

**FINANCING THE ANSWER TO CLIMATE CHANGE:  
CHALLENGING BUT FEASIBLE**



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**FINANCING THE ANSWER TO CLIMATE CHANGE:  
CHALLENGING BUT FEASIBLE**

CLÉMENTINE D'OULTREMONT



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## INTRODUCTION

An agreement on climate finance is crucial to ensure an equitable approach between developed and developing countries in the fight against climate change. Given their economic capabilities and their historical responsibility for global warming, developed countries are expected to bear the majority of the costs associated with global climate action. The Cancun Agreements formalise a commitment by developed countries to jointly provide USD 30 billion for the period between 2010 and 2012 and USD 100 billion annually by 2020 for developing countries. This funding will be balanced between adaptation and mitigation and is destined primarily for the most vulnerable developing countries. The objective is to help developing countries adapt to the adverse impacts of climate change and to undertake mitigation actions so as to bring them towards a low-carbon economy.

This report addresses the following question: How is it possible to secure a framework for mobilising, managing and delivering financing on the necessary scale? Without a credible framework, the risk remains that developing countries' actions to tackle climate change will be insufficient, inefficient, inadequate and delayed. The global costs would thereby increase and the path towards a low-carbon future would be jeopardized.

With regard to mobilisation, the report of the High Level Advisory Group on Climate Change Financing – mandated by the UN Secretary-General to study the contribution of potential sources of revenue towards meeting the USD 100 billion per year by 2020 – has concluded that this goal is challenging but feasible.<sup>1</sup> The Cancun Agreements stipulate that the money will come from various sources, public and private, multilateral and bilateral, including alternative sources. However, how developed countries will raise new and additional funds to close the gap in finances to attain the USD 100 billion per year is unclear, especially in a period of economic and financial crisis. While a lot of innovative ways of financing climate change exist, the debate is highly political and raises very contentious questions.

As for the management of climate finance, the Cancun Agreements establish a Green Climate Fund (GCF) to help developing countries finance the fight against climate change in the long-term. However, many questions require further clarification about the design of the GCF and the way it will interact with

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1. Report of the Secretary-General's High-Level Advisory Group on Climate Change Financing, 5 November 2010, [http://www.un.org/wcm/webdav/site/climatechange/shared/Documents/AGF\\_reports/AGF\\_Final\\_Report.pdf](http://www.un.org/wcm/webdav/site/climatechange/shared/Documents/AGF_reports/AGF_Final_Report.pdf)

the intricate network of existing funds. In order to improve the effectiveness of the administration of international climate finance over time, transparency and accountability will need to be enhanced.

The final step – the delivery – is fundamental when assessing the effectiveness, efficiency and fairness of climate finance. Yet, many questions remained unanswered; how can we ensure direct access to funding for developing countries? How can we reach a fairer distribution of funds between developing countries, as well as between mitigation and adaptation? How can the money be made available in a timely manner? And, what modalities of payment should be used?

The paper is organised as follows. Section 1 considers what is required in terms of climate finance to tackle climate change. Section 2, 3 and 4 respectively analyse the issues linked to the mobilisation, administration and delivery of climate financing. Section 5 briefly examines the EU's fast start financing and long-term financing in light of what has been said regarding the mobilisation, administration and delivery of funds. Finally, the conclusion outlines some key insights on how an effective mobilisation, administration and delivery of climate financing could be reached over time.

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# 1. WHAT IS NEEDED?

Tackling climate change will require substantial financial and investment flows to support mitigation and adaptation activities in developing countries. Overcoming this challenge will largely depend on the rapidity and the efficiency of the global response. As stated by the Stern Report, the benefits of strong and early action far outweigh the economic costs of failing to act.

## 1.1. Estimating global needs for mitigation and adaptation

In order to limit the rise in global temperature to no more than 2°C, significant abatement of emissions will be needed from both developed and developing countries. Developing countries will be able to reach some emissions reductions at negative costs, particularly through improved energy efficiency. However, the major part of abatement will incur additional costs. This share should be taken on by developed countries on the basis of the “agreed incremental cost”.<sup>2</sup> The incremental cost is the additional cost incurred when undertaking a climate-friendly action, compared to the economic cost of the activity in a business-as-usual scenario.

Estimating the incremental costs of mitigation and adaptation actions in developing countries is very difficult. Currently, the main method available is a global top-down approach.<sup>3</sup> When one looks at the largely different figures coming from diverse evaluations, it is clear that this method is far from conclusive (see Table 1 and 2). In order to have appropriate estimates, regional or national bottom-up assessments are needed. These assessments should be based on policy choices in accordance with specific needs. Whereas the majority of countries are currently discussing which climate policies are the most effective, a substantial part of these assessments are still sorely missing.

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2. Project Catalyst, “Financial Architecture”, Project Catalyst Brief, August 2010, [http://www.project-catalyst.info/images/publications/100825\\_project\\_catalyst\\_financial\\_architecture\\_aug25\\_final.pdf](http://www.project-catalyst.info/images/publications/100825_project_catalyst_financial_architecture_aug25_final.pdf)

3. N. BIRD and J. BROWN, “International Climate finance: Principles for European Support to Developing Countries”, EDC2020 Working Paper, March 2010, p. 4, [http://www.edc2020.eu/fileadmin/publications/EDC\\_2020\\_Working\\_Paper\\_No\\_6.pdf](http://www.edc2020.eu/fileadmin/publications/EDC_2020_Working_Paper_No_6.pdf)

### 1.1.1. Mitigation

Steering the global economy in a low-carbon direction requires increasingly important investment and financial flows to reduce GHG emissions, particularly in energy supply, industry, buildings, transportation, waste, agriculture, forestry, research and development (R&D) and deployment of climate-friendly technologies.

Investment and financial flows for reducing GHG emissions in developing countries are expected to be particularly cost-effective. While only 46% of the total funds needed should be directed towards developing countries by 2030, it is estimated that two-thirds (68%) of the global emission reduction potential will be achieved in these countries.<sup>4</sup>

It is worth noting that more than half of the developing countries' mitigation potential is in forestry.<sup>5</sup> Financing the reduction of emissions from deforestation and forest degradation (REDD+) requires far less resources than investing in new low-carbon technologies. It is thus a cost-effective means for large emissions reductions in the short and medium term.

According to the various estimates given in table 1, the incremental costs required to mitigate climate change in developing countries could range from USD 92 to USD 175 billion per year by 2030.

**Table 1: Estimating incremental mitigation costs**

Sources of estimate (\$bn per annum)	2010-2020	2020	2030	Assumptions
European Commission (2009)		118		In 2005 prices (\$1.25 to €1 exchange rate, total net additional ("incremental") costs, assuming successful agreement -30% reduction for developed countries by 2020 compared to 1990, and NAMAs by developing countries.
McKinsey & Co (2009)	81-113		175	In 2005 prices, includes tech R&D
Pacific Northwest National Lab (2008)			139	Taken from World Bank World development Report (2010)
UNFCCC (2007)			92-97	In 2005 prices
Project Catalyst (2009)	69-100			In 2005 prices, 450 ppm stabilisation case
G77 + China (2009)		200-400		Estimate includes both Adaptation and Mitigation. Proposed at: 0.5% to 1% of GNP of Annex II Parties
African Group (2009)		200		0.5% of GDP of Annex II Parties

Source: Climate Funds update, available on: <http://www.climatefundsupdate.org/resources/estimated-costs-climate-change>

4. UNFCCC, "Investment and Financial Flows to Address Climate Change", October 2007, available on: [http://unfccc.int/cooperation\\_and\\_support/financial\\_mechanism/items/4053.php](http://unfccc.int/cooperation_and_support/financial_mechanism/items/4053.php)

5. Global Canopy Programme, "The Little Climate Finance Book – A guide to financing options for forests and climate change", 2009, p.22, available on <http://www.odi.org.uk/resources/download/4619.pdf>

In the short to medium term, international public funding and other official flows will be paramount for capacity building, R&D, deployment of new technologies, correcting market imperfections and leveraging private finance in developing countries. However, the main sources of finance to support investment in mitigation activities in the long-term will come from the private sector, in particular via market-based mechanisms. To date, the Clean Development Mechanism (CDM) has been the main source of mitigation finance for developing countries. It allows both governments and the private sector from developed countries to fulfil part of their climate obligations by investing in emission-reduction projects in developing countries. Section 2.1.2 will further analyse the CDM; the several design and operational shortcomings as well as the improvements that should be made in the future.

According to the International Panel on Climate Change (IPCC) in 2007, future energy infrastructure investments are expected to total over USD 20 trillion between 2007 and 2030. A large portion of these investments will be made in developing countries. As the lifetime of these infrastructures generally lasts thirty years or more, these large investments must be directed towards climate-friendly technologies. This will ensure we are not trapped in a high-carbon global economy. Failure to act now will have a long-term impact on greenhouse gas emissions, increasing both mitigation and adaptation costs.

### *1.1.2. Adaptation*

At the UN Summit in December 2010, adaptation has been given as much priority as mitigation. Adverse effects from atmospheric warming have already occurred in a number of countries and will continue in the years ahead even under the most optimistic scenarios. Actions involving significant adaptation measures will be required in many sectors, such as water supply, agriculture, forestry, health care, beach nourishment and new infrastructure.

The incremental costs required for adaptation in developing countries are even harder to estimate than those required for mitigation. Actions surrounding climate adaptation are widespread and diverse. They are also often directly linked to support for sustainable development, making it particularly difficult to identify their incremental costs relative to a development as usual scenario.<sup>6</sup> Furthermore, estimates on the level of damage incurred from climate change will also vary depending on our ability to act on mitigation in the long-term.

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6. J. BROWN and N. KAUR, "Financing adaptation: matching form with function", Overseas Development Institute, Background Paper, December 2009, <http://www.odi.org.uk/resources/details.asp?id=4184&title=climate-change-finance-adaptation-background-note>

The estimates of the incremental costs of adaptation in developing countries by 2030 are thus very assorted. While the UNFCCC estimates they could range from USD 28 to USD 67 billion per year<sup>7</sup>, the World Bank considers they could range from USD 70 to USD 100 billion per year.<sup>8</sup> As for the International Institute for Environment and Development (IIED), adaptation costs by 2030 are estimated to 2 to 3 times higher than UNFCCC figures.<sup>9</sup> Therefore, more regional and sector based assessments on the incremental costs of adaptation are needed to support effective global action against the adverse effects of climate change.

**Table 2: Estimating incremental adaptation costs**

Sources of estimate (\$bn per annum)	2010-2015	2020	2030	Assumptions
European Commission (2009)		13-30		In 2005 prices (\$1.25 to €1 exchange rate, total net additional (“incremental”) costs, assuming successful agreement -30% reduction for developed countries by 2020 compared to 1990, and NAMAs by developing countries.
World Bank (2006)	9-41			450 ppm stabilisation case
Stern Review (2006)	4-37			450 ppm stabilisation case
UNDP HDR (2007)	83-105			450 ppm stabilisation case
UNFCCC (2007)			28-67	450 ppm stabilisation case
World Bank EACC (2010)			70-100	In 2005 prices, average annual costs between 2010-2050. Additional public sector costs, not costs incurred by private agents.
G77 + China (2009)		200-400		Estimate includes both Adaptation and Mitigation. Proposed at: 0.5% to 1% of GNP of Annex II Parties
African Group (2009)		>67		Estimate based on the programme for Adaptation Action under the AWG-LCA
IIED (2009)	No specific figures cited			Costs estimated to 2 or 3 times higher than UNFCCC figures

Source: Climate Funds update, available on <http://www.climatefundsupdate.org/resources/estimated-costs-climate-change>

## 1.2. Mind the financing gap

Ensuring that adequate financing is provided to address climate change remains a highly political and contentious issue within international climate negotiations. The amount of financing required to tackle climate change will depend on

7. UNFCCC (2007), *op. cit.* note 4.

8. The World Bank Group, “The Economics of Adaptation to Climate Change”, Washington DC, August 2010, [http://siteresources.worldbank.org/EXTCC/Resources/EACC\\_FinalSynthesisReport0803\\_2010.pdf](http://siteresources.worldbank.org/EXTCC/Resources/EACC_FinalSynthesisReport0803_2010.pdf)

9. M. PARRY *et al.*, “Assessing the costs of Adaptation to climate change: A critique of the UNFCCC estimates”, International Institute for Environment and Development, August 2009, <http://pubs.iied.org/11501IIED.html>

many factors, including “the level of ambition of mitigation goals and adaptation objectives, and the extent to which “correct” price signals are provided.”<sup>10</sup>

During the UN Climate Change Conference in December 2009 in Copenhagen, an important first step was made. Developed countries committed to jointly mobilise USD 100 billion annually by 2020 from both public and private sources. In addition, they have pledged new and additional resources amounting to USD 30 billion for the period 2010-2012. This funding will be balanced between adaptation and mitigation and is destined primarily for the most vulnerable developing countries. In addition to formalizing these two commitments, the Cancun Agreements of December 2010 also foresee the establishment of a Green Climate Fund under the Conference of the Parties through which much of the funding will be channelled.

