ensure the same net revenue stream to the seller, the current VER ERPA general conditions of other World Bank carbon funds provide that in case there is any decrease in the ERs to be generated by the project activity when the ERs estimated in the original methodology are compared with the actual ERs calculated in accordance with the approved methodology, the ER unit price is increased to ensure the aggregate amount to be paid to the seller would remain the same; this results in the buyer receiving fewer ERs at a higher per unit cost, reflecting the fact that the ERs purchased at that point can be utilized for compliance purposes.

4.3 Program Eligibility Criteria

To be eligible for allocation to a Tranche of the Carbon Fund, a Program must meet certain eligibility criteria. The following criteria apply to the whole Facility regardless of the specific Tranche of the Carbon Fund:

- (i) be consistent with the sustainable development objectives, relevant sector policy and climate change strategy, if any, of the Host Country;
- (ii) be expected to have a demonstration or scaling up impact and to make a contribution to lowering GHG emissions or limiting their growth in the relevant geographic region or sector;
- (iii) comply with the Portfolio and Program Selection Criteria or other requirements of the relevant Tranche or other requirements determined by the Trustee of the Carbon Fund in consultation with Buyer Participants and Eligible Participants for that Tranche;
- (iv) comply with the World Bank's Operational Policies and Procedures and support the World Bank's Country Assistance Strategy in the Host Country;

4.4 Portfolio and Program Selection Criteria

The Portfolio and Program Selection Criteria for each Tranche will be set by the Trustee based on prior consultations with potential Buyer and Seller Participants and other stakeholders. They specify the criteria and principles to be applied to the portfolio of a given Tranche (e.g., regional and technology distribution, maximum allocation to a given program) as well as the types of Programs that can be included in a given Tranche. The Portfolio and Program Selection Criteria will be notified to the potential Buyer and Seller Participants in advance of the Opening Date of the relevant Tranche.

4.4.1. First Tranche Portfolio and Program Selection Criteria

The Portfolio and Program Selection Criteria of the First Tranche of the Carbon Fund have been set by the Trustee taking into account consultations with potential Buyer and Seller Participants.

When selecting Programs for the First Tranche, the Trustee shall apply the following Portfolio and Program Selection Criteria:

- The Trustee will strive for a technologically diverse portfolio of Programs;
- The Trustee will strive for a geographically diverse portfolio of Programs;
- No more than 20% of the funds of the First Tranche would be committed to any one Program;
- No funds of the First Tranche would be committed to purchase AAUs unless otherwise agreed by the Trustee with the Buyer Participants in the First Tranche.

- No more than 25% of the aggregate ERPA value in the Portfolio would be committed to advance payments.

Furthermore, the Trustee shall select Programs for the First Tranche that:

- (i) are consistent with the UNFCCC and/or the Kyoto Protocol, and/or any future agreement under the UNFCCC, and/or any other regime as deemed appropriate by the Trustee in consultation with the Participants; and
- (ii) fit one or more of the following categories:
 - a) energy generation, transmission and distribution
 - b) energy efficiency measures
 - c) management and treatment of municipal, industrial and agricultural wastes
 - d) activities in the oil and gas sector that promote efficient production and use of oil and gas
 - e) transportation activities
 - f) cross-sectoral and other thematic Programs
 - g) other types of activities based on consultations the Trustee would conduct with the First Tranche Buyer Participants prior to approving the relevant PIN.

Given the current specific treatment of hydro power CDM and JI project activities in the EU ETS, and taking into account any evolution in the treatment of such activities in the EU ETS or under other regulations, the Trustee would engage in upstream consultations with the Buyer Participants prior to reviewing any hydro power ER Program PINs.

4.5 Mitigating Various Kinds of Risks

The Trustee shall seek to ensure that Programs are selected to mitigate various types of risk. Programs should generally entail manageable technical risks. The technology to be used in a Program should be available, already demonstrated or at an advanced stage of development. In addition, the level of technical competence in the Host Country to manage this technology should be established in the course of Program appraisal. Projected ERs over the life of the Program should be predictable and should involve an acceptable level of uncertainty. The Trustee shall make conservative ER generation estimates and seek to ensure that all Programs employ proven management techniques and contain contingencies and back-up mechanisms, such as buffers of uncommitted carbon asset reserves, to reduce the risk of under-supply to the Facility. ERs should also be amenable to standardized Validation/determination and Verification processes.

Experience with the World Bank carbon funds and the carbon market at large has demonstrated that the risks associated with creating a carbon asset are often not covered in the standard due diligence undertaken on a project or a program. These risks are generally associated either with policy issues still to be resolved in the regulatory frameworks, including CDM and JI (e.g., eligibility and baseline risk), or concern technical issues of GHG emission volumes and flow rates.

Therefore, the Facility will undertake additional carbon asset related risk assessments to complement standard due diligence, and take the specifics of programmatic approaches into account in such risk assessment. For example, while the implementation of an overall Program framework may not be at risk, it is quite possible that several of the investments in a Program may get delayed, cancelled, or perform at levels lower than expected. Therefore, it may be necessary, for example, to limit the CPF purchase volume to a relatively low level compared to the expected total ER generation.

Each Program identification, approval and design criterion will be developed to ensure compliance with the objectives of the Facility as a whole. Consultations with stakeholders, Participants and Partners are intended to strengthen portfolio design, Program criteria, and quality assurance processes.

4.6 The CPF Pricing Approach

One important function of the Partnership Committee will be to discuss and endorse a Pricing Approach for the Facility, on the basis of a proposal made by the Trustee of the Carbon Fund. Indeed, in the absence of a fully transparent and liquid market or other existing mechanisms to set prices for ERs for the term of the ERPAs, the Facility will need to establish its own pricing mechanism(s). The Partnership Committee would provide guidance on the principles, mechanisms and guidelines of the Pricing Approach, including price indexing if adopted, as the basis for negotiating ERPAs for specific Programs.

An annual review of the Pricing Approach by the Partnership Committee would further ensure that it is adjusted as more is known about the regulatory and market environment going forward. In addition, as noted above, specific decisions made with respect to the Pricing Approach may be reviewed by all Participants at the Annual Meeting (in the event that decisions of the Partnership Committee are overturned at the Annual Meeting, the Partnership Committee shall in a special meeting reconsider its decisions).

While the interests of the Buyer and Seller Participants are somewhat different, the inherent uncertainties on the future of the carbon market mean that both sides have an interest in ensuring that the Pricing Approach safeguards their respective interests in a reasonable manner. Therefore, sharing some of the potential upside and downside in prices while ensuring some minimum cash-flow (e.g., through a fixed price component or a pricing floor) as well as reflecting regulatory and other risks in determining appropriate price benchmarks is likely to be an approach that both Buyer and Seller Participants are willing to consider and upon which a consensus can be reached.

Consequently, the CPF will use a Pricing Approach that is transparent, reflects the transaction risk profile, e.g., the asset type, the market segment and the length of the contract, and the risk allocation and benefit sharing between the Buyer Participants and Seller Participant(s) in each transaction. As appropriate, ER pricing will also take into account the marginal abatement costs of achieving ERs, the state of the market for ERs and the likely evolution of prices. ER pricing also needs to provide incentives to the

Seller Participants to maintain the environmental and other management systems, including monitoring, in the Programs in order to maximize the ERs generated.

The CPF Pricing Approach may use both fixed and variable pricing elements, e.g., indexation and specific inflation/currency devaluation-based price corrections. The Trustee will develop such a Pricing Approach in consultation with the Buyer and Seller Participants, and further to the Partnership Committee's endorsement, the Trustee would aim to use it broadly for individual Programs within different technologies or sectors, while seeking an overall coherence of pricing across the Facility.

The CPF Pricing Approach will only be endorsed by the Partnership Committee during the operation of the CPF, but following the feedback received from potential Seller and Buyer Participants in the consultation meetings during the design phase of the CPF, it is expected to include at least the following elements:

- A *benchmark/reference*, which represents the class of asset being transacted (e.g., primary market CER prices), will be defined by the Trustee and its price in the market will be assessed.⁹ The same asset type will be consistently monitored in the market after the ERPA signature¹⁰ during the life-time of the contract, i.e., every subsequent year when Programs deliver their annual contracted ERs. Based on continuous monitoring of the market, and as deemed appropriate, the Trustee will inform the Buyer Participants about any adjustments to the benchmark price for a given specific asset type.
- From the benchmark price, *appropriate risk adjustments*, i.e., discounts or premia, reflecting the specifics of any given ER program at the time of ERPA signature will be applied to reach an appropriate reference price level for that Program. Such adjustments would include the risk profile in each program and the risk allocation in each contract, and include program/project risk (e.g., financing, technology, sponsors' creditworthiness), regulatory risk (e.g., UNFCCC/Kyoto risks, methodology), risk allocation and ERPA terms (e.g., CER vs. VER contract; seniority rights to ERs, ER options), any premium for pre-2012 ERs, up-front payment for ERs, and recovery of costs and expenses, if any.
- If preferred by both Buyer and Seller Participants, ERs would be transacted at a pre-determined, negotiated *fixed price* that would not be adjusted during the ERPA term or would be adjusted only for a pre-defined factor or factors, such as inflation.

However, if preferred, a *variable price* component would be included whereby, at every ER delivery and payment date, the Buyer and Seller Participants would share both the

⁹ The Trustee obtains price information through publicly available notes and reports, as well as interviews and consultations with relevant market participants, e.g., private and public compliance buyers based in Europe and Japan, fund managers (compliance funds and investors funds), and brokers. For example, interviews carried out in the preparation of the [State and Trends of the Carbon Market 2010 revealed an international average price for primary CERs of \$12.70 (EUR9.10).

¹⁰ The forward contract is agreed, prior to the program's implementation.

upside and downside in market prices for the asset class (e.g. primary CER) defined in the ERPA. For such a variable component, *a floor and a ceiling* in ER prices could be defined and included in the ERPA to reduce price fluctuation in the contract and to limit the down or upside market risk to the Seller and the Buyer Participants, respectively; this would provide a more predictable ERPA value for the benefit of both parties (i.e., Buyer Participants will be able to assess the maximum budget needed to obtain a certain amount of ERs, while Seller Participants will be able to ensure a minimum annual revenue stream). Illustrative examples of possible pricing formulas are provided in Annex 3.

The major advantages of a Pricing Approach that would include the possibility of both a fixed and variable component for Seller and Buyer Participants are, respectively, as follows:

(i) for Seller Participants

- Long-term annual, reasonably well-defined revenue streams beyond 2012 allow Seller Participants to mitigate investment risks and take early investment decisions by providing them with good estimates of project/program's profitability and investment returns;
- Seller Participants are particularly concerned with the downside risk. In that regard, fixed pricing components and/or floor prices mitigate downside price risk and ensure minimum revenue streams, while providing access to potential price upsides;
- Predictable revenue streams tend to make ERPAs more bankable, helping project/programs to access better and broader financing alternatives.

(ii) for Buyer Participants

- Long-term contracts provide Buyer Participants early mover advantage, as they may start receiving compliance credit (e.g., issued CERs or ERUs) at a certain stage of the contract life-time, i.e., as Programs evolve through the regulatory process, while prices remain comparable to the asset class initially contracted (e.g., primary market CER);
- Buyer Participants are particularly concerned with the upside risk. Fixed pricing components and/or ceiling prices mitigate upside risks and allow Buyer Participants to assess the maximum budget needs that will be required to obtain a certain amount of ERs.

4.7 Methodology development

While the CPF will utilize existing CDM and JI methodologies wherever available and appropriate for the needs of the ER Program, the CPF will also take the work on baseline and monitoring methodologies to the level of large-scale Programs. Carbon offset projects measure the reduction of greenhouse gases in comparison with established baselines. This concept is being used in JI projects and the CDM.

Baselines in offset systems could gradually move away from (business as usual) scenarios of “what would happen otherwise” and integrate elements of standardization leading beyond the project-by-project approach. Standardized baselines can be used for individual sources (multi-project baselines) and for sectors of an economy. Emission limits could be agreed upon as baselines to facilitate trading (whereby any actual emission level that is below the emission limit would allow the difference between the limit and the actual emissions to be traded).

A system of program-based and sector-wide ERs would ideally explore all options for standardization and simplification of methodologies and baselines, where this would be needed in order to scale up mitigation efforts and the impact of carbon finance in a cost-effective way. The CPF attempts to do that by exploring and piloting methodological alternatives.

4.7.1. Progress with CDM methodologies

The CDM has, to date, provided a rich experience with methodologies for offset projects, using a bottom-up approach for methodology development by project proponents combined with a rigorous review and approval process. The CDM has demonstrated that offset-based reductions of greenhouse gases can work in an international context and for a variety of project types and technologies. But it has become apparent that the process of creating new methodologies and applying an accepted methodology to a proposed project is expensive, time consuming and often risky.

In response to calls for improvements, and significant work in that direction, (including by the World Bank) the CDM has developed the concept of a Program of Activities. This concept is based on the idea that a program is, in essence, nothing but a repetition and multiplication of the same or several individual activities to which a project-by-project methodology can be applied. The simplification introduced by the “programmatic CDM” thus lies more on the procedural and organizational level than on the methodological level, although certain generalizations, such as sampling of data, are allowed. The CPF will be actively exploring the practicalities and operational implications of different arrangements for Program of Activities under the CDM. As of August 30, 2010, three CPF programs had entered the CDM validation process.

4.7.2. From projects to programs

The main operational tools of the CPF are mitigation Programs. Programs can be described as “the purposeful implementation of sets of measures by public or private agents within a sector or region.” In the context of the CPF, “purposeful” refers to the purpose of large-scale mitigation and to the strategic choices that will need to be made to maximize the impact on emissions over a long period of time, in the most effective way, through mobilizing partners and bundling resources. This definition of programs includes CDM Program of Activities but its scope – like the CPF approach to Programs – is much broader. The definition covers programs of lending and investment activities, which may rely on single-project methodologies under the CDM, but also programs and appropriate

policies and measures, which can be implemented as CDM Program of Activities or for which new approaches need to be developed. Programs, broadly defined, may be good vehicles to tackle sector- or system-wide emissions as it may be possible to use (sub)sector- or system-wide characteristics to define the program (such as common efficiency benchmarks for an industry or a technology, and common organizational structures).

Methodologies that are suitable for scaling up may be found over a wide spectrum of options. These options are partly provided by the current CDM, partly outside of the current limits of the CDM. Concretely, CPF Programs can utilize traditional CDM project-by-project methodologies and procedures or follow rules for CDM Program of Activities. Beyond this, the CPF may target activities in specific sectors of an economy using methodological approaches that emphasize the emission reduction trend and transformational impact over the tracking and accounting of every individual ton of reduction. Such approaches have been described in the literature as “sector CDM” and “policy CDM”. If designed well and sufficiently conservative, they can have the same credibility and infer the same environmental integrity on the traded ERs as the traditional CDM project-by-project approach. At the extreme end, sector and policy CDM can come close to what is known in the literature as “no-lose sectoral targets”.

