OPERATIONALISING THE UNFCCCFINANCE MECHANISM

Summary

This is a Summary of South Centre Research Paper 39. The full paper can be obtained at the South Centre website: www.southcentre.org

Introduction

Parties to the UNFCCC have recognized the need to "urgently enhance implementation of the Convention in order to achieve its ultimate objective in full accordance with its principles and commitments" (Preamble, Bali Action Plan).

The Bali Action Plan recognizes the need for "enhanced action on the provision of financial resources and investment to support action on mitigation and adaptation and technology cooperation". Implementing these mandates requires consideration of a range of factors including:

- The scale of financial resources required;
- The sources of financial resources;
- The uses of financial resources; and
- The governance of financial resources under the UNFCCC financial mechanism.

Efforts to scale up financial resources and investment should build where possible on the best practices under the UNFCCC financial mechanism and other relevant financial mechanisms, with the objective of enabling all Parties to fully implement the principles and provisions of the UNFCCC and address the threat of dangerous climate change.

Building on existing experience

A number of existing financial mechanisms and funds can be drawn on as models when enhancing implementation of the UNFCCC's financial mechanism. These include:

- The Global Environment Facility (an operating entity of the UNFCCC financial mechanism);
- The Adaptation Fund established under the Kyoto Protocol;
- The Multilateral Fund for the Implementation of the Montreal Protocol;
- The Global fund to Fight AIDS, Tuberculosis and Malaria; and
- The World Bank's Climate Funds (i.e. the Clean Technology Fund and the Strategic Climate Fund).

These models can be drawn on, while also recognizing the specific context of climate change and the requirements of the UN Climate Convention, which provide the starting point for any discussion of climate finance and ultimate yardstick against which any effort must be measured.

Scale of finance

The Convention requires the Conference of Parties to "seek to mobilize financial resources" in accordance with Article 11, as well as Articles 4, paragraphs 3, 4 and 5. It requires the COP and the entities entrusted with operating the financial mechanism to agree on arrangements to determine in a predictable and identifiable manner "the amount of funding necessary and available for the implementation of the Convention and the conditions under which that amount shall be periodically reviewed" (Article 11.3(d)).

In practice, determining the amount of funding necessary for the implementation of the Convention requires consideration of a number of related questions:

- What are the main thematic areas that require financing?
- For each area what costs are to be covered and at what level?
- How can these costs be accurately estimated?
- How will assessments differ based on final outcomes of other negotiating parameters?

The main ***thematic areas***for financing are set out in Article 4 of the Convention and include:

- *Communication of information related to implementation*. The Convention (Article 4.3) commits the developed countries to provide new and additional financial resources to meet the "agreed full costs" incurred by developing countries in complying with their obligations to provide national communications (as set out in Article 12.1).
- *Implementation of other commitments by developing countries*. The Convention (Article 4.3) commits developed countries to provide such financial resources needed to meet the "agreed full incremental costs" of implementing certain measures (as set out in Article 4.1).
- *Adverse impacts of climate change*. The Convention (Article 4.4) commits developed countries to assist developing countries that are particularly vulnerable to the adverse effects of climate change in meeting the costs of adaptation to those adverse effects.
- *Technology transfer*. The Convention (Article 4.5) commits developed countries to take all practicable steps to "promote, facilitate and finance" the transfer of or access to environmentally sound technologies and know-how, and in the process to support the enhancement of endogenous capacities and technologies in developing countries.

Determination of the ***types of costs to be covered***, for each of the thematic areas and collectively, is necessary in order to evaluate the scale of funding necessary to implement the Convention. The Convention requires communication of information related to implementation (under Article 12.1) to be funded at *agreed full costs*, which can be calculated based on costs actually incurred by developing countries in implementing their reporting requirements. It also requires implementation of other commitments by developing countries (Article 4.1) to be funded at *agreed full incremental costs*. Different approaches have been advanced to calculate and assess incremental costs:

- The Global Environment Facility has adopted a generic process to evaluate incremental costs based on the expected "global environmental benefits".[1]
- The Montreal Protocol[2] and Convention on Biological Diversity[3], by contrast, each require the development of more detailed "indicative lists" of incremental costs.
- Under the Montreal Protocol a request for financing of a project's incremental costs are evaluated in light of general principles. The Montreal Protocol has agreed indicative lists to enable a more precise calculation of incremental costs, enabling a practical and solution-oriented approach involving participation by experts from developed and developing countries, the private sector, academia and civil society.

[1] Global Environment Facility, *Operational Guidelines for the Application of the Incremental Cost* Principle, 14 May 2007
[2] Ozone Secretariat United Nations Environment Programme, *Handbook For The Montreal Protocol On Substances That Deplete The Ozone Layer – 7th Edition*, 2006, p. 424
[3] Convention on Biological Diversity, Article 20.2 Financial Resources

In the context of climate change, a sector-by-sector approach (using, for instance, the mitigation and adaptation sectors referenced by the IPCC) could help to replicate key lessons in the context of the UNFCCC.