However, Parties have so far not agreed on a mid-term financial plan which should address the gap between the annual USD 10 billion until 2012, known as “fast-start financing” and the yearly 100 billion by 2020 which is labelled as long-term financing. Moreover, although the amount of long-term financing has been set in accordance with the goal of maintaining the temperature rise below 2°C, the amount of financial support will need to be continually scaled-up beyond the USD 100 billion target after 2020. According to the aforementioned estimations given by McKinsey & Co and the World Bank, the financial needs required for mitigation and adaptation could easily expand to USD 275 billion by 2030 (see table 1 and 2).

According to the last update of the World Resources Institute published in May 2011<sup>11</sup>, individual fast start finance pledges from 21 developed countries and the European Commission amount to USD 28.14 billion. While this puts developed countries on the right track, much remains to be done to meet the fast-start pledges. In the Cancun Agreements, it has been confirmed that fast-start funds have a “balanced allocation between adaptation and mitigation”, are “new and additional”, are “prioritized for the most vulnerable developing countries”, and include “investments through international institutions”. However, these criteria must be clearly defined in order to avoid the possibility of wide and politically convenient interpretations on the part of developed countries as is presently the case. Fast start finance is often referred to as a pilot period to enable

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10. OECD, “Financing Climate Change Action and Boosting Technology Change – Key messages and recommendations from current OECD work”, 10 March 2011, <http://www.oecd.org/dataoecd/34/44/46534686.pdf>

11. A. BALLESTEROS, C. POLYCARP, K. STASIO, E. CHESSIN and C. EASTON, “Summary of Developed Country ‘Fast-Start’ Climate Finance Pledges”, World Resources Institute, 20 May 2011, <http://www.wri.org/publication/summary-of-developed-country-fast-start-climate-finance-pledges#qanda>

“readiness” for the post-2012 period. It will therefore provide important lessons on how best to finance preventative climate change actions in the long term.

So far, it is unclear how scaled-up, new and additional funding will be raised to mobilise up to a USD 100 billion per year by 2020. Bridging the financial gap will require innovative approaches, both in terms of additional finances and effective use of available resources.

Without a credible framework for mobilising, managing and delivering financing on the required scale, there is a risk that developing countries’ actions to tackle climate change will be insufficient, inefficient, inadequate, and delayed. The global costs would increase as a result, and the path towards a sustainable economic model would be jeopardized. The following sections will analyse the issues related to the mobilisation, management and the delivery of the funds.

## 2. MOBILISING THE FUNDING

### 2.1. Where should the money come from?

Developed countries reaffirmed in the Cancun Agreements their commitment made a year earlier in Copenhagen to mobilise USD 100 billion a year by 2020 for developing countries. Nevertheless, there is little clarity on where this money should come from. The agreement only stipulates that the money will “come from various sources, public and private, multilateral and bilateral, including alternative sources.”

It is increasingly likely that the majority of climate funding will come from the private sector. An over-reliance on private financing has been criticised by many as unpredictable as it is overly dependent on fluctuant market forces. These concerns are well grounded in light of the recent decrease of interest in the carbon market. However, the current budget constraints in most developed countries will make public climate finance very difficult to increase. The emission reductions pledged by developed countries during the last climate negotiations cannot be kept without a far more substantial contribution from the private sector than is currently the case.

In the aftermath of the Copenhagen Summit, the UN Secretary-General established a High-Level Advisory Group on Climate Change Financing (AGF) with a 10 month mandate. This Group was mandated to study the contribution of potential sources of revenue, including alternative sources of finance, towards meeting the USD 100 billion goal. The final report, issued in November 2010, concluded that this goal is “challenging but feasible”. It is important to underline that the task of the AGF was not to reach a deal on the sources of finance to achieve the long-term financing goal but to provide an important contribution to the climate negotiations.

The AGF emphasised the importance of new public instruments based on carbon emissions pricing for mobilising both public and private climate financing. These instruments are particularly appealing because “they both raise revenue and provide incentives for mitigation action.” A carbon price in the range of USD 20 – USD 25 per ton of CO<sub>2</sub> equivalent in 2020 was estimated by the AGF as a central element for reaching the USD 100 billion a year.

A lot of innovative ways of financing climate change exist. The range of sources identified by the Advisory Group can be classified into four groups which will

be analysed below: public finance, carbon market offsets, private capital and development bank instruments. However, whilst recognising that there was a complementary role to be played by each of these financing groups, no agreement has been reached in Cancun on the sources of funding. What's more, the Parties were unable to agree on the role of the private sector in climate financing, as well as on the adequate mechanisms for its involvement. The debate is highly political and touches upon very contentious issues. Therefore, such concerns should also be discussed outside of the UNFCCC, in other informal political settings such as the G20 or the Major Emitters Forum.

### *2.1.1. Public finance*

Scaling-up public finance will be difficult given the tightening of government budgets in the wake of the global economic crisis, but it should not be a reason to delay action. Scaled-up public finance will be particularly needed for financing adaptation where the involvement of private funding will be weaker. It is to the poor developing countries – often suffering the most from the impacts of climate change and unable to bear the costs – that adaptation funding must first be directed. Within the next few years, public finance will also focus on supporting developing countries in their transition via capacity building, technical assistance and pilot actions. Although mitigation will mainly be financed by the private sector, public finance will be essential to leverage private investments. It will be equally needed for actions unlikely to attract sufficient private funding, particularly in poor countries.

Public sources of financing can be delivered via two main modalities; grants or concessional loans. However, public sources are, in principle, available to be used directly for grants. They are disbursed to beneficiaries through multilateral and bilateral funds.

Before delving into the proposals of public financing instruments established by the AGF, it is important to underline that the potential revenues generated by these instruments will mainly depend on the share allocated to international climate finance and the carbon price.

#### ◆ **Direct budget contribution**

Direct budget contributions include the revenues provided through national budgetary decisions. Despite the great budgetary pressure that Governments are facing, these contributions continue to play a key role. Most of the USD 30 billion committed over the fast-start finance period is expected to come directly from budget contributions. However, in the longer term, it would be difficult for



governments to increase these contributions, as it would reduce public expenditure for other public policies. Considering that many developed countries are already struggling to reduce their budget deficits, increasing direct public contributions is an equally difficult political challenge as the introduction of new instruments to generate resources.

◆ **Revenues from international auctioning of emission allowances**

A proposal, originally submitted by Norway, would auction a fraction of each country's emission allowances, more officially referred to as assigned amount units (AAUs). The AGF estimates that in a medium carbon price scenario of USD 25 per tonne of CO<sub>2</sub>, auctioning between 2 and 10 per cent of emissions allowances would provide between USD 8 and 38 billion annually. A similar system already exists.

However, the Commission Staff Working Document of April 2011<sup>12</sup> put forward three main barriers to this approach. First, it would require dealing with the issue of surplus AAUs from the first commitment period under the Kyoto Protocol. If this surplus is carried over into the next commitment period, it could greatly weaken the 'stringency' of the emissions reduction targets. Second, if the current framework of the Kyoto Protocol was to be extended after 2012, the US and the emerging market economies would be exempt from contributing. Third, the revenue potential of this approach is unpredictable as it will depend on the AAUs price and the success of auctioning.

◆ **Revenues from auctioning of emission allowances in domestic emission trading schemes**

An important source of additional public revenues is via the auctioning of allowances in domestic emissions trading schemes (ETSs), under the condition that an agreed percentage of the auction revenues is made available to finance climate change in developing countries. These domestic ETSs are in operation or under consideration in most developed countries.

In the EU ETS, the expected revenues stemming from auctioning should amount to around EUR 55 billion yearly for the period 2012 to 2080.<sup>13</sup> However, this is a rough estimate as these revenues will depend largely on the market price and the way participants respond to it. The ETS Directive proposes that at least half

12. Commission Staff Working Document, "Scaling up international climate finance after 2012", SEC (2011) 487 final, 08 April 2011.

13. N. FUJIWARA, A. GEORGIEV and C. EGENHOFER, "Financing Mitigation and Adaptation: Where should the funds come from and how should they be delivered?", ECP Report No. 7, December 2008, p. 5, <http://www.ceps.eu/node/1568>.

the revenue should be used to support mitigation and adaptation efforts, mainly within the EU, but also in developing countries.

◆ **Revenues from offset levies (CDM)**

This proposal would involve withholding a share of revenues from carbon offsetting as a global source of funding. Carbon offsetting allows developed countries that have emission reduction targets to meet their obligations by investing in emission reduction projects in other countries. So far, the most important offset mechanism is the Clean Development Mechanism (CDM). This latter allows investments in mitigation projects in developing countries only.

This system already provides the Adaptation Fund (AF) with the majority of its funds through a 2% levy on the proceeds from CDM projects. According to the AGF, if the rate of the levy is kept at 2%, the annual revenues from carbon offsetting by 2020 could range from USD 0.15 to USD 0.24 billion in case of low carbon price scenario, and add up to USD 3 billion in case of high carbon price scenario. Although these amounts are not negligible, the AGF points out that an offset levy is a kind of tax on emission reductions, rather than a tax on emissions.

◆ **Revenues from taxes on international aviation and shipping**

Putting a price on carbon emissions from international aviation and shipping could also generate important public revenues for climate action in developing countries. In order to do so, three alternative approaches are considered: a levy on maritime bunker/aviation jet fuel consumption for international journeys, a tax on passenger tickets for international flights, and an emissions trading scheme. The latter proposal would involve the auctioning of international aviation and maritime allowances in a separate emission trading scheme for these activities. As these sectors are by definition international, these instruments should be applied globally in order to, *inter alia*, avoid important competitiveness issues and preferential treatment between operators from developed and developing countries. However, as rightly stated by the AGF, “these instruments may present difficulties in terms of political acceptability and incidence on developing countries.” To ensure respect of the principle of common but differentiated responsibilities, some members of the AGF and the European Commission<sup>14</sup> proposed that a part of the revenues raised from internal transportation be redistributed to developing countries.

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14. Communication from the Commission to the European parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, “Stepping up international climate finance: A European blueprint for the Copenhagen deal”, COM (2009) 475/3, Brussels, October 2009.

Taking into account the redistribution of part of the revenues to developing countries and assuming that between 25 and 50% of the remaining revenues could be earmarked for climate finance, the AGF estimates that the revenues in 2020 could range from USD 2 to USD 3 billion from international aviation emissions<sup>15</sup>, and from USD 4 to USD 9 billion from international maritime emissions (in the medium carbon price scenario). In order to be able to raise such revenues, further work is required at the global level in the relevant organisations, i.e. the UNFCCC, the International Civil Aviation Organisation and the International Maritime Organisation.

◆ **Revenues from carbon taxes**

The AGF made some broad estimates on the potential revenues stemming from a global tax on carbon emissions. During the UNFCCC negotiations, Switzerland has proposed a global carbon tax on emissions from fossil fuel use at a rate of USD 2 per tonne of CO<sub>2</sub>, with an exemption for the first 1.5 tonnes of emissions per head. According to the AGF, if all energy-related CO<sub>2</sub> emissions worldwide were subjected to the tax, it would raise about USD 30 billion in 2020 for every dollar of tax per tonne of emissions. If the tax were to be levied only in “OECD+” countries, gross revenue would be about USD 10 billion for every dollar of tax per tonne of emissions.

◆ **Revenues from wires charge**

The AGF also suggested a “wires charge” based on a small charge of electricity generation, either on the amount of kWh produced or linked to the amount of carbon emissions per kWh produced. Based on the International Energy Agency’s outlook on developments in electricity generation in OECD countries, a “wires charge” levied at a rate of USD 0.0004 per kWh (equivalent to USD 1 per tCO<sub>2</sub>) in OECD countries would raise up to USD 5 billion by 2020.

