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**GUIDELINES FOR THE MONETIZATION OF  
CARBON ASSETS  
(DOCUMENT AFB/EFC.16/3)**



ADAPTATION FUND

AFB/EFC.16/3  
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Ethics and Finance Committee  
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## **NEW GUIDELINES FOR THE MONETIZATION OF CARBON ASSETS**

**New Adaptation Fund Carbon Assets Monetization Program Guidelines (prepared by the trustee)**

**Background**

1. Monetization of Adaptation Fund CERs is currently governed by the CER Monetization Guidelines, approved by the Adaptation Fund Board. These Guidelines have been amended over time (most recently in June 2012) to reflect various decisions by the Adaptation Fund Board, and developments in carbon markets.
2. With the decision of the Adaptation Fund Board to request the interim trustee to monetize other carbon assets for the Adaptation Fund, in addition to CERs, the trustee and the CMP have amended the Terms and Conditions of Service of the trustee by CMP Decision (1/CMP.10) and subsequent adoption by the World Bank's Board of Directors. In addition, amendments to the Adaptation Fund's current CER Monetization Guidelines will be required, to incorporate the monetization of other carbon assets to be added to the Adaptation Fund Share of Proceeds (specifically AAUs and ERUs).
3. The trustee therefore recommends that the current CER Monetization Guidelines be replaced with the attached Carbon Assets Monetization Program Guidelines, which incorporate these most recent developments.

**Decision Requested**

4. The Adaptation Fund Board is hereby requested to approve the attached Carbon Assets Monetization Program Guidelines. Upon approval by the Board, these Guidelines would replace the current CER Monetization Guidelines.

## **CARBON ASSETS MONETIZATION PROGRAM GUIDELINES**

### **APRIL 2015**

#### **I. SCOPE**

1. These Guidelines apply to monetization of certified emission reductions (CERs), assigned amount units (AAUs), and emission reduction units (ERUs) (collectively, Carbon Assets) 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 Carbon Assets Monetization Program) pursuant to the terms and conditions (the Terms and Conditions) of services to be provided by the Trustee. These Guidelines supersede the Adaptation Fund Amended and Restated CER Monetization Guidelines (June 2012)<sup>1</sup>.

#### **II. OBJECTIVES OF THE MONETIZATION PROGRAM**

2. Through the Carbon Assets Monetization Program, the Trustee will convert the AF's Carbon Assets 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. These three Program objectives apply to the Carbon Assets Monetization Program and are discussed below.

##### **A. Ensure Predictable Revenue Flow**

4. The CMP, in subsequent decisions, noted concern regarding the predictability of funding for the AF based on uncertainty regarding the market prices of CERs that were outside the control of the AF or the Trustee. Carbon Assets Monetization will continue to be undertaken in advance of formal approvals of AF programs/projects by the AF Board. This 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. For this purpose, the Trustee will provide the AF Board, through the Secretariat, with information on funds in the AF Trust Fund available to be transferred for program/project commitments. AF Board approvals 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 Carbon Asset markets.

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<sup>1</sup> As approved by Decision AFB 18/37

## B. Optimize Revenue and Limit Financial Risks

5. An essential objective of the Carbon Assets Monetization Program is to obtain at least the prevailing market value for the AF's assets.

6. **Sales revenue optimization:** Ideally, the Trustee will carry out Carbon Assets 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. Trading at the spot prices on liquid exchanges represent the best approximation of an efficient market as long as the volume of sales is consistent with their capacity. With developments in the carbon markets, this may not always be possible, therefore the Trustee may supplement spot sales with the use of futures contracts, direct or "Over the Counter" (OTC) sales.

7. **Risk mitigation:** Market risk arising from movements in Carbon Assets prices will be managed by spreading transactions over time to smooth the impacts of price fluctuations on proceeds from monetization when market conditions allow. Settlement risk from the potential default by buyers of Carbon Assets will be mitigated by the use of delivery-versus-payment settlement mechanisms, either when trading on exchanges, OTC, or other means.

## C. Enhance Transparency, Inclusiveness and Cost-Effectiveness

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

9. **Transparency and disclosure:** The Carbon Assets 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 Carbon Assets 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 Carbon Assets Monetization Program, especially major Carbon Asset 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, but may not always be possible in difficult market conditions. The Trustee will make best efforts

to minimize transactions costs, and balance them against the benefits associated with specific transactions.

#### **D. 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 Carbon Assets 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 Carbon Assets Monetization Program is structured.

### **III. RULES GUIDING 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 Carbon Assets Monetization Program guidelines outline an approach consisting of:

- Ongoing mechanistic sales conducted on liquid carbon exchanges (including auctions);
- Over-the-Counter (“OTC”) sales through brokers or dealers ;
- Sales directly to governments or other institutions;
- Sales using other methods (e.g. on-line and other platforms under development by the UNFCCC Secretariat); and
- Request for guidance from the AF Board under exceptional market circumstances, or with respect to other approaches.

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.

#### **A. Ongoing Mechanistic Sales Conducted on Liquid Carbon-Exchanges**

17. The Trustee will follow a mechanistic approach for Carbon Assets sales executed on exchanges and will not try to time the market or make forecasts as to the direction of

Carbon Asset prices. The approach described below will be driven by the volume of Carbon Assets available to monetize, 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 Carbon Assets spot sales conducted on exchanges over the period of the Carbon Assets 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 sales of Carbon Assets over time so as to achieve average Carbon Assets market prices.
  - 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 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 Carbon Assets on selected exchanges primarily through spot contracts, the Trustee may use futures to a limited extent. Specifically, the Trustee will sell Carbon Assets 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 Carbon Assets trading to diversify selling channels and maintain a continuous and seamless access to Carbon Assets 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 Carbon Assets 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 Carbon Assets could entail suddenly raising large amounts of cash to post as collateral.
  - b) The Trustee will set the limit on future trades of Carbon Assets 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 available cash balance allocated by the AF Board to cover potential margin call, which would result from the increase in the Carbon Asset price. Cash used will be put aside in the Trust Fund cash account. The amount of Carbon Assets 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. For instance, 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) The Trustee will continue to monitor the evolution of the status of various exchanges 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.

