



ADAPTATION FUND

Adaptation Fund Board

**AMENDED AND RESTATED
CER MONETIZATION PROGRAM GUIDELINES
JULY 2013**

I. SCOPE

1. These amended and restated Guidelines apply to monetization of certified emission reductions (CERs) by the International Bank for Reconstruction and Development (the World Bank) as trustee for the Adaptation Fund (the Trustee) for the Adaptation Fund (the AF) (the CER Monetization Program) pursuant to the terms and conditions (the Terms and Conditions) of services to be provided by the Trustee.

II. OBJECTIVES OF THE CER MONETIZATION PROGRAM

2. Through the CER Monetization Program, the Trustee will convert the AF's CERs into cash to support funding decisions by the AF Board. According to Decision 1/CMP.3, paragraph 28, the three objectives of the CER Monetization Program are to:

- Ensure predictable revenue flow for the AF;
- Optimize revenue for the AF while limiting financial risks; and
- Enhance transparency and monetize the share of the proceeds in the most cost-effective and inclusive manner, utilizing appropriate expertise.

3. The three Program objectives are discussed below.

Ensure Predictable Revenue Flow

4. CER Monetization is undertaken in advance of formal approvals of AF programs/projects by the AF Board. This will support the AF Board's decisions about calls for proposals and specific project/program commitments, and ensure cash will be available to fund the initial disbursements for AF programs/projects.

- i) The CER Monetization Program will help to ensure that project and program commitments authorized by the AF Board are made on the basis of liquid assets, consistent with best financial management practice.
- ii) The Trustee will provide the AF Board with information on funds in the AF Trust Fund available to be disbursed for program/project commitments. AF Board authorization of specific projects and programs would then be based on cash levels in the AF Trust Fund. This process will help insulate AF commitments from the uncertainties of the CER market.

Optimize Revenue and Limit Financial Risks

5. An essential objective of the CER Monetization Program is to obtain the market value for the AF's assets.

6. **Sales revenue optimization:** Ideally, the Trustee will carry out CER monetization through an ongoing program of spot sales in highly liquid markets. This will ensure fair and transparent pricing, reduce transaction costs associated with price discovery, and minimize costs and risks coming from insufficient liquidity or settlement processes. It is possible to trade spot on liquid exchanges, which represent the best approximation of an efficient market as long

as the volume of sales is consistent with their capacity. The Trustee may supplement spot sales with the use of futures contracts and OTC sales.

7. **Risk mitigation:** Market risk arising from future movements of CER prices will be managed by spreading transactions over time to smooth price fluctuations. Settlement risk from the potential default by buyers of CERs will be mitigated by the use of delivery-versus-payment settlement mechanisms, either when trading on exchanges or OTC.

Enhance Transparency, Inclusiveness and Cost-Effectiveness

8. The CER Monetization Program should be designed so that the sales processes are transparent, inclusive, and cost-effective.

9. **Transparency and disclosure:** The CER Monetization Program guidelines will be made publicly available. The Trustee will record details of all transactions executed under the Program, either conducted on exchanges or OTC. While full transparency may be difficult to implement and potentially detrimental to best execution in some instances, given the public international nature of the AF and its role under the Kyoto Protocol, the highest level of transparency possible will apply to the implementation of the CER Monetization Program.

10. **Inclusiveness:** The guidelines should allow the broadest range of compliance buyers and participants in emissions trading to participate in the transactions executed under the CER Monetization Program, especially major CER buyers (governments and corporations with Kyoto or EU ETS commitments).

11. **Cost effectiveness:** The most cost-effective approach is trading spot on highly liquid and developed markets in which various transaction costs are minimized. Trading on exchanges represents the approach closest to trading on an efficient market. Nevertheless the Trustee will be responsible for minimizing implied costs (membership, margin calls for future trading, etc.). The direct cost of selling through dealers (payment of fees) will also have to be minimized and balanced against the benefits associated with the sponsorship of the dealer community (broad outreach to investors, market information, etc.).

Six Criteria to Implement the Program Objectives

12. These three objectives are divided into six criteria which have been presented and discussed with the AF Board, and which the CER Monetization Program guidelines aim to satisfy. The six criteria are to:

- Optimize revenues;
- Minimize risks;
- Enhance transparency;
- Be inclusive;
- Be cost effective; and
- Make funding rapidly available.

13. These overall objectives and six related criteria establish the framework for how the CER Monetization Program is structured.

III. RULES GUIDING THE EXECUTION: THREE-TIERED APPROACH

14. It may not be possible to achieve all these criteria at the same time, and in certain circumstances tradeoffs may have to be considered. To help address this, the CER Monetization Program guidelines outline an approach consisting of:

- Ongoing mechanistic sales conducted on liquid carbon exchanges (including auctions);
- Over-the-Counter (“OTC”) sales through dealers in the case of high CER inventory;
- Sales directly to governments and other institutions; and
- Request for guidance from the AF Board under exceptional market circumstances.