◆ **Revenues from removal of fossil fuel subsidies/redirection of fossil fuel royalties**

Environmentally-harmful subsidies to fossil fuel energy should be removed as they provide incentives to continue using carbon intensive energy. According to OECD studies, the suppression of energy subsidies would have many advantages. Not only would it save money for both governments and tax payers but it would also shift the economy away from activities that emit CO<sub>2</sub>, promote energy efficiency, enhance energy security and encourage the development and

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15. In the aviation sector, the estimates of the available revenue exclude also flights within the European Union considered as “domestic” aviation.

deployment of low-carbon technologies.<sup>16</sup> The OECD and the IEA have also shown in recent analysis that suppressing these subsidies in 20 emerging countries and developing countries could cut GHG emissions by 10% globally by 2050 in comparison with the business as usual scenario.<sup>17</sup>

A share of the savings from the subsidies suppression should be diverted to climate finance. Phasing-out these subsidies would nonetheless be politically difficult, and could have harmful impacts on low-income households. Therefore, a share of the freed budget should also be reallocated to those most affected by the measure. During the G20 summit in September 2009, the heads of State expressed their will “to rationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption”. However, major economies have not yet implemented concrete collective actions in response to the G20.

◆ **Financial transaction tax**

In light of the global financial crisis, a financial transactions tax (FTT), inspired by the Tobin tax, has been proposed as a means of reducing speculative flows. The idea is to tax all financial transactions, including trade of equities, bonds, currencies and derivatives.<sup>18</sup> It has been suggested that a share of revenues from the tax would be used for climate change. However, according to the AGF report, “the lack of political acceptability and unresolved issues of incidence on developing countries make it difficult to implement universally.” Therefore, it is likely that that a financial transaction tax will be “only feasible among interested countries at the national or regional level.”

### 2.1.2. *Carbon market offsets*

Carbon market offsets represent one of the international climate regime’s core strategies for both reducing emissions in developing countries and, coupled with a strong carbon price, delivering a significant part of climate funding. Carbon offsetting refers to transfers of resources related to purchases of ‘credits’ from projects that reduce GHG emissions in developing countries. By purchasing project-based offset credits, individuals, private entities or Governments in

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16. OECD, “Financing Climate Change Action, Supporting Technology Transfer and Development – Key messages and recommendations from recent OECD work”, 2009, p. 3, <http://www.oecd.org/dataoecd/60/1/44080723.pdf>

17. OECD, “The Economics of Climate Change Mitigation: Policies and Options for Global Action Beyond 2012”, September 2009, [http://www.oecd.org/document/56/0,3746,en\\_2649\\_34361\\_43705336\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/56/0,3746,en_2649_34361_43705336_1_1_1_1,00.html)

18. Bretton Woods Project, “IMF pours cold water on monetary reform”, update 68, 20 November 2009, <http://www.brettonwoodsproject.org/art-565603>

developed countries can compensate for emissions that they are unwilling or unable to reduce domestically.

The Clean Development Mechanism (CDM) under the Kyoto Protocol is the most important market instrument involving developing countries. This offset mechanism has two main objectives. Firstly, it enables developed countries to meet their emission reduction targets at a lower cost. Secondly, it helps developing countries achieve sustainable development by generating private investments and encouraging the transfer of low-carbon technologies.

So far, the CDM has proven to be the greatest source of mitigation finance to developing countries. About USD 7 billion are invested each year.<sup>19</sup> However, the CDM suffers from many structural shortcomings. Firstly, the bulk of investments are concentrated in a few emerging countries with China, India and Brazil accounting for 75% of carbon revenues. Conversely, low-income countries which are most in need of CDM revenues receive only 3%.<sup>20</sup> Secondly, the development of the CDM has revealed an inherent tension between its two-fold objectives: contributing to sustainable development in developing countries and reducing emissions in a cost-effective way in developed countries. Indeed, the most cost-effective and successful projects (the most criticised are the HFC and N<sub>2</sub>O projects) are also those which contribute least to sustainable development. Thirdly, CDM is often criticized for being a UN instrument suffering from weak governance. The prohibitive transaction costs, the lack of transparency and predictability in the board's decision making and the delays in the approval of methodologies and assessments of projects are significant constraints to the efficiency of the regulatory framework. Finally, the environmental integrity of the CDM itself is disputed. In order to reduce emissions, CDM projects must contribute to more emission reductions than those which would have taken place without the projects' existence. However, this claim of additionality is difficult to demonstrate and the risk of approving 'business as usual' projects is real.

The future of the CDM is uncertain as it expires with the Kyoto Protocol in 2012. Regardless of the form under which the CDM will most probably be extended, the current design of the mechanism needs to be deeply revised. Many ideas of differentiation between countries and project types have been put forward to address the CDM's shortcomings. The EU has been encouraging this revision by allowing new CDM projects in LDCs only and by prohibiting the use of credits from certain industrial gas projects in the post-2012 EU Emissions

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19. *Ibidem*.

20. World Bank, "Generating the funding needed for mitigation and adaptation", in *World Development Report 2010: Development and Climate Change*, November 2009, <http://siteresources.worldbank.org/INTWDR2010/Resources/5287678-1226014527953/Chapter-6.pdf>

Trading Scheme (ETS). To achieve a better geographical balance and increase finances for the poorest countries, the revised CDM should increasingly focus on the Least Developed Countries (LDCs), while sectoral carbon market crediting approaches should be phased in after 2012 for more economically advanced developing countries.<sup>21</sup> The development and implementation of these sectoral carbon markets (SCMs) should allow developing countries to scale up private investments in accordance with their climate priorities. Ultimately, these SCMs could become multi-sectoral cap-and-trade systems in developing countries that could be linked to wide ETS in developed countries. Currently, developing countries such as China, India and the Republic of Korea are seriously considering implementing such market mechanisms.

The AGF estimates that increased carbon market flows could generate between USD 30 billion and USD 50 billion annually for developing countries, but only “when and if carbon markets are further developed and deepened”. The scale of additional financial flows depends on several key elements of the future climate international architecture. These include the stringency of the emissions reduction targets from developed countries and mitigation actions from developing countries; the future carbon market design and the stringency of starting levels for the emissions reduction paths for the period 2013-2020. In its Working Document entitled “Scaling up international climate finance after 2012” of April 2011, the European Commission spells out a warning. It alerts that the current mitigation pledges, the maintaining of the expected huge surplus of Assigned Amount Units from the first Kyoto commitment and the setting of the Kyoto Protocol target as the starting level for the emission reduction paths for the period 2013-2020 would result in “no demand for international credits additional to what was already been enabled by the current legislation (on the EU Emissions Trading Scheme) and in the cap-and-trade systems planned by other developed countries.”<sup>22</sup> Without demand, the price signal would not be stringent enough. In such a scenario, it is likely that public finance would need to cover a larger share of mitigation actions, which is not feasible in the current economic situation.

### 2.1.3. *Private capital*

It is increasingly recognised that the majority of the incremental investment capital required to tackle climate change will need to come from the private sector.<sup>23</sup>

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21. Commission Staff Working Document (2011), *op. cit. note 12*.

22. Commission Staff Working Document (2011), *op. cit. note 12*.

23. B. BUCHNER, J. BROWN and J. CORFEE-Morlot, “Monitoring and tracking long-term finance to support climate action”, OECD/IEA, May 2011, <http://www.oecd.org/dataoecd/52/63/47514140.pdf>

Given the state budget crisis in most developed countries, the capacity of private investors to make the best uses of scarce capital will be most needed. Private investments are essential for ensuring developing countries' transition towards a low-carbon economy. Leveraging private flows from developed countries will be crucial for mitigation and technology transfers, but it is also important for many investment decisions in adaptation.

Green foreign direct investment (FDI) into developing countries is already considerable. Depending on the definition, estimates of these green FDI vary significantly. UNCTAD estimates that green FDI flows in three key low-carbon business areas (renewables, recycling and low-carbon technology manufacturing) to developing countries over 2003-2009 amounted to USD 149 billion (i.e. about USD 20 billion annually). From this amount, about two-thirds came from developed countries.<sup>24</sup> The OECD estimates that green FDI flows to developing countries in the electricity, gas and water sectors were about USD 7.6 billion per year between 2005 and 2007, whereas FDI flows in all “environmentally-relevant” sectors amounted to about USD 190 billion annually.<sup>25</sup>

The AGF report estimates that international private capital flows directed to climate actions in developing countries could amount to somewhere between USD 100 and 200 billion per year by 2020. However, there is currently no global approach for monitoring and accounting the net benefits of these gross private flows. Acknowledging that significant work would be required to develop an internationally agreed approach, the AGF report provides a methodology on how to calculate net private flows. According to this approach, up to USD 200 billion in gross private flows per year could lead to private net flows in the range of USD 20 to 24 billion per year.

Despite the key role of the private sector in financing climate change, the AGF report identifies several important barriers to scaling up private investment in developing countries. These include a difficult policy environment, unattractive business investment framework, inadequate access to finance and insufficient risk-adjusted returns. Private investment incentives are therefore needed to encourage the development of low-carbon technologies in developing countries. Public instruments can address these barriers by improving the general business investment environment, supporting risk-sharing instruments, and providing revenue support through concessional loans, grants and guarantees.<sup>26</sup> Carbon

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24. UNCTAD, “World Investment Report 2010 – Investing in a low-carbon economy”, New-York and Geneva, 2010, p. 111, [http://www.unctad.org/en/docs/wir2010\\_en.pdf](http://www.unctad.org/en/docs/wir2010_en.pdf)

25. S. S. GOLUB, C. KAUFFMANN and P. YERES, “Defining and Measuring Green FDI: An Exploratory Review of Existing Work and Evidence”, OECD Working Papers on International Investment, No. 2011/2, OECD Investment Division, June 2011, pp. 27-28, <http://www.oecd.org/dataoecd/26/8/48171454.pdf>

26. Commission Staff Working Document (2011), *op. cit.* note 12.

pricing and domestic policies also have a role to play in making low-carbon technologies economically viable.

The AGF report considers that “multilateral development banks, the United Nations system and bilateral agencies, other institutional institutions, public-private risk-sharing instruments and more developed carbon markets can all play key roles” in providing these private investment incentives. According to the Organisation for Economic Co-operation and Development (OECD), experience with the Global Environment Facility (a multilateral financial mechanism operating under the UNFCCC) shows that public funding dedicated to mitigation can generate private investment with a leverage factor of 7 or more.<sup>27</sup> Furthermore, the World Bank (WB) estimates that funding from the CDM can leverage on average private investment by a factor of 4:6.<sup>28</sup>

#### **2.1.4. Development bank instruments**

As an important channel of climate finance to developing countries, the Multilateral Development Banks (MDBs), in close cooperation with the United Nations system, can play a significant role in increasing both public and private finance. According to the United Nations Environment Programme (UNEP), MDBs accounted for more than half (about USD 16.5 billion) of total revenue for public climate financing in 2009 (about USD 30 billion).<sup>29</sup> The AGF estimates that for every USD 10 billion in additional resources, multilateral development banks could deliver between USD 30 billion and USD 40 billion per year in gross capital flows and even more by fostering private flows. The net flows from multilateral development banks could reach USD 11 billion per year. Alongside this leveraging role, they also have a track record in providing technical assistance as well as financial and sector expertise. Accordingly, the capacity of these banks should be strengthened through additional resources over the course of the next decade.

## **2.2. Who will pay and how?**

As climate finance will be substantially scaled up and provided by different sources and via different channels, an agreement on an equitable burden-sharing

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27. OECD (2011), *op. cit.* note 10.

28. World Bank (2009), *op. cit.* note 21.

29. UNEP, “Bilateral Finance Institutions and Climate Change – A Mapping of 2009 Climate Financial Flows to Developing Countries”, 2010, [http://www.unep.org/publications/search/pub\\_details\\_s.asp?ID=6178](http://www.unep.org/publications/search/pub_details_s.asp?ID=6178)



at a global level will have to be found. There is a growing consensus that to be equitable, countries' financial contributions should respect the 'polluter pays' principle and be established according to their respective 'ability to pay', i.e. national wealth. The 'polluter pays' principle engenders a responsibility for greenhouse gas emissions. The timescale against which emissions can be measured is however difficult to determine, and a reference year will have to be determined. Until now, most emission estimates take either 1990 or 2005 as their reference year. Regarding the 'ability to pay' of each country, the most common measure of national wealth is the gross domestic product (GDP).