Methodologies that support programs of ERs, in particular if they intend to target specific activities in a (sub)-sector of an economy in a cost-effective way, will have to rely on certain simplifications across individual activities. Simplifications in programmatic methodologies can be achieved through, or may involve, standardization, generalization and procedures to assess emissions on an aggregate level. Program or sector-wide methodologies would involve modifications to existing project-level methodologies in at least four areas: demonstration of additionality, assessment of baseline scenario and emissions, monitoring and verification, and the treatment of policies and standards in relation to ER programs. In addition, for certain technologies it may be possible to standardize performance and project emissions, which could lead to a standard ER factor for these technologies.

4.8 Program Cycle

All Programs considered by the Facility go through the Program cycle steps laid out in this section. These steps are based on and designed to ensure compliance with the UNFCCC and the current CDM and JI regulations as well as the due diligence requirements, environmental and social safeguard policies and other Operational Policies and Procedures of the IBRD. However, as the regulations at the international, regional and national levels continue to evolve, some of the program cycle steps may need to be modified as appropriate to ensure they are consistent with the UNFCCC and/or the Kyoto Protocol, and/or any future agreement under the UNFCCC, and/or any other regime as deemed appropriate by the Trustee in consultation with the Participants.

Given the programmatic nature of the CPF operations, some of the program cycle steps may need to be modified to fit the programmatic nature of the operation, or repeated at

the level of the individual activities included in the program. For example, the current CDM Program of Activities approach requires separate validation of the CDM Project Activities (CPAs). Programs targeting Assigned Amount Units could also have somewhat different steps, e.g., with regard to the validation of the program activities.

Several steps in the program cycle are expected to overlap or be undertaken in parallel, and the order of some steps may vary depending on the specifics of a given program.

(a) Program Idea Note

ER program proponents in both the private and public sectors interested in becoming a Seller Participant in the Facility will submit potential Programs to the Facility in the form of a PIN.¹¹ Information required in a PIN includes summary descriptions of:

- (i) the Program proponent seeking to become a Seller Participant in the CPF;
- (ii) the type of Program;
- (iii) a technical summary of the Program;
- (iv) the Program coordination entity and institutional and organizational set-up;
- (v) the location of the Program;
- (vi) the expected schedule of Program construction and operation;
- (vii) estimates of potential ERs and preliminary analysis of baseline and additionality;
- (viii) the proposed financing plan; and
- (ix) the expected environmental and socio-economic benefits (local and global).

The Program proponent may also, in conjunction with the submission of the PIN (or, during the latter steps of the Program cycle), submit a CADF grant request for the consideration of the Trustee of the CADF. However, a Program proponent would only be able – subject to availability of CADF funds and acceptance of the CADF grant request – to receive any CADF grant at the Trustee’s discretion after signing a Seller Participation Agreement (step (c) below).

All PINs will be reviewed by the CFU (including by the CPF Operations Team Leader, financial and methodology experts) as well as the World Bank’s regional and corporate units. After the PIN has been reviewed and approved, the PIN will be tentatively allocated by the Trustee to one or more Tranches and included in the pipeline of the relevant Tranches.

¹¹ The PIN template used by other World Bank Carbon Facility is available at www.carbonfinance.org. The PIN template for the Facility is expected to be amended for the purposes of programmatic approaches.

In the PIN review process, in addition to evaluating the proposed Program against the Portfolio and Program Selection Criteria laid out in the Instrument, the Trustee will evaluate several factors in order to make an upstream assessment of the viability and risk profile of the program. Such factors would include:

- (i) expressed priority sector or technology of the Host Country;
- (ii) strategic and operational priority for the World Bank's Country and Sector Management Unit, CFU and other rationale for World Bank engagement;
- (iii) commercially available/demonstrated technology and the existence of country capacity to effectively utilize the technology;
- (iv) level of program preparation, including availability of feasibility studies and business plans;
- (v) enabling policy and business environment;
- (vi) overall financing commitments/sources for the program; likelihood of IBRD or IDA financing; likelihood of eligibility for Climate Investment Funds financing;
- (vii) availability of existing applicable CDM or JI methodologies that can be utilized directly or amended, or need for development of a new methodology;
- (viii) applicability of the CDM Program of Activities procedure/approach;
- (ix) World Bank Group environmental and social safeguards policy risk;
- (x) timeline of implementation (design, implementation, commissioning, ER delivery etc.);
- (xi) estimated ER volume (annually and/or over a 10-year period; if expected to vary, estimated schedule) and delivery risk;
- (xii) replication potential; and
- (xiii) assessment of potential or perceived conflicts of interest that could arise, e.g., due to the combination of World Bank lending and carbon finance in certain Programs.

(b) Seller Participation Agreement

Upon approval of a PIN by the Trustee, the Trustee will ask the Program proponent to sign a Seller Participation Agreement to become a Seller Participant in the Facility. The Seller Participation Agreement is signed between the owner of the legal right to sell the ERs (a Seller Participant may be the entity undertaking the activity that generates the ERs, or a coordinating entity/intermediary that has obtained the legal rights to sell the ERs) that will result from the Program and the IBRD, as Trustee of the Carbon Fund and the CADF. By signing the Seller Participation Agreement, the Seller Participant commits itself to develop one or more Programs, negotiate in good faith towards the conclusion of

an ERPA or ERPAs, and to repay the Trustee's Program preparation costs to the CADF if it unilaterally ceases to negotiate with the Trustee of the Carbon Fund during the exclusivity period provided for in the Seller Participation Agreement. In addition to the Contract ER Volume, the Seller Participation Agreement may include other indicative terms, including the timing of ER delivery and the application of the CPF Pricing Approach.

(c) CADF Grant

Subject to availability of CADF funds and acceptance of a CADF grant request by the Trustee of the CADF, a Seller Participant may, following the signing of the Seller Participation Agreement, receive a CADF grant to cover incremental costs of preparing the Program (as noted in step (a) above, a CADF grant request may be submitted at the earliest with the PIN). Supported activities could include:

- (i) preparation of the Carbon Finance Document (CFD);
- (ii) preparation of the PDD and the monitoring plan, including development of a baseline and monitoring methodology in certain cases; and
- (iii) design of any dedicated and specific ER program implementation structures or institutional set up (which may be required in addition to normal investment program management and implementation structures funded from other sources).

In case a CADF grant request is approved by the Trustee, a CADF Grant Agreement would be signed between the CADF Trustee and the Seller Participant.

(d) Carbon Finance Document

The Seller Participant will typically be expected to prepare a CFD within 12 months of signing the Seller Participation Agreement. The CFD includes more detailed information on all areas included in the PIN, a financial analysis, a risk assessment and a baseline analysis.

Preparation of a CFD is relatively detailed and during the CFD preparation phase initial due diligence would be undertaken on:

- (i) the Program's baseline and additionality;
- (ii) the Program's environmental and social issues;
- (iii) the status of Program financing; and
- (iv) the quality and experience of the Seller Participant and of any financial or other intermediaries involved in the Program.

The Seller Participant would also include in the CFD its expectation on the application of the Pricing Approach to the Program and other key terms, taking into account and ensuring consistency with the Pricing Approach and the General Conditions.

Upstream consultations with the Host Country government and Program stakeholders will also be conducted at this stage to discuss the proposed Program. This helps ensure full understanding of the transaction by all parties, as well as its sustainability.

(e) Buyer Participants' Consent to the CFD

Once the Seller has prepared the CFD in form and content satisfactory to the Trustee, the Trustee would submit it to the Buyer Participants of the relevant Tranches for their approval. The Buyer Participants would have a minimum of fifteen (15) Business Days to review the relevant CFD and provide written notification of any objections to the inclusion of the Programs in the portfolio, including the reasons for such objection. If a two-third majority of the Buyer Participants objects to the inclusion of a Program and these objections cannot be resolved within thirty days, the Program would not be included in the Tranche's portfolio.

The Trustee of the Carbon Fund would also include with the CFD a proposed ERPA negotiation mandate based on, inter alia, the Pricing Approach and the General Conditions, the Trustee's risk analysis of the Program, and any terms included in the Seller Participation Agreement (e.g., on Contract ER volume). The Trustee would also take into account, in its proposal for a negotiation mandate, the expectations of the Seller Participants contained in the CFD.

The Buyer Participants would at that point, in addition to giving their consent to the Program for its further development, provide their consent to the Trustee on the Trustee's proposed negotiation mandate. The Trustee would subsequently formally allocate the Program to the relevant Tranche or Tranches and seek to negotiate the ERPA with the Seller in accordance with the negotiation mandate and within the CPF Pricing Approach. In the event that the ERPA cannot be negotiated within these parameters, the Trustee would, through additional consultations with both the Seller and Buyer Participants, seek to find a solution.

(f) Draft ERPA

The Trustee of the Carbon Fund would – based on the Pricing Approach and the General Conditions, as well as the negotiation mandate from the relevant Buyer Participants at the time of their approval of the CFD – draft an ERPA and submit it to the Seller Participant for consideration and subsequent technical discussion, leading to the negotiation of the ERPA (step (l) below).

(g) Program Design Document

The Seller Participant, typically with the help of consultants, will prepare a PDD. The PDD will typically utilize the CDM or JI PDD templates and include:

- (i) detailed Program description, including description of the baseline scenario established using an appropriate baseline methodology;
- (ii) a monitoring plan;
- (iii) a summary of the results of the environmental and social assessments; and
- (iv) a summary of the comments received in the stakeholder consultations.

If a Program cannot utilize an existing, approved CDM methodology, a new baseline and monitoring methodology would be developed. The required work may be unbundled with parts undertaken by separate consultants, intermediaries, the Seller Participant, or the Trustee. Typically, the Trustee would commission the preparation of new baseline and monitoring methodologies and would supervise and provide quality control on the work carried out. In some cases the Policy and Methodology Team of the CFU may undertake the entire work on a methodology in-house.

In all cases, the Trustee would review the PDD prior to it being submitted to Validation/determination under step (j) below.

A detailed estimate of the flow and volume of ERs to be achieved throughout the Program and which forms the basis for negotiations of the ERPA terms, is also required at this stage of the Program cycle.

(h) Environmental Review and Stakeholder Consultations

All Programs must comply with the World Bank's Operational Policies and Procedures. An integrated environmental and social safeguard policies review, environmental assessment and stakeholder consultations are performed as a standard part of the Trustee's due diligence process and appraisal of the Program. For all Programs, documentation must be provided indicating results of any environmental and social review at the national and local governmental levels, following the guidance provided by the UNFCCC¹² and the respective safeguard policies of the World Bank.

¹² As noted at the beginning of this Section 5.8., the steps in the Program cycle may need to be modified as appropriate to ensure they are consistent with the UNFCCC and/or the Kyoto Protocol, and/or any future agreement under the UNFCCC, and/or any other regime as deemed appropriate by the Trustee in consultation with the Participants. Therefore, for example, in the event a regime other than the UNFCCC would apply, the requirements here would need to be modified accordingly. The same applies for any subsequent reference to the UNFCCC in the Program cycle steps below.

(i) Letter of Approval

A Host Country is expected to approve a Program through the issuance of a Letter of Approval (LoA). With the issuance of a LoA, under the Kyoto Protocol mechanisms, the Host Country formally approves the Program for the purposes of Article 6 or 12 of the Kyoto Protocol, and, in the case of CDM, confirms that the Program assists the Host Country in achieving sustainable development. The LoA is a prerequisite for the effectiveness of an ERPA.

(j) Validation / Determination

In consultation with the Seller Participant, the Trustee will normally select and contract a Designated Operational Entity (DOE) or an Accredited Independent Entity (AIE), or one having applied for DOE or AIE status to conduct Validation or determination of the Program. In specific cases it may be agreed that the Seller Participant directly contracts for these services, but even in such cases the Trustee would maintain quality control of the outputs.

The Trustee will submit the PDD and monitoring plan to the DOE/AIE. The Trustee, Seller Participant and/or Coordinating Entity then will work with the DOE/AIE performing the Validation/determination of the Program to meet the necessary requirements to achieve a satisfactory Validation/determination opinion. The DOE/AIE undertakes the Validation/determination of the Program in accordance with applicable UNFCCC modalities and procedures.

Where an Annex-I Host Country is eligible to verify ERs in accordance with the applicable JI guideline (so called "Track One JI"), the Host Country may agree to undertake the verification of the ERs generated by the Programs approved for support from the Facility.

The PDD, monitoring plan and stakeholder consultations documentation are made available to the public as required by the relevant CDM and JI procedures at the validation stage to enable stakeholders to review and comment on the Program.

In the event the CPF is developing Programs for any other regime than the UNFCCC and/or the Kyoto Protocol, and/or any future agreement under the UNFCCC, or in the absence of a clear applicable regulatory framework, the Partnership Committee would advise the Trustee on which independent third parties should be used for the independent evaluation/validation of such Programs.

(k) Program Due Diligence and Appraisal

, the Trustee will appraise the Program in accordance with World Bank Operational Policies and Procedures.

All Programs receiving carbon finance are appraised to determine their financial and technical feasibility and soundness, as well as their compliance with the World Bank

safeguard policies. Both Programs with underlying World Bank Group financing as well as Programs that do not receive any World Bank Group financing are appraised as per standard procedures for World Bank Group operations.

As noted above, many of the Programs are expected to include World Bank lending or other form of support, and the due diligence and appraisal of such Programs would be integrated into the due diligence of the lending project/program.

This work is undertaken by the relevant regional, country and sector business units of the World Bank Group so as to ensure that the underlying investment will perform as expected, that ERs can be generated, and that the long-term supervision of the Program will take as part of regular quality and performance reviews by the World Bank's regional management. The CFU is responsible for the carbon asset related due diligence in this process (e.g., PDD quality control, baseline and additionality, ER estimates etc.).

(l) Negotiation of the ERPA

Once the appraisal of the Program has been completed, for each Program, the Trustee of the Carbon Fund will negotiate the ERPA with the Seller Participant and enter into an ERPA with the Seller Participant. Key elements of an ERPA include:

- (i) agreement by the Seller Participant to sell to the Trustee all rights, title and interests in and to a nominated contracted amount of ERs generated by the Program;
- (ii) commitment by the Trustee to pay the purchase price upon delivery of the contracted amount of ERs generated by the Program;
- (iii) purchase period of the ERs and a schedule of the annual volume of ERs to be delivered and purchased;
- (iv) statement of the agreed price or price determination mechanism or formula for the ERs and conditions for payment in accordance with the CPF Pricing Approach;
- (v) the monitoring plan for the Program;
- (vi) provisions relating to satisfactory Program implementation;
- (vii) identification and allocation of common Program related risks; and
- (viii) provision for the management of any other issues relating to the mitigation of environmental or social impacts.

Given that the CPF Pricing Approach may include a variable price component, CPF ERPAs may need to include a specified maximum value of ER payments to enable both the Trustee and Buyer Participants to better manage the funds committed to the Carbon Fund and specific ERPAs. In such case, the ER volume paid for and delivered may become a variable for a part or all of the contracted ER volume.