15. The Guidelines may be amended or supplemented by decision of the AF Board, with the agreement of the Trustee.

16. See *Table 1* at the end of this Section for an illustration of how the three-tiered approach meets each of the Program’s objectives and corresponding criteria.

Ongoing Mechanistic Sales Conducted on Liquid Carbon-Exchanges

17. The Trustee will follow a mechanistic approach for CER sales executed on exchanges and will not try to time the market or make forecasts as to the direction of CER prices. The approach described below will be driven by the volume of incoming CERs, exchange liquidity and desired inventory levels.

(i) Continuous execution of spot straight sales on liquid exchanges

a) The Trustee will primarily conduct straight spot sales (meaning sales executed spot, according to the way trades are normally executed on the exchange, as opposed to a specific form of auction or any form of customized and out-of-the-ordinary transaction), whenever possible on every trading day on the selected exchange(s). The size and the number of transactions executed on a given day will be determined by the Trustee so as to:

- Maximize, to the extent possible, the volume of CER spot sales conducted on exchanges over the period of the CER Monetization Program.
- Accommodate the liquidity on the exchange and not move or disrupt the market price. To determine the size and number of transactions, the Trustee will rely on indicators made public by exchanges such as the total number of trades per day and the average size of a transaction.
- Spread the sales of CERs over time so as to average CER market prices. At the beginning of each quarter, the Trustee will determine the planned daily sales volume for such quarter based on the amount of CERs issued during the previous quarter and based on the volume of CERs expected to flow into the AF account, with the goal being to spread transactions evenly throughout the upcoming quarter.

- b) The Trustee will keep records of all transactions executed on the selected exchange(s). In particular, the record of daily number, volume and selling price of transactions will be kept as well as the corresponding data applicable to the exchange.
 - c) The Trustee will monitor over time the effective presence and access to the selected exchange(s) of compliance buyers and investors, either directly or through brokers.
 - d) The Trustee will conduct trades on an anonymous basis.
 - e) The Trustee will mitigate settlement risk by using the delivery-versus-payment settlement facility provided by the exchange. The Trustee will interrupt trading whenever and as long as this facility is discontinued.
- (ii) Limited use of futures contracts
- a) Although the Trustee will sell CERs on selected exchanges primarily through spot contracts, the Trustee may use futures to a limited extent. Specifically, the Trustee will sell CERs on exchanges using futures contracts only to: access through the futures contracts a liquidity which is manifestly lacking on the spot contracts in the selected exchange(s); and maintain a presence in futures CER trading to diversify selling channels and maintain a continuous and seamless access to CER markets.
- (iii) The Trustee will determine the maximum amount of sales through futures contracts based on their characteristics and associated costs and risks:
- a) The Trustee will place a limit on selling CERs through futures contract derived from the costs and risks associated with “margin calls” or collateral requirements. Selling futures could entail the transferring of cash, known as “collateral”, or “margin”, to the exchange or the clearing house performing the settlement functions for the exchange. An initial margin deposit, which would be made in cash in the case of the AF, is required whenever a futures position is opened. With market movements, the margin is recalculated over time, resulting in margin adjustments or “margin calls” and the possible provision of additional collateral until the futures contract is closed. While all margin posted is returned at the expiration of the contract, a sharp increase in the price of CERs could entail suddenly raising large amounts of cash to post as collateral.
 - b) The Trustee will set the limit on future trades of CERs in the following way; determine the cumulative size of futures trades so as to cap to a reasonable amount the margin call, not to exceed €20 million, which would result from the strongest possible increase in the CER price. Cash used will be put aside in the Trust Fund cash account. The amount of CERs that should be delivered at expiration will be kept aside as well in the CDM registry account of the AF.

- c) The Trustee will furthermore limit the trading on futures based on the AF's objective of rapid availability of funds. Currently CER futures contracts only have liquidity for December expiration. Therefore, cash proceeds from the sales will not become available until the end of a given year. The Trustee will continuously assess the availability and liquidity of futures contracts with intermediate expiry dates (March, June and September for instance). In determining the maximum amount of futures sales in a given year, the Trustee will incorporate the objective of keeping a cash inventory in the AF Trust Fund cash account commensurate with the expected disbursements of the AF throughout the year.
- (iv) Selection of exchanges based on their strength, reputation and liquidity
 - a) Several exchanges have been established for emissions trading; the largest are ICE/ECX, and the BlueNext environmental exchange. The Trustee will continue to monitor the evolution of the status and offering of the various exchanges in competition in carbon markets according to the criteria used for the initial selection, and will adapt accordingly its selection of exchanges in the future.