While LDCs should be relieved from any financial commitment, economically more advanced developing countries should ideally contribute to climate financing. Nevertheless, the long-term financial pledge stipulated in the Cancun Agreements has until now only been made by developed countries. In its 2011 Staff working Document of April 2011, the European Commission assumes that the group of developed countries is identical to the group of Annex 1 countries under the Kyoto Protocol and gives estimates of these countries' contributions to long-term climate finance on the basis of both criteria: GHG emissions and GDP (see table 3).<sup>30</sup> In light of this, a key concern will be determining the share given to each of the two criteria when calculating national contributions. Assuming that the share allocated to emissions is larger than the GDP's share, the incentive to reduce emissions would be higher.

**Table 3: Annex 1 countries' contributions in % to the long-term climate finance**

Criteria %	GHG 100	GHG/GDP 75/25	GHG/GDP 50/50	GHG/GDP 25/75	GDP 100
United States	38	37	36	35	34
EU-27	29	31	33	36	38
Russian Federation	11	9	7	5	3
Japan	8	9	10	11	13
Canada	5	4	4	4	4
Australia	4	4	3	3	3
Other	6	6	5	5	5
Total	100	100	100	100	100

Source: COM SEC (2011) 487 final

Note: GHG emissions (including LULUCF), 2008; GDP in USD at market exchange rates, 2010; "other" includes Ukraine, Belarus, Switzerland, New Zealand, Norway, Croatia and Iceland.

30. Commission Staff Working Document (2011), *op. cit.* note 12.

### 2.3. What kind of money?

The Cancun Agreements state that “*new and additional, predictable and adequate funding* [...] shall be provided to developing countries”. The UNFCCC, under its Article 4.3, already recognised that developed countries “shall provide *new and additional* financial resources to meet the agreed full costs incurred by developing country Parties [...] The implementation of these commitments shall take into account the need for *adequacy* and *predictability* in the flow of funds.”

Firstly, the meaning of ‘new and additional’ funding is one of the most critical issues in the negotiations on climate financing. Although developed countries have pledged funds, they have not predefined a baseline against which the financial contributions could be assessed. This is causing levels of mistrust between developed and developing countries. Developing countries and leading NGOs insist on the importance of climate funding being new, i.e. not money already pledged in the past, and additional, i.e. superior to the developed-countries’ commitment to provide 0.7% of their gross national income to Official Development Assistance (ODA). However, given current strains on domestic budgets resulting from the economic recession, most developed countries have an interest in upholding an elusive and ambiguous definition of additionality. Consequently, donors have developed a variety of methods to define at which point international public financial support can be considered additional to existing aid funds. For the minority of those who already contribute up to 0,7% of their GNI to ODA, it is easy to agree with this baseline. For the others, it is, *inter alia*; the support above the 2009 ODA support, a specified percentage of the rising ODA levels, or the financial support from sources not connected to ODA.<sup>31</sup>

A clear definition of what constitutes new and additional climate finance is needed to establish clear common rules on the monitoring reporting and verification (MRV) of climate funding. However, given that the issue is highly contentious and political, it is unlikely to be addressed in the near future. According to most of the definitions of additionality, ODA will continue to be an important source of funding for climate change in the short term, at least.<sup>32</sup> Therefore, the MRV system of ODA, if improved, could at least ensure that the amount of money going to climate change is known, so as to determine what

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31. For an explanation of climate finance additionality and the advantages and drawbacks of different definitions and baselines, see: J. BROWN, N. BIRD and L. SCHALATEK, “Climate finance additionality: emerging definitions and their implications”, Overseas Development Institute and Heinrich Böll Stiftung, Climate Finance Policy Brief No. 2, June 2010, <http://www.odi.org.uk/resources/download/4931.pdf>; M. STADELMANN, J. TIMMONS ROBERTS, S. HUQ, “Baseline for trust: defining ‘new and additional’ climate funding”, IIED Briefing, June 2010, <http://pubs.iied.org/pdfs/17080IIED.pdf>

32. J. BROWN *et al.* (2010), *op. cit.* note 31.

may be considered as additional. In the long-term, a workable baseline could be to count the funds from new funding sources only, such as revenues from taxes on international aviation and shipping or from auctioning of emission allowances. These funds are ‘new’ by definition and are likely to be ‘additional’ to ODA.<sup>33</sup>

Secondly, the level of funding must be ‘adequate’ to ensure that global temperatures do not increase more than 2°C<sup>34</sup> and to help countries adapt to the impacts of climate change. The commitment of developed countries to provide USD 100 billion by 2020 to developing countries is tied to the objective of limiting the increase in global temperature to 2°C (although it is estimated that current pledges of industrialised countries to reduce emissions put the world on a path for a global warming of 3.5°C by 2100). However, as mentioned above (see Table 1), funding needs remain difficult to assess, hence the uncertainty over the required levels of funding. The current top-down approach in determining the funding needs should therefore be replaced by estimates based on national needs as set out in the national Low-Carbon Growth Plans (LCGPs) containing Nationally Appropriate Mitigation Actions (NAMAs) and National Adaptation Programmes of Action (NAPAs).<sup>35</sup>

Thirdly, developing countries insist on the ‘predictability’ of funding. It is important that funding is known and secure over a long-term period in order to allow national authorities to plan, scale-up and implement their action programmes. So far, a huge gap exists between the amount of money pledged by developed countries and the amount of money actually disbursed. In April 2011, out of the USD 30.88 billion of funds pledged to the 24 multilateral and bilateral funds listed so far, only USD 10.6 billion have been deposited and barely USD 1.9 billion has been disbursed.<sup>36</sup> Moreover, due to the fact that private sector funding is inherently unpredictable, it is crucial to ensure the delivery of an increased flow of public funding to the most vulnerable developing countries, which are least likely to benefit from private investments. In order to improve

33. M. STADELMANN *et al.* (2010), *op. cit.* note 31.

34. Although, the COP officially decided in Cancun to keep a global temperature increase below 2°C, significant risks are now associated with this temperature threshold. Hence, the important call from more than 100 countries in Cancun and previously in Copenhagen to consider holding the raise in global temperature to 1.5°C.

35. L. SCHALATEK, “A Matter of Principle(s)” – A normative Framework for a Global Compact on Public Climate Finance”, Heinrich Böll Stiftung, November 2010, <http://www.boell.de/ecology/economics/ecological-economics-study-a-matter-of-principle-s-10723.html>; N. BIRD, “A transparency agreement for international climate finance – addressing the trust deficit”, Overseas Development Institute, March 2010, <http://www.odi.org.uk/resources/details.asp?id=4798&title=transparency-agreement-international-climate-finance-addressing-trust-deficit>

36. Information available on Climate Funds Update: <http://www.climatefundsupdate.org/graphs-statistics/pledged-deposited-disbursed>

predictability, some observers suggest increasing the number of contributing country pledges to be delivered according to a verifiable and enforceable timetable over successively longer periods.<sup>37</sup>

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37. L. SCHALATEK (2010), *op. cit. note 35*; N. BIRD (2010), *op. cit. note 35*.

### 3. ADMINISTRATING THE FUNDS

Between the mobilisation and the delivery, the funds will have to be administered efficiently and allocated to the most effective climate actions. A mix of both bilateral and multilateral funds will be required to manage the amount of money that will have to be raised and delivered. In Cancun, a decision was made to establish a new Green Climate Fund (GCF) to channel scaled-up finance to address climate change in a more equitable and efficient manner.

The intricate network of existing bilateral and multilateral climate funds, as well as the potential role of the new GCF will be analysed in the first part of this section. Then, the importance of transparency and accountability in the management of climate funds will be examined in the second part.

#### 3.1. Who will manage the funds?

##### 3.1.1. *The current climate funds architecture*

Both bilateral and multilateral climate funds will be required to manage the scaled-up funding. In the past couple of years, many new multilateral and bilateral climate funds have been established in order to develop channels of international climate financing. Contrary to the Paris Declaration on Aid Effectiveness (which requires a reduction in the fragmentation of aid), this has increased the complexity of the funds architecture and has resulted in a lack of coordination of international support. Moreover, it has led to high transaction costs in recipient countries, where institutional capacity is often too weak to deal with the administrative burden of different funding initiatives.<sup>38</sup>

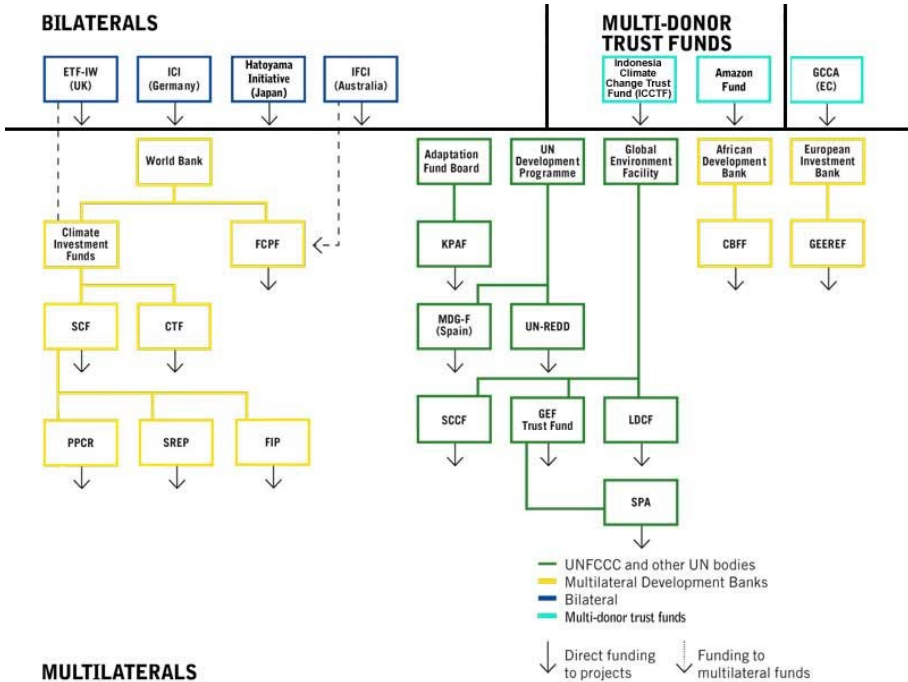
Currently, there are 23 dedicated multilateral and bilateral climate funds (see Table 4).<sup>39</sup> Bilateral funds are nationally driven initiatives from single contributor countries. The largest one is the Hatoyama Initiative from Japan. Multilateral climate funds are those which receive contributions from different countries, such as the Global Environment Facility (GEF) under the financial mechanism of the UNFCCC and the Climate Investment Funds (CIFs) created by the World Bank and other regional Multilateral Development Banks (MDBs).

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38. N. BIRD, "The Challenge of Securing European Coherence on Climate Finance", EDC 2020, January 2011, <http://www.odi.org.uk/resources/details.asp?id=5416&title=challenge-securing-european-coherence-climate-finance>

39. Information available on Climate Funds Update: <http://www.climatefundsupdate.org/listing>

Table 4: Climate funds architecture diagram



Source: Climate Funds Update, available on: <http://www.climatefundsupdate.org/listing/architecture>

### 3.1.2. The new Green Climate Fund

The decision to establish a new Green Climate Fund (GCF) was made in Cancun. This fund is considered by many, especially developing countries, as an opportunity to create an efficient institution for the delivery of scaled-up climate funding on the basis of a shared vision from developed and developing countries. A transitional Committee was commissioned by the Parties to design the GCF and make recommendations to the next COP in Durban. However, there are doubts on whether this new central initiative would be able to deliver adequate and predictable funding in a timely manner. Much work remains to be done before the GCF can be fully operational.

In addition to the GCF and the Transitional Committee, the Cancun Agreements also established a Standing Committee. The latter should assist the COP in exercising its functions with respect to the financial mechanism of the Convention but its role and functions remain to be defined.



### a. *The Green Climate Fund*

The GCF will “be accountable to and function under the guidance of the Conference of the Parties”. A controversial issue regarding the GCF was whether the fund should be ‘accountable and under the guidance’ of the COP as argued by the majority of developed countries<sup>40</sup> or whether it should also fall ‘under the authority’ of the COP as argued by the G77+China.<sup>41</sup> Given that the Parties finally agreed on ‘accountable to and under the guidance’ in the Cancun Agreements, it is important to understand what ‘under the authority’ implies. In a study in 2009, Müller<sup>42</sup> infers an informal definition of the concept ‘under the authority’ based on two key features, namely that the COP has the authority (i) to select (‘hire and fire’) the members of the Board, and (ii) to approve general rules and guidelines proposed by the Board.<sup>43</sup> While it is unlikely that the COP will have these prerogatives with respect to the Board of the GCF, the relationship between the GCF and the COP should be defined more clearly.

