



European Climate Platform (ECP)

An Initiative of Mistra's Climate Policy
Research Programme (Clipore) and the Centre
for European Policy Studies (CEPS)



Negotiating around Tradeoffs: Alternative Institutional Designs for Climate Finance

Arunabha Ghosh

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The primary question addressed in this paper is: How would different governance priorities affect the institutional arrangements for a credible financing mechanism in the climate regime? The paper argues that tradeoffs are inevitable in climate finance negotiations, so it is important to recognise them upfront and organise negotiations around the priorities that different sets of countries identify. Such a process would generate alternative institutional designs, each offering a different balance of voice in governance, scale of funding, and timely action.

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Contents

Introduction	1
1. Context – a shift in power?	1
2. How to assess the governance of climate finance?	2
3. What can climate finance learn from other regimes?	9
4. What options for institutional design?	10
5. Conclusion.....	18
References	19

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Arunabha Ghosh*

Introduction

Securing a credible pool of climate finance is one of the lynchpins for successful negotiations in the climate regime. Several initiatives are already underway and more are being planned. However, existing mechanisms have failed to deliver the level of funding required for the task, even as developing countries have clearly expressed dissatisfaction with the governance of climate finance. The Copenhagen climate summit in December 2009 offered new promises of funds, of up to \$100 billion per year by 2020. Since then the UN Secretary General's High-Level Advisory Group on Climate Change Financing has concluded that 'it is challenging but feasible to meet that goal'.¹ The funds will have to come from various sources, public and private, multilateral and bilateral. But there is little clarity on how additional funds will be channelled or the options for institutional design for the Copenhagen Green Climate Fund. This paper is a summary of findings and recommendations from a longer research report on climate finance.² The primary question it asks is: how would different governance priorities affect the institutional arrangements for a credible financing mechanism in the climate regime? The paper argues that tradeoffs are inevitable in climate finance negotiations, so it is important to recognise them upfront and organise negotiations around the priorities that different sets of countries identify. Such a process generates alternative institutional designs, each offering a different balance of voice in governance, scale of funding, and timely action.

1. Context – a shift in power?

The focus of this brief is institutional design. While climate finance will come in different phases (fast start finance followed by long-term funding), many governance-related questions remain unanswered. Before we assess those questions, it is worth noting six imperatives for climate finance.

- The scale of funding required is vastly greater than what the existing climate regime or other international environmental agreements have been able to generate so far.³

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¹ UN (2010), 5.

² Ghosh (2010a).

³ According to www.climatefundupdate.org less than \$27 billion has been pledged, and \$9 billion deposited since 2000.

- Funding is needed for both mitigation and adaptation. The less effort is taken to mitigate the emission of GHGs into the atmosphere, the more will have to be spent on adaptation activities due to the adverse consequences of climate change.
- A third issue is additionality. If public resources leverage private funding, will all of the private finances be considered towards assessing compliance by rich countries? Further, developing countries are legitimately concerned that funds intended for development assistance will be reclassified as adaptation expenditure.
- Funds for mitigation activities are needed for deploying existing technologies as well as for developing new ones. In the absence of funding for technology transfer, there is the risk that poor countries will end up at the wrong end of a new technological divide.
- Market uncertainty affects available funding. Globally, there was a surge in investments for renewables-based energy from 2004 to 2007. Whereas only 8 per cent of additional capacity in 2003 was in renewables, by 2008 this share had risen to 25 per cent.⁴ This upward trend was halted by the economic crisis. By Q3 2008, the four-quarter moving average was on a downward trend. Estimates suggest that investments fell by at least 20 per cent in 2009. While market-based funding has slowed down, public funding support has not filled the gaps.
- Meanwhile, emerging economies have become important actors in another respect, namely investments in clean technologies. China and India have the highest and fifth highest installed renewable energy capacity respectively. During 2004–08, Brazil, China, and India experienced compound annual growth rates in renewable energy investments of 171 per cent, 104 per cent, and 52 per cent respectively.⁵ The Copenhagen negotiations also signalled the ability of emerging powers to co-ordinate their negotiating strategies and to drive a hard bargain.⁶ The danger presented by the Copenhagen process is that if, in pursuit of a flexible set of agreements, major emitters strike bilateral and plurilateral deals, what incentives will they have to provide financing and technology to poorer countries?

2. How to assess the governance of climate finance?

In other words, the problem for climate negotiators is how to harness the power shifts while balancing the varied financial imperatives. A better understanding of these imperatives depends on, first, identifying funding channels; secondly, identifying the key concerns of parties; thirdly, developing a framework of governance functions to reflect these concerns; and fourthly, evaluating the funds based on such a framework.

Funding for climate-related activities comes from multiple sources. Six funding channels can be identified.

- Multilateral development bank (MDB) funds
- United Nations funds
- Government-promoted funds
- Public-private investment funds

⁴ UNEP, Sustainable Energy Finance Initiative, *New Energy Finance* (2009).