(m) Registration

The DOE/AIE contracted to undertake Validation/determination, upon the request of the Trustee, will submit the Validation/determination report and Validation/determination opinion to the CDM Executive Board or Article 6 Supervisory Committee, along with a request for Program registration (in the case of CDM)¹³, the PDD, monitoring plan, and stakeholder consultation documentation and the LoA, plus any other appropriate supporting documentation. If the Executive Board or Article 6 Supervisory Committee decides to review the Program, the Trustee and the Seller Participant will facilitate the review process as requested. If the Executive Board or Article 6 Supervisory Committee does not agree to registration of the Program, the Trustee will consult the Seller Participant and the Buyer Participants of relevant Tranches and, if deemed appropriate, make revisions and resubmit the Program for Validation/determination and subsequent registration. Program Registration may be a condition of effectiveness of the ERPA.

(n) Monitoring, Verification and Certification

The Seller Participant will be responsible for monitoring the ER generation in accordance with the monitoring methodology and monitoring plan contained in the PDD, as well as for preparing the monitoring reports.

In consultation with the Seller Participant, the Trustee will normally select and contract a DOE or an AIE, or one having applied for DOE or AIE status, to conduct periodic verification and certification of the ERs generated by the Program (Verifier). In specific cases it may be agreed that the Seller Participant directly contracts for these services, but even in such cases the Trustee would maintain quality control of the outputs.

The Monitoring Reports are submitted to the Verifier and the DOE/AIE undertakes the verification of the ERs in accordance with applicable CDM/JI modalities and procedures.

Where an Annex-I Host Country is eligible to verify ERs in accordance with the applicable JI guideline (so called “Track One JI”), the Host Country may agree to undertake the verification of the ERs generated by the Programs approved for support from the Facility.

In the event the CPF is transacting ERs from Programs intended for any other regime than the UNFCCC and/or the Kyoto Protocol, and/or any future agreement under the UNFCCC, or in the absence of a clear applicable regulatory framework, the Partnership Committee would advise the Trustee on which independent third parties should be used for the independent verification of ERs generated by such Programs.

¹³ As per the JI guidelines, there is no separate registration step in the JI Program cycle. However, the determination report is made public by the AIE, and it is considered final unless Article 6 Supervisory Committee requests a review of the determination.

(o) Payment for ERs

The payment for ERs is made upon delivery (typically, completion of Verification in VER ERPAs, and CER/ERU issuance in CER/ERU ERPAs). The Trustee will start the payment process upon receipt of the payment request by the Seller Participant. The payment request should include an ER transfer form and ER verification documentation (i.e., a Verification Report issued by DOE/AIE which indicates the number of ERs verified or an Annual ER Report (Monitoring Report) issued by the Program entity).

The payment request goes through multiple levels of review, due diligence and authorization in the CFU. After the payment request is approved by all the reviewers, the payment instruction with payment details and supporting documentation will be submitted to the IBRD Loan Department for processing.

4.9 Supervision During Program Implementation

The Trustee, either directly or through a third-party contractor, will perform specific administrative functions during the Program implementation stage, as appropriate. These are likely to include:

- (i) monitoring Program implementation, including assessing the impact of any modifications in the implementation plan on the ERPA and ER delivery;
- (ii) arranging, if deemed necessary, for initial verification to ensure all data collection and management systems mandated by the monitoring plan are in place and subsequent successful verification and certification is enabled; and
- (iii) confirming that a satisfactory initial verification report has been received and that the Program is ready to deliver ERs.

The Trustee will also play a Program supervisory role during the lifetime of the Facility, including:

- (i) typically, procuring Verification services for each Program;
- (ii) maintaining Program accounting and ER records, including information on the ERs achieved and outstanding as per the contracts, utilizing a carbon asset registry system of the CFU;
- (iii) administering consultant contracts for Program verification and on-going supervision;
- (iv) reviewing Program performance against the ERPA, including but not limited to defaults; and
- (v) performing ongoing social and environmental assessments as required.

4.10 Renewal of the Crediting Period

For Programs subject to renewal of crediting periods during the Facility's life, the Trustee will make arrangements for requesting a renewal of the crediting period in accordance with relevant decisions on guidelines and modalities adopted under the UNFCCC and/or the Kyoto Protocol, and/or any future agreement under the UNFCCC, and/or any other regime as deemed appropriate by the Trustee in consultation with the Participants. If required, this may include interacting with the Executive Board of the CDM and the JI Supervisory Committee to address any concerns arising in connection with the renewal of the crediting period.

4.11 Distribution Policy of the ERs by the Facility

Once the ERs have been verified, certified and/or issued as per the terms of the ERPA, Buyer Participants will receive ERs from the Programs in the Tranche(s) to which they have contributed, *pro rata* to their Contribution to such Tranche(s).

Reports will be provided to the Participants on the status of the Facility property, including the Buyer Participants' entitlements to any ERs. At any time, a Buyer Participant may obtain a statement of account outlining the number of ERs generated by the Facility, and the Buyer Participant's entitlement, by accessing the Carbon Asset Registry System maintained by the CFU.

4.12 Safeguards

Investment activities supported by the CPF through an ERPA will be expected to comply with the World Bank's applicable environmental and social safeguard policies. Annex 1 provides a summary overview of these policies, and World Bank staff will be expected to appraise the Programs accordingly, either as a financial intermediary type operation with an operational manual or as a series of distinct investment operations. As is the case for regular World Bank projects, activities will be expected to be classified as category A, B, C or Financial Intermediary, depending on the type, location, sensitivity and scale of the activities, and the nature and magnitude of their potential impacts. All relevant documents, such as Environmental Assessment Reports, Environmental Management Plans, Indigenous Peoples Plans, Resettlement Plans or other management plans, or material produced pursuant to the safeguard policies, will be disclosed in line with relevant Operational Policies and Procedures, both at the World Bank's Infoshop in Washington, D.C and the Public Information Center in the Host country.

If a Seller Participant proceeds with one or several ER Programs under the Carbon Fund, the Seller Participant will be expected to prepare, consult and disclose full assessments, according to the World Bank Policy on Disclosure of Information.¹⁴

¹⁴ The World Bank Policy on Disclosure of Information is accessible at <http://www1.worldbank.org/operations/disclosure/documents/disclosurepolicy.pdf>

4.13 Procurement

As required by the World Bank's Operational Policies and Procedures, all goods, works and services financed out of the proceeds of grants under the CADF shall be procured pursuant to the World Bank's Procurement Guidelines (please see Annex 2). Each CADF grant recipient will also be required to maintain a financial management system and prepare financial statements in accordance with consistently applied accounting standards acceptable to the World Bank, in a manner adequate to reflect the operations, resources and expenditures related to the activities financed under the Grant Agreement.

Purchases of ERs by the Carbon Fund will not be subject to the Operational Policy on Procurement since payments to be made under ERPAs will be for environmental services performed by the Seller Participant, namely ERs generated by the ER Programs, as opposed to the procurement by the Seller Participant of goods, works and services in the future.

CHAPTER 5 CHARGE AND COST STRUCTURE

5.1 Charge Structure Overview

As described in Chapter 4, the CPF is comprised of two main trust funds¹⁵: (i) CADF; and (ii) the Carbon Fund.

The charges to the Buyer Participant (i.e., the CADF Charge) and Seller Participant (i.e. the SCC) are defined by the Trustee separately for each Tranche of the Carbon Fund.

5.2 Buyer Participant's Contributions and CADF Charge for the First Tranche of the Carbon Fund

The Minimum Contribution for the First Tranche of the Carbon Fund is thirty five million Euros (€35,000,000) for each eligible Buyer Participant. This Minimum Contribution is split in two components:

- (i) 91% (or €31.85 million for a Minimum Contribution) will be drawn down over time for the Carbon Fund in Euros to finance ER-related payments only (e.g., payments for ERs, options/option premiums, advanced payments for ERs, if any, etc).
- (ii) 9% (or €3.15million for a Minimum Contribution) will be the CADF Charge paid into the CADF. The CADF Charge shall be paid in three equal installments in three consecutive years, as follows: (i) the first installment shall be paid fifteen (15) days after the effectiveness of the Buyer Participation Agreement; (ii) the second installment shall be paid thirty (30) days after receipt by the Buyer Participant of written notice from the Trustee of the Carbon Fund of the anniversary of Operational Date of the First Tranche; and (iii) the third installment shall be paid thirty (30) days after receipt by the Buyer Participant of written notice from the Trustee of the Carbon Fund of the second anniversary of the Operational Date of the First Tranche.. The upfront payment of the CADF Charge is in Euros¹⁶ and will be converted to US\$ at the spot rate at the time of the transfer. The 9% CADF Charge will go towards funding all non-ER payment related costs (e.g., project costs, administration costs, supervision costs, etc.) and CADF grants. The SCC (see below) will reduce the effective charge to the Buyer Participants which will be lower than 9% on a net basis. As the lifetime of the First Tranche is expected to be about 16 years, on an annualized basis the CADF Charge would represent about half a percentage point per year.

¹⁵ The Carbon Asset Development Fund (CADF) shall be denominated in United States Dollars(US\$) and the First Tranche of the Carbon Fund and the Prepaid Contribution fund shall be denominated in Euros (€).

¹⁶ The CADF Charge payment could also be in another currency, but it will be converted first to Euro and then to US\$ at the Euro/US\$ foreign exchange spot rates of the date of payment.

5.3 Seller Contribution Credit

The SCC will be applied when payment is due to a Seller for ERs delivered under the terms of the ERPA.

The SCC is a reduction in the ER payment due to the Seller Participant under the terms of the ERPA and is independent of the negotiated ERPA terms and conditions. The SCC percentage rate is determined for each Tranche of the Carbon Fund prior to launch of the tranche. For the First Tranche of the Carbon Fund the SCC will be 2%.

The SCC is applied to the number of verified (in VER contracts) or issued (by the relevant regulator or authority in CER/ERU or other compliance asset based contracts) ERs.

Buyer Participants will receive 100% of the ERs verified or issued but the payment due to the Seller will be reduced by the following formula:

$$\text{Payment due to Seller} = \text{ER verified or issued} \times (100\% - \text{SCC}\%) \times \text{ERPA Unit Price}$$

Under the current CDM regulations, there are additional regulatory fees charged by the UNFCCC to cover administrative expenses and to assist Developing Countries that are particularly vulnerable to the adverse effects of climate change to meet the costs of adaptation (i.e., the share of proceeds for administration and share of proceeds for adaptation). Whether the Seller Participants or the Buyer Participants will bear any share of proceeds deductions may vary depending on the contractual allocation in the ERPA. Treatment of such regulatory fees would be subject to the General Conditions to be endorsed by the Partnership Committee.¹⁷

An example of Buyer Participant's costs per unit is shown in Table 4; Table 5 illustrates Seller Participant's revenues and costs assuming current levels of CDM regulatory fees and that such fees are born by the Seller Participant. Finally, Table 6 shows an example of an ER payment calculation, and, for illustration purposes, assumes current levels of CDM regulatory fees and that the CDM regulatory fees are paid by the Seller Participant.

¹⁷ The general conditions of other World Bank carbon funds and facilities provide that under CER contracts these fees are borne by the Seller and under VER contracts by the buyer.

Table 4: Buyer Participant's Costs per Unit

Buyer Estimated Unit Costs Per tCO _{2e}	Charge Rate	ERPA Price	SCC	CADF Charge	All Up Cost
ERPA Price		€10.00			€10.00
SCC	-2.00%		-€0.20		-€0.20
CADF Charge	9.00%			€0.90	€0.90
Total	7.00%	€10.00	-€0.20	€0.90	€10.70
		(A)	(B)	(C)	(D)
Gross Charge %	(C) / (A) =	9.00%			
Net Charges	(D) / (A) =	7.00%			

Table 5: Seller Participant's Costs per Unit assuming current CDM regulatory fees

Seller Estimated Revenue / Costs Per tCO _{2e}	Charge Rate	ERPA Price	SCC	Share of Proceeds	All Up Cost
ERPA Price		€10.00			€10.00
Share of proceeds for administration (B)	1.27%			-€0.13	-€0.13
Share of proceeds for adaptation (C)	2.00%			-€0.20	-€0.20
SCC	2.00%		-€0.20		-€0.20
Total	2.00%	€10.00	-€0.20	-€0.33	€9.47
		(A)			(D)
Effective charge rate	[(A) - (D)] / (A) =	5.27%			
of which due to regulator:	[(B) + (C)] / (A) =	3.27%			

Table 6: An example of an ER payment

ERPA life years	16
ER price per tCO _{2e}	€10.00
SCC	2.00%
UNFCCC share of proceeds for administration	\$0.10 / \$0.20 tCO _{2e}
UNFCCC share of proceeds for adaptation	2%

Example	
Program ERs verified	tCO _{2e} 6,000,000
Less adaptation fee (2%)	tCO _{2e} 120,000
ERPA tCO _{2e} issued by regulator	tCO _{2e} 5,880,000
	↓
ERPA tCO _{2e} delivered to Buyer (A)	tCO _{2e} 5,880,000
Less SCC (B = 2% of A)	tCO _{2e} 117,600
ERPA tCO_{2e} paid for by Buyer (C = A-B)	tCO_{2e} 5,762,400
ERPA unit price (D)	€10.00
Buyer Payment (E = C x D)	€57,624,000
Reimbursement for upfront fees paid by Buyers (G = B x D)	€1,176,000
Effective Unit Price (F = A / E)	€9.80

5.4 Investment Income

All investment income generated by the CADF, the Carbon Fund and any pre-paid Contributions will be channeled and contribute to the CADF and its eligible uses.

5.5 Overview of Cost Categories for the CPF

The CADF will have three broad categories of costs: (i) administration costs (the costs of day-to-day operation of the Fund and Trustee functions); (ii) Program related costs (including Project preparation and Verification costs, Project supervision costs); and (iii) payments for the purchase of ERs:

- (i) Administration costs include: Costs associated with activities such as the appraisal, selection, and supervision of Programs and CADF; grants and grant administration; trusteeship-related activities such as accounting, external audits, asset recording and forwarding, calling for funds, provision of legal services; provision of information technology services, facility management and program coordination; secretariat support to the Facility and Participants and organization of meetings. Costs by expense type may include communication expenses, salaries and benefits, travel, documentary expenses, compensation for consultants, costs of insurance policies; costs of professional and other services; public relations and representation costs. The Trustee will recover costs that cannot be traced directly to the CFP (such as space costs, utilities, information technology and other services provided by the Bank) using standard overhead recovery rates or pro-rata allocations as appropriate. This approach is common to the World Bank's trust fund portfolio and assures efficiency and reduced administrative burden.
- (ii) Program related costs will broadly comprise:
 - a. Program and sub-project preparation costs. The CADF will cover the technical assistance and CADF grants provided to the Seller Participants and Host Countries and the costs incurred by the Trustee in relation to the preparation of each Program, which include: Program appraisal, methodology development, baseline studies, Validation, monitoring plans, project registration with regulatory authorities, due diligence, and preparation of legal agreements and negotiation of the ERPA.
 - b. Program and sub-project ongoing monitoring and supervision costs. The CADF will fund the costs of World Bank supervision and monitoring of projects for compliance with the World Bank's Operational Policies and Procedures and other contractual obligations.
 - c. Program Verification and carbon asset maintenance costs. Each Program and sub-projects will require initial Verification at Program startup and periodic Verification of the ERs throughout the term of the ERPA. These costs also include ongoing monitoring and measurement of the ERs

generated and maintenance of methodologies and other technical aspects of the Program relating to the generation of ER credits.