## **B. OTC Sales to dealer banks/market makers**

18. OTC transactions will be considered in the following situations:
- i) Over-accumulation in the AF Carbon Assets account due to high rates of Carbon Assets issuance by the CDM, temporary suspension of ongoing mechanistic sales, or other reasons.
  - ii) Illiquid markets for certain types of Carbon Assets after careful separation of the AF Carbon Assets (e.g. 'green' CERs, CERs generated by large hydros, industrial gas, etc.)
  - iii) To attract potential price or volume advantages for bespoke CERs or other Carbon Assets.
  - 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 dealer banks/market makers involved in carbon markets. The Trustee will select the dealers/market makers 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.
20. 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.

## **C. Direct Sales to Governments or other institutions**

21. While sales on exchanges and via OTC transactions will be the principal methods for monetizing Adaptation Fund Carbon Assets, direct sales to governments or other institutions will be considered in the following situations:
- i) Over-accumulation in the AF Carbon Assets account due to high rates of Carbon Assets issuance by the CDM, temporary suspension of ongoing mechanistic sales, or other reasons.

- ii) Illiquid markets for certain types of Carbon Assets, after careful separation of the AF Carbon Assets.
  - 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 other institutions express an interest in purchasing Carbon Assets, subject to the criteria below.
22. **Execution of direct sales:** Direct sales to governments or other 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. The benefit would be identified either as: i) a price premium, net of transactions costs, when compared with alternative approaches, and/or ii) a higher volume of sales than would otherwise be possible through exchanges or OTCs. The Trustee will review eligibility of institutions that will participate in direct sales based on an objective process, using the same general criteria used by the Trustee when selecting counterparties for its own capital market operations.
23. Direct sales to national governments or other institutions must meet the CMP principle of cost-effectiveness. Under certain circumstances, transaction costs associated with such sales may be high, as sales to national governments and other institutions 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 related issues.
24. The Trustee will ensure that the settlement processes applicable to direct sales transactions are DVP processes to limit counterparty credit risk for the AF.
25. The results of any direct 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.

#### **D. Sales Using Other Methods.**

26. If a new sales method is identified by the Trustee, the Trustee will work with the appropriate parties, if applicable, to develop a formal proposal for submission to the AF Board in advance.

#### **E. Further Requests for AF Board Guidance**

27. 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 Carbon Assets in carbon markets generally. Such an event could be brought on by global macro-economic conditions, events specific to the Carbon Assets markets, or a significant governance or economic policy change in the Kyoto Protocol, the UNFCCC or the global institutional framework for climate change.

28. 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 Designee<sup>2</sup>, in accordance with its Terms and Conditions.

29. The Trustee will suspend spot sale transactions under the Carbon Assets Monetization Program if the Carbon Assets 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.

## **F. Settlement**

30. **Settlement of Carbon Assets transactions:** 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 Carbon Assets 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 Carbon Assets. 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 Carbon Assets 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.

31. **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.

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<sup>2</sup> The Chair of the Adaptation Fund Board or authorized designee

## G. Summary

TABLE 1

	<b>Optimization of Revenues</b>	<b>Minimization of Risk</b>	<b>Transparency</b>	<b>Inclusiveness</b>	<b>Cost Effectiveness</b>	<b>Funding Availability</b>
<b>Start of Monetization</b>	After Connection	After Connection	After Connection	After Connection	After Connection	Before Connection
<b>Ongoing Straight Sales on exchanges</b>	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	Immediate in the case of spot; delayed payment in the case of long dated futures
<b>OTC sales through dealers based on criteria</b>	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
<b>Direct Sales to Governments or other institutions</b>	Price would be at minimum of the average bid-ask prices	DVP	All sales would be publicly disclosed in the trustee's financial status reports to the AF Board	Any purchaser would be eligible, subject to Trustee policies and procedures	Only when such trades present net benefit to AF	Immediate
<b>Other sales methods (e.g. on-line sales)</b>	Price would be at minimum of the average bid-ask prices	DVP	All sales would be publicly disclosed in the trustee's financial status reports to the AF Board	Any purchaser or intermediate would be eligible, subject to Trustee policies and procedures	Only when such trades present net benefit to AF	Immediate

#### IV. REPORTING

32. On a quarterly basis, or as otherwise agreed with the AF Board, the Trustee will provide the AF Board with a report on its activities undertaken under the Carbon Assets Monetization Program.

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

- Total of each Carbon Asset held by the AF Carbon Assets accounts at the beginning and at the end of the period;
- Volume of new Carbon Assets entering the accounts of the AF in the CDM registry during the quarter; total volume of Carbon Assets entered the AF Carbon Assets accounts with the CDM registry since inception;
- Volume of sales of each Carbon Assets 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, 4) sales to governments and other institutions, and 5) other.
- Revenues in cash associated with the sales of each Carbon Asset (in US dollars) during the quarter, and since the beginning of the calendar year; these revenues will be broken down into sales categories: 1) spot sales on exchanges, 2) futures sales on exchanges, OTC sales, 4) sales to governments and other institutions, and 5) other.
- Average sales price per ton sold (in Euros or in US dollars) during the quarter, and since the beginning of the year for each Carbon Asset sold;
- For futures trades, the amount of each Carbon Asset 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.

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