The GCF will be supported by an independent Secretariat and governed by a Board of 24 members comprising an equal number of members from developed and developing countries.<sup>44</sup> The Equal and balanced representation of all Parties in the governing body of the fund is crucial for building trust. So far, developing countries often have the feeling that they are unable to influence decisions, which are dominated by donor concerns. In order to change the still very actual “one dollar-one vote” system, equitable representation of all stakeholders in the administration of multilateral funds should be applied.

One of the most contentious issues of the Fund’s structure is the role of the World Bank. Many developing countries had opposed proposals for the World Bank to manage the new fund, arguing that the Bank is dominated by rich and industrialised countries, which pursue their own commercial interests. Instead, the fund will be managed by the board, but the bank will still be involved as an interim trustee of the fund. The role of the Bank will be subject to a review by

40. Proposal submitted by the EU for a COP decision on the Copenhagen Green Climate Fund, available at <http://unfccc.int/resource/docs/2010/awglca12/eng/misc06a01.pdf>

41. G77 and China Proposal, “Financial Mechanism for Meeting Financial Commitments under the Convention”, available at: [http://unfccc.int/files/kyoto\\_protocol/application/pdf/g77\\_china\\_financing\\_1.pdf](http://unfccc.int/files/kyoto_protocol/application/pdf/g77_china_financing_1.pdf)

42. B. MÜLLER, “Under the Authority of the COP?”, Oxford Institute for Energy Studies, November 2009, [http://www.oxfordclimatepolicy.org/publications/documents/comment\\_02\\_10\\_09.pdf](http://www.oxfordclimatepolicy.org/publications/documents/comment_02_10_09.pdf)

43. This informal definition of the concept ‘under the authority’ is inferred from the Bali Adaptation Fund Decision (CMP.3/1). In this Decision, the Adaptation Fund Board is stipulated to be “*under the authority* and guidance of, and fully accountable to” the CMP (Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol). By comparing this relation to that between the COP and the Global Environmental Facility (GEF), in which the GEF is ‘accountable and under the guidance of the COP’, Müller infers the two key features.

44. The representation of developing countries in the Board will include representatives from the United Nations regional groupings as well as the Small Islands Developing States (SIDS) and the LDCs.

all Parties after a period of three years. It is very unlikely though that its responsibilities will be rescinded once its functions have been established. As trustee, the Bank will mainly play a role of financial administrator, having no official role in the fund's management and policy-making. Given the important role of the Multilateral Development Banks of the World Bank in leveraging public and private funds, the Cancun Agreements allow the Bank to "commingle" its assets with those of the GCF for "investment purposes". However, the text also states that the Bank will "administer the assets of the GCF only for the purpose of, and in accordance with, the relevant decisions of the GCF Board", to which it will be entirely accountable. As rightly stated by Neil Bird *et al.*, regarding the need of scaled-up finance, it is crucial that the Board has confidence in the administrator of its financial assets.<sup>45</sup>

The decision reached on the internal management and administration arrangements of the GCF is quite balanced. The calls made by developing countries for an equitable governance regime have been heeded to.

#### *b. The Transitional Committee*

The GCF is to be designed by the Transitional Committee (TC), which was entrusted with the task of making recommendations to the COP in Durban and developing the operational documents on the basis of the terms of reference set out in Annex III of the Cancun Agreements. The Committee is composed of 40 experts, of whom 25 are from developing countries<sup>46</sup> and 15 from developed countries. Having a majority representation of developing countries should help in building trust in the future design of the GCF. The staff must be seconded from "relevant United Nations agencies, international financial institutions, and multilateral banks, along with the secretariat and the Global Environment Facility". The Cancun decisions also state that "the TC meetings will be open to observers". These observers from the civil society can actively participate in the meetings.<sup>47</sup> This is important in order to ensure the legitimacy and transparency of the TC's work. However the TC may "at any time decide that a meeting or part thereof be closed to observers"<sup>48</sup>.

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45. N. BIRD, J. BROWN and L. SCHALATEK, "Design challenges for the Green Climate Fund", Climate Finance Policy Brief No. 4, Heinrich Böll Stiftung and Overseas Development Institute, January 2011, <http://www.odi.org.uk/resources/details.asp?id=5256&title=design-challenges-green-climate-fund>

46. Seven members from Africa, seven members from Asia, seven members from the Group of Latin American and Caribbean States, two members from Small Island Developing States and two members from the Least Developed Countries.

47. UNFCCC Secretariat, "Working arrangements for the Transitional Committee for the design of Green Climate Fund", UNFCCC, 13 April 2011, [http://unfccc.int/files/cancun\\_agreements/green\\_climate\\_fund/application/pdf/tc\\_1\\_3\\_working\\_arrangements\\_for\\_the\\_tc\\_.pdf](http://unfccc.int/files/cancun_agreements/green_climate_fund/application/pdf/tc_1_3_working_arrangements_for_the_tc_.pdf)

48. *Ibidem*.



In developing its recommendations for the next COP in Durban, the TC will work on the operational documents for the GCF that address several issues laid down in Annex III of the terms of reference of the Cancun Agreements.<sup>49</sup> It is very unlikely that the TC will be able to tackle all these issues in time for the Durban Conference. However, progress could be made by putting in place the institutions that will manage the GCF (the GCF Board and the Secretariat), and by agreeing on the role of the GCF, i.e. its objectives, scale and scope.<sup>50</sup> The text of the Cancun Agreements is very vague when it comes to the Fund's role. It only mentions that "a significant share of new multilateral funding for adaptation should flow through the GCF". Bird *et al.* rightly highlight that "this clause contains a number of possible limitations that could be seen as to constrain the ambition of the fund"<sup>51</sup>.

The operationalisation of the GCF will be difficult as long as contentious issues regarding the mobilisation and the delivery of funds remain unsolved within the negotiations. A key issue is how the fund will find adequate and predictable resources to carry out its mandate. If the GCF wants to compete with the numerous existing funds and become a central element of international climate finance, it will have to complement and add value to existing initiatives by developing innovative financing systems in accordance with financing needs.

### c. *The Standing Committee*

In addition, the Cancun Agreements proposed establishing "a Standing Committee (SC) under the COP to assist the COP in exercising its functions with respect to the financial mechanism of the Convention". These functions include "improving coherence and coordination in the delivery of climate change financing, rationalization of the financial mechanism, mobilization of financial resources and measurement, reporting and verification (MRV) of support provided" to developing countries. This list of functions appears to be a basket containing all the most contentious issues which will need to be dealt with later on.<sup>52</sup> Parties will need to further define the role and functions of the SC in line with the execution of these issues.

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49. These issues include; the legal and institutional arrangements, the Fund Board Rules of Procedure, the financial instruments, the funding windows and the access modalities, the complementarity between the Fund's activities and the other funds and institutions, the role of the Secretariat, the independent evaluation of the Fund's performance, the establishment of mechanisms to ensure environmental and social safeguards, fiduciary standards and financial accountability, and the set up of mechanisms to ensure expert and technical advice as well as stakeholder input and participation.

50. A. BALLESTEROS, "The Road to the Green Climate Fund", World Resources Institute, 14 February 2011, <http://www.wri.org/stories/2011/02/road-green-climate-fund>

51. N. BIRD *et al.* (2011), *op. cit.* note 45.

52. *Ibidem.*

Apart from the assistance in the mobilisation of funds and MRV, another important issue the SC will have to address is how the new GCF will interact with the intricate network of existing bilateral and multilateral funds. In order to address this issue, the SC will have to improve the “coherence and coordination” in the delivery between the climate funds, while also dealing with the “rationalisation of the financial mechanism”. In Cancun, a consortium of 215 civil society organisations called for a global climate fund functioning as a ‘one-stop shop’ that would replace the current ‘spaghetti bowl’ of different channels. This solution would surely reduce both complexity and transaction costs for developing countries. However, it is very unlikely that the GCF will replace existing initiatives. Therefore, a pragmatic approach has to be followed. First, a new hierarchy is required. This hierarchy should make the GCF the largest existing fund inside (and eventually outside) the Financial Mechanism of the UNFCCC. Second, an appropriate division of labour amongst climate funds, which would increase complementarity and reduce transaction costs, should be promoted. This division of labour implies coordination among funds in areas such as the geographical distribution of funding, the most appropriate use of multiple sources of funding and the balancing of funds between mitigation and adaptation.

### **3.2. How should the funds be administrated?**

In order to administrate the climate financing more efficiently, more transparency will be required. Transparency requires information on fund development from the mobilization stage to delivery. This information must be publicly available, accurate and timely.

Transparency – which implies measuring, monitoring and verifying (MRV) climate financing – is paramount for many reasons. Not only does it build trust between developed and developing countries by showing that the money pledged is actually delivered<sup>53</sup>, but it also facilitates coordination between climate funds and avoids duplications. Furthermore, it enables all interested parties to assess the scale and type of support provided, to identify possible difficulties in specific sectors or regions and to hold governments and climate finance funds accountable for their actions.

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53. K. STASIO and R. MONCEL, “Transparency of Climate Finance: Results from Cancun and Next Steps”, World Resources Institute, 3 April 2011, <http://www.wri.org/stories/2011/04/transparency-climate-finance-results-cancun-and-next-steps>

Tracking climate finance is very challenging, as the flows come from different sources (public and private, national and international), and are channeled via a multitude of different bilateral and multilateral funds, as well as having different aims (mitigation, adaptation or capacity-building).<sup>54</sup> Currently, the different methods used by countries to measure, report and verify (MRV) climate financing provide limited and incomplete information. A clear and comprehensive framework for MRV international climate financing must therefore be developed.

Some progress was registered in the Cancun decisions. Reporting by developed countries should be enhanced for long-term financing. This entails the development of “common reporting formats” and “methodologies for finance”, ensuring that the “information provided is complete, comparable, transparent and accurate.” Developing a comprehensive framework for MRV should be built on existing reporting mechanisms such as the OECD – Development Assistance Committee (DAC) system for measuring public climate finance to developing countries. Such a framework should provide information on both the aid delivered by developed countries and received by developing countries. Further methodological work is needed on how to measure and assess the effectiveness of public climate flows, especially with regards to adaptation given its intricate linkages with development.<sup>55</sup> The OECD is currently working on this issue.

Furthermore, the Cancun Agreements aimed to establish a registry which will help developing countries to match their nationally appropriate mitigation actions (NAMAs) with international financial support.

With regard to fast-start finance, developed countries are required to annually report their financial commitments up until 2012. However, there is no indication on the contents or form of such reporting.<sup>56</sup> Currently, countries are reporting information which is neither comprehensive nor comparable.<sup>57</sup> This lack of transparency from developed countries could jeopardise the negotiations towards a global climate agreement. Developing countries are awaiting progress with fast-start financing before going any further.<sup>58</sup>

Although the important role of private finances has been acknowledged, there are no established monitoring tools for climate-related private financing.

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54. OCDE (2011), *op. cit.* note 10.

55. *Ibidem.*

56. K. STASIO and R. MONCEL (2011), *op. cit.* note 53.

57. The gaps in information are revealed in the fast-start table of the World Resources Institute, available on: <http://www.wri.org/publication/summary-of-developed-country-fast-start-climate-finance-pledges>

58. C. POLYCARP, “Have countries delivered on Fast-Start Climate Finance?”, World Resources Institute, 20 May 2011, <http://www.wri.org/stories/2011/05/have-countries-delivered-fast-start-climate-finance>

According to the OECD, the system of MRV could be extended to include some climate-related private financial flows, such as those related to CDM. However, methods for measuring the potentially important role of green foreign direct investment (FDI) are much needed. Relevant international organisations such as the OECD and the UNCTAD are working on it, “with a view to promoting a better understanding of the contribution FDI can make to help the shift to a low-carbon economy and the role policies may play in the greening of FDI”<sup>59</sup>.

In brief, as long as there is no clear definition of what counts as “climate finance” (especially private climate finance), it will be difficult to track it.

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59. K. STASIO and R. MONCEL (2011), *op. cit.* note 53.

## 4. DELIVERING THE FUNDS

So far, little focus has been put on the delivery of funds and the Cancun Agreements shed little light on the subject. Yet, this is fundamental when assessing the effectiveness, efficiency and fairness of climate finance.