- (iii) Payments for the purchase of ERs: The Carbon Fund funds will be used for ERPA-related payments. Primarily these are payments for ERs, advance payments for ERs and ER option premiums. The timing of payments due under the ERPA depends on the Programs selected, the outcome of ER price negotiations, and the delivery of ERs from the Programs. The projected ERPA-related payments per individual Buyer Participant for a base case in the First Tranche are shown in Table 7, and different scenarios based on different price assumptions in Table 8 below.

**Table 7: Projected ERPA-related Payments (in million)
and assuming a €10 average price per ER**

Price €10 tCo2e	Base case	Fast Start (More ERPA Payments in early years)	Payments delayed by 1 year)
Year	ERPA Payments (Est.)	ERPA Payments (Est.)	ERPA Payments (Est.)
Inception	€ -	€ -	€ -
1	€ 0.46	€ 1.59	€ -
2	€ 1.37	€ 2.16	€ 0.46
3	€ 2.28	€ 2.28	€ 1.37
4	€ 2.28	€ 2.28	€ 2.28
5	€ 2.28	€ 2.28	€ 2.28
6	€ 2.28	€ 2.28	€ 2.28
7	€ 2.28	€ 2.28	€ 2.28
8	€ 2.28	€ 2.28	€ 2.28
9	€ 2.28	€ 2.28	€ 2.28
10	€ 2.28	€ 2.28	€ 2.28
11	€ 2.28	€ 2.28	€ 2.28
12	€ 2.28	€ 2.28	€ 2.28
13	€ 2.28	€ 2.28	€ 2.28
14	€ 2.28	€ 2.28	€ 2.28
15	€ 1.82	€ 0.68	€ 2.28
16	€ 0.91	€ 0.11	€ 1.82
17	€ -	€ -	€ 0.91
Total	€ 31.85	€ 31.85	€ 31.85

**Table 8: Volume of ERs delivered for different ER pricing scenarios
(MtCO2e per individual Buyer Participant assuming a €35 million Contribution)**

Base case	Price €10 tCO2e	Price €11 tCO2e	Price €12 tCO2e	Price €14 tCO2e	Price €15 tCO2e	Price €20 tCO2e
Year	Volume of ER delivered	Volume of ER delivered	Volume of ER delivered	Volume of ER delivered	Volume of ER delivered	Volume of ER delivered
Inception	-	-	-	-	-	-
1	0.05	0.04	0.04	0.03	0.03	0.02
2	0.14	0.12	0.11	0.10	0.09	0.07
3	0.23	0.21	0.19	0.16	0.15	0.11
4	0.23	0.21	0.19	0.16	0.15	0.11
5	0.23	0.21	0.19	0.16	0.15	0.11
6	0.23	0.21	0.19	0.16	0.15	0.11
7	0.23	0.21	0.19	0.16	0.15	0.11
8	0.23	0.21	0.19	0.16	0.15	0.11
9	0.23	0.21	0.19	0.16	0.15	0.11
10	0.23	0.21	0.19	0.16	0.15	0.11
11	0.23	0.21	0.19	0.16	0.15	0.11
12	0.23	0.21	0.19	0.16	0.15	0.11
13	0.23	0.21	0.19	0.16	0.15	0.11
14	0.23	0.21	0.19	0.16	0.15	0.11
15	0.18	0.17	0.15	0.13	0.12	0.09
16	0.09	0.08	0.08	0.07	0.06	0.05
17	-	-	-	-	-	-
Total	3.185	2.895	2.654	2.275	2.123	1.593

5.6 Reporting

The Trustee will determine the funds required by each Tranche of the Carbon Fund for ERPA-related payments on a periodic basis, usually annually, and send Buyer Participants a demand for payment which is due within 30 days. From time to time the Trustee will prepare longer-term cash flow projections to assist Buyer Participants with their cash flow planning and budgeting.

5.7 Miscellaneous

The estimated expenses needed to honor commitments already made through approved CFDs and signed ERPAs will be considered as sunk costs and will not be returned to a withdrawing Buyer Participant – only the remaining balance of the pre-paid charge will be returned. However, in all early withdrawal scenarios, Buyer Participants will bear the foreign exchange risk as any repayment of charges would be in US\$.

CHAPTER 6 RISKS ASSOCIATED WITH PARTICIPATION IN THE CARBON FUND

6.1 General

Participation in any Tranche of the Carbon Fund should be considered a speculative investment, subject to a high degree of risk. Potential Buyer Participants are advised that they may lose their entire proposed Contribution in the Carbon Fund and that no assurance can be made by the Trustee that their liability would be limited to the amount of their proposed participation.

PLEASE NOTE THAT THERE CAN BE NO ASSURANCE THAT THE CARBON FUND WILL ACHIEVE ANY OR ALL OF ITS OBJECTIVES, OR OTHERWISE SUCCESSFULLY CARRY OUT ITS OPERATING STRATEGY, OR THAT BUYER PARTICIPANTS WILL REALIZE ANY RETURN ON THEIR INTERESTS IN ONE OR MORE TRANCHES OF THE CARBON FUND OR RECOVER THEIR RESPECTIVE CONTRIBUTIONS. THEREFORE, PROSPECTIVE BUYER PARTICIPANTS SHOULD CAREFULLY CONSIDER THE FOLLOWING RISK FACTORS AS WELL AS THE OTHER INFORMATION CONTAINED IN THIS INFORMATION MEMORANDUM PRIOR TO MAKING A DECISION WHETHER OR NOT TO PARTICIPATE IN THE CARBON FUND.

THE RISK FACTORS SET OUT IN THIS CHAPTER ARE NOT REPRESENTED TO BE EXHAUSTIVE, AND THERE MAY BE FURTHER RISK FACTORS THAT A PROSPECTIVE BUYER PARTICIPANT IN THE CARBON FUND, OR A SPECIFIC TRANCHE OF THE CARBON FUND, SHOULD CONSIDER CAREFULLY THAT ARE OF A GENERAL NATURE OR RELEVANT TO ITS PARTICULAR CIRCUMSTANCES.

The main categories of risks of participation in the Carbon Fund, which are discussed in further detail below, may be summarized as follows:

- **ER Programs May Not Generate Anticipated ER Credits** – Although it is the intention of the World Bank acting as Trustee of the Carbon Fund to make payment against delivery of anticipated ERs generated by the Programs, including the underlying Program activities, there may be situations where a portion of a Buyer Participant's Contribution is paid to a Seller Participant prior to delivery of credits. In that situation, if the Seller Participant defaults on its delivery or repayment obligations, the Buyer Participant may suffer a loss. Furthermore, Seller Participants should be aware that its rights to receive payments under ERPAs critically depends on the proper performance of its obligations under the respective ERPA, the successful implementation of Programs, including any underlying Program activities, and the generation and transfer of contracted amounts of ERs.

- **ERs may not be Transferable and Interests in Tranches of the Carbon Fund are Not Liquid:** The Trustee believes that the contracted ERs will be transferable to the Buyer Participants in various Tranches. If, however, ERs are not transferable to a Buyer Participant for any reason, the Buyer Participant could lose the value represented by those ERs. Further, unless the Trustee has given its consent, interests in any Tranche of the Carbon Fund will generally not be transferable by the Buyer Participant and, as a result, there will be no public market for a Buyer Participant's interest in a Tranche. Finally, a Buyer Participant is generally not permitted to withdraw its interest in any Tranche of the Carbon Fund other than when specified in the Instrument.
- **There is No Assurance as to the Value of any ERs:** Even if all of the contracted ERs are delivered and can be transferred to the Buyer Participants, there can be no assurance as to what the value of these credits will be in the hands of the Buyer Participants and whether the value of such credits will equate with the value of the Contribution made by the Buyer Participant to obtain such credits. From the perspective of Sellers, there can be no assurance that, in case of fixed forward pricing, the unit prices contracted for will reflect the prevailing market value of such ERs at the time of delivery. The Trustee makes no representation, warranty or guaranty with respect to the value of any ERs that may be distributed to any Buyer Participant.
- **Potential Unlimited Liability:** Although the Trustee believes that the Buyer Participants in the Carbon Fund should be accorded limited liability, there is a risk that a court could treat the Carbon Fund as a general partnership and the Buyer Participants as general partners with exposure to unlimited liability. In this situation, a Buyer Participant could face losses that exceed the amount of its committed Contribution. As the Carbon Fund will be contracting with counterparties in a variety of situations (e.g., contract for funding Program Entities, etc.), Buyer Participants may be faced with third party claims that are based on the respective Buyer Participant's participation in the Carbon Fund. If the Carbon Fund were to be found to be a general partnership for liability purposes (and the Participants as general partners), each Buyer Participant could be held to be jointly and severally liable for any amounts owed to the Seller Participant or any third party, if the Carbon Fund were unable to meet its respective obligations.
- **Potential failure of Buyer Participants to Make Payments:** Under the BPA and the Instrument, every Buyer Participant is required to pay its respective contribution to the Facility ("Contribution") through the issuance and delivery of one or more promissory notes payable to the Trustee on demand. The Trustee has no reason to believe that any Buyer Participant would fail to make payments up to its respective Contribution when called on to do so by the Trustee. Nevertheless, Seller Participants do bear the risk of such failure. In the event of the Trustee not having sufficient funding available in the Carbon Fund to make payment in full under the ERPA, the payment to be made by the Trustee to the Seller Participant

under the ERPA would be limited to the amount of funding available to the Trustee at the time payment is due.

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- **Property May Not Be Treated as Separate:** Although the Trustee intends to treat the property and results of each Tranche as separate property of the Buyer Participants in each Tranche, there can be no assurance that a court or regulatory authority will respect the separate nature of the respective Tranches and, in that case, liability arising out of one Tranche that cannot be satisfied out of the assets of that Tranche may impact the value of other Tranches of the Carbon Fund.
- **Conflicts of Interest:** The Trustee may be subject to a variety of conflicts of interest, which are described in more detail in Chapter 9 (Conflicts of Interest).

6.2 Risk of the reduction or nullification in value of the ERs to be generated from the Carbon Fund's Programs

When the Carbon Fund purchases CERs, ERUs, or AAUs (together referred to as “ERs”), the Seller Participant usually assumes a larger component - if not all – of the risk that ERs generated by a Program will not be compliant with the International Rules. When the Carbon Fund purchases VERs, in particular for those to be generated by Programs post 2012, Buyer Participants assume most if not all of the international regulatory risks.

6.2.1. International, regional and national regulatory risks

With its programmatic approach, the Facility is a prototype that plans to pilot more advanced methodologies that would move away from the traditional project-by-project approach to yet untested sector-based methodologies in the face of international, regional and national regulatory uncertainty after 2012. It is difficult to predict the exact course of development of the regulations or the market and either may develop in ways that are not currently foreseen. This observation applies both to the generation of ERs and also to any rights which may arise from such reductions under domestic, regional or international regimes, including the EU ETS. The following examples of risk related to regulatory uncertainty are presented as illustration of the risks that may arise in this area. They do not include all possibilities or risks related to future regulatory decisions regarding ERs.

- (i) The Kyoto Protocol sets out the first commitment period from 2008 to 2012 during which a group of industrialized countries commit to reduce their emissions against the base year of 1990. Though the negotiation process for the second and subsequent commitment periods was initiated at the Bali Conference in December 2007, it is uncertain at this stage (a) whether the negotiation would be concluded successfully and in a timely fashion to ensure that there is no gap between the first and the following commitment period; and (b) what form and level of the emission reduction commitments the governments would be willing to make in any future international climate change regime. The final outcome of the negotiation of any international climate change regime will significantly affect the demand of ERs

generated after 2012. There is a risk that the market for ERs will cease to exist and/or that no post-2012 international agreement on emissions reductions will be developed.

- (ii) ERs from some Programs may not be eligible to become CERs or ERUs under the International Rules or EUAs under the EU ETS. ERs may also fail to achieve accreditation under relevant verification standards and therefore be ineligible to become VERs. If the ERs do not meet the relevant current or future international, regional or national guidelines, modalities and procedures and CERs, ERUs, EUAs or VERs are not issued in relation to those ERs, the value of the ERs will likely be adversely affected and may even reach zero. In a contract for the purchase of ERs, a Program's failure to meet relevant current or future international, regional or national guidelines (or verification standards) means that Buyers may not receive the ERs that they made their contributions for or may not be able to utilize them for compliance or other purposes and Sellers may not receive payment. Furthermore, ERs may not be eligible for compliance purposes under existing and future regulatory regimes, including emissions trading schemes. This may adversely affect the value of, and the ability of Buyer Participants to use or on-sell, those ERs. For example, the recent European Commission proposal on the third phase of the EU ETS, which runs from 2013 to 2020, puts more or less severe restrictions on the use of CERs and ERUs generated post 2012 to be used for compliance purposes in the third phase of the EU ETS depending on the execution of a "satisfactory" international agreement¹⁸.
- (iii) The International Transaction Log (ITL), the electronic platform that will allow CERs to be transferred into the national registries, became operational on November 14, 2007. However, it is unclear when all national registries will connect to the ITL. In particular, there have been delays in the ITL connecting to the EU ETS transaction log (the Community Independent Transaction Log or CITL). The go-live of European registries with the ITL, which must occur through the CITL according to EU Commission policy has only begun [on October 6, 2008 and it is estimated that the process will take at least until October 17, 2008.¹⁹] Linking delays or other technical failures associated with the ITL may affect the ability of Buyer Participants to receive ERs into, or transfer ERs from, their registry accounts. ER transfers may also be blocked if a relevant party to the Kyoto Protocol is not in compliance with the eligibility criteria prescribed by the International Rules.
- (iv) Regardless of the allocation of regulatory risks associated with a Tranche between Buyer and Seller Participants, CERs, ERUs or VERs are generated by Programs that

¹⁸ See Questions and Answers (No.21) on the Commission's proposal to revise the EU Emissions Trading System at: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/35&format=HTML&aged=0&language=EN&guiLanguage=en>

¹⁹ See the latest information dated October 3, 2008 at <http://ec.europa.eu/environment/ets/>. In addition, according to the European Commission press-release IP/08/1246 of August 6, 2008, the "EU's Community Independent Transaction Log (CITL) and Member State registries will be connected to the UN's International Transaction Log (ITL) before December 2008 at the latest." See press release at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1246&format=HTML&aged=0&language=EN&guiLanguage=en>

must comply with certain regulatory procedures and project cycles. In addition, there is also significant lead time and uncertainty involved with the generation of ERs as Programs need to be implemented, made operational and continuously monitored. Thus, Buyer Participants may experience significant delays in the receipt of ERs for which they made contributions as a result of delays in the international processes and this may also result in a smaller number of ERs coming into existence.