OTC Sales

18. OTC transactions will be considered in the following situations:
- i) Over-accumulation in the AF CER account due to high rates of CER issuance by the CDM, temporary suspension of ongoing mechanistic sales, or other reasons.
 - ii) Illiquid markets for certain types of CERs after careful separation of the AF CERs ('green' CERs, CERs generated by large hydros, industrial gas, etc.)
 - iii) To attract potential price or volume advantages for 'green' CERs.
 - iv) To accelerate the availability of cash in response to the need for new project financing expressed by the AF.
 - v) To accelerate the availability of cash for administrative costs associated with the management of the AF Trust Fund.
19. **Execution of an OTC transaction:** The Trustee will determine the size and timing of the OTC trade based on ongoing consultation with dealers involved in carbon markets. The Trustee will select the dealers that will participate in the OTC sale based on an objective process, using the same general criteria that the Trustee uses when selecting dealers for its own capital market operations. In respect of a particular transaction, the Trustee will consult with dealers and seek their advice. The quality of the recommendations applicable to the specific transaction under consideration will be among the criteria the Trustee will use to select the dealers who will participate in the transaction.
20. When executing an OTC sale, the Trustee will verify the distribution of CERs to buyers achieved by the selected carbon dealer. The Trustee will ensure that the distribution meets the requirement of the CER Monetization Program for inclusiveness of all interested CER buyers.

This includes making sure that as many as possible compliance buyers and governments will be made aware of, and given the opportunity to participate in, the OTC sale. While the sale price achieved in an OTC sale may not be directly comparable to prices then prevailing on exchanges, notably because of its larger size making it non-tradable on any existing exchange, the Trustee will monitor the pricing based on a number of public price references.

21. The Trustee will ensure that the settlement processes applicable to OTC transactions are 'Delivery-Versus-Payment (DVP) processes to limit counterparty credit risk for the AF.

Direct Sales to Governments and Institutions

22. While CER sales on exchanges and via OTC transactions will be the principal methods for monetizing Adaptation Fund CERs, direct sales to governments and institutions will be considered in the following situations:

- i) Over-accumulation in the AF CER account due to high rates of CER issuance by the CDM, temporary suspension of ongoing mechanistic sales, or other reasons.
- ii) Illiquid markets for certain types of CERs, after careful separation of the AF CERs ('green' CERs, CERs generated by large hydros, industrial gas, etc.)
- iii) To accelerate the availability of cash in response to the need for new project financing or for administrative costs associated with the management of the AF Trust Fund.
- iv) Governments or institutions express an interest in purchasing CERs, subject to the criteria below.

23. **Execution of direct sales:** Direct sales to governments and institutions would be undertaken only if there is a net benefit to the Adaptation Fund when compared with the alternatives of selling through exchanges or OTC transactions. .

24. Direct sales to national governments and institutions must meet the CMP principle of cost-effectiveness. Under normal circumstances, transaction costs associated with such sales could be high, as sales would require the negotiation and execution of a legal agreement for the sale, incurring legal and other costs both to the Adaptation Fund (through the trustee administrative budget), as well as to the buyer. Such a sale may also require an analysis of any tax, regulatory and other issues related to CER sales to be settled in the buyer's jurisdiction.

25. Thus, direct sales to national governments and institutions would only be undertaken if the buyer agrees to purchase a minimum of 500,000 CERs, subject to review and adjustment by the trustee based on prevailing CER market prices, thereby rendering the costs of the sale comparable to alternative sales methods. The trustee has the right not to proceed with any particular transaction.

26. The Trustee will ensure that the settlement processes applicable to direct sales transactions are DVP processes to limit counterparty credit risk for the AF.

27. Sales to national governments and institutions would be disclosed publicly. The ability to sell Adaptation Fund CERs directly to governments and institutions would be communicated in advance of any sales. The results of any sales, including amounts and average prices would be

reported by the trustee in the quarterly financial reports to the Board; such reports are publicly available on the Adaptation Fund website.

Further Requests for AF Board Guidance

28. If extraordinary events occur that make compliance with the guidelines impracticable or impossible, the Trustee will report to the AF Board and request further guidance from the AF Board. An extraordinary event would include any event that results in extreme movements in prices and/or liquidity of CERs or in carbon markets generally. Such an event could be brought on by global macro-economic conditions, events specific to the CER markets, or a significant governance or economic policy change in the Kyoto Protocol, the UNFCCC or the global institutional framework for climate change.

29. In such event, the Trustee will provide the AF Board with relevant information about the event and its impact on the market and will propose alternative courses of action for consideration by the AF Board. The Trustee will act only upon these AF-Board approved Guidelines, AF Board decisions adopted according to AF Board rules and procedures, or written instruction from the AF Board Authorized Designee¹, in accordance with its Terms and Conditions.