### 4.1. Who should be responsible for the funds delivery?

As rightly stated by Neil Bird *et al.* (2011), one of the main lessons to be drawn from the experience of development aid finance is the recognition that national ownership over the development process is paramount.<sup>60</sup> A shift of responsibility in the disbursement of multilateral climate financing from the current donor dominated approach to a recipient country-led approach should be made. In conformity with the subsidiarity principle, funding decisions should be made at the lowest efficient level. As such, recipient countries should – as much as possible – exercise leadership over their climate change policies, and determine their funding needs according to their national strategies. This requires an important role for governments in developing countries in order to overcome weak institutional capacity through the establishment of national governance structures for planning, implementing and monitoring financial flows. An early financial support must therefore be allocated to build up adequate institutional, technical or managerial capacity so that recipient countries can absorb and use new financial flows effectively. It is increasingly recognised that unless climate funds are provided in ways that strengthen national governance systems and accountability mechanisms, the scaling-up of these funds might “undermine years of efforts promoting national ownership and accountability.”<sup>61</sup>

While the Cancun Agreements are silent about national ownership, its terms of reference (Annex 3) do mention ‘direct access’ to funding, which is considered as a means to increase national ownership and decrease transaction costs. Direct access entails that “the recipient countries can access financial resources directly from the fund, or can assign an implementing entity of their choosing”.<sup>62</sup> Tra-

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60. N. BIRD *et al.* (2011), *op. cit.* note 45.

61. Global Climate Change Alliance, “GCCA Support Facility”, Information note on the GCCA events of 28 February to 4 March 2001, Port Vila, Vanuatu, <http://www.gcca.eu/usr/GCCA-Pacific---Information-note-on-the-GCCA-events.pdf>.

62. J. BROWN, N. BIRD and L. SCHALATEK, “Direct Access to the Adaptation Fund: realising the potential of National Implementing Entities”, Heinrich Böll Stiftung and Overseas Development Institute, Climate Finance Policy Brief No. 3, November 2010, [http://www.fao.org/fileadmin/user\\_upload/rome2007/docs/Adaptation%20Fund%20Direct%20Access%5B1%5D.pdf](http://www.fao.org/fileadmin/user_upload/rome2007/docs/Adaptation%20Fund%20Direct%20Access%5B1%5D.pdf)

ditionally, funds are channelled via a bilateral or multilateral organisation such as the World Bank or UNDP, acting as an implementing agency of the funds administrator.<sup>63</sup> Direct access thus allows the beneficiary countries to perform the functions of developing, approving and monitoring projects, without having to rely on the assistance of intermediary entities. It is the Kyoto Protocol Adaptation Fund that has developed direct access through the accreditation of National Implementing Entities (NIEs).<sup>64</sup> NIEs directly receive the Adaptation Fund's funding that will be used for in-country adaptation projects and programmes. However, these NIEs are not easy to establish. So far, the Adaptation Fund Board has accredited only four of the numerous NIE applications.<sup>65</sup> Despite the difficult development of NIEs, direct access has raised great interest among the International Community.

## 4.2. How should the funds be allocated?

The questions related to the way funds should be allocated can be asked with respect to several issues; (i) the allocation between countries, (ii) the allocation between mitigation and adaptation and, (iii) the allocation of funds in a timely manner. Each of them will be respectively addressed in the following section.

Firstly, the GCF will surely encounter difficulties when trying to allocate climate change funding in an equitable manner. The Cancun Agreements state that funding for the most vulnerable countries, such as the LDCs, SIDS and Africa will be prioritised. However, in light of the lack of institutional, human and technical capacity, creating the means for these countries to access the funding will be a major challenge. The eligibility for receiving funds should be decided on the basis of internationally agreed vulnerability indicators, instead of the current 'first mover' advantage that prevails in most of the funds. The funds allocation should reflect the needs of the beneficiary regions and countries while simultaneously encompassing social and economic realities.

In any case, aspiring to a more equitable distribution of funds is likely to create ongoing tension amongst private investors, who are inclined to seek profitability and cost-effectiveness. The concentration of CDM projects in specific regions shows that 'flexible' instruments do not lead to equitable distribution. This tension has already appeared in the distribution of fast-start finance, impeding international climate negotiations as a result. While fast-start finance was spe-

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63. L. SCHALATEK (2010), *op. cit. note 35*, p. 47.

64. The Adaptation Fund also allows Parties, seeking financial resources, to submit proposals using the services of Multilateral Implementing Entities (MIEs).

65. In Jamaica, Senegal, Uruguay and Benin.

cifically intended for LDCs, SIDS and Africa, it appears that rich countries are trying to sneak in their existing funding to emerging economies as part of their fast-start finance package. For instance, the US has listed about \$26 million to India as part of their fast-start finance pledges.<sup>66</sup> Yet, the BASIC countries – Brazil, South Africa, India and China – have voluntarily declared that they are not candidates for fast-start finance.

Secondly, the Cancun Agreements require a “balanced allocation between adaptation and mitigation.” However, there is yet to be found a consensus on what “balanced allocation” actually means. The current allocation of funds between mitigation and adaptation is considerably unbalanced. To date, only 13,9% of public climate finance has been allocated to adaptation.<sup>67</sup> The GCF should address this adaptation gap. According to the Cancun Agreements, “a significant share of new multilateral funding for adaptation should flow through the Green Climate Fund”. It is the TC which will be charged with providing clarity on what “balanced” signifies. In the meantime, developed countries should try to ensure a balanced allocation close to 50% for each adaptation and mitigation.

Finally, in their proposal for a future financial framework, developing countries insist on the availability of resources in a timely manner.<sup>68</sup> In order to ensure the successful implementation of national policy actions, funding must be allocated when required. Regarding previous development aid experiences, the timeliness of funding has always represented quite a challenge. Liane Schalatek (2010)<sup>69</sup> proposes to take the amount of disbursed funds within a relatively short period of time as performance indicators and to calculate the reduction of the current wide gap between pledged and disbursed funds<sup>70</sup> during that same period. Then, a public “naming and shaming” of contributing countries with unfulfilled pledges could help in accelerating the flow of climate funds. Two significant initiatives are already attempting to do this with regard to fast-start finance.<sup>71</sup> However, this strategy is currently difficult to implement due to the lack of available data in the reporting on the delivery of climate finance from developed

66. P. JEBARAJ, “Fast-start finance for climate change has not even passed double digit”, *The Hindu*, New Delhi, 27 February 2011, <http://www.thehindu.com/news/national/article1495744.ece>

67. Information available on Climate Funds Update website: <http://www.climatefundsupupdate.org/graphs-statistics/areas-of-focus>

68. G77 and China Proposal, *op. cit. note 41*, p. 2.

69. L. SCHALATEK (2010), *op. cit.*, pp. 45-46.

70. Information available on Climate Funds Update website: <http://www.climatefundsupupdate.org/graphs-statistics/pledged-deposited-disbursed>

71. For a state of play of fast-start climate finance, see: <http://www.faststartfinance.org/home>, Fast Start Finance is a Netherlands-led initiative, developed with support from other countries and in consultation with the UNFCCC, UNEP, UNDP and the WB monitoring efforts; <http://www.wri.org/publication/summary-of-developed-country-fast-start-climate-finance-pledges>, the civil society monitoring efforts of the World Resources Institute.

countries. While the enhanced reporting provisions of the Cancun Agreements will be essential “for successful tracking of developed country climate financial flows”, their implementation “will not be ready in time to provide guidance for reporting on the short-term, fast-start finance.”<sup>72</sup> Therefore, despite clear pledges from developed countries, the delivery of funds remains slow and uncertain so far.

### **4.3. What finance modality should be used for mitigation and adaptation?**

Two main modalities can be used to finance climate change, namely grants and/or concessional loans. There is a general agreement that funding should be ‘appropriate’, meaning that the finance modalities used to deliver resources should not place any additional burdens on the recipient country.

It is widely acknowledged that adaptation should be financed only through public grants, not by repayable loans (even under favourable conditions). Adaptation finance must not be viewed as ‘aid’, but rather as a compensation for the damages caused by climate change in developing countries due to the excess of carbon emissions from developed countries. In practice, necessary adaptation investments could be constrained if recipient countries have to finance them through loans.

As for mitigation, the choice between loan and grant should be assessed on a case by case basis. In poor countries, already heavily indebted, it is clear that mitigation finance should be predominantly provided through grants. Concessional loans could often come at the expense of reductions in social public expenditures, affecting vulnerable populations who are already living in poverty. One of the biggest challenges will therefore be raising enough funds so as to provide the necessary grant financing. Loans will undoubtedly also have a key role to play in financing climate change, especially to leverage private funds. Many developing countries are inclined to believe that loan finance is acceptable under certain national conditions, depending on the sector and the project/programme financed.<sup>73</sup> It is important to underline that climate finance in the form of loans is often conducted according to highly concessional terms.<sup>74</sup>

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72. A. BALLESTEROS *et al.* (2011), *op. cit.* note 11.

73. N. BIRD and J. BROWN (2010), *op. cit.* note 3.

74. According to the OECD definition, “the concessionality is achieved either through interest rates below those available on the market or by grace periods, or a combination of these.”



## 5. THE EU'S CONTRIBUTION TO CLIMATE FUNDING

The EU and its Member States have committed to providing new and additional finance for tackling climate change in the short and long term. As the world's leading provider of ODA and a frontrunner in the provision of climate finance, the EU must take the lead in ensuring the mobilisation, administration and delivery of climate financing in the most efficient, consistent and transparent manner possible.

While the EU fast-start finance contribution will be based on existing initiatives, the long-term financing process is still uncertain. Both the EU's contribution to long-term financing, and the management of this long-term financing remain unknown. As climate change is an area of shared competences between the EU and the Member States, a coherent and credible European approach on international climate financing is and will be difficult to develop. Indeed, the first challenge for the EU remains in defining the added-value of the European approach to the existing national and international initiatives.<sup>75</sup>

The following section will analyse how the EU is meeting its fast-start finance pledge and how it is planning to deliver scaled-up climate finance from 2013 to 2020 before examining the lessons learned from the EU's experience so far. The trajectory of scaled-up climate finance will depend largely on the fast-start finance experience.

### 5.1. EU fast-start finance up to 2012

A clear and consistent reporting framework is vital for the long-term success of global climate financing and the EU has a central role to play towards achieving this. Despite the difficulties to gathering data from 27 Member States, the EU has made relevant efforts to ensure the reporting of the commitments of the Member States and the European Commission on fast-start finance. The EU's first annual report on fast-start finance in 2010<sup>76</sup> as well as the pro-active EU communications in Cancun and before demonstrate the EU's willingness to send the right message to developing countries, i.e. the EU and its Member States are

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75. N. BIRD and J. BROWN (2010), *op. cit.* note 3.

76. Council of the European Union, "EU Fast Start finance Report for Cancun", 6 December 2010, <http://register.consilium.europa.eu/pdf/en/10/st15>; Council of the European Union, "Addendum to note: EU Fast Start finance Report for Cancun", 11 November 2010, <http://register.consilium.europa.eu/pdf/en/10/ST15/ST15889-ad01.EN10.pdf>

serious about meeting their pledges in a transparent, open and cooperative manner.

Although the reporting efforts of the EU cannot be denied and are the most comprehensive relative to other developed countries, the execution of these efforts is still insufficient.<sup>77</sup> However, 2010 being the first year of the fast start finance period, it would have been unrealistic to expect much better. In analysing the shortcomings of this first year experience, lessons can be learnt so as to improve future reports in the short term and the mobilisation, administration and delivery of funds in the long term. The trajectory of scaled-up climate finance will largely depend on the fast-start finance experience.

### *5.1.1. Mobilising EU fast-start finance*

Of the US \$ 30 billion that the developed countries have committed to provide for the period 2010-2012 as fast-start financing for developing countries, the EU and its 27 Member States have pledged EUR 7.2 billion, or EUR 2.4 billion annually, as a single global contribution. Ensuring the EU raises these funds is crucial for building trust with developing countries, reinstating its role in global climate negotiations and paving the way towards larger amounts of long-term climate funds.

Despite hard economic times and significant budgetary constraints, all 27 Member States and the Commission have made funding commitments for the fast-start finance period. These commitments amount to EUR 7.213 billion for 2010-2012, which slightly exceeds the initially pledged EUR 7.2 billion.