- (v) The Kyoto Protocol provides that "a share of proceeds from certified project activities" undertaken under Article 12 will be used to cover administrative expenses of the Clean Development Mechanism. The level of this share of proceeds has been approved by COP/MOP and consists of US\$0.10 per CER for the initial 15,000 tCO₂ per annum and US\$0.20 per CER thereafter. Whether the Seller Participants or the Buyer Participants will bear any share of proceeds deductions may vary depending on the contractual allocation in the ERPA. Depending on the resolution of this issue, if Buyer Participants are responsible for the administrative share of proceeds, Buyer Participants may receive fewer CERs for their investment in the Fund than expected or incur greater costs in relation to the distribution of CERs. In addition, there is a risk that the Supervisory Committee or the JI Host Country for a JI Program may deduct a percentage of ERUs from a transaction.
- (vi) The International Rules also provide that the share of proceeds to assist Developing Country Parties particularly vulnerable to the adverse impacts of climate change to meet the costs of adaptation shall be 2% of the CERs issued for a Program – unless the Program is undertaken in a so-called "Least Developed Country". Again, whether the Seller Participants or the Buyer Participants will bear any share of proceeds deductions may vary depending on the contractual allocation in the ERPA. If the percentage for such share of proceeds were to be increased by the Parties to the UNFCCC, and if Buyer Participants are responsible in a particular Tranche for the share of proceeds, the Buyer Participants may receive fewer CERs for their investment in the Tranche of the Carbon Fund.
- (vii) Under the current CDM rules, Host Countries and Annex I Parties approving individual project participants are entitled to elect whether or not they wish to be considered so-called "Project Participants," with the ability to veto distribution arrangements of CERs. There is a possibility that a Host Country or Annex I Party may refuse to consent to the allocation of CERs in accordance with an ERPA unless it receives a portion of the CERs from the relevant Program.
- (viii) A Host Country or Annex I Party may impose a "tax" on the sale proceeds of ERs (as is the case with China). In addition, a Host Country or Annex I Party may impose a "tax" on the purchase of ERs (as is the case with Vietnam). Finally, Host Countries may impose a fee on certain processes such as the issuing of Letters of Approval. If such deductions, taxes or fees were borne by the respective Tranche of the Carbon Fund, the Trustee may not be able to purchase as many ERs as anticipated with the money obtained from Buyer Participants. Buyer Participants

should be aware that the World Bank will not assert its immunity from taxation to shield Buyer Participants from taxes to which they would otherwise be liable.

- (ix) Under the current CDM rules, private sector entities must obtain the consent or approval of one or more Parties to the Kyoto Protocol to become a “Project Participant” and receive CERs directly from a CDM Program (rather than through the emissions trading mechanism). If a private sector Buyer Participant does not properly obtain such consent or approval, it may not be entitled to receive CERs from the relevant Program.
- (x) Future guidance issued by the CDM Executive Board, the JI Supervisory Committee, any another body established under any future international climate change regime, or individual Host Countries in terms of the technical operation of the CDM, JI or any other future project/Program based flexible mechanism may impose restrictions or limitations on the operation and activities of the Carbon Fund. It is impossible to predict how this guidance may impact the operations of the Carbon Fund, the Carbon Fund's Programs or ERs generated by Programs in which the respective Tranches of the Carbon Fund have invested. There is also a possibility that the guidance provided by the CDM Executive Board, the JI Supervisory Committee or any another body established under any future international climate change regime may be inconsistent with previous guidance or with future guidance from the Parties to the UNFCCC and the Kyoto Protocol. There is an additional risk that the Fund may not be able to adapt its activities (including with respect to particular Programs) to any such new requirements.
- (xii) International, regional and national regulatory regimes governing the generation, sale, transfer and ownership of ERs remain under development and the risk remains that the rules, procedures and requirements governing the respective generation, sale, transfer and ownership of ERs may change and, thereby, *impose restrictions or limitations on the operations of the Carbon Fund*. In particular, laws may allocate legal title to ERs to entities other than the Carbon Fund or the Buyer Participants or reserve them for the Kyoto Protocol Parties themselves, including, for example, by providing that the Host Country government is entitled to some or all generated ERs. Host Country governments may also mandate a floor price for ERs and prohibit ERs being sold by a Program, ERs being generated from certain projects or to the Carbon Fund. There is an additional risk that the Carbon Fund may not be able to adapt its activities to any such new requirements, and that ERs purchased under any Tranche may be limited in, or cease to have, value.
- (xiv) The ways in which ERs may be characterized by national, regional or international commodities or securities regulatory bodies, and whether any restrictions, taxes, charges or other imposts on Programs or the sale or transfer of ERs may be imposed by such bodies on the ownership, sale and transfer of ERs are unknown. Any such restrictions, taxes, charges or other imposts may adversely affect the viability of some Programs, the value of ERs from those Programs, the number of ERs that Buyer Participants are able to receive in return for their contributions or the amount of payment Seller Participants are able to receive under ERPAs.

- (xv) Most Annex 1 Parties are imposing limits on the number of ERs that can be used within their domestic or regional emissions trading regimes under the supplementarity principle. This limit may increase over time. This will most likely have a direct impact of ER price and demand.
- (xvi) There is a risk that delivery of CERs or ERUs to Buyer Participants may be delayed as a result of UNFCCC delays in establishing the registry infrastructure (including the ITL) or Annex I Party delays in implementing national or regional registries. Additionally, delays in the regulatory infrastructure, including the ITL and CITL, could delay emissions trading and the transfer of CERs, ERUs or AAUs. The transfer of VERs may also be hampered if difficulties arise with the infrastructure surrounding the creation of VERs, including voluntary registries. The Trustee will endeavor to ensure that Seller Participants have a contractual duty to work with the Trustee to deliver ERs by an alternative arrangement acceptable to the Trustee in the event that they cannot be delivered to one or more particular Buyer Participants.

6.2.2. *Sovereign non-compliance risks*

As part of the body of international law, the International Rules are agreed between nation states. The Kyoto Protocol contemplates the participation of private entities in the Clean Development Mechanism, Joint Implementation and International Trading. Private and/or public entity Buyers or Sellers authorized by its respective countries will only be able to transfer and acquire Kyoto Protocol credits (CERs, ERUs and AAUs) if the authorizing country (Annex I Party or Non-Annex I Party) remains in compliance with the Kyoto Protocol and is itself eligible to transfer and acquire Kyoto Protocol credits. Where an authorizing country does not satisfy the eligibility requirements under the International Rules the ability of private entities with registry accounts in that Party to acquire, transfer or otherwise use Kyoto Protocol credits is restricted. Furthermore, for ERs to be transferred between national registries, both the buying and selling countries must meet the eligibility criteria.

The future international climate regime (if developed) may impose a penalty on countries that do not meet their emission reduction targets. Such countries may not be eligible to receive ERs from the fund under the future international rules.

Sovereign and political risks are particularly significant as the Carbon Fund seeks to implement Programs exclusively in Developing Countries and Countries with Economies in Transition. The success or failure of any particular Program is likely to have a significant impact on the results achieved by the Tranches of the Carbon Fund. While the Trustee will take these factors into account in deciding which Programs to finance and undertake to mitigate these risks, such risk factors could jeopardize the viability of some Programs, the timing of their implementation, and the volume and value of any ERs produced by such Programs.

Furthermore, the new partnership structure of the Facility will encourage participation of Developing Countries and Countries with Economies in Transition hosting Programs in

the Facility. Therefore, Programs may be exposed to a significant degree of political Host Country risk. Although the Trustee will try to mitigate such additional risks, there may be politically motivated Program delays or failure or non-compliance with contractual arrangements which may negatively impact on the success of specific Programs and the expected amount of ERs to be generated. There is also a risk that a change in the laws of a Host Country may adversely affect Programs or transactions entered into by the Carbon Fund. Such changes could, for example, prevent the creation, transfer or pricing of ERs.

6.2.3. *Market risks*

There exists a high level of uncertainty as to the potential future market value of ERs, particularly post-2012. ERs are currently traded in different national, regional, and international markets, often with the terms remaining confidential between the trading parties. ERs are being, and will be, priced based on a number of factors, including their current and perceived future market value, which depends to some extent on the outlook of the EU ETS, other national and/or regional regimes and any potential future international climate change regime. Such market determination of price carries risks for the Participants that the price may vary based on market demand and supply. Buyer Participants may not receive as many ERs as expected if the market price increases. Moreover, since ERPAs entered into by the Carbon Fund will generally be for delivery on a forward basis, there is no guarantee that the price committed to upon entry into an ERPA will reflect the market value of ERs at the time of delivery.

Market risks specific to the Carbon Fund include, but are not limited to, the following:

- (i) Carbon prices vary based on demand and supply. ER Programs under the Facility may generate large amounts of ERs. This could turn into an oversupply if it is not met by adequate demand and could potentially adversely affect the value and demand for these and other ERs. On the other hand, demand is highly uncertain, largely depending on whether a future international climate change regime or another regulatory regime would recognize ERs generated post-2012 for compliance purposes.
- (ii) As the post-2012 carbon market expands to incorporate more private sector entities, the terms on which the Trustee contracts to acquire ERs pursuant to the respective ERPA may prove to be above or below future market value. The Trustee will endeavor to mitigate this risk by having a Pricing Approach agreed and regularly reviewed by the Participants in the Facility.
- (iii) The sale by some Annex I Parties of AAUs during the Kyoto Protocol's first commitment period may adversely affect the value and demand for ERs created from Programs in which the Carbon Fund invests if there is an oversupply of AAUs during the Kyoto Protocol's first commitment period. On the other hand, the Carbon Fund may consider purchasing so-called "greened" AAUs. Note that activities of one Tranche of the Carbon Fund might conflict with activities in another Tranche of the Carbon Fund. For instance, one Tranche's purchase of a

large number of AAUs could diminish the value of CERs, ERUs or VERs generated in another Tranche.

6.3 Reputational risks

Due to the objective of the CPF to assist Developing Countries and Countries with Economies in Transition in the transformation towards a low-carbon economy, moving away from a project-by-project approach to a large scale Program approach (including multiple CPAs in potentially various countries), the failure of a Program may have profound consequences for local economies and populations and may attract wide public criticism. Furthermore, due to the potentially large supply of ERs from Programs under the CPF, some worry that industrialized countries could simply buy cheap credits for compliance rather than take domestic action on mitigation, thereby delaying the move towards decarbonizing their own economies. The greater the supply and the lower the price of offsets, the lower will be the price incentive for internal abatement. This could make some organizations criticize and exert influence on existing or potential Participants of the Facility.

Also, it is highly uncertain as to how the ERs generated by Programs under the CPF would affect the CDM/JI market. If the post-2012 carbon market allows ERs from Programs without any limitation, the whole carbon market could see its price diminish. As a result, some developing countries that benefit from the current CDM but do not host Programs under the CPF could criticize such Programs and cause a reputational harm to the Participants of the Facility.

Buyer Participants may also have concerns about the reputational risk associated with acquiring ERs from certain project types. Similarly, problems or accidents such as environmental damage may be caused by Programs and could cause reputational harm to Participants.

6.4 CPF governance structure risk

One of the objectives for establishing a Partnership Committee of the CPF that consists of representatives of all Participants of the Facility is to build a partnership among different players to make joint decisions on issues that are of concern to all parties. Nevertheless, the divergent, sometimes conflicting interests of members of the Partnership Committee could politicize the decision-making process of the Partnership Committee, leading to delay of decisions and potentially jeopardizing the credibility of the Facility.

Nevertheless the CPF Instrument identifies some functions that would be exclusively exercised by the Buyer Participants of a Tranche, including reviewing CFDs for each proposed Program submitted by the Trustee in order to determine whether or not to consent to the inclusion of such Program in the Tranche's portfolio.

6.5 Risks related to ER generation

6.5.1. Political risk related to inability to implement Programs

Programs are expected to be undertaken exclusively in Developing Countries and Countries with Economies in Transition. Thus, changes in economic or political conditions in any Host Country of a Program may have an adverse effect on such Programs and, therefore, on the overall financial performance of a Tranche of the Carbon Fund. While the Trustee will take these risk factors into account in deciding from which Programs it shall purchase ERs, such risk factors could jeopardize the viability of some Programs, the timing of their respective implementation, and the volume and value of any ERs produced by such Programs.

6.5.2. Stakeholder risk

Under current CDM and JI rules, stakeholder consultation must be sought prior to registration of the Program and many of the documents required to register the Program and issue CERs or ERUs (such as the baseline methodology and validation and verification reports) must be publicly exhibited for comment. There is a possibility that some Programs may be subject to negative comments or publicity from stakeholders, including NGOs, thereby delaying registration of the Program or issuance of CERs or ERUs and potentially even leading to a "request for review" from the CDM Executive Board or the JI Supervisory Committee or a Party to the Kyoto Protocol involved in the Program. There is also a possibility that such adverse comments may be directed towards the World Bank or the Participants.

6.5.3. Construction and start-up risks

The construction and implementation of the Program involves many uncertainties, including shortages of equipment, labor and materials, work stoppages, inclement weather and unforeseen engineering, environment and geological problems. As a consequence, actual Program construction and implementation costs may be higher than anticipated. For example, delays and cost overruns may have an adverse impact on power sales agreements for renewable energy Programs, which may adversely impact the power purchaser and result in the imposition of penalties on the Program Entity. As a result, Seller Participants may experience delays in providing, or fail to provide, ERs subject to purchase by a Tranche of the Carbon Fund. The Carbon Fund may also commit to make a payment to a Seller Participant for ERs prior to the construction or implementation of the Program or prior to the creation of the ERs to which the payment relates, exposing the Buyers to some financial risk.

6.5.4. Technical and operating risks

There is a risk that unanticipated flaws in the Program design or construction may result in the Program not generating the predicted amount of ERs in the timeframe anticipated when the Trustee entered into ERPAs. Furthermore, each Program will be new and

therefore will have no operating history. This may have an adverse effect on the ability of the Program to generate ERs. Failure to generate ERs could occur during operation for a number of reasons, including a Force Majeure event.

6.5.5. Overestimation of ER Volumes

In addition, there is also a real risk that estimated volumes of ERs to be produced by a project may be an overestimation of ERs actually produced. Experience in the market to date has shown that many PDD estimates are often overly optimistic and need to be revised throughout the project life. This could lead to Buyer Participants receiving fewer ERs than expected and may, for example, impact upon on-selling arrangements entered into by Buyer Participants.

6.5.6. Specific issues relating to Programs

The investment in ER-generating Programs, rather than individual projects, is a relatively new area, with no Programs being registered as such in accordance with the International Rules to date. The rules for creating a Program introduce several new concepts into the regulatory system, many of which are yet to be tested in practice. As the area develops, the rules may well evolve over time, potentially having an adverse impact on the ability of Programs under the CPF to generate ERs. Given the uncertainty around the CDM and JI rules post-2012 and the lead times involved in implementing Programs, there may be limited ability to create and utilize ERs created by such Programs.