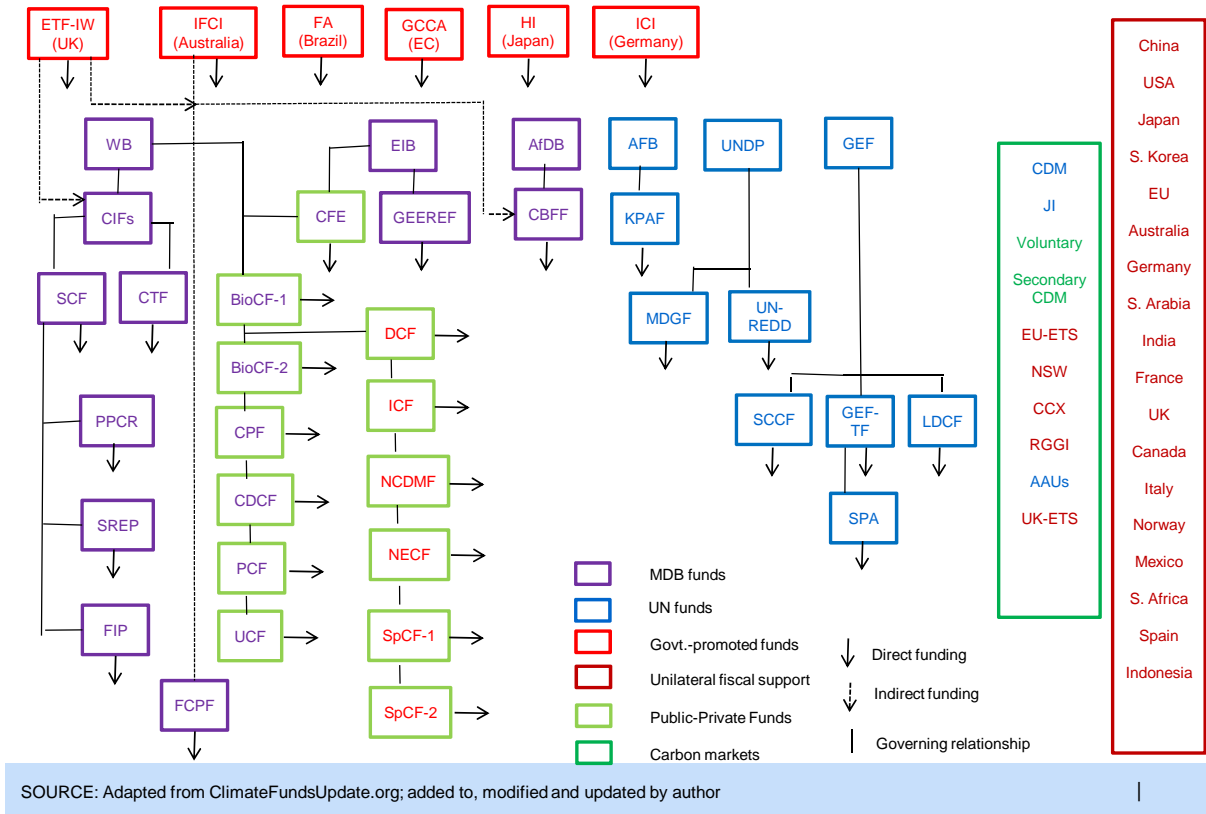
⁵ REN21 (2009).

⁶ For a detailed discussion on potential shifts in the climate regime's architecture and governance, see Ghosh (2010b).

- Carbon markets
- Unilateral fiscal support

Figure 1.

Funding sources are many but their governance is often interlinked



Each category, in turn, has numerous funds raised and managed by different countries and institutions. The funding sources might be diverse, but in many instances their governance structures are linked and even overlapping. MDBs manage many of the multi-donor trust funds (MDTFs). But even those that are managed by UN agencies have some degree of MDB involvement. Government-supported funds are managed by donor ministries but some also route a portion of the funding via existing MDTFs. Further, public-private investment funds are often under MDB management, but representation in these funds varies depending on whether there is only one country contributing, or several. The different carbon markets have their own governance arrangements, but they do interact when credits are purchased in one market towards fulfilling obligations under other schemes. Only unilateral fiscal support initiatives can be regarded as having entirely independent governance. The complexity of different sources of funding and the links between them are illustrated in Figure 1.

Next, we summarise the key concerns that contributing and beneficiary countries have in climate finance negotiations.

Contributing countries

- **No free lunch:** Annex I countries are unwilling to contribute any money unless developing countries, particularly the large ones that are now also major emitters, also promise to undertake mitigation actions.
- **Competitiveness and transfers:** Developed countries also fear that flows of finance and technology to emerging economies will pose the risk of them losing their own competitive edge in clean technologies.
- **No new bureaucracy:** Rich countries are keen to use existing channels of funding rather than create new institutions. Contributing countries also argue that creating new institutions will only add to the bureaucracy and transaction costs in disbursing money when the landscape is already populated with so many funds.
- **Monitoring projects is critical:** Verifying that the money is being used for the purposes outlined in each fund and that the purported emissions reductions are both credible and additional remains a major concern for contributors.

Beneficiary countries

- **Climate finance is not aid:** For Non-Annex I parties, the most important argument in climate finance negotiations is that financial flows cannot be treated as aid. On ethical, the reasoning is that poor countries have not hitherto contributed to the problem of climate change but they are expected to bear the brunt of the adverse impacts of a rise in average temperatures. The political reasoning draws upon the experience with ODA and a long history of unmet promises.⁷
- **Climate finance must not displace aid:** A related concern for developing countries is that, even if the transfer is not called ‘aid’, it will simply crowd out assistance for other development goals. This raises questions about how climate financing will be counted.⁸
- **A single mechanism to govern:** Developing countries demand a comprehensive financing mechanism under the UNFCCC to operate under the ‘authority and guidance, and be fully accountable to the COP’.⁹ A single mechanism under the COP is attractive to developing countries not only for controlling its governance but in accessing the funds more directly.
- **Adaptation is also an imperative:** Poor countries fear that financing for adaptation will be treated as an afterthought or a ‘poor cousin of mitigation’ in climate negotiations. The Copenhagen Accord promised balanced allocation of the fast start funding of \$30bn until 2012. It also suggests that funding for adaptation will be prioritised in LDCs, small island developing states (SIDS), and Africa.¹⁰ But while the Accord puts a figure of \$100bn per year by 2020 for ‘meaningful mitigation actions’, there is no figure ascribed to adaptation purposes beyond 2012.
- **More grants, less conditionality:** Funding can be delivered as non-repayable grants, as concessional loans, as direct investments in projects, or as guarantees to insure against project risk. A new financing mechanism has to be flexible in order to offer a range of

⁷ Ghosh and Woods (2009), pp.456-457.

