

# Background Information

## RATIONALE

The Community Development Carbon Fund (CDCF) will link small-scale projects with a growing niche market demand for verified emission reductions (ERs) that have the additional attribute of contributing to measurable sustainable development benefits.<sup>1</sup> The ERs generated by small-scale projects in the CDCF portfolio will have a well defined sustainable development component intended to benefit local communities. There is already some evidence that carbon assets similar to those generated by the proposed CDCF are attracting a premium in the carbon market.<sup>2</sup>

Project proposals received by the Prototype Carbon Fund (PCF) and input received from host countries, NGOs, and project developers suggests that there are many small-scale projects seeking carbon finance. Examples include mini-hydro, wind energy, small municipal and agricultural waste projects (with methane emissions), energy efficiency, clean transport, and agroforestry projects eligible under the Kyoto Protocol.

Carbon finance, for the most part, is not reaching these small-scale projects. Small and least developed countries, and poorer, rural communities in all developing countries, where small-scale projects tend to be located, are at a disadvantage when competing for carbon finance. Evidence from the PCF<sup>3</sup> experience, the Pilot Phase of Activities Implemented Jointly (AIJ)<sup>4</sup>, and other pro-

grams indicate that the lion's share of global carbon finance slated for the Clean Development Mechanism (CDM) will likely go to a few, large developing countries with large projects for the following reasons:

- Transaction costs per ton of ERs for small-scale projects are higher than for large projects.
- Investment conditions in many small developing countries and poorer rural areas are unfavorable or risky.

## OBJECTIVES OF THE CDCF

- Reach communities not presently benefiting from development through carbon finance.
- Generate high value ERs with measurable sustainable development attributes that will be potentially creditable against the obligations of Annex B Parties to the Kyoto Protocol as well as other emerging mandatory and voluntary greenhouse gas markets.
- Offer relevant information and support to the UNFCCC Parties as they streamline procedures for small-scale projects.

## BENEFITS TO PARTICIPANTS

Socially responsible businesses, governments, municipalities, emissions brokers, banks, foundations, and NGOs will accrue the following benefits:

- Portfolio diversification and risk management through a stake in several small-scale projects in several countries to meet obligations under emerging carbon management regimes.
- Knowledge about creating differentiated, potentially premium products for a growing socially responsible market.
- For companies, a concrete and visible contribution to their sustainable development and corporate responsibility agendas.
- For emissions brokers and traders, a supply of high value, high quality emission reductions for socially responsible corporate and retail buyers.
- For national, state, and local governments, access to a robust portfolio of high quality ERs to backstop climate change commitments.
- For governments, the ability to leverage private investment to help equitably distribute the benefits of carbon finance and sustainable development.

## BENEFITS TO HOST COUNTRIES AND COMMUNITIES

Countries and communities hosting CDCF projects will benefit from cleaner technologies and sustainable natural resource management practices. Specifically, the CDCF will:

- Open up access to and distribute the benefits of carbon finance to small-scale projects in small countries and rural areas of all developing countries.
- Help build the market for high-quality ERs<sup>5</sup> through projects that alleviate poverty and improve basic services for local communities.
- Encourage local community entrepreneurs, small and medium-enterprises (SMEs), and NGOs to implement sustainable energy and agro-forestry projects.
- Build intermediation capacity to bundle small transactions and use financial innovation to lower market entry barriers and costs.
- Build local capacity to benefit from carbon finance and to attract investment.

## FUND CRITERIA AND QUALITY ASSURANCE

CDCF projects will comply with all relevant CDM procedures in order to be potentially Kyoto Protocol-eligible.

The project portfolio will be developed with the intention that over the lifetime of the Fund:

- Preference will be given to small-scale projects that are compatible with the definition of “small-scale CDM project activities” as defined by the UNFCCC<sup>6</sup>.
- No more than 10 percent of the Fund capital will be committed to projects located in the same country.
- Priority will be given to small island developing states and least developed countries (LDCs) as defined by the United Nations.
- Up to approximately 25 percent of the Fund capital may be committed to small-scale projects in afforestation or reforestation.
- Fund operations will have measurable local and global sustainable development benefits.

Fund resources will support a range of technologies such as renewable energy technologies, energy efficiency improvements, improved waste management, and agroforestry activities eligible under the CDM<sup>7</sup>.

Project selection and review criteria that ensure compli-

ance with Fund objectives will be established in consultation with an Advisory Group of development, climate policy, and corporate social responsibility specialists. Consultations with stakeholders and potential Participants will strengthen portfolio design, project criteria, and quality assurance processes.

Quality will also be enhanced by the application of World Bank Safeguard Policies; professional fund management by the World Bank; guidance from Participants and the Host Country Committee, and review of Fund operations by the Advisory Group. The PCF experience will be particularly valuable in ensuring quality in CDCF operations.