A Program is made up of multiple underlying Program activities. A Program activity is a single measure, or a set of interrelated measures, to reduce greenhouse gas emissions. If any relevant Governmental Authority identifies an error that disqualifies a Program activity from inclusion into the Program, the Program activity may be excluded from the Program. The consequences of such exclusion includes that the excluded Program activity may not be re-included again in that or any other Program and the inclusion of new Program activities and the issuance of ERs for that Program may be put on hold.

6.5.7. Baseline risk

The baseline of a Program at the time that an ERPA is entered into may need to be modified to meet CDM Executive Board, JI Supervisory Committee, JI host country or other requirements to achieve registration and generate transferable ERs. There is a risk that the CDM Executive Board, the JI Supervisory Committee, the JI host country or any other competent authority may find that the baseline must take into account additional criteria that were not considered in the development of the initial baseline. If the baseline has to be changed, this could lead to a different output of ERs from that originally anticipated by the Trustee. The contractual allocation of this “baseline risk” may vary between Tranches and could lead to Participants receiving fewer CERs, ERUs or VERs than the Trustee had initially expected under the ERPA.

6.5.8. Risk of fluctuations in price of Program output

Price risks include the risk relating to the price of any Program output, for instance the price of electricity or of a product which a manufacturing facility produces. Unpredictable fluctuations in the price of Program output may have an adverse effect on the performance of a Program and the overall long-term financial viability of the Program. This may result in a reduction or termination in the generation of ERs.

6.5.9. Risk of unavailability of renewable resources or raw materials

Some of the Programs may depend on the availability of renewable and natural resources for operation. Extended periods of drought may reduce river flows on which hydroelectric Programs rely, thus reducing electricity output. Similarly, adverse weather conditions may affect historical wind patterns, reducing the amount of wind resources used by wind power Programs. Biomass Programs may be affected by drought, crop failures and changes in harvesting practices or regulations, all of which could reduce the amount of fuel available. In each of these cases, reduction in electricity output may lead to a reduction of the amount of ERs generated by a Program. Moreover, Programs may be unable to obtain raw materials necessary for operations, which could result in a reduction or termination in the generation of ERs.

6.5.10. Intermediary risk

The Carbon Fund may use implementing entities, such as local intermediaries, including small and medium enterprises, NGOs, banks or brokers and micro-credit agencies, to help establish Programs, enable payments to Program beneficiaries, and deliver the ERs to the Carbon Fund. While, in this case, the Carbon Fund intends to bind the conduct of such intermediaries through appropriate contractual arrangements, the presence of additional entities in the ERs supply chain raises additional risks, including delay in the delivery of ERs or delivery of ERs that do not meet the requirements of the International Rules or the terms and conditions set by the Carbon Fund. The involvement of implementing entities or other parties may complicate or delay the approval and registration process for Programs, as they may be required to comply with various host country or other regulatory requirements.

6.5.11. Risk related to additional co-financing of Programs

Due to the size of potential ER Programs, it is likely that the World Bank as lending organization or any other financier may provide additional financing to a Program or part of a Program supported by the CPF. Regarding the conflicts of interest the World Bank may face by potentially acting at the same time as Trustee of the Carbon Fund and as additional financier with respect to specific Programs under the CPF reference is made to Chapter 9 (Conflicts of Interest). Additional co-financing of Programs under the CPF through additional financiers may make the construction, operation and ultimately the success of a Program also dependent on the behavior of such additional financiers, in

particular with respect to the exercise or non-exercise of remedies or other actions or omissions under the respective financier's additional finance agreement.

Any such action may have a negative impact on the Program Entity's ability to honor its obligations under the ERPA. For example, the exercise of claims for damages and/or the suspension, acceleration or termination of financing by additional financiers may jeopardize the Program Entity's financial position (including its ability to timely repay any advance payments provided under an ERPA), the financial viability of the Program, the timely implementation of the Program and ultimately its success in having the contracted amount of ERs generated and delivered to the Trustee.

6.6 Risk of loss of part or all of interests placed in the Carbon Fund

6.6.1. Illiquid market for interests in the Carbon Fund

There is no market for interests in the Carbon Fund, and none is expected to develop. Such interests will not be redeemable and may not be assigned without the prior written consent of the Trustee. In addition, at the end of the Carbon Fund's term, the assets to be distributed among Participants may include rights related to ERs which have not yet been created. It is not yet known how such rights would be treated under international regulatory regimes and/or the Participants' regional or national legal and regulatory regimes. As a result, the assets to be distributed by the Trustee may not be in liquid form, which may adversely affect the value of interests in the Carbon Fund.

6.6.2. Risk of cost overruns

The design, preparation, construction, implementation and operation of Programs requires substantial financial resources which may be partially provided for by the Trustee through the issuance of grants under the CADF or carbon finance under the Carbon Fund of the Facility and partially provided for by other financing means. There is a risk that initially calculated Program costs will increase significantly during the development and implementation of a Program and that the funding provided for will not suffice to cover such costs. Any such funding shortfall may jeopardize the ultimate success of a Program to generate ERs, may reduce the total value of ERs ultimately transferred to Buyer Participants from one or more Programs and may also reduce the total number of Programs the Facility is able to finance.

6.6.3. Transaction cost risks

There is limited experience in applying methods related to monitoring and verification of large Programs and in achieving ongoing, cost-effective measurements. The Carbon Fund will seek to encourage cost-effective measuring regimes and to maintain simple modalities and procedures in monitoring consistent with the International Rules. In addition, one of the operating principles for the CPF is to ensure that all the activities under the CPF comply with the World Bank's Operational Policies and Procedures. While application of the World Bank's policies is critical to ensure credibility and quality

of Programs, these procedures may nevertheless result in higher transaction costs than anticipated and Program costs for the Carbon Fund being higher than expected.

6.6.4. Foreign exchange risks

According to the Instrument, the CADF shall be denominated in United States Dollars (US\$) and the First Tranche of the Carbon Fund and the Prepaid Contribution Fund shall be denominated in Euros (€) (“Holding Currency”). Notwithstanding the foregoing, the Trustee may, at its discretion, also establish accounts under the Facility denominated in currencies other than the Holding Currency. Upon receipt of a Contribution in a currency other than the Holding Currency, the relevant Trustee shall convert such funds into the Holding Currency at the prevailing rate, and will only be able to make payments in the denominated currency. Therefore, members of the Facility making payment in another currency than the Holding Currency are exposed to foreign exchange risk. In addition, if a Buyer Participant withdraws from the Facility in accordance with the terms and provisions of the Instrument, the uncommitted part of the Contribution made would be returned in the Holding Currency, also potentially exposing the respective Buyer Participant to some foreign exchange risk.

6.6.5. Liquidated damages

In case an ERPA is terminated by the Trustee of the Carbon Fund because of the termination of the Carbon Fund, the ERPA may provide for a termination payment to the Seller for the difference to compensate the Seller for losses resulting from the termination of the ERPA. Such claim for liquidated damages may also adversely affect the value of interests in the Carbon Fund.

6.7 Other risks

6.7.1. Resignation of World Bank as Trustee for the Facility

The Instrument allows the World Bank to resign as Trustee for the Facility or any of its Funds. Although the World Bank does not currently contemplate such action, future circumstances such as political events or budgetary limitations may result in the World Bank deciding to withdraw from the carbon business generally or to resign from its position as Trustee for the Facility or any of its Funds. If the World Bank resigns as Trustee, the Participants may decide that a third party will continue the management of the Facility or any of its Funds. This third party may not have the same level of climate change project management experience as the World Bank has acquired over the years, which will increase the individual Program risks, including the risk that any single Program does not generate ERs. In addition, a third party manager may charge fees that are more expensive than those currently charged by the World Bank, which may decrease the ability of the relevant Tranche of the Carbon Fund to deliver ERs to Buyer Participants in that Tranche. Participants may also suffer loss as a result of any interruption to, or termination of, the Carbon Fund's operations arising out of the World Bank's resignation as Trustee.

6.7.2. Counter-party credit risk

It is an objective of the Carbon Fund to secure the supply of ERs created by Programs located in Developing Countries and Countries with Economies in Transition, many of which will have significant sovereign and political risk issues. Project supply agreements for commodities other than ERs may be entered into with counterparties that may have poor credit profiles. Default by such counterparties may impair the long-term viability of a Program and the supply of ERs from the Program.

6.7.3. Competition risk

It is acknowledged that the Trustee may face competition in respect to some elements of the Carbon Fund's business, both from existing and new institutions entering into the carbon finance market over the life of the Carbon Fund. This competition may reduce the number of available Programs or may otherwise affect the operations of the Carbon Fund.

6.8 Liability risk

Pursuant to the Instrument, the CADF and the Carbon Fund under the Facility are to be constituted as trust funds under international law for which the World Bank acts as Trustee and in relation to which the Buyer Participants' potential liability is intended to be limited to the amount of their respective Contributions. However, given the novel nature of these Funds and uncertainty as to how the Instrument might be interpreted under the laws of any jurisdiction where a third party might choose to bring a claim against the Trustee, the Facility or any of the Funds or the Participants, no assurance can be given that this intention will be respected in practice. The Trustee, the Facility or any of the Funds or the Participants could be exposed to general liability claims arising from or in connection with Programs.

6.9 Buyer default risk

Under the BPA and the Instrument, every Buyer Participant is required to pay its respective contribution to the Facility ("Contribution") through the issuance and delivery of one or more promissory notes payable to the Trustee on demand. As is the practice with the other carbon funds for which IBRD acts as trustee, the Trustee expects to demand payment from the Buyer Participants [annually] based on the projected disbursements to be made by the Trustee over the following [year], including payments expected to be made under ERPAs with Seller Participants.

The BPAs provide that, if at the time the Trustee intends to enter into an ERPA, a Buyer Participant has no credit rating or a credit rating less than Baa/BBB, the Trustee may demand that such Buyer Participant either (i) prepays its pro rata share of the amount payable by the Trustee under that ERPA or (ii) provides an irrevocable standby letter of

credit (“LoC”) by a financial institution acceptable to the Trustee covering its respective pro rata share over the term of that ERPA.²⁰

Given the foregoing provisions and the identity of the Buyer Participants in the Facility, the Trustee has no reason to believe that any Buyer Participant would fail to make payments up to its respective Contribution when called on to do so by the Trustee. Nevertheless, Seller Participants do bear the risk of such failure.

Implications for Seller Participants

In the event of the Trustee not having sufficient funding available in the Carbon Fund to make payment in full under the ERPA, the payment to be made by the Trustee to the Seller Participant under the ERPA would be limited to the amount of funding available to the Trustee at the time payment is due.

Section 19.2 of the Instrument provides that neither the Trustee, the IBRD nor the Buyer Participants (nor any of their respective officers, employees or agents) shall have any personal liability whatsoever to any third party (including any Seller Participant) in connection with the activities of the Carbon Fund and that all such third parties shall look solely to the Carbon Fund property for satisfaction of any claims arising in connection with the activities of the Carbon Fund.

Section 19.2 of the Instrument further provides that every contract entered into by the Trustee (including every ERPA) shall state that the obligations under such contract are not binding on IBRD or any of the Participants personally or in their individual capacities but bind only the Carbon Fund. In addition, this Section also provides that the liability of a Buyer Participant is limited to the amount of its respective Contribution that remains unpaid under the BPA.

Accordingly, the Seller Participant would not have any recourse to the Trustee, IBRD or any other Buyer Participant to remedy the lack of funding available to the Carbon Fund as a result of the failure by a Buyer Participant to make payment to the Trustee.

Please note that to date there has not been any such payment failure in any of the carbon funds administered by IBRD.

²⁰ In addition, please note that in the event a Buyer Participant (or the LoC-issuing financial institution, if applicable) fails to make payment in whole or in part to the Trustee when due, Section 14.2 of the Instrument requires the Trustee to notify the other Buyer Participants of the failure and such other Buyer Participants would then have the right, but not the obligation, to purchase the interest of the such Buyer Participant and make the outstanding payment to the Trustee. In the event no other Buyer Participant elects to purchase such interest, the Trustee may try to arrange for a private sale of that interest to a third party. In the event that the Trustee does not do so or fails to find a third party buyer, the defaulting Buyer Participant would then forfeit its interest.

CHAPTER 7 REGULATORY AND TAX CONSIDERATIONS

7.1 United States Tax Issues

DISCLAIMER

The following discussion of United States income tax matters is included because the principal offices of the IBRD are located in the United States. The following is a general summary of the United States income tax aspects of the Carbon Fund under the Carbon Partnership Facility and its operations based upon generally applicable U.S. Federal income and withholding tax laws and the applicable provisions of the World Bank's Articles. Neither the Trustee nor the World Bank has sought guidance from the U.S. Treasury Department or the U.S. Internal Revenue Service with respect to the application of the U.S. Tax Rules to the Carbon Fund and its operations. *The following general summary is not intended as tax advice to any person, and all persons considering an investment in the Carbon Fund should consult their own tax advisers.* Prospective Fund members are hereby notified that: (i) any discussion of United States federal tax issues in this document is not intended or written to be relied upon, and cannot be relied upon by any Fund member, for the purpose of avoiding penalties that may be imposed on investors under the United States Internal Revenue Code of 1986, as amended (the "Code"); (ii) such discussion is written in connection with offering participations in the Carbon Fund; and (iii) prospective Fund members should seek advice based on their particular circumstances from their own independent tax advisers. Furthermore, the Carbon Fund is not the type of business customarily dealt with by tax laws and tax authorities, and accordingly there is difficulty and uncertainty in applying to the Carbon Fund tax law that was developed primarily to tax profit-making enterprises. This uncertainty exists in particular with respect to proper characterization of the Carbon Fund for tax purposes.

7.1.1. *The Trust Fund as an Activity of the World Bank*

The World Bank has adopted the Instrument under the general authority of the World Bank's Articles of Agreement (its "Articles") and applicable international treaties. The Instrument provides that the Carbon Fund shall be a trust fund of the World Bank. The World Bank, as Trustee of the Carbon Fund, will administer the Carbon Fund in accordance with its Articles, applicable international treaties, the terms of the Instrument and the Participation Agreements entered into by the Trustee and the Participants.

7.1.2. *Tax Liability under the World Bank's Articles*

Congress provided that the relevant provisions of the Articles of the World Bank shall have full force and effect in the United States and its territories and possessions under 22

USC 286h. The World Bank's Articles provide that the World Bank's obligations and securities are not subject to any tax by a member:

- (i) which tax discriminates against such obligations and securities because they are issued by the World Bank or
- (ii) if the sole jurisdictional basis for the tax is the place or currency in which such obligations and securities are issued, made payable or paid, or the location of any office or place of business maintained by the World Bank. It is the World Bank's position that interests in the Carbon Fund are not obligations and securities of the World Bank. If interests in the Carbon Fund are treated as obligations or securities of the World Bank, no Buyer Participant may be subjected to U.S. income tax solely by virtue of the fact that the World Bank maintains offices within the United States. However, it is not clear whether Buyer Participants would be exempt from U.S. income tax if interests in the Carbon Fund are not treated as obligations or securities of the World Bank by the United States tax authorities.