⁸ Stadelmann, Roberts, and Huq (2010) outline eight ways to define the baselines above which contributions could be considered additional. Also see Brown, Bird, and Schalatek (2010), pp.3-6 on the implications for ODA of alternative definitions of ‘additionality’.

⁹ G77 and China (2008).

¹⁰ Copenhagen Accord, 18 December 2009, para. 8.

different financial products.¹¹ But beneficiary countries do not want to become burdened by debt in order to undertake adaptation or mitigation actions. A related concern is about the kind of conditionality that might be imposed on beneficiary countries, depending on the type of financial instrument on offer.

- **Monitoring of funding is equally critical:** The Bali Action Plan recognises that the nationally appropriate mitigation actions (NAMAs) taken by developing countries have to be ‘supported and enabled by technology, financing and capacity-building, *in a measurable, reportable and verifiable manner*’.¹² From the point of view of developing countries, this provision not only makes their actions *contingent on* the funds provided but also means that the funds need to be monitored properly.

The contradictions among stakeholders’ needs suggest that the governance of climate finance cannot necessarily satisfy all conditions for all parties. Yet, the priorities of the parties point towards specific governance functions that a financing mechanism ought to fulfil. These governance functions and the criteria embedded in each are outlined below. For each function, 33 climate funds were analysed to reveal patterns that either satisfy some parties or are sources of discontent for others.

Making decisions

The choice of institutions matters above all else because countries’ say in and influence over decisions vary. The GEF became an ‘operating entity’ of the UNFCCC by default because, when created, there was no alternative channel.¹³ Since then funding sources have expanded, the scale of funding required has increased, and the number of institutions involved in climate finance has multiplied. The evaluation of alternative institutions and funds with regard to how decisions are governed will be based on:

- Administration, or which agency has the authority to manage the funds;
- Representation, or which countries (or non-governmental actors) are members of the main decision-making body;
- Decision rules, whether by votes or consensus or a mix of both;
- Consultation, or whether experts, beneficiary countries, and other stakeholders are consulted in the design and operation of the funds.

The results from the analysis of 33 funds are summarised in Table 1.

¹¹ Ghosh and Watkins (2009).

¹² Bali Action Plan, Decision 1/CP.13, para. 1b(ii) (emphasis added).

¹³ Gomez-Echeverri and Müller (2009).

Table 1: Few funds have equitable decision-making procedures				
	Administration	Representation	Decision	Consultation
MDB	Mostly World Bank	Recent initiatives give beneficiary countries balanced representation	Mostly reliance on consensus	Partnership forums; expert groups
UN	World Bank also plays role in GEF	Only KPAF gives developing countries more seats; civil society in CBFF and UN-REDD	Consensus, in the absence of which voting rules vary	NGO networks; also indigenous people for forestry-based funds
Government-promoted	Contributing country agencies	Poor countries seldom involved in fund design	No voting rights for beneficiary countries	Consultation procedures vary
Public-private	World Bank manages most	Only contributing countries and private sector participants	No voting rights for beneficiary countries	Mostly expert advisory groups

Source: Author's analysis

Securing commitments

Although references to financing appear regularly in the climate regime's decisions, there is still no legally enforceable set of commitments that promise a certain amount of funding. In order to evaluate funding sources in terms of securing commitments, four criteria can be identified:

- Adequacy, or the amount of funding that each source offers and whether it meets expected needs;
- Additionality, or whether resources will be additional to sums already committed in each fund;
- Predictability, or whether funds will be committed with guarantees so that contributing countries do not backtrack in future;
- Appropriateness, or whether the funds strike a balance between public and private sources and between the designated uses for the resources (mitigation versus adaptation).

The results are as summarised in Table 2.

Table 2: Pledges unlikely to be additional or predictable, especially during an economic crisis				
	Adequacy	Additionality	Predictability	Appropriateness
MDB	Level of ambition low so far	Not if counted as ODA or if concessional loans are discounted	Depend on voluntary contributions	Mostly for mitigation
UN	Very low pledges	Unclear status for GEF funds post-2012	Depend on voluntary contributions; KPAF depends on CDM market	Greater number of funds for adaptation but very low pledges
Government-promoted	Mostly because of HI	Counted as ODA	Purely voluntary contributions	Mix of adaptation and mitigation
Public-private	Low	Not ODA but not for additional actions in developing countries	Depend on state of carbon markets, level of carbon price	Unlikely to flow to LDCs; private sector leverage during crisis is difficult

Source: Author's analysis

Ensuring disbursements

Table 3: Disbursements low and a mix of loans and grants, mostly for projects				
	Scale	Instrument	Modality	Conditionality
MDB	Tiny fraction of pledges	Grants and concessional loans	Projects but programmatic and budget support also envisioned for CIFs	Recipient-developed strategies
UN	Greater disbursements but scale is small	Mostly grants	Mostly projects; KPAF can support programmes	Meant to be country-driven; but also bureaucratic hurdles
Government-promoted	The largest funds see few disbursements	Mix of loans and grants	Mostly projects	Mostly through normal bilateral channels, or for specific countries
Public-private	Bias towards large projects or a few large countries	Investments and guarantees	CPF and UCF aim for programmatic support	Technical competence of host country important; CDCF focus on small countries; CFE preference for short lead times

Source: Author's analysis

The gap between commitments and disbursements has been a source of mistrust between contributing and beneficiary countries. The issue is not restricted only to the amount of funds

provided. It also concerns the manner in which resources flow and under what conditions. Disbursements in a climate finance mechanism can be judged on the following terms:

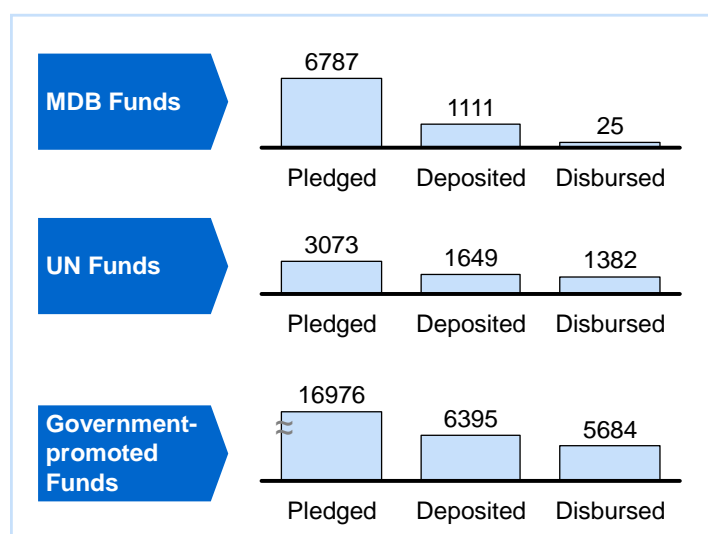
- Scale, or whether resources tend to flow towards large or small projects or large or small countries;
- Instruments, or whether the funds deliver resources through one or several different financing instruments (investments, loans, grants, and guarantees);
- Modality, or the manner in which governments and private entities in beneficiary countries can access the funds (for projects, for sectoral programmes, or directly for government budgets);
- Conditionality, or the kind of pre-conditions that are imposed by contributing countries.

The analysis of disbursements for the funds and the low scale of ambitions are captured in Table 3 and Figure 2, respectively.

Figure 2.

Many recent initiatives for climate financing but low ambitions so far

\$mn, figures updated as of August 2010



NOTE 1: UK Environmental Transformation Fund – International Window: Funds channelled through CIFs, FCPF and CBFF, hence not included separately

NOTE 2: Strategic Climate Fund (MDB): Funds channelled through PPCR, FIP and SREP, hence not included separately

NOTE 3: For the Adaptation Fund (UN), the money raised from the monetization of CERs is included under pledges

NOTE 4: Funds for the Strategic Priority on Adaptation (SPA) are sourced from the GEF Trust Fund

NOTE 5: For the GEF Trust Fund, only pledges/deposits under the climate change focal area for the fourth and fifth funding replenishments are included

Source: Author's calculation based on data available at <http://www.climatefundsupdate.org/graphs-statistics/pledged-deposited-disbursed/>;
Accessed 13 August 2010

Monitoring performance

The last governance function relates to monitoring projects and financial flows, verifying and reviewing them, and the procedures for promoting compliance. These are politically fraught questions and no mechanism yet exists that performs all of these tasks. Nevertheless, it is useful to explore alternative design options based on:

Reporting funds, or what kind of reporting format the fund adopts;

- Reporting performance, or who has the responsibility for reporting on project outcomes;
- Verification, or whether independent agencies are tasked with verifying reports and certifying projects;
- Review, or whether the funds also undertake political reviews and overall evaluations;
- Compliance, or whether there are any procedures in place to enforce commitments, both for providing resources and for meeting project aims.

For monitoring both the flow of funds and how effectively they are used, the different channels reveal patterns captured in table 4.

Table 4: Little attention to monitoring and enforcing financial flows					
	Reporting funds	Reporting performance	Verification	Review	Compliance
MDB	Annual reporting but lags in data	Each MDB follows its own M&E procedure	Unclear	Three-yearly impact evaluation	Unclear
UN	Online database for GEF	Secretariat and agencies monitor GEF	Evaluation Office but no separate verification of fund contributions	M&E results to GEF Council	Unclear but unlikely any compliance procedure for funding
Government-promoted	Ad hoc	Monitoring capacity is key criterion	Unclear	Unclear	Voluntary contributions, so no compliance procedure
Public-Private	Some data in World Bank reports but not comprehensive	Some funds help build methodologies	Independent verification for many funds but no separate verification of fund contributions	Unclear	Many are single country-led, so no compliance mechanism
<i>Source: Author's analysis</i>					

3. What can climate finance learn from other regimes?

Notwithstanding the challenges facing climate funds, important funding initiatives exist in other regimes as well, such as the Multilateral Fund of the Montreal Protocol; the Global Fund for HIV/AIDS, Malaria and Tuberculosis; the Global Alliance for Vaccines and Immunisation (GAVI); and the World Bank's Trust Fund for the Global Agricultural and Food Security Programme (GAFSP). Their governance also offers valuable lessons for climate finance.

- First, multiple funding sources are necessary but not sufficient. These funding initiatives have all had the aim of significantly increasing the scale of funding available while making sure that it is additional to other development assistance. The main advantage of vertical funds is the ability to raise more resources through both public and private

sources. Moreover, contributors to the Global Fund and the GFASP include large, developing, and emerging economies as well. Nevertheless, the sustainability of funding remains in doubt even when private sources are tapped.