## COSTS AND INDICATIVE PRICES

Small-scale projects may generate ERs at a somewhat higher cost per ton than ERs from larger CDM projects. Not only are the transactions costs higher when spread over small-scale projects, but LDCs and rural areas have higher risks associated with them, raising the cost of capital for such projects.

The CDCF fund management team will strive to narrow the differential between large and small-scale projects by:

- Placing carbon finance through local financial and NGO intermediaries.
- Streamlining and standardizing procedures, such as baseline studies, verification, and using umbrella agreements with host countries.

- Bundling projects and using financial innovation, where possible.
- Mobilizing substantial resources from donors to buy down project preparation and technical assistance costs (see below).

The Executive Board for the CDM is in the process of developing measures designed to reduce the transaction costs of small-scale projects. In addition, LDC projects are exempt from paying two percent of issued certified ERs into an adaptation fund established under the Kyoto Protocol. The CDCF will strive to take advantage of such benefits.

## STRUCTURE, SIZE, AND TERM OF THE FUND

The CDCF will be a multi-donor Trust Fund administered by the World Bank with Participants from both the public and the private sector. Participants will acquire a *pro rata* share of emission reductions from purchase agreements signed with host countries or project sponsors.

The CDCF's initial target capitalization level is US\$100 million, and operations will begin upon achieving a threshold of US\$50 million.

## PARALLEL RESOURCES

Fund management will mobilize resources from donors (governments and foundations) and from Participants for

parallel project preparation and technical assistance resources. These resources will support project identification and preparation, research, capacity building (e.g. of intermediaries), training, and other technical assistance. Participants will be encouraged to transfer their contributions up-front or significantly advance their payment in order to generate investment income to support Fund-related technical assistance.

## ADVISORY GROUP

Along with IETA,<sup>9</sup> the World Bank has co-convened an Advisory Group comprised of internationally recognized sustainable development experts. Each Advisory Group member has public or private sector experience as a leader in promoting sustainable development, and acts in his or her individual capacity.

After the launch of the Fund and during its implementation, the role of the Advisory Group will be to advise management on the directions of the Fund, including adjustments to the project selection criteria.

The Advisory Group will review and advise on overall portfolio development in terms of types of projects and distribution of projects between countries, regions, and technologies.

## ANNEX

- <sup>1</sup> The CDCF concept emerged from informal discussions with a wide range of stakeholders including individuals from host countries, industrial companies and banks, carbon brokers, NGOs, and government agencies.
- <sup>2</sup> The World Bank's carbon finance team regularly consults with carbon market makers, brokers, traders, and companies purchasing ERs to receive updated market and price information.
- <sup>3</sup> See Prototype Carbon Fund, Occasional Papers Series Number 1, October 2, 2000.
- <sup>4</sup> About 60 percent of the total AIJ portfolio was in the industrializing economies of Eastern Europe; in comparison, only one project was completed in Africa.
- <sup>5</sup> These are ERs with a high social and local development component, and hence, it is our intention that in some practical way they are branded as such (*Development + Carbon* or *Carbon with a Human Face*)
- <sup>6</sup> These, as defined in paragraph 6, subparagraph (c) of decision 17/CP.7 on modalities and procedures for a CDM are:
  - a) "Renewable energy project activities with a maximum output capacity equivalent of up to 15 megawatts (or appropriate equivalent);
  - b) Energy efficiency improvement project activities which reduce energy consumption, on the supply and/or demand side, by up to the equivalent of 15 gigawatthours per year;
  - c) Other project activities that both reduce anthropogenic emissions by sources and directly emit less than 15 kilotonnes of carbon dioxide equivalent annually."
- <sup>7</sup> Following any specific post-Marrakech guidance to be provided by the UNFCCC Parties on eligibility and requirements of CDM afforestation and reforestation projects.
- <sup>8</sup> Participants are encouraged to transfer their contributions upfront or to advance their contributions in order to allow the Trustee to use any interest accrued to support research, capacity building, and training activities.
- <sup>9</sup> IETA played an important role in developing the fund concept and the Bank and IETA have agreed to continue their collaboration during the design phase of the Fund. Co-managing the Advisory Group on aspects of design is representative of this collaboration.

*The material contained in this document is intended only to provide a summary of the current state of development of the IBRD's proposed new carbon funds and does not constitute an offer to sell, or an invitation by or on behalf of the fund to purchase an interest in the fund. The document does not represent an obligation of, nor the final position of the World Bank, and should not be relied upon for the purposes of making any decision regarding possible contributions to the proposed new funds. There are legal and other risks involved in participating in the fund, including potential conflicts of interest. Entities considering making financial contribution to the funds should consult their own legal and financial advisors on the risks and other considerations of an involvement in the funds. The statements made in this document are current as of 2 May 2002, unless stated otherwise. The World Bank has no obligation to update the document - updates will occur at the sole discretion of the World Bank and will not necessarily be advised.*