In the EU's first official annual report on fast-start finance, the Ministers of Finance have reaffirmed the mobilisation of EUR 2.35 billion of fast start finance for 2010. Four Member States reported a zero contribution for 2010 but they did not change their contribution for the fast-start period and should meet the later in the course of 2011 and 2012. The national contributions are not based on a distribution key but are voluntary pledges. The voluntary character of these commitments is the result of a concession made to some Eastern European Member States, which feared an additional financial burden on their economies. To show the actual contribution of each Member States to fast-start finance, the commitments of the 27 countries plus the European Commission should be set up separately in the EU's official report. Yet, the 2010 report only

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77. L. SCHALATEK, "B+ for Effort, C- for Execution – The EU's Fast Start Finance Report", Climate Equity, 30 November 2010, <http://climateequity.org/2010/11/30/b-for-effort-c-for-execution-the-eus-fast-start-finance-report/>

provides EU-wide figures or a very detailed annexed list of more than 50 pages containing the several projects financed by Member States and the Commission along with their funding contributions.<sup>78</sup>

The main pitfall of the EU fast start finance report lies in the absence of an EU-wide baseline against which “new and additional” funds can be counted. While the EU is on track to meet its fast-start finance commitment, a significant share of the funds is simply redirected basic development aid, or repackaged commitments already made in the past. Member States have interpreted and defined the principle of “additionality” in accordance with their respective contributions. For instance, although the UK has pledged by far the biggest contribution (about EUR2.4 billion over the period 2010-12), all the money is expected to come from its previous commitment to reach an ODA contribution of 0.7% of GNI by 2013. Germany has committed about half the amount of money pledged by the UK. However, the funds which exceed Germany’s 2009 baseline for climate financing as well as the country’s share from auctioning in the EU ETS are considered to be additional money. The Dutch, the Danes and the Swedish, which already exceed the 0.7% of GNI on ODA, are in favour of the 0.7% of GNI baseline, which is preferred by developing countries. However, this definition cannot guarantee the additionality of funds for these countries as they can simply recycle their existing ODA commitments in new and additional climate funding. In response to this multitude of ‘additionality’ definitions, the EU has truthfully recognised that a substantial part of EU fast-start finance will be implemented through existing initiatives and that ODA will continue to play a role in climate financing. This is mainly due to the increasing integration of climate actions in broader development strategies. In order to avoid damaging trust with developing countries, the EU has also committed itself to ensuring that “fast start funding and other climate finance neither undermines nor jeopardises the fight against poverty and continued progress towards the Millennium Development Goals (MDGs).”<sup>79</sup>

### 5.1.2. *Administrating EU fast-start finance*

Climate change being an area of shared competency, Member States can choose whether they administrate their climate financial contributions unilaterally or together via the EU.<sup>80</sup> In order to rapidly deploy the fast-start funding, the EU and its Member States currently use existing bilateral and multilateral delivery

78. Individual country commitments can therefore be calculated in an inconvenient manner by adding up the contributions of all projects financed by a Member State.

79. Council of the European Union (2010), “EU Fast Start finance Report for Cancun”, *op. cit. note 76*

80. N. BIRD (2011), *op. cit. note 38*.

channels.<sup>81</sup> Out of the EU fast start finance for 2010, 44,7% of the funds will be implemented through bilateral channels, especially by member states' development cooperation programmes, and 55,2% through multilateral channels of international and regional institutions. Regarding the multilateral channels, more than one third of the EUR 2.35 billion mobilised for 2010 will be delivered through the World Bank funds. The rest of the funding is also being channelled through the UNFCCC, the UN and other multilateral and bilateral instruments.

N. Bird and J. Brown (2010)<sup>82</sup> examine several European initiatives which highlight the different approaches towards climate finance, limiting the overall coherence of the European response. Among these European initiatives, the two existing European Commission initiatives<sup>83</sup> as well as two significant Member States initiatives are summarised as follows:

- *The Global Climate Change Alliance (GCCA)*: This European Commission initiative has been created as the “EU’s answer to the development dimension of climate change”<sup>84</sup>. The objective is to establish an alliance between the EU and poor developing countries that are most affected by climate change. Operational since 2008, the GCCA has so far failed to act as a real ‘clearing house’ for Member States’ support to developing countries. Only two European countries, namely Sweden and the Czech Republic, have given modest support. This shows that alternative channels are clearly favoured by Member States over an EU coordinated approach. Moreover, donor funding is classified as ODA and there is very little ownership among Member States and beneficiary countries. Therefore, if Member States agree to channel part of their climate funding through the fund, a more transparent governance structure will have to be adopted.
- *The Global Energy Efficiency and Renewable Energy Fund (GEEREF)*: It can best be defined as a public-private partnership designed to attract funds with high capital risk from the private sector, managed by the European Investment Bank Group. The objective is to develop energy efficiency and renewable energy projects in developing countries. Contrary to the GCCA, the approach is to attract private funds in order to invest in mitigation technologies in developing countries. Endorsed by the European Commission in 2006, it took some time before the fund finally became operational in November 2008. The mix of public and private funds makes the assessment

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81. Council of the European Union (2010), “EU Fast Start finance Report for Cancun”, *op. cit.* note 76.

82. N. BIRD and J. BROWN (2010), *op. cit.* note 3; N. BIRD (2011), *op. cit.* note 38.

83. N. Bird and J. Brown examine a third European Commission initiative which has not been taken forward, called the Global Climate Financing Mechanism. Due to the large resistance it met from Member States and other reasons, it is unlikely that this approach will resurface.

84. European Commission, “Commission Staff Working Document: Implementation of the Global Climate Change Alliance”, SEC (2008) 2319, July 2008, p. 4.

of additionality very difficult to conduct. Should the fund be able to leverage sufficient private finance, this innovative approach could mobilise finance of up to EUR 1 billion. However, whether this significant figure will be reached will depend on market conditions being able to leverage private finance, which currently are not proving to be all that promising.

- *The International Climate Fund (ICF) (formerly the Environmental Transformation Fund – International window (ETF-IW))*: This fund is a UK initiative, which aims to support development and poverty reduction through environmental protection, and helps poor countries tackle climate change. As the ICF should account for 7.5 per cent of UK ODA by the end of the Spending Review period 2014-15, it is no wonder that the UK's contribution to fast-start funding is part of the rising ODA budget. Every fund of the ICF has always been allocated to three multilateral funds: the World Bank's Climate Investment Funds, the World Bank's Forest Carbon Partnership Facility and the Congo Basin Forest Fund. By helping capitalise upon the World Bank-administered funds, the UK has clearly demonstrated its lack of interest in pursuing an approach led by the European Commission.
- *The International Climate Initiative (ICI)*: This German innovative initiative provides financial support to international projects supporting climate change mitigation, adaptation and biodiversity. The ICI mobilises its funds from the EU ETS auction revenues. In 2008, the German Government started to auction 8.8% of its allowable emission permits to businesses. Of all the revenue earned, EUR 120 million has been allocated yearly to the ICI for developing countries and countries in transition. This innovative source of funding is additional to ODA contributions (though it is not sure whether it will be additional to ODA commitments). Moreover, the initiative has demonstrated its ability to deliver climate finance in a timely manner while respecting national ownership over allocation and disbursement of funds in developing countries.

According to N. Bird, the German initiative is a model of efficiency that other Member States could consider following as they will have to decide how to spend their new auction revenues from 2012. However, some Member States initiatives, such as the UK's, are pursuing their own national interests "at the expense of a European Commission-coordinated approach." Multilateral approaches allow economies of scale, better coordination and less fragmentation, therefore reducing the burden to beneficiary countries. However, they also lead to a slower pace of action, as it has been the case with both the GCCA and the World Bank-administrated funds.<sup>85</sup>

85. N. BIRD (2011), *op. cit.* note 38.

In his analysis of these different European initiatives, N. Bird points out a variety of approaches towards raising public finance. In the short term, it will be difficult to ensure European coherence on climate financing with such a fragmentation in funding initiatives. This will require coordination and coherence through improved MRV in order to avoid inefficiency, inadequacy and duplication.

### 5.1.3. *Delivering EU fast-start finance*

EU Member States have committed themselves under the Rome and Paris Declaration on Aid Effectiveness to enhance national ownership of developing countries over financial support, especially via direct access to funding. However, it appears that, apart from a few efforts, the EU and its Member States are not yet ready to break with the traditional donor-driven approach to climate financing, both via existing delivery channels and new climate finance initiatives.<sup>86</sup> For instance, budget support (i.e. the transfer of funds directly to the recipient country's consolidated fund, thus avoiding additional administrative burdens) is supposed to be the preferred aid modality of the GCCA. However, of the twelve countries where initial support projects have been identified, only four of them will have funding channelled through budget support modalities.<sup>87</sup>

With regard to the geographic allocation of funds, the requirement of the Cancun Agreements to prioritise fast-start finance for the LDCs, the SIDSs and Africa has to a great extent not been respected. When one looks at the annex of the EU's fast start finance report containing the list of the different projects funded by the Member States and the EC, slightly less than one third of the EU's fast start finance in 2010 has been allocated to China and Brazil only. Yet, the voluntary statement of the BASICs specifies that they do not want to be candidate countries for fast start funding.

Furthermore, the allocation between mitigation and adaptation is not really what we could consider "balanced" as required by the Cancun Agreements. Adaptation received around one third of the EU's 2010 fast start funding (35,9%). In contrast, mitigation received 45,6% of the EU's 2010 climate contribution, plus 16% allocated to REDD+ (mitigation via forest protection). The remaining 2,5% has not been allocated. However, when this is compared to the high historical global percentage going to mitigation (more than 85%), it shows that the EU contributors are increasingly focused on measures concerning adaptation.

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86. L. SCHALATEK (2010), *op. cit.* note 77.

87. N. BIRD (2011), *op. cit.* note 38.

Finally, less than half of the EU's 2010 funding (47,9%) came in the form of grants. These grants have mainly financed adaptation projects (not all of them though), leaving a small percentage to finance mitigation projects. The remaining 52,7% of 2010 fast-start finance came in the form of loans, equities and other means of funding. Most of these EU loans were often made on the basis of highly concessional terms, including a major grant element of up to 75%.<sup>88</sup>

## 5.2. EU long-term finance

The European Commission in a Staff Working Document of April 2011 called "scaling-up international climate finance after 2012" confirms the AGF report's conclusion that mobilising USD 100 billion per year by 2020 will be "challenging but feasible".<sup>89</sup> It has been explained above that the burden sharing of the USD 100 billion amongst developed countries could depend on the share given to two criteria; the responsibility for GHG emissions and the ability to pay (GDP). Accordingly, the EU's contribution would be about one third of long-term financing if both criteria were given equal weight (see table 3 above).

On the basis of the AGF report, the Commission states that the mobilisation of the USD 100 billion per year by 2020 will require a mix of public finance, carbon market finance and private finance. Development bank instruments would also play a role in leveraging some of these sources.

The EU has already established many of the public sources related to carbon pricing analysed in the AGF report, especially those related to the EU Emissions Trading Scheme (ETS). These sources will play an increasingly important role in financing climate change. However, the rigorous budgetary constraints in most Member States stipulate that the revenues of these sources will be subjected to competing uses. The most important source of innovative finance in the EU will be revenues stemming from the auctioning of allowances under the EU ETS. The Commission estimates that these revenues could amount to EUR 20 billion per year by 2020, of which Member States should use at least half for domestic and international climate change actions. From 2012, emissions coming from aviation will be included in the EU ETS. The ETS directive states<sup>90</sup> that the revenues from the 15% of the allowances to be auctioned should be used to tackle climate change domestically and internationally. This could amount to about EUR 600

88. European Commission, "EU Climate financing aid – clarification", 2 December 2010, [http://ec.europa.eu/clima/news/articles/news\\_2010120201\\_en.htm](http://ec.europa.eu/clima/news/articles/news_2010120201_en.htm)

89. Commission Staff Working Document (2011), *op. cit. note 12*.

90. Directive 2009/29/EC

million per year.<sup>91</sup> Moreover, carbon taxes have already been or are planned to be established in several Member States. However, the revenues from these taxes are generally used for other purposes in the budget. At the global level, the Commission does not believe that the proposal to auction a share of Assigned Amount Units (AAUs) will constitute a relevant source of revenues. Conversely, taxes on international aviation and maritime transport and a tax on financial transactions could have a significant revenue-raising potential. However, due to concerns related to competitiveness, the revenues from these sources would preferably require global agreements, which will not be easy to achieve.