- Secondly, targeting funds improves outcomes but also reduces flexibility. The relative success of these funds is at least partly due to their focus on specific diseases or technologies – but there are caveats. Whereas the Montreal Protocol targeted one specific set of pollutants, the UNFCCC covers a wide range of greenhouse gases. At the same time, vertical health funds are generally criticised because they target specific diseases or pollutants at the cost of under-funding systemic infrastructure. Under GAVI, for instance, where health systems support has recently been provided, recipient countries are further burdened by the need to prepare additional plans to secure funding.
- Thirdly, direct access to funding is achievable. The GAFSP's main lesson for climate finance is its focus on providing funds much more quickly than existing bilateral and multilateral cycles. Such funding is also expected to be more flexible, giving countries a chance to restructure their programmes midway, depending on outcomes. In both ways, the programme hopes to make aid flows more predictable, something that the various climate funds have not achieved. The Montreal Protocol's fund also permitted programmatic funding, which allowed for a more strategic orientation away from ozone-depleting substances.
- Fourthly, the legitimacy of governance depends on both rules and practice. All the funds have balanced representation of rich and poor countries and many also formally include other actors such as international organisations and civil society representatives. Yet tensions persist on the terms of funding and regarding decision-making rules. Recipient countries remain sceptical of concessional loans as opposed to grants, fearing the conditionalities attached to them and the size of the potential debt burden. In climate change, where estimates of funding requirements vary widely, even low-interest loans can become burdensome. The lessons from the health-related funds show that while private sector participation can increase the available funds, there is no easy transition to recipient countries taking on larger co-payment obligations. Balanced representation on boards and expert committees can create an illusion of legitimacy if consensus-based voting rules ensure that contributing countries still maintain effective vetoes over the allocation of resources.
- Fifthly, monitoring and evaluation remains a key concern even for targeted funds. The use of performance-based indicators as the basis of reward schemes has led to the perverse outcome of inflating immunisation figures in GAVI recipient countries. There have been calls for independent monitoring and tracking of vaccination coverage and common reporting structures for developing countries. Monitoring and evaluation has also remained a problem with the Montreal Protocol, due to inflated project costs and lack of independent audits.

4. What options for institutional design?

Noting the lessons learned in other regimes and the outstanding concerns of parties in the climate regime, four institutional architectures for the governance of climate finance can be considered (these are summarised in Table 5). These schematic options have one principle in common, namely explicit recognition of the trade-offs between different priorities in climate change financing. The following discussion sets out the key elements of each design option, its merits and demerits, and its implication for the Copenhagen Green Climate Fund (GCF),

envisaged in the Copenhagen Accord and through which a ‘significant portion’ of new and additional funding will flow.¹⁴

Table 5: Options for institutional design for governing climate finance				
	A: Consolidate and specialise	B: Create and legitimise	C: Innovate and de-bureaucratise	D: Separate and indigenise
<i>Focus</i>	Voice	Scale of funding	Scale of funding	Hastening actions
<i>Elements</i>	Coordination	Voice		Adaptation is key
	No new institutions	New Low Carbon Global Fund	Innovative financing	No overarching mechanism
	Reform of MDBs	Increased voice	MDBs face competition	Self-reliance and innovative finance
	Aim for budget support	Upfront financing commitments	Mainly project financing	MDBs underwrite risk
<i>Merits</i>	MRV under UNFCCC	Programmatic support with flexible, project financing	MRV by market actors	Legal commitments for adaptation funding under UNFCCC
		MRV by public-private agencies		MRV needs domestic capacity
<i>Demerits</i>	Beneficiaries get more voice	G77 and China’s formal demands met	Contributors do not have to contribute greater public funds if private markets fill the gap	Political feasibility high, especially for a deal between rich and emerging countries
	Contributors’ preference for existing agencies maintained	Contributors might accept if precedents from Montreal Protocol, Global Fund, GAVI, and GAFSP are noted	Emerging economies secure greater financial flows for technological upgrading	Adaptation finally gets separate attention – poorest countries’ demands met
<i>Implications for Green Climate Fund</i>	Innovative financing limited	Political feasibility low given funding requirements	UN-centred governance declines	Small countries potentially lose in technology race
			Adaptation funding suffers	
<i>Implications for Green Climate Fund</i>	GCF resembles GEF	LCGF morphs into GCF: legitimacy rises	Less voice	GCF primarily as operating entity for adaptation/capacity-building financing
	GCF answerable to COP	LCGF more a vertical fund for mitigation and technology transfer: sub-set of GCF remit	Limited role as operating entity: most funds through private channels	Reduced role of GCF in mitigation
	COP determines equitable allocation		Challenge of counting ‘new and additional’ resources under GCF	

Source: Author.

¹⁴ Copenhagen Accord, 18 December 2009, para. 8.

The Accord also states that the GCF will be established as an operating entity of the financial mechanism under the UNFCCC. It is expected to fund projects, programmes, policies, and other activities related to mitigation (including REDD-plus), adaptation, capacity-building, and technology development and transfer.¹⁵ The GCF needs a COP decision to be established but, as an operating entity, it can be housed elsewhere.¹⁶ The question is how far different design options will fulfil alternative priorities for raising funds, allocating them, monitoring flows and activities, and giving contributors and recipients a say in its governance.

Option A: Consolidate and specialise

This option prioritises two governance concerns: more voice or decision-making power for beneficiary countries, and coordination among existing institutions. It will have four key elements.

- **No new institutions:** Instead of creating more institutions, better co-ordination between existing institutions will be the norm. Of course, this is exactly what the GEF was supposed to do (a tripartite arrangement between UNDP, UNEP, and the World Bank). The difference is that, in this case, the funds promised will be significantly greater and will be linked to a compliance mechanism under the UNFCCC. The various institutions could also specialise in funding particular sectors or activities to reduce overlaps in mandates and programmes. The resources counted under this mechanism could be all of the \$100bn promised under the Copenhagen Accord. In that case, the share of private financing would have to be agreed because it will be less predictable, depending on market conditions. Alternatively, a smaller but guaranteed sum from public sources could be counted (there are many ideas for raising these resources).¹⁷ These funds will be channelled through MDBs and UN agencies only (bilateral channels will not be permitted).
- **Reform MDBs:** The other difference with current arrangements will be much greater voice for beneficiary countries in all funding channels. This means not only representation on the governing boards of funds but also voting rules that do not discriminate against beneficiaries (i.e. no double majority voting). Consultations with beneficiaries and stakeholders will take place in designing the funds, not just for discrete projects. Public-private investment vehicles will also give representation to countries that are intended targets for investments.
- **Aim for budget support:** In order to reduce transaction costs for contributing countries and increase voice for beneficiaries, attempts will be made to provide more programmatic and budget support rather than focusing only on projects. For this arrangement to be credible, reporting and transparency will be critical and monitoring capacity will have to be increased in beneficiary countries.
- **MRV by specialised bodies with UNFCCC reviews:** Instead of each MDB and UN agency adopting its own monitoring and evaluation criteria, common reporting formats will be devised. The reporting will be directed to the UNFCCC rather than the MDB, so that information on all funding allocations is collected at a centralised location. A technical committee at the UNFCCC will then independently verify the allocations and report to its political principals. The UNFCCC will undertake a political review (not just a

