



The World Bank

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President

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MEMORANDUM TO THE EXECUTIVE DIRECTORS
Proposed Amendment to the Instrument Establishing the BioCarbon Fund

1. Introduction

I submit for approval a proposal to amend the Instrument Establishing the BioCarbon Fund (“Instrument”) in order to allow the BioCarbon Fund (“BioCF”) to accept contributions exceeding US\$ 200 million.

The Executive Directors approved the establishment of the Fund through Resolution No. 2003-0006 (R2003-0163 approved on September 11, 2003), and the Executive Directors authorized Management to open the Fund for subscription following the date of this Resolution.

The BioCF is a World Bank administered public-private trust fund designed to provide the Bank’s Borrower Member Countries with an opportunity to benefit from carbon finance dedicated to land use projects. The capitalization of the BioCF is currently US\$83 million. The Fund has supported over 20 projects around the world which sequester carbon in forest and agro-ecosystems, ameliorating the local environment and improving rural livelihoods. The BioCF purchases so-called “carbon credits” from these projects on behalf of its public and private sector Participants.

In November 2013, a new Tranche of the BioCF was launched at the Warsaw Climate Change Conference. Tranche 3 aims to leverage the existing BioCF experience to incentivize better land management at a much larger scale, in order to mitigate climate change and increase the resilience of local communities and environments. US\$280 million was jointly pledged by Norway, the United Kingdom, and the United States. If Tranche 3 of the BioCF were to accept this amount, the total contributions to the Fund would exceed US\$200 million.

2. Reasons for the proposal to amend the Instrument

The US\$ 200 million limit was introduced in the BioCF Instrument in 2003 as an exit strategy to prevent the Fund from crowding out other players in the carbon market, which was expected to experience an upturn in the future. The overall carbon market has recently plummeted and is experiencing negligible activity. In particular, the activities envisaged under Tranche 3 of the BioCF are unique and the World Bank is currently the only market player that possesses the capacity to pilot these innovative carbon products at the necessary scale and to create the enabling environment for private sector participation. For these reasons, this contribution limit is no longer relevant.

3. Recommendation

I therefore recommend that the Executive Directors approve the amendment to the Instrument.

Jim Yong Kim
President

Sri Mulyani Indrawati
Managing Director

Annex I -

1. More Background on the BioCF and its Instrument

The Executive Directors approved the establishment of the Fund as described in the President's Memorandum entitled "Proposal to Establish a BioCarbon Fund" (R2003-0163, dated August 26, 2003). The Instrument was attached to Resolution No. 2003-0006 as its Annex I.

Section 4.1(c) of the Instrument currently provides that:

"If at any time, the total Contributions to the Fund meet or exceed US\$200 Million, the Fund Manager must seek approval of the Board of Executive Directors prior to accepting any additional Contributions from new or existing Participants."

At the time, it was customary to set a capitalization target for new Carbon Fund initiatives. A similar contribution limit can be found in Section 8.1(d) of the Instrument Establishing the Prototype Carbon Fund (US\$180 million) and Section 4.1(c) of the Instrument Establishing the Community Development Carbon Fund (US\$500 million), which became operational in 2000 and 2003 respectively.

Tranche 1 of the BioCF became operational in 2004 with a capitalization of US\$53.8 Million, committed by a number of public and private sector contributors ("Participants"). Due to continued demand, Tranche 2 was launched in 2007 with a capitalization of US\$29.5 million. The BioCF Participants are comprised of six governments and 11 private companies, who mostly use the carbon credits purchased by the Fund for compliance with their climate change mitigation targets. Tranches 1 and 2 are closed to projects and new financing.

The BioCF is a pioneer in its field and its work has led to a valuable body of experience that has informed and built the capacity of the land use carbon market. The Fund undertakes activities such as reforestation on degraded lands, providing incentives to keep forest standing and to slow down degradation, and improving agriculture practices to increase yields. Although results are assessed in tons of carbon dioxide sequestered or shown to have been saved from release to the atmosphere, there are two significant benefits associated with land use activities: i) the improved and sustainable productivity of the land has shown to further improve the local environment increasing resilience to climate impacts and ii) the improved productivity leads to an increase in local incomes and improved livelihoods. The co-benefits of land use projects are documented in: <http://go.worldbank.org/9CTEJSIP50>.