In order to deliver climate finance at the required scale, the carbon market, with a robust carbon price, is expected to play an indispensable role. The CDM has so far been the main source of climate finance for developing countries, to a great extent due to the EU. However, the Kyoto Protocol expires in 2012 and the numerous issues surrounding the adoption of a new global climate agreement are expected to create no demand for international offset credits additional to what was already foreseen by the current cap-and-trade legislations of the EU and other developed countries for the period post-2012. Despite this situation, the Commission's strategy to take advantage of the low-carbon investment opportunities in developing countries offered by the carbon market is two-fold. On the one hand, the CDM should be urgently reformed globally and mainly focused on LDCs. The EU has already reviewed its ETS legislation accordingly. Not only the use of credits which come from some industrial gas projects will be prohibited from 2012 onward but, in the absence of an ambitious international climate agreement, new CDM projects will be allowed in LDCs only as of 2013. Therefore, CDM credits will receive continued recognition in the EU ETS even in the absence of a global climate agreement or a second commitment period under the Kyoto Protocol. Under this current EU legislation, carbon offsets could generate up to EUR 3 billion of financial flows to developing countries per year in the period 2013-2020<sup>92</sup> (without counting additional flows generated by investments underlying CDM projects).<sup>93</sup> On the other hand, the Commission requires "a step-wise move" towards new and more ambitious sectoral carbon market mechanisms, especially in economically more advanced countries.<sup>94</sup> In order to do so, the revised Directive provides the opportunity to conclude non-binding arrangements with third countries in order to allow credits from these markets to be recognised for use in the EU ETS.

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91. Assuming a carbon price of EUR 20 per tonne of CO<sub>2</sub>.

92. Assuming the current price for CDM credits of about EUR 13 per tonne of CO<sub>2</sub>.

93. Commission Staff Working Document (2011), *op. cit.* note 12.

94. *Ibidem*.



As analysed in section 2, the European Commission considers that private finance will have a key role in scaling up international climate finance and that development bank instruments can play a significant role in widening the sources of and access to climate finance. In 2010, the European Investment Bank (EIB) raised EUR 2 billion for climate action projects in third countries.<sup>95</sup>

Considering the increasing demand for climate finance in developing countries, the adoption of the post-2013 EU multiannual financial framework should be the occasion for the EU to scale-up its budget from 2013 so as to complement the future Member States' contributions. The Commission proposed to raise the share of climate-related spending to at least 20% of the whole EU budget, i.e. at least EUR 1,000 billion for the period 2014-2020. This represents more than three times the current amount. Under the EU budget for the period 2007-2013, the funding of climate-related actions in developing countries amounts to about EUR 400 million per year. Decisions will have to be taken on the instruments in the EU budget to administrate and deliver climate finance to developing countries. The EU should also consider "whether and to what extent EU support to the GCF should best be channelled through the EU budget or come directly from Member States' budgets."<sup>96</sup>

### 5.3. Lessons from the EU experience so far

In light of the fact that the amount of EU contribution to long-term public climate finance is not yet determined, how exactly these funds will be administered cannot yet be analysed, let alone how they will be disbursed. However, the lessons learned from fast-start finance will be essential not only when scaling up financial flows but also to prepare an efficient administration and delivery of these flows.

First, a common reporting framework with clear rules on monitoring, reporting and verification of EU climate finance is central. The remaining shortcomings identified in this respect during the fast-start period will need to be addressed for the post 2012 period. The EU has to take the lead and show the right example by providing reports with complete information in the most clear and consistent way possible.

Second, fast start finance has not been delivered fast enough as of yet. The funds are being distributed too slowly, undermining the much-needed trust with devel-

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95. *Ibidem.*

96. *Ibidem.*

oping countries as a result. Yet, it has been highlighted that for successful implementation of national climate actions in developing countries, the availability of funds in a timely manner is crucial.

Third, the EU should increase ownership and direct access of developing countries in the delivery of funds. This implies funds to equip developing countries with the capacity to manage an increase in flows in an accountable manner and to determine their funding needs in accordance with their national strategies.

Finally, the vast array of European initiatives to finance climate change during the fast start period has shown different degrees of efficiency in the mobilisation, administration and delivery of climate finance. It appears that Member States' initiatives, particularly the German ICI, have so far delivered more tangible results than the ones initiated by the European Commission.<sup>97</sup> This German initiative could influence other Member States to adopt a similar model, especially now that revenues stemming from auctioning will become increasingly important. While this would be at the expense of the development of an EU approach, the first challenge to address is to define what the added-value of an EU-approach is.<sup>98</sup> This is far from being clear. A common approach has the advantage of offering the possibility of greater scale and decreasing the administrative burden on beneficiary countries by reducing fragmentation. However, this comes at the expense of delayed delivery, as the experience with the GCCA has shown. Furthermore, in light of the preference of some Member States – such as the UK – for channelling funds according to their own priorities, the question is whether there is room for further collective actions among Member States in order to develop a European strategy, such as the GCCA, in the long-term. This question is even more pressing now that the new GCF will increase the number of initiatives, leaving even more choice to Member States. Moreover, the predominance of the World Bank's instruments in the first year of fast start finance somewhat decreases the likelihood of establishing a GCF or an EU initiative channelling a significant portion of climate finance. All these lessons may prove helpful when seeking to improve the architectural design of international climate finance.

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97. N. BIRD and J. BROWN (2010), *op. cit.* note 3.

98. *Ibidem.*

## CONCLUSION

The mobilisation, administration and delivery of climate financing in an equitable, effective and efficient manner is one of the most important challenges in our global effort to address both adaptation and mitigation in developing countries. Although progress has been achieved on support for climate action in Cancun, critical issues remain, especially regarding the mobilisation and delivery of funds.

In the absence of a credible financial framework, the risk remains that actions to tackle climate change will be insufficient, inefficient, inadequate and delayed. The global costs would thereby increase and the path towards a low-carbon economy would be jeopardized.

### **Mobilising climate funding**

The commitment from developed countries to mobilise USD 30 billion for the fast start period 2010-2012 and USD 100 billion per year by 2020 already represents a significant step forward. However, long-term financing remains to be mobilised. The AGF report concluded that going from the current mobilisation of USD 10 billion per year to USD 100 billion by 2020 is feasible, but represent an enormous challenge. Given the tightening of many Government budgets coming out of the economic recession, new and additional sources of funds must be identified. It will require a mix of new public financing instruments, carbon market finance and private finance, as well as development bank instruments to leverage some of these sources. Moreover, it is important to highlight that the scaling-up of these sources will have to take place in a context of ambitious emissions reduction targets and progress towards an ambitious, comprehensive and legally-binding international agreement on climate change.

Public sources will be important for financing adaptation and, in the next few years, for supporting developing countries in their transition through the provision of capacity building, technical assistance and pilot actions. Furthermore, public funding will be required to leverage private investment and to finance mitigation actions in areas the private sector is likely to neglect. Among the innovative sources of public finance set out in the AGF report, some of them deserve particular attention for their revenue-raising potential. The most evident is the revenue from auctioning of emission allowances in domestic emission trading schemes. These schemes are already in operation or under consideration in many developed countries. In the EU, the auction revenues under the EU ETS

will be the biggest source of innovative finance. At the global level, the most promising new sources for public finance are taxes on international aviation and shipping and a Financial Transaction Tax. However, the revenues stemming from both these sources would ideally require global agreements in order to avoid competitiveness issues, which have so far not been achieved.

The carbon market will be a key element for mobilising funding at the required scale. Stringent emissions reduction targets will be required to create enough demand for offset credits and to support a robust carbon price. The higher the carbon price, the bigger the revenue and the stronger the price signal to reduce emissions. The post-2012 strategy is two-fold: to substantially reform the CDM globally, which should focus mainly on LDCs; and, to promote the development of sectoral carbon market mechanisms in economically more advanced countries. These sectoral carbon markets should allow these countries to scale up private investments in key competitive sectors.

It is increasingly recognised that the majority of climate finance will need to come from the private sector. Private investment flows are crucial not only to bring developing countries towards a low-carbon future, but also to protect investments through adaptation measures. These investments can be stimulated through a more efficient use of public instruments in order to improve the general business environment, support risk-sharing instruments, and provide revenue support through concessional loans, grants and guarantees. Strengthening the public-private sector dialogue is therefore crucial in order to leverage additional green investments.

The multilateral development banks, which are important channels of climate finance to developing countries, can play a significant multiplier role in leveraging both public and private finance. Apart from this leveraging role, they also have a track record of providing technical assistance as well as financial and sector expertise. Therefore, the capacity of these banks should be strengthened through innovative financing instruments to leverage additional resources over the course of the next decade.

One of the most critical issues present in negotiations on climate financing remains the establishment of a common baseline against which the funds mobilised can be considered as “new and additional”. Regarding fast start financing, each developed countries, according to its national interests, has given its own definition of how much its financial contribution is “new” in comparison to its previous pledges and “additional” to its existing ODA commitment. Without a commonly agreed baseline, future financial contributions cannot be deemed credible. A clear definition of what constitutes new and additional climate

finance is needed to establish clear common rules on the MRV of climate funding, which are paramount to ensure accountability and mutual trust between developed and developing countries. However, given the important role that ODA will continue to play as a source of climate finance in the short term, an agreement on a common definition seems difficult to reach in a near future.

In a nutshell, the AGF report proposed a lot of innovative ways to mobilise new and additional climate funding in the long-term. However, the debate on the sources of climate financing touches on highly contentious and political issues, which will not be solved by the next COP in Durban at the end of the year. Therefore, mobilising \$100 billion annually seems feasible yet extremely difficult.

## **Administrating climate funding**

Both bilateral and multilateral climate funds will be required to manage the scaled-up funding. During the last few years, many new multilateral and bilateral climate funds have been established in order to develop new ways of channelling international climate financing. This has increased the complexity and the coordination of international support as well as the transaction costs for the recipients.

In Cancun, the decision was taken to establish a new Green Climate Fund (GCF) under the guidance of the UNFCCC. The governance structure of the fund provides for equitable representation of developed and developing countries. However, many fundamental questions need to be answered rapidly, such as what funding windows, what access modalities and how the fund is going to interact with existing funds. Despite the addition of another new fund in the intricate network of multilateral and bilateral funds, the GCF is deemed to simplify, rationalise and complement this complex structure. The EU's experience in fast start finance has already shown that a common European strategy is difficult to reach due to the preference of some donor countries for channelling funds according to their own interests. Therefore, a pragmatic approach is required. As it is unlikely that the GCF will replace existing initiatives, a new hierarchy under the guidance of the UNFCCC could be established with an appropriate division of labour amongst the different climate funds in order to increase complementarity and reduce transaction costs. This division of labour implies a certain level of coordination between the funds on the geographical distribution of funding, the balance of the allocation of funds between mitigation and adaptation or the most appropriate use of multiple sources of funding. Therefore, if the

GCF wants to administrate the majority of new and additional climate funding by 2013, it will have to innovate and complement existing initiatives.

For a more efficient, coherent and coordinated approach towards the administration of climate funds, enhanced transparency and accountability are essential. The MRV of climate finance must therefore be enhanced under a clear and comprehensive framework. This is the prerequisite for “a global trust, unity and action”<sup>99</sup>, which will ensure the long-term success of climate financing. However, as long as there is no clear definition of what counts as “climate finance”, it will be difficult to monitor, report and verify it.

## Delivering climate funding

Fund delivery is fundamental when assessing the effectiveness, efficiency and equity of climate finance. A key challenge is to better determine funding needs according to priority climate actions in developing countries. In order to do so, ‘national ownership’ must be increasingly secured through ‘direct access’ to funding for recipient countries. This requires early financial support in order to build up institutional capacity so that recipient countries can absorb and use new financial flows effectively.

An equitable and balanced allocation of financing poses many challenges. First, an equitable allocation of funds between developing countries will prove difficult due to the inclination of investors to seek profitability and cost effectiveness. Public finance must thus be prioritised in the most vulnerable countries. Furthermore, the balanced allocation between mitigation and adaptation required by the Cancun Agreements should be interpreted as being close to 50% for adaptation and mitigation each. In addition, a serious effort must be made to deliver the fund in a timely manner so as to address the wide current gap between pledged and disbursed funds. Finally, it is widely recognized that finance for adaptation should be provided in the form of grants, not repayable loans.



To conclude, although progress has been achieved in the administration of funds in Cancun, many issues remain unresolved. A balanced administration of cli-

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99. K. LVOVSKY, “Making the Most of Climate Finance: A Development Perspective”, International Institute for Sustainable Development, 18 February 2010, <http://climate-l.iisd.org/guest-articles/making-the-most-of-climate-finance-a-development-perspective/>



mate financing is of little value without the necessary sources to mobilise the amount of funding required and without the needed capacity to deal with the delivery of scaled-up funding in developing countries. Negotiations involving financial issues always touch upon sensitive questions. Therefore, pragmatism and good will are and will be fundamental ingredients to overcome this challenge.