¹⁵ Ibid., para. 10.

¹⁶ Rajamani (2010).

¹⁷ These include auctioning international permits (Norway's proposal), levies on aviation and maritime transport (LDC proposal), taxes on international financial transactions (India's proposal), and selling IMF bonds in global markets, among others.

technical one) of contributing countries fulfilling their funding commitments. Even if a formal compliance procedure is not in place, independent reporting, verification, and review of financial flows will be a step change from the current opaque arrangements in place.

- **Disadvantage – innovative finance is limited:** This option satisfies beneficiaries' demand for voice and contributors' preference for funding through existing channels. As a result, it maintains a plethora of different institutions that would be involved in climate financing. It is unlikely that such a design will stimulate innovative financing models to raise private capital, which require a long time horizon, more stable carbon prices, and more flexible monitoring provisions. Here, innovative financing mainly refers to new private funding sources or ways to leverage public funds for greater private investments. Notwithstanding the potential to raise additional funding from public sources (such as aviation or maritime levies, green bonds, auctioning emission allowances, etc.), the scale of the effort still requires significant private financing. Even with greatly improved co-ordination among MDBs and other agencies, there will be bureaucratic obstacles and mixed regulatory signals, which undermine private investments. Also, if private sources of finance are capped or bilateral funding is not counted, then the climate regime's finance mechanism will have a lesser share of new funding streams flowing through it.
- **Implication for Green Climate Fund:** By not creating any new institutions, under this option the GCF will look more like the GEF. The expectation would be that co-ordination between multiple funds (serving as implementing agencies) will improve. More importantly, by establishing MRV and reviews under the UNFCCC, the GCF will be directly answerable to the COP. The allocation of funds for different projects can be determined by technical committees, but the COP will deliberate on the overall balance of financial flows between mitigation, adaptation, capacity-building, and technology transfer.

Option B: Create and legitimise

Like Option A, this option also relies largely on public funding, but aims to create a wholly new global fund that would increase the legitimacy of any deal on climate finance in the international negotiations. The governance priorities here are both the scale of funding as well as increasing the voice of developing countries in the management of such a fund. However, the tension between scale and voice is expected to remain.

- **New low-carbon global fund:** A dedicated new facility – the Low Carbon Global Fund (LCGF) – will be charged with mobilising resources and building capacity to cover the incremental cost of achieving specified GHG reduction goals.¹⁸ 'Incremental' would be defined as costs over and above those envisaged in current energy strategies, with an explicit target of lowering the emissions trajectory of beneficiary countries. Detailed metrics and verification procedures would be developed to compare current emission pathways with lower-carbon pathways, with the LCGF financing the costs of transition. In so doing, the model draws on the experience of the Montreal Protocol, whose membership increased once developing countries were guaranteed a fund that would cover their costs.
- **Legitimacy via increased voice:** Developing countries are unlikely to accept a governance and decision-making structure dominated by rich countries. Even with modified governance rules for the numerous trust funds, major developing countries are

¹⁸ For a similar proposal for a Low Carbon Technology and Finance Facility, see Ghosh and Watkins (2009).

unlikely to accept MDB-led financing schemes. But for developed countries the legitimacy of the UNFCCC will hinge critically on perceptions of its capacity for overseeing compliance. The proposed LCGF will be overseen by a separate Executive Board comprising equal numbers of developed and developing countries, with additional representation of civil society and private sector representatives. The Executive Board will be headed by a respected international figure. MDBs will have only specialised operational tasks, such as assistance in data collection, analysis, and framing country programmes.

- **Legitimacy via upfront commitments:** The new global fund will secure upfront financing commitments in five-year tranches, as has been the case with the GAVI Alliance. Further, following the example of the Global Fund for HIV/AIDS, Malaria and Tuberculosis, eligibility for direct access to financing will be determined through a three-step process. First, developing countries will estimate the financing requirements of moving towards their own national mitigation targets. The incremental costs will be over and above current plans for efficiency gains. Second, the proposals will be submitted to a technical panel constituted under the LCGF, which will make recommendations to the Executive Board for the release of finance. Third, resources will either be released promptly if the proposal is accepted or withheld subject to further clarification if there is a negative vote.
- **Programmatic support with flexible project funding:** The primary role of the LCGF will be to tap into public financing to subsidise and/or insure the upfront capital expenditure for low-carbon transition programmes. Countries vary in the type of finance and support they require. As with the new agricultural fund (the GAFSP), funding support could be provided through parallel public and private funding windows. Low-income countries are likely to need highly concessional finance, including grants. For middle-income countries, especially those with high levels of private investment in the energy sector, trade finance and commercial risk mitigation through loan guarantees, insurance, and other instruments may be more relevant. For energy utilities, whether public or private, subsidised risk insurance, advance payment guarantees, and performance bonds can significantly reduce the costs of construction and technology. This is an area in which the World Bank's International Finance Corporation has extensive experience. One option might be for the IFC to manage the subsidy element in commercial risk provision.
- **MRV by specialised, public-private agencies:** Any system that develops metrics for plant performance and not financial transfers would not be credible in the eyes of developing countries. Any system that measures and reports financial flows and not the efficiency of new plants would not get the support of developed countries. Only a partnership model of joint implementation and monitoring can satisfy the demands and concerns of all groups of countries. In order to increase the legitimacy of the process, the services of independent private auditors can also be used (a recent example was the use of PricewaterhouseCoopers for tracking and auditing relief funding after the 2005 Indian Ocean tsunami).
- **Disadvantage – political feasibility declines with funding requirements:** The main disadvantage of this model is that, in the middle of a severe economic crisis, it is unlikely that contributing countries will make upfront financial commitments of sufficient scale. The Montreal Protocol, under which financial requirements were much smaller, suffered shortfalls within three years of commencing operations. Even the use of innovative public-private mechanisms, under the GAVI Alliance, for instance, has not generated a lot of funds compared with the needs. In seeking to strike a balance between greater voice