In November 2013, Tranche 3 of the BioCF (Initiative for Sustainable Forest Landscapes ("ISFL")) was launched at the Warsaw Climate Change Conference, which served as the nineteenth session of the Conference of the Parties ("COP 19") to the United Nations Framework Convention on Climate Change ("UNFCCC") and the ninth session of the Meeting of the Parties ("CMP 9") to the Kyoto Protocol.

2. Reasons for the proposal to amend the Instrument

The reasons the US\$200 million limit is no longer relevant is due to the change of the carbon market environment and the innovative activities envisaged under Tranche 3 of the BioCF, for which the World Bank is currently the only market player that possesses the capacity to pilot these. These reasons are elaborated further below:

a) Change of Carbon Market Environment

Since the establishment of the Prototype Carbon Fund – the first carbon fund worldwide – in 2000, the World Bank played a key catalytic role in the establishment of the carbon market. The overall market for

the Kyoto Protocol project-based mechanisms grew from exploratory transactions, limited in number, in the early 2000s to a much larger volume of transactions from 2005 onwards, with the entry into force of the Kyoto Protocol and the official start of operations in the European Union Emissions Trading Scheme (“EU-ETS”). Over the years, the World Bank created a whole family of carbon funds and facilities – capitalized at more than US\$3.5 billion – designed to facilitate access to these mechanisms by its borrowing countries, reduce risks, and extend the reach of carbon finance into diverse niches in the market. Rather than crowding out the market, the World Bank took the necessary early risks and drove the innovation needed for other market players to come in. It created the global public goods and needed infrastructure for the market to operate. After the market started to grow in 2005, the World Bank’s share of market transactions decreased from 39% to 5% – and it kept decreasing thereafter. At the height of the carbon market in 2007, project-based transactions peaked at US\$7.9 billion in a single year, but the share of World Bank transactions only amounted to 3% or US\$237 million.

Following the economic downturn in 2008–2009 and slow economic recovery in major economies, industrial output plummeted, leading to a fall in demand for carbon assets used for compliance. Moreover, the first commitment period of the Kyoto Protocol ended in 2012 and its second commitment period did not result in any additional emission reductions commitments – and thus there was no further demand for carbon assets. For these reasons, the carbon market is only experiencing negligible activity at present. Despite the earlier success of the overall market, the carbon market for land use activities – which the BioCF caters to – never really took off mainly because carbon assets from these activities were classified as “temporary” and had to be replaced with permanent credits after expiration. As a result, these assets were not attractive for the private sector and were also not allowed in the EU-ETS (the largest regional carbon market). However, since land use activities support an area of particular importance to the rural poor and to poor countries with small industrial and energy sectors, the BioCF filled the void by supporting these activities and establishing an enabling environment to encourage private sector participation. Considering the absence of a market for land use activities, there was (and still is) no risk that the BioCF will crowd out other market players. Rather, the BioCF has played a critical role creating and sustaining this small but important market niche.

b) Activities Envisaged under the ISFL (Tranche 3 of the BioCF)

Through consultations during the design phase of the new initiative it became clear that given the state of the carbon market the private sector was not interested in purchasing any carbon assets from land management activities. However, due to a strong interest from a number of donor governments to continue developing this unrepresented sector of the carbon market, the ISFL was created. This initiative is expected to pilot innovative approaches, build the necessary capacity, and develop an enabling environment for land management at the landscape level so that these activities can benefit from the carbon market as soon as it recovers. It also aims to engage and leverage the private sector where there are synergies with their core business; for example, by appealing to their interest of adopting sustainable land use practices to secure long term supply chains and reduce their investment risk.

The World Bank is the only player that has the capacity to drive this innovation. In order to do this, scaling up to larger levels of fund capital is needed. The Bank will continue to lead by innovation and bridge the gap before new climate negotiations fuel renewed demand for land use credits; the latter is not expected till after 2020 when an international climate agreement may be reached. While Tranches 1 and 2 of the BioCF committed US\$83.3 million to over 20 projects, Tranche 3 is expected to commit US\$280 million to up to four programs. Tranche 3 will close by December 2030.