Transaction Structuring and Risk Management

A Systematic Pricing Approach

Over the past year, the carbon market has evolved to become a true resource for facilitating climate-friendly projects. Market dynamics have changed as transaction times shortened and overall prices increased. As a result, the World Bank has worked on developing a pricing approach which seeks to achieve three main objectives: assure equitable sharing of benefits between buyers and sellers (i.e. offer project sponsors fair and coherent prices for their emission reductions), improve transparency in the carbon market, and fully commit the resources placed in the Bank's trust by carbon fund participants. The process also ensures credibility from host countries and promotes durability of the emission reductions purchase contracts.

To avoid the risk that the World Bank would follow unilateral and inconsistent trends and to assure the prices chosen reflect global market trends, the Bank will consult with other market players and monitor external transactions and general market conditions.

The prices, which will reflect the risk and benefits profile of the deal, will be constantly reviewed and changed if significant market evolution or price discovery events are observed—for example as a result of surveys, auctions and other methods.

A pricing advisory committee has been established, made up of senior staff from relevant sectors within the World Bank. Members of the committee have a broad range of expertise in areas such as financial markets, risk management, legal issues, and country and project risks, reflecting different aspects of emission reductions purchase agreements. The new pricing approach was cleared by the committee in July 2006.

As part of the pricing approach and responding to market demands, the World Bank is developing comprehensive guidance for upfront payment requests under the emission reductions purchase agreements. The guidance addresses risks and sets up minimum conditions for eligibility and guarantees requested to mitigate the carbon fund participants' incremental risk exposure. It is expected to support World Bank carbon finance operations and help climate-friendly project developers to overcome investment barriers and reduce project commissioning lead-time.

Streamlining Transaction Development

To reduce transaction costs and processing time, the World Bank has standardized the financial due diligence that will identify a project's viability in its earliest stages. This financial tool helps to identify key strengths and weaknesses of a project early in the process and allows for tailored carbon finance solutions and/or quicker decisions on the project's inclusion in the carbon finance portfolio.

Transaction Structuring and Risk Management *continued*

Financial Engineering Securing Underlying Financing

The World Bank has continued to develop specific emission reductions purchase agreements that enable project sponsors to borrow against carbon revenues, while maintaining acceptable terms and appropriate risk allocation. For example, in order to facilitate third-party financing of the Huaycoloro landfill gas project in Peru and allow the project to use its early emission reductions to secure underlying finance, the World Bank agreed to fund project preparation and asset creation costs, while deferring the delivery of the contracted emission reductions by two years after project completion.

Catalysing Climate-Friendly Projects

The World Bank has continued to promote the catalytic role of carbon finance in securing underlying finance for climate-friendly projects in developing countries and countries with economies in transition. These efforts have been leveraged by the World Bank's recent broader efforts to promote renewable energy and energy efficiency projects through the *Investment Framework for Clean Energy and Development* report.

In addition, the Bank has been working with multilateral, bilateral and private financial institutions, to raise awareness of the impact of carbon finance on climate-friendly investment and to encourage lending against carbon revenue streams.