and greater funding, the legitimacy of the Low Carbon Global Fund will always be contingent on wider economic and political conditions.

- **Implication for Green Climate Fund:** If a Low Carbon Global Fund were to morph into the Green Climate Fund, it would perhaps have the greatest legitimacy among a majority of UNFCCC parties. To be sure, the Copenhagen Accord explicitly seeks funding from a mix of public and private sources as well as multilateral and bilateral channels. Therefore, the LCGF will probably only serve as a sub-set of the overall financing mechanism under the UNFCCC. That said, the LCGF has the advantage of leveraging upfront public funds for greater sums of private investment. Its decision-making structure also offers voice to developing countries while MRV by independent, private agencies could increase confidence among contributing countries. There is a danger, however, that the LCGF will be viewed more as a vertical fund focused on mitigation and transfer of specific technologies. If that were to happen, then the GCF's commitment to adaptation and capacity-building could be called into question.

Option C: Innovate and de-bureaucratise

In this option, the priority is to significantly increase the scale of funding to ensure that climate financing is adequate for the purpose. Conversely, the other priority is to reduce administrative barriers to increasing the flow of resources.

- **New innovative mechanisms:** The model here will rely much more on innovative market-based financing mechanisms. These could include upfront financing from public sources to stimulate investments in cleaner technologies (or what is called Advanced Market Commitments), green bonds issued by the IMF,¹⁹ programmatic CDM, integrated carbon markets, etc. Whatever the mix of funding sources, a likely outcome will be a much reduced share of public financing though a potentially large pot of money for beneficiaries.
- **MDBs part of the mix, but face competition:** MDBs and UN agencies will not be replaced; some are already in the process of creating innovative funds. But they will no longer be the primary or default managers for climate financing. Instead they will have to compete with several other possible modes, such as bilateral public-public technology partnerships, regional or plurilateral public-private arrangements, private-private transactions via voluntary carbon markets, etc. Thanks to such competition, these agencies will also have to streamline bureaucratic procedures for funding approvals, implementation, monitoring, and verification.
- **Programmatic support possible but mostly projects:** Although programmatic and budget support can be conceived under this model, the dominant modality will be for projects. Funds will flow to countries and projects that are able to offer quick returns or guarantee markets or minimum prices for longer-term investments.
- **MRV largely by market actors:** In order to reduce transaction costs, the burden of monitoring and verifying projects will fall on private actors. Either this will be done by project developers themselves or jointly with investors or by specialised third-party verifiers. The point is that the stability of the markets will depend on the credibility of projects operating in particular jurisdictions. It will be up to the investors to ensure that offset credits are credible.²⁰

¹⁹ Bredenkamp and Pattillo (2010). The Green Fund could be partly financed by the issuance of additional Special Drawing Rights (SDRs).

²⁰ For more on a buyer liability system, see Keohane and Raustiala (2008).

- **Disadvantage – UN-centred governance declines:** As is evident, this model will not appeal to many developing countries because of the reduced role of the UNFCCC. There will be little guarantee of the actual amount of money available (contingent on economic conditions) or an equitable allocation of resources to small and large developing countries (contingent on a UN-led process). UNFCCC members will also have less oversight over financial flows and, consequently, little leverage over contributors to comply with funding commitments. The only reason why countries might still accept this option is if the upside of scale of funding is significantly large. In numerical terms, the projections would have to be in the hundreds of billions of dollars. In governance terms, some form of public finance guarantee for a minimum amount of funding per year might be necessary.
- **Disadvantage – adaptation funding suffers:** The other downside is that market-based mechanisms do not offer funding at scale for adaptation. There are signs that private sector funding for adaptation could be leveraged (for instance, through micro-finance products) but a number of institutional preconditions will have to be fulfilled. Further, if most governance functions are relegated to market participants, climate regime members will have little influence in pressing for more funds to be channelled to adaptation activities. One could argue that the Adaptation Fund's resources could increase (with levies on CDM and perhaps other carbon market transactions). Given the experience so far, however, this will be a big risk for highly vulnerable countries and communities to shoulder.
- **Implication for Green Climate Fund:** Under this design option, the Green Climate Fund will not fulfil its objectives of balanced representation or allocation of resources between countries or between different types of climate-related activities. The GCF's role as an operating entity will also be limited since most of the funds will flow through private channels. To the extent that MDBs will be part of the funding mix, the GCF could co-ordinate their activities. The most difficult challenge for the GCF will be counting 'new and additional' resources, depending on how it treats carbon market transactions or purely private sector-led investment flows. If parties can agree on a baseline and a formula to count private funds, then the potential scale of funding under this option might still give the GCF some credibility under the UNFCCC.