7.1.3. The Carbon Fund as Unincorporated Foreign Entities under US Law

If interests in the Carbon Fund are not treated as obligations or securities of the World Bank, United States tax law may be applicable to the interests. The Carbon Fund would probably be treated as unincorporated foreign entity under the United States Internal Revenue Code and applicable Treasury Regulations (the "U.S. Tax Rules") because it is a trust organized under laws other than the laws of the United States and its political subdivisions. While the matter is not free from doubt, it appears that the Carbon Fund will be treated as business entity under the U.S. Tax Rules because some or all of its members may be motivated at least in part by commercial and profit-making objectives. As an unincorporated foreign business entity, all of the members of which claim that their liability in respect of the Carbon Fund is limited to their respective contribution, the Carbon Fund will probably be treated as a foreign corporation under the U.S. Tax Rules unless it affirmatively elects to be treated as partnership.

The Carbon Fund will probably not have to decide whether to elect partnership treatment unless and until it acquires a member that is a United States corporation or other United States entity, including certain foreign banks, securities firms or insurance companies actively engaged in business in the United States, or engages in an activity or makes an investment that could yield U.S.-source interest, dividend or other income within the meaning of the U.S. Tax Rules. The World Bank anticipates, however, that the Carbon Fund will not elect to be treated as a partnership.

If the Carbon Fund is treated as a foreign corporation under the U.S. Tax Rules, distributions by the Carbon Fund to non-U.S. members would be treated as income from sources outside the United States and would not be subject to U.S. income tax. Distributions by the Carbon Fund to U.S. members would be taxable under the provisions of the U.S. Tax Rules governing distributions by foreign corporations to U.S. taxpayers. Distributions to U.S. members would first be treated as dividends to the extent of the

current and accumulated earnings (if any) of the Carbon Fund. Thereafter, distributions would be treated as a return of capital up to the member's basis in its interest in the Carbon Fund. Distributions of various types of Emission Reduction credits would be valued at the market value of such credits. To the extent that the market value of the credit exceeds their cost to the Carbon Fund, the Carbon Fund would be treated as having earnings in the amount of such excess at the time of distribution to its members. Such earnings may increase the amount treated as a taxable dividend to the members, and it is possible that the members will be taxable on receipt of such dividends even though they have not yet received back rights equal to the member's investment in the Carbon Fund.

7.1.4. Filing Returns and Withholding

The World Bank's Articles provide that "[t]he Bank, its assets, property, income and its operations and transactions authorized by [its Articles] shall be immune from all taxation and from all customs duties." The World Bank's Articles further provide that "[t]he Bank shall also be immune from liability for the collection or payment of any tax or duty." The privileges and immunities accorded to the World Bank apply to the property, archives, operations and transactions of the Carbon Fund, provided the Carbon Fund is treated as part of the World Bank and not as unincorporated foreign legal entity as described in c) above. Accordingly, neither the Carbon Fund nor the World Bank, as Trustee of the Carbon Fund, will file any returns or pay or withhold any taxes in or to the United States or any political subdivision of the United States.

Assuming the Carbon Fund is treated as a foreign corporation under the U.S. Tax Rules, distributions by the Carbon Fund to its members, given that they will not be U.S. members, will be treated as income from sources outside the United States and will not be subject to U.S. income tax.

7.2 Other tax regimes, including Value Added Tax

It is likely that Emission Reductions acquired by the Carbon Fund will be subject to some form of taxation, whether that be a general tax, charge or other imposts on projects and Programs, or the ownership, sale or transfer of Emission Reductions. In particular it is already clear that in a number of jurisdictions Value Added Tax (VAT) will be applied to the acquisition and/or transfer of VERs and CERs.

Most jurisdictions in the world impose VAT and other indirect taxes. VAT is also known as goods and services taxes. This, in general terms, is a tax on consumption. The rate may be a flat rate. Alternatively, different rates may apply to different goods and services. Applicable VAT is calculated as a proportion of the purchase price for the good or service supplied (but sometimes can be imposed on its market value if this is higher). While generally the seller is liable for payment of VAT, this is not always the case. However, if the seller is liable it could be expected that the seller will increase the price to cover the amount of the VAT. The cost effectively gets passed on to the buyer. Most jurisdictions allow some kind of mechanism for a credit for VAT paid by a buyer in this way. However, most jurisdictions do not allow this where the buyer is a financial

institution or private individual. In some cases, the supply in question may be exempt. This means that while no VAT is charged on the relevant transaction, incidental costs of the transaction such as brokerage and advisory fees may include an embedded VAT cost which does not give rise to a right of recovery. In addition to VAT, some jurisdictions may charge transaction taxes such as transfer tax or stamp duty. These taxes may be payable in addition to the VAT, if any. Financing may also attract liability such as loan security taxes, debits taxes and deposit taxes. These are usually calculated as a proportion of the payment that is taxed. Another kind of tax that may apply is so-called "service tax". In general terms, this tax is charged instead of VAT as a proportionate value of a transaction and could apply in respect of the transactions in question.

The VAT and indirect tax regimes that apply across the world and which could apply to the acquisition or transfer of VERs and/or CERs are complicated and jurisdiction-specific. Any investor would need to take specific advice in respect of their jurisdiction. The Trustee undertakes no obligation to estimate, calculate, withhold, pay, notify or take any action whatsoever with regards to taxes on behalf of Fund members. Furthermore, the Trustee assumes no liability with regard to payment of taxes, or the failure to pay any taxes due, by Fund members. The World Bank, under its Articles of Agreement, is generally immune to taxation by member countries. Fund members should be aware that the Trustee will not assert its immunity from taxation to shield Fund members from taxes to which they would otherwise be liable, including, without limitation, any value added or other tax that may be imposed on the purchase of Emission Reductions through the Carbon Fund.

CHAPTER 8 CONFLICTS OF INTEREST

Considering the various roles of the World Bank, the various activities engaged in by the Participants (Buyer Participants and Seller Participants) and Donors (including its respective affiliates and employees) and the different groups of Members of Facility, certain conflicts or potential or perceived conflicts of interest may arise from time to time between and among the respective interests of the members of the Facility, the World Bank as trustee of the CADF and the Carbon Fund of the CPF or the World Bank as lending organization. These conflicts may include, among others, the following:

8.1 Conflicts of Interest of the World Bank

The World Bank performs multiple roles as (i) Trustee of the CADF, administering contributions from Donors and Participants and disbursing grants to Partners and or Seller Participants; (ii) Trustee of the Carbon Fund administering contributions from Buyer Participants, in which capacity it will, among others, select Programs and enter into ERPAs with Seller Participants; (iii) Facility Coordinator responsible for the day-to-day operation of the CPF Facility; and (iv) financier to its member countries. These multiple roles may give rise to various potential conflicts.

8.1.1. World Bank's Fiduciary Obligations

On one hand, the World Bank as Trustee will have fiduciary obligations to Donors and Buyer Participants with respect to the funds contributed by them to the CADF and the Carbon Fund. On the other hand, the World Bank as Trustee will disburse grants to Partners and/or Seller Participants and will enter into ERPAs with Seller Participants. The interests of the respective Facility Participants may be in conflict with respect to (i) the selection of specific Programs, (ii) the Pricing Approach used in determining the price for ERs under ERPAs, (iii) the General Conditions for the ERPAs to be negotiated between the trustee of the Carbon Fund and Seller Participants and (iv) the potential exercise of remedies under ERPAs or CADF Grant Agreements.

The Trustee will select Programs in accordance with portfolio and Program selection criteria established for each Tranche of the Carbon Fund by the Trustee of the Carbon Fund in consultation with Buyer Participants and Eligible Participants for that Tranche. The Members of the Facility (Donors and Partners in an advisory role only) will be represented in the Partnership Committee of the CPF which will provide operational guidance on the existing portfolio and Program selection criteria. Furthermore, Buyer Participants in a Tranche of the Carbon Fund will review the Program-underlying Carbon Finance Documents of each proposed Program in order to determine whether or not to consent to the inclusion of such Program in the Tranche's portfolio.

Being equally represented in the Partnership Committee, Buyer Participants and Seller Participants will endorse, regularly review and potentially amend the Pricing Approach as

well as the General Conditions for the ERPAs to be negotiated and entered into by the Trustee of the Carbon Fund.

Prior to proposing and presenting draft General Conditions for the ERPAs and other ERPA terms to the Partnership Committee, it is likely that the World Bank would disclose them and seek feedback from a panel of recognized lawyers that have widely represented sellers or buyers in carbon transactions. Comments would then be disclosed and discussed in the Partnership Committee in an informed and transparent manner. Such an approach reduces the risk that the General Conditions for the ERPAs and other ERPA terms proposed and presented by the Trustee at the Partnership Committee could be viewed as biased.

With respect to any potential exercise of remedies under ERPAs, if the Trustee of the Carbon Fund identifies any potential conflict of interest, the Trustee may recuse itself from taking any legal action or making any claim or demand against any defaulting party to an ERPA and assign and transfer its rights under the respective agreement, partially or fully, to a Buyer Participant or another third party. In that case, the decision whether to take any action under the ERPA rests with the assignee and not the Trustee of the Carbon Fund.

8.1.2. Conflicts with other Carbon Funds managed by the World Bank

Additionally, conflicts may arise between the World Bank as Trustee of the Carbon Fund and the World Bank as trustee of other carbon funds. For example, the World Bank as trustee of other carbon funds may pursue projects or programs in the same host country, or with the same project sponsor or entity, as Programs under the CPF. In so doing, the World Bank is under no obligation to take into account the interests of Members of the Facility. The Trustee may take actions, or fail to take actions, in conjunction with other carbon funds that could adversely impact relations with Host Countries or project sponsors and entities to the detriment of the members of the Facility.

8.1.3. World Bank's Involvement in Program Preparation and Associated Liability

Under certain circumstances, the involvement of the World Bank as Trustee of the CADF or of the Carbon Fund may be required in the preparation of a Program, the development of certain documents (e.g., PDDs) or the contracting of independent third party auditors for validation and/or verification purposes. As a result of its potential aforementioned involvement the Trustee may be biased or conflicted in pursuing remedies under an ERPA related to Program delay or failure. In that case, the Trustee may recuse itself from taking any legal action or making any claim or demand against any defaulting party to an ERPA and assign and transfer its rights under the respective ERPA, partially or fully, to a Buyer Participant or another third party. In that case, the decision whether to take any action under the ERPA rests with the assignee and not the Trustee of the Carbon Fund.

In order to be reasonably protected against any liability in connection with its required aforementioned involvement, the World Bank acting as Trustee of the CADF or as

Trustee of the Carbon Fund, except in cases of gross negligence or willful misconduct, cannot be held liable and will be indemnified out of Funds property against any incurred loss, liability, cost, claim, action, demand or expense arising out of or in connection with its activities under the Facility.

8.1.4. World Bank's Co-financing of Programs

It is likely that the World Bank as lending organization may provide additional financing to support the implementation of a Program or part of a Program supported by the CPF. Such financing may either be provided by the World Bank for its own account or on behalf of donors who have provided funding to other trust funds administered by the World Bank. Such co-financing may take the form of loans, grants, or guarantees. In such cases, circumstances may arise where the World Bank as financier for its own account or that of another trust fund or as Trustee may have to decide on exercising remedies or taking action against the counterparty, or refraining from doing so, under the World Bank's loan, financing agreement or ERPA.

Any such action may have a negative impact on the counterparty's ability to honor its obligations under the other contract(s). For example, the exercise of claims for damages and/or termination under the ERPA or suspension or acceleration of financing by the World Bank as lending organization may jeopardize the counterparty's financial position (including its ability to repay any advance payments provided under an ERPA in a timely fashion), the financial viability of the Program, the timely implementation of the Program and ultimately its success in having the contracted amount of ERs generated and delivered to the Trustee of the Carbon Fund. The potential exercise of such rights and remedies by the World Bank as financier and its potentially negative impact on the other contractual relationship(s) may put the World Bank in a conflict of interest.

In this context, the World Bank, when acting as lending organization, is under no obligation to take into account in its decision-making process the interests of the Members of the Facility, and the Trustee of the Carbon Fund, when acting as such, is under no obligation to take into consideration the interests of the World Bank and its shareholders as additional financiers.

However, if the World Bank as Trustee identifies a potential conflict of interest between the World Bank as lending organization and the World Bank as Trustee of the Carbon Fund, the Trustee may recuse itself from taking any legal action or making any claim or demand against any defaulting party to an ERPA and assign and transfer its rights under the respective ERPA, partially or fully, to a Buyer Participant or another third party. In that case, the decision whether to take any action under the ERPA rests with the assignee and not the Trustee of the Carbon Fund.

8.2 Conflicts of Interest of the Participants, Donors or Partners

On account of the various activities engaged in by Participants, Donors or Partners and their respective affiliates and employees, certain conflicts or potential conflicts of interest may arise from time to time between their respective interests and the interests of the Trustee. These potential conflicts of interest include, but are not limited to, the following:

8.2.1. Other Interests in Programs and Other Ventures

Being a Member of the Facility will not preclude Participants, Donors or Partners from having another interest in a specific Program of the CPF. However, this gives rise to similar potential conflicts of interest as are described above in relation to the World Bank's interest in the success of its potential additional financing endeavors. Participants, Donors or Partners and their respective affiliates and employees may also participate individually and/or collectively in funds or other investment vehicles having objectives and policies similar to those of the CPF which, as a result, compete with the CPF for investment opportunities (Other Ventures). Further, projects or programs owned, developed or financed by such Other Ventures may compete with Programs developed and financed by the CPF.

Where a Participant or Donor has another interest in an underlying Program or Other Venture, such other interest must be fully disclosed to the Facility Coordinator. This disclosure policy also applies to Seller Participants whose Programs are being submitted to the Partnership Committee or to Buyer Participants who are involved in the preparation of a specific Program. If the Facility Coordinator determines that a conflict of interest with respect to a Program exists, the Participant or Donor shall recuse itself from participating in any discussions or decisions in the Partnership Committee with respect to such involvement or Program. If the Participant or Donor disagrees with the Facility Coordinator's determination, it shall advise the Partnership Committee of the conflict or potential conflict, and the Partnership Committee (excluding the disclosing Participant) will decide whether such Participant's or Donor's representative should be permitted to participate in the Committee's deliberations on the Program concerned. The failure of a Participant or Donor to disclose its conflicting interest in an underlying Program or Other Venture in a timely manner may result in sanctions to be determined by the Trustee after consultation with the other members of the Partnership Committee.

8.2.2. Non-Competition by Participants, Partners and Donors

Following the provision of information on a proposed Program of the CPF to the Participants, Donors and Partners, they may, together or individually, develop an interest (i) in commencing discussions or negotiations with the relevant Program Entity or any shareholder of the Program Entity regarding the purchase of any ERs generated or to be generated by that Program and/or (ii) in entering into agreements with any other person regarding the dealing in or sale of the ERs to be generated or to be generated by that Program as a result of any such discussions or negotiations. With respect to such amount

of ERs to be generated by a Program that shall be sold to the Trustee of the Carbon Fund in accordance with the Seller Participation Agreement, the Instrument expressly prohibits such competing activities of members of the Facility, except with the Trustee of the Carbon Fund's prior written consent, until the expiration of the exclusivity period agreed upon in the Seller Participation Agreement between the Trustee of the Carbon Fund and the Program Entity.