30. The Trustee will suspend spot sale transactions under the CER Monetization Program if the CER market infrastructure becomes impaired. If the market infrastructure remains disrupted over an extended period, the Trustee will seek guidance from the AF Board. The Trustee will then present specific short-term funding options based on then-existing market conditions and limitations.

Settlement

31. **Settlement of a CER transaction:** The Trustee may settle trades directly, or rely on a bank to perform settlement functions (the "Settlement Agent") as follows:

- i) The Trustee will close a selling transaction with an eligible counterparty, either on an exchange or OTC. In the case of a spot transaction, on the settlement date, the trustee (or Settlement Agent) will then ensure that the CERs are delivered to the buyer while the payment in cash is received by the trustee for credit to the AF Trust Fund. The trustee will endeavor to use the DVP framework of an exchange, whereby confirmation of payment is received prior to delivery of the CERs. In case it is not possible on the exchange, the trustee will seek to settle outside the exchange on a DVP basis. Based on instructions from the trustee, the CERs sold will be transferred from the AF account in the CDM registry to the trustee's account in the registry used for settlement, and then to the clearing house. The buyer's cash payment will be transferred from the buyer's account to the clearing house, and then to the AF Trust Fund cash account. The cash proceeds from the monetization will then be held in the AF Trust Fund.

32. **Selection of a Settlement Agent:** If the Trustee uses a Settlement Agent the selection of the Settlement Agent will be in a transparent manner following the procurement guidelines of the World Bank. Only firms that have experience in carbon trading and a strong settlement department will be considered for the role of Settlement Agent.

¹ The Chair of the Adaptation Fund Board or authorized designee

Summary

TABLE 1

	Optimization of Revenues	Minimization of Risk	Transparency	Inclusiveness	Cost Effectiveness	Funding Availability
Start of Monetization	After Connection	After Connection	After Connection	After Connection	After Connection	Before Connection
Ongoing Straight Sales on exchanges	Price efficiency in developed Market	Spot transactions, averaging of prices, DVP settlement	Liquidity and price transparency in large and developed exchanges	Large fraction of compliance buyers, either directly or through brokers trade on selected exchanges	Trading on exchange avoids dealer's fee. Cost of exchange membership	Spot transactions make funding immediately available (approx. 1 wk)
OTC sales through dealers based on criteria	Efficient distribution and price discovery by dealers. Pricing checked by Trustee	DVP settlement applies. Dealers provide information on market price evolution and best timing	The Trustee checks the pricing with public prices (exchanges or brokers). The Trustee has access to the order book of the dealer(s)	The dealer is requested to distribute broadly to all compliance buyers	Dealer's fee controlled by competitive selection process of dealer(s)	Immediate and large funding availability
Direct Sales to Governments and Institutions	Price would be at minimum of the average bid-ask spread	DVP	All sales would be publicly disclosed in the trustee's financial status reports to the AF Board	Any government would be eligible to purchase CERs; institutions may be subject to prior due diligence by the trustee	Minimum purchase of CERs would be required to ensure at least comparable cost to other sales methods	Depends on the number of countries and institutions likely to avail of this option

IV. REPORTING

33. On a quarterly basis, the Trustee will provide the AF Board with a report on its activities undertaken under the CER Monetization Program.

34. The report will communicate the details of the trading activity in CER markets undertaken by the trustee on behalf of the AF. In such quarterly reports, the following information will be provided:

- Tonnage of CERs held by the AF CER account at the beginning and at the end of the period;
- Volume of new CERs tonnage entering the account of the AF in the CDM registry during the quarter; total volume of CERs having entered the AF CER account with the CDM registry since inception;

- Volume of sales of CERs executed during the quarter, and since the beginning of the calendar year; these volume of sales will be broken down into three categories: 1) spot sales on exchanges, 2) futures sales on exchanges, 3) OTC sales, and 4) sales to governments.
- Revenues in cash associated with the sales of CERs (in Euros and in US dollars) during the quarter, and since the beginning of the calendar year; these revenues will be broken down into four categories: 1) spot sales on exchanges, 2) futures sales on exchanges, OTC sales, and 4) sales to governments.
- Average sales price per ton sold (in Euros and in US dollars) during the quarter, and since the beginning of the year for CERs sold either spot or futures on exchanges, OTC, or to governments;
- For futures trades, the tonnage of CERs to be delivered at various maturities in the future (for instance the December maturity of the year under review) and the cash amount to be received (in Euros or in US dollars) at the expiration of the contracts. The report will indicate the value placed or received as collateral, the average at the beginning and at the end of the period.

35. In a highly volatile market, the Trustee will report on a more ad-hoc basis.