Option D: Separate and indigenise

The fourth model squarely confronts the shifting power trajectories in climate negotiations and in investments in the development of clean technology. Its focus is on prioritising actions now rather than later by leveraging what leading economies are doing already. Although this makes it a variant of option C, its other distinguishing priority is to significantly increase funding for adaptation. This option might appeal to rich and emerging economies, reducing the former's public financing obligations and allowing the latter to secure finance and technology-based bilateral and plurilateral deals with rich countries. For the poorest economies, a legally binding financing commitment on adaptation might also be an attraction.

- **No overarching financing mechanism:** Negotiations on an overarching vertically integrated finance mechanism have continued for a long time. For various reasons discussed in this paper (fiscal pressure, economic uncertainty, governance failures, conflicting priorities), there is no reason to expect that a new mechanism will be agreed soon or, if it is, will generate sufficient resources within a short period of time. Instead, like Option A, the preference here will be to better co-ordinate the work of existing funds. What is different, however, is that the regime will draw a clear distinction between mitigation and adaptation and will be structured accordingly. It will not try to govern both

through a single mechanism and risk adaptation becoming a lesser priority. At the same time, a separate focus on mitigation will prioritise the environmental integrity purpose of the climate regime, namely stabilising, sequestering, storing, and reducing GHG emissions in order to keep average temperature increases to less than 2°C.

- **Self-reliance and innovative finance:** In pursuit of the mitigation goals, the regime will recognise that a large portion of funds will have to flow to large developing countries, where the emissions reduction potential is the greatest. It will also recognise that these countries are now at the forefront of investing in R&D and capacity for cleaner technologies. The substantial resources that these countries have already committed (through subsidies, stimulus packages, etc.) and are planning to commit through their national plans on climate change should be a signal of their seriousness. In turn, innovative finance will flow towards these countries through private-private collaborations or public-private arrangements. This does not absolve rich countries from their responsibility to contribute funds. Instead, it creates a clear market opportunity to devote funds in those countries that offer the scale to develop new technologies and generate the greatest returns on investments.
- **MDBs (and bilateral funds) play an important role in underwriting risk:** Existing funding institutions will increasingly play a facilitating role rather than directly investing in projects. That role will focus on underwriting project risk, offering concessional trade finance for the flow of environmental goods and technologies, covering insurance costs, etc. They could also offer upfront guarantees to stimulate greater private sector investments.
- **Adaptation funding with legal commitments under UNFCCC:** Meanwhile, rich countries will undertake legally binding commitments to provide adaptation finance. These funds will be deposited with the Adaptation Fund and its Board will determine the allocation of resources based on some formula (say, based on potentially vulnerable population, incidence of natural disasters, levels of poverty, etc.). Non-compliance with these commitments will be reviewed by the UNFCCC. Sanctions could take the form of an allocation of the contributing country's share of IMF Special Drawing Rights (SDRs) to the Adaptation Fund until it provides the money. Each contributing country will be free to devise its own fund-raising scheme (auctioning permits, taxing fossil fuels, etc.). Each beneficiary country will develop indigenous plans for adaptation. By separating adaptation and mitigation, this model also has the advantage of reducing potential domestic political obstacles to transfers of money to competitor developing countries. At the same time, large, developing countries will also partake of adaptation funding since they, too, have large vulnerable populations.
- **MRV depends on robust domestic capacity:** For large developing countries to attract more investments in cleaner technologies, they will also need to improve their domestic monitoring and enforcement capacity. This means not only federal-level institutions but strengthening governance at the provincial and local levels as well. The use of satellite technology will also be crucial to monitor emission sources and target investments where the maximum returns can be expected.
- **Disadvantage – small countries lose out on technology:** Despite its political feasibility, the main disadvantage of this model is that many small countries might lose out in the technological race. The fear of a widening technology divide (already driven by the concentration of mitigation projects or patents in just a few countries) will be exacerbated if there is no multilateral mechanism to guarantee the sharing of new technology. The Copenhagen Accord envisages a Technology Mechanism and the Indian government has

proposed creating a network of innovation centres. However, past experience in the climate regime does not offer reason for optimism. If this model were to be pursued, the climate regime will need a better strategy for ensuring technology transfer than has been attempted so far.

- **Implication for Green Climate Fund:** Here, the GCF would become the operating entity primarily for adaptation-related funding. Compared with past experience, this in itself will be a major responsibility and a source of legitimacy under the UNFCCC. Funding for capacity-building could also conceivably be channelled through the GCF. Contributing and recipient countries will continue to have a say in the allocation of these funds, which will be reviewed both at the national level and by the COP. However, the GCF will have a much reduced role in mitigation if this option is followed. It might still have a role in technology transfer if funds are earmarked for that purpose and dedicated for the poorest countries, although it is unclear whether guaranteed public funds will be made available.

5. Conclusion

Climate finance is due for an upheaval. For far too long, parties to the climate regime have tinkered with funds and facilities, spending years negotiating over minuscule resources that come nowhere close to meeting the global challenge. In reality, the concern has been less over the scale of resources and more over who gets to control, collect, disburse, and monitor them. Put differently, the governance of finance is a major stumbling block to securing international co-operation on climate change. This situation is unsustainable.

The institutional design options offered here are far from ideal, but they offer a change from the status quo. In an imperfect world, the pursuit of ideal-type solutions can only delay action. As power shifts in climate negotiations, it is important to find ways to ensure that leading countries do not exit the playing field entirely, leaving the smaller players with neither money nor technology. The GCF, promised under the Copenhagen Accord, might suffer a similar fate if parties do not recognise the trade-offs between voice, co-ordination, scale, and the different kinds of actions that are necessary to confront climate change. The different design options here offer some gains to all parties. The upshot: compromises will be necessary, but they will have to be honest and upfront if a modicum of trust has to be restored in climate negotiations. And the best must not become the enemy of the good.

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