Annex 1: Environmental and Social Safeguard Policies

This annex provides a summary of some of the main features of the World Bank's environmental and social safeguard policies. For a more complete treatment of the subject see www.worldbank.org, under "Projects and Operations" and "Policies and Procedures".

Operation Policy (OP)/World Bank Policy (BP) 4.01 Environmental Assessment

World Bank policy establishes procedures for the environmental assessment (EA) of World Bank lending operations. EA is an important instrument to help countries achieve sustainable development, through preventing and/or mitigating any harmful consequences of project activities. All projects must be screened to determine the appropriate level of EA. The most rigorous EA process is used for a project which is likely to have significant adverse environmental impacts, such as impacts that are sensitive, diverse or unprecedented or that affect an area broader than the sites or facilities subject to physical works. If the environmental impacts are less adverse (e.g. site specific, reversible and subject to satisfactory mitigation measures), a less exhaustive form of EA is required. If the project has no, or minimal, adverse environmental impacts, no EA is required.

OP/BP 4.04 Natural Habitats

The World Bank supports the protection, maintenance, and rehabilitation of natural habitats. The World Bank does not finance projects that involve the significant conversion or degradation of critical natural habitats. Where no feasible alternatives exist for projects that convert natural habitats, mitigation and restoration are included in the project to minimize habitat loss. In addition, the World Bank may require that the project include the establishment and maintenance of an ecologically similar compensatory area.

OP 4.09 Pest Management

In assisting borrowers to manage pests that affect either agriculture or public health, the World Bank supports a strategy that promotes the use of biological or environmental control methods and reduces reliance on synthetic chemical pesticides. In World Bank-financed projects, the borrower addresses pest management issues in the context of the project's environmental assessment.

Specific criteria apply to procurement of pesticides.

OP/BP 4.10 Indigenous Peoples

The World Bank recognizes that the identities and cultures of Indigenous Peoples are inextricably linked to the lands on which they live and the natural resources on which they depend. For all projects that are proposed for World Bank financing and affect Indigenous Peoples, the World Bank requires a process of free, prior, and informed consultation, and provides project financing only where free, prior, and informed consultation results in broad community support to the project by the affected Indigenous Peoples. This policy also seeks to ensure that potentially adverse effects of proposed projects on indigenous people are avoided, minimized, mitigated and/or compensated for. World Bank-financed projects are also designed to ensure that the Indigenous Peoples receive social and economic benefits that are culturally appropriate and gender and intergenerationally inclusive.

OP/BP 4.11 Physical Cultural Resources

The World Bank assists countries to avoid or mitigate adverse impacts on physical cultural resources from projects that it finances. The impacts on physical cultural resources resulting from project activities, including mitigating measures, may not contravene either the borrower's national legislation, or its obligations under relevant international environmental treaties and agreements. The borrower addresses impacts on physical cultural resources in projects proposed for World Bank financing, as an integral part of the environmental assessment (EA) process.

OP/BP 4.12 Involuntary Resettlement

This document outlines the World Bank policy and procedures covering World Bank staff and borrower's responsibilities in operations involving involuntary resettlement. Involuntary resettlement should be avoided or minimized where feasible. Any operation that involves involuntary land acquisition is reviewed for potential resettlement requirements early in the project cycle to protect the livelihood of people who lose their land, their houses, or both. The objective of the World Bank's resettlement policy is to assist displaced persons in their efforts to restore or improve former living standards and earning capacity. To achieve this objective, the borrower is required to prepare and carry out resettlement plans or development programs.

OP/BP4.36 Forests

World Bank operations in the forest sector aim to harness the potential of forests to reduce poverty in a sustainable manner, integrate forests effectively into sustainable economic development, and protect the vital local and global environmental services and values of forests. The World Bank does not finance projects that, in its opinion, would involve significant conversion or degradation of critical forest areas or related critical natural habitats.

OP 7.50 Projects on International Waterways

The World Bank recognizes that projects involving the use of international waterways for development purposes may affect relations between the World Bank and its clients and also between states, whether members of the World Bank or not. Any proposed project's potential to harm the interests of other riparian states through deprivation of water, pollution, or otherwise is determined and affected riparian states are notified, in principle, by the government of the country in which the project will be implemented. The World Bank attaches great importance to riparian states making appropriate agreements or arrangements for the use and protection of the waterway; where differences exist, prior to financing, the World Bank urges states to negotiate to reach appropriate agreements or arrangements.

OP/BP/GP 7.60 Projects in Disputed Areas

In order not to prejudice the position of any state where a proposed project is located in an area the ownership of which is disputed between governments, such a project may normally only proceed if all the governments concerned agree that, pending settlement of the dispute, the project may go forward without prejudice to the final settlement.

OP 4.37 Safety of Dams

Because there are serious consequences if a dam does not function properly or fails, the World Bank is concerned about the safety of new dams it finances and existing dams on which a World Bank-financed project is directly dependent. When the World Bank finances a project that includes the construction of a new dam, it requires that the dam be designed and its construction

supervised by experienced and competent professionals. It also requires that the borrower adopt and implement certain dam safety measures for the design, bid tendering, construction, operation, and maintenance of the dam and associated works.

Annex 2: Other Applicable Operational Policies

This annex provides a summary of some of the main features of the World Bank's Operational Policies and Procedures applicable to the CPF operation. For a more complete treatment of the subject see www.worldbank.org, under "Projects and Operations" and "Policies and Procedures."

OP/BP 11.01 Procurement

The World Bank has the fiduciary responsibility to ensure that financial resources are used for the intended purposes, with due attention to economy and efficiency and without regard to political and other non-economic influences or considerations. To ensure this the World Bank has established procurement rules to be followed by borrower/grant recipient in the procurement of goods, works and services required for World Bank financed projects. Additionally, the World Bank has established procedures for the review of procurement decisions. The said rules and procedures are detailed in the *Procurement Guidelines*; and those that apply to the selection and employment of consultant services are detailed in the *Consultant Guidelines*, both of which are binding on borrower/grant recipient and recipient of the grants. The following basic principles guide the World Bank's procurement requirements: fair competitive bidding; economy and efficiency in the purchase of goods, works and services; domestic preference to enhance development in the borrower/grant recipient's country; and, transparency throughout the procurement process.

The borrower/grant recipient is responsible for all aspects of the project implementation, including procurement. However, the World Bank assesses the capacity of the implementing agencies to carry out the required procurement and establishes the level of associated risk. The level of risk determines the scope and intensity of the supervision arrangement for the project by the World Bank and the actions to be undertaken by the borrower/grant recipient necessary to maintain such risks at an acceptable low level. A borrower/grant recipient who fails to carry out procurement in accordance with the procedures agreed in the Loan Agreement attracts a cancellation of the amount of the loan allocated to goods, works and services that have been misprocured.

The borrower/grant recipient prepares a procurement plan that covers the activities necessary to ensure that the project procurement will be carried out efficiently and professionally.

The World Bank assists the borrower/grant recipient in planning for procurement, including preparation of the procurement plan, as well as supervises and monitors procurement decisions throughout project implementation.

OP/BP 11.01 Fraud and Corruption (Paragraph 16)

The World Bank requires that its own staff, borrower/grant recipient and bidders observe the highest ethical standards during the procurement and execution of World Bank-financed contracts. Firm's found to have participated in fraudulent or corrupt practices or activities are declared ineligible to be awarded future World Bank-financed contracts, either indefinitely or for a stated period of time. If a representative of the borrower/grant recipient is found to be engaging in such corrupt or fraudulent practices, the World Bank cancels the amount of the loan allocated to the contract in question unless the Borrower/grant recipient takes appropriate action satisfactory to the World Bank to remedy the situation.

OP10.02 Financial Management

1. Financial management arrangements are the budgeting, accounting, internal control, funds flow, financial reporting, and auditing arrangements of the entity or entities responsible for implementing World Bank-supported operations. For each operation supported by a World Bank loan or grant, the World Bank requires the borrower/grant recipient to maintain financial management arrangements that are acceptable to the World Bank and that, as part of the overall arrangements that the borrower/grant recipient has in place for implementing the operation, provide assurance that the proceeds of the loan are used for the purposes for which the loan was granted. Where feasible, the World Bank expects these financial management arrangements to be integral to existing borrower/grant recipient institutions and to enhance institutional sustainability.

2. *Assessments of Financial Management Arrangements.* The World Bank assesses the adequacy of the borrower/grant recipient's financial management arrangements during the preparation and implementation of each operation and requires the borrower/grant recipient to undertake appropriate measures, including institutional capacity strengthening, to mitigate risks posed by weaknesses that are identified.

3. *Interim Financial Reporting.* The World Bank normally requires the borrower/grant recipient to submit interim financial reports of which the format, content, periodicity, and due date are acceptable to the World Bank.

4. *Audited Financial Statements.* The World Bank requires that the borrower/grant recipient provide audited financial statements that reflect the activities of the operation supported by the World Bank loan. It requires that the financial statements be prepared in accordance with accounting standards acceptable to the World Bank and that the audit be conducted in accordance with auditing standards acceptable to the World Bank. It further requires that the scope of the audit and the independent auditors who conduct it be acceptable to the World Bank. The World Bank normally requires that the financial statements be audited annually, and provided to it no later than 6 months after the end of the reporting period. The World Bank may allow an exemption from these requirements if the borrower/grant recipient has more cost-effective mechanisms that provide the World Bank with equivalent assurance that loan proceeds have been used appropriately. In all such cases, the World Bank retains the right to request an audit.

5. *Failure to Maintain Acceptable Financial Management Arrangements.* If the borrower/grant recipient fails to maintain acceptable financial management arrangements, or to submit the required financial reports by their due dates, the World Bank takes action to rectify the situation.

Annex 3: Illustrative Examples of Possible ER Pricing Approaches

This annex aims to illustrate possible ER pricing approaches and formulas that could be considered in the context of developing the CPF Pricing Approach.

Two possible example formulas for adding a variable component include:

- I. ER prices could result from the *average between the prevailing price at the time of the ERPA signature²¹ and the market price at the time of each subsequent ER delivery*. This price formula would allow Buyer and Seller Participants to access any future price upside and downside; any variation in market prices from the date of the ERPA signature to the date of each annual ER delivery would be equally split between the parties. This could be represented as:

$$FP_{1,2,n} = (P_{ERPA} + P_{DEL})/2 \text{ or } FP_{1,2,n} = 0.5 * P_{ERPA} + 0.5 * P_{DEL}$$

Where

$FP_{1,2,n}$ = Final price applicable to all ERs on a specific delivery date

$1,2,n$ = Each delivery date (i.e., year)

P_{ERPA} = Price prevailing at ERPA signature

P_{DEL} = Price prevailing at delivery

- II. ER prices could be derived using a formula in which 50% of the ER price would be fixed and defined as the prevailing level at ERPA signature, and 50% would be the average between the (same) prevailing price at the ERPA signature and the market price at the time of each subsequent ER delivery. This could be represented as:

$$FP_{1,2,n} = [P_{ERPA} + (P_{ERPA} + P_{DEL})/2]2 \text{ or } FP_{1,2,n} = 0.75 * P_{ERPA} + 0.25 * P_{DEL}$$

Where

$FP_{1,2,n}$ = Final price applicable to all ERs on a specific delivery date

$1,2,n$ = Each delivery date (i.e., year)

P_{ERPA} = Price prevailing at ERPA signature

P_{DEL} = Price prevailing at delivery

Compared to the first formula, the second formula above further reduces the amplitude of variations in the final price paid under an ERPA and provides a higher degree of predictability for both Buyer and Seller Participants as 75% of the final price would be agreed and defined at the ERPA signature (i.e., and would ensure a "buffer" of protection to extreme price variations), while the 25% variable component would still share some of the upside and downside in market prices, following market trends at delivery.

²¹ As already mentioned earlier in this note, prices would reflect market conditions for that type of asset transacted at that specific time.

In both pricing formula examples above the final equation includes a certain percentage component based on price prevailing at ERPA signature and a second (residual) percentage component based on the prevailing market price at delivery. Therefore, if the Partnership Committee would deem it appropriate, a combination between the two percentages components could be established as follows:

$$FP_{1,2,n} = X\% * P_{ERPA} + (100 - X)\% * P_{DEL}$$

Where

$FP_{1,2,n}$ = Final price applicable to all ERs on a specific delivery date

$1,2,n$ = Each delivery date (i.e., year)

P_{ERPA} = Price prevailing at ERPA signature

P_{DEL} = Price prevailing at delivery

X = percentage of ERs priced at P_{ERPA}

In order to safeguard the interests of both the Buyer and the Seller Participants in a reasonable manner in such a Pricing Approach, it would likely be desirable to have established within which bounds X could vary and to include a floor and a ceiling for P_{DEL} .

Illustrative example of a possible pricing approach: A buyer and seller would agree on a reference base price (for example, €10.50 per ER) and agree to share, say 50%, of the price difference at the time that the carbon asset is delivered. For carbon assets delivered in e.g. 2014, should the selected market price for primary market assets be €15.50 at that time, the Seller and Buyer Participants would equally share the €5 upside, and the final price would be €13.00 [= (€10.50 + €15.50)/2]. The buyer would pay €2.5 less than the selected prevailing market price as a compensation for being an early mover. Should the market price be €5.5 at the time of the ER delivery, the final price would be €8 [= (€10.5 + €5.5)/2], limiting the seller's exposure to the down-side risk.

However, if a floor and a ceiling are defined, they would limit the amplitude of price variation during the contract. In the same example as above, if a floor of e.g. €9.00 is agreed to be applicable at any point in the life-time of the ERPA, €9.00 would become the price should the market price be of €5.50 at delivery (instead of €8). Following the same principle, should the market price be of €15.50 at delivery and a ceiling of €12.00 was established, €12.00 will be the actual price (instead of €13). The base price could be derived from the current pricing method used by the World Bank (a risk-based approach), from results of auctions, from a simple agreement between Buyer and Seller Participants, etc.

PART II

THE INSTRUMENT ESTABLISHING THE CPF

*FOR EASE OF REFERENCE, THIS DOCUMENT
IS PROVIDED UNDER A SEPARATE COVER*

PART III

BUYER PARTICIPATION AGREEMENT

*FOR EASE OF REFERENCE, THIS DOCUMENT
IS PROVIDED UNDER A SEPARATE COVER*

PART IV

SELLER PARTICIPATION AGREEMENT

*FOR EASE OF REFERENCE, THIS DOCUMENT
IS PROVIDED UNDER A SEPARATE COVER*

PART V

PARTNERSHIP MEMORANDUM OF UNDERSTANDING

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PART VI

CADF DONOR ADMINISTRATION AGREEMENT

*FOR EASE OF REFERENCE, THIS DOCUMENT
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