The ***scale of financing should be accurately estimated on the basis of clear methodologies and processes***. Estimates should be comprehensive and reflect the relevant provisions of the Conventions. Unfortunately, few if any of the estimates offered so far provide a comprehensive evaluation of scale of funding necessary to implement the Convention. For example:

- A recent review of a UNFCCC finance[4] study suggests actual costs could be up to three times higher for the sectors covered and "much more if other sectors are included".[5]
- The World Bank's recent *Global Report on the Economics of Adaptation to Climate Change* unconvincinglytakes the cost of educating young women as a proxy for the total costs of extreme weather events.[6]

Recent studies illustrate levels of costs and damage that exceed these estimates by one or more orders of magnitude:

- The Global Humanitarian Forum, headed by Kofi Annan, "estimates future economic losses could amount to more than USD 340 billion by 2030 (Only 30 countries in the world currently have a GDP higher than this number)".[7]
- Allianz insurance company and WWF estimate that Global sea level rise "of 0.5 m by 2050 is estimated to increase the value of assets exposed in all 136 port megacities worldwide by a total of $US 25,158 billion to $US 28,213 billion in 2050".[8]

Estimates of financial needs should be revisited to ensure they are complete, adequate, fair and consistent with the Convention. At a minimum they should address:

- A comprehensive evaluation of *both* the costs of "climate proofing" to avoid adverse impacts as well as estimates of the actual costs of unavoidable adverse impacts;
- An evaluation of the level of mitigation effort and costs involved in limiting temperature increases to well below levels of 1 or 1.5°C (rather than 2°C), and of achieving this with some reasonable degree of probability; and
- The latest scientific and economic information, which suggests that the level of effort may need to be significantly greater than considered in the IPCC Fourth Assessment Report.

The ***scale of financial needs must also be calibrated*** to reflect the relationship between the necessary level of financing and other parameters in the negotiation – including the proposed global goal and the level of ambition by Annex I countries. An inadequate global goal implies rising costs of loss and damage. Inadequate ambition by developed countries, in turn, implies greater costs for mitigation or adaptation in developing countries.

Developing countries financial demands should be calibrated to these other factors, and should avoid locking in a sum for long-term financing that provides a "ceiling" rather than a "floor" for future levels of financial resources. Any long-term amount for financing should thus be prefaced by the terms "at least" (as is the case with Annex I mitigation targets). And a process should be established to ensure the scale of financing necessary for the implementation of the Convention is periodically reviewed (as required by

[4] UNFCCC, *Investment and Financial Flows to Address Climate Change*. (2007, UNFCCC Secretariat, Bonn)
[5] Parry, Martin, N. Arnell, P. Berry, D. Dodman, S. Fankhauser, C. Hope, S. Kovats, R. Nicholls, D. Satterthwaite, R. Tiffin, T. Wheeler. *Assessing the Costs of Adaptation to Climate Change: A Review of the UNFCCC and Other Recent Estimates*, International Institute for Environment and Development and Grantham Institute for Climate Change, London, 2009.
[6] The World Bank, *The Cost to Developing Countries of Adapting to Climate Change – New Methods and Estimates*, 2010
[7] Global Humanitarian Forum, *Human Impacts Report: Climate Change – The Anatomy of a Silent Crisis* (2009), at page 20
[8] *Id*., p. 30

Article 11.3(d)), based on sound technical and economic advice from bodies accountable to the Parties, as is the case with the Montreal Protocol.[9]

In light of emerging evidence of levels of impacts[10], levels of committed warming[11], and risks associated with tipping points[12], ***larger levels of financing than currently under consideration must be taken seriously*** in discussions at the UNFCCC. Financing of significantly higher levels is justified to maintain the stability of the Earth's life support system, and by comparison to the likely costs of inaction, and the sums spent on other issues such as the global financial crisis or military conflicts.

Sources of finance

Raising financial resources of the scale necessary requires consideration of the sources of finance, and how it is raised and channeled. Key considerations include:

- Who is responsible for providing financial resources?
- How to ensure contributions are new and additional?
- How to ensure the scale of financial resources is adequate?
- What is the role of "innovative" sources of financing?
- What is the role of channels outside the UNFCCC financial mechanism?

The ***responsibility for meeting financial commitments lies squarely with the developed countries*** listed in Annex II of the Convention. Recognition in the Bali Action Plan of the need for "enhanced action on the provision of financial resources" is recognition of the need for enhanced implementation of these commitments. Raising financial resources of the necessary scale requires renewed commitment, and innovative thinking on how to raise and channel climate finance.

To enhance action on climate change, financial contributions must occur in practice and not merely on paper. Consequently, ***financial contributions are to be new and additional***. Developing modalities for evaluating whether financing is new and additional is a priority, particularly in light of the fact that emerging information suggests that a substantial proportion of "pledged" finance was pledged previously (and so is not "new") or will be counted towards ODA commitments (and so is not "additional").

The Convention provides that the implementation of ***financing commitments shall also "take into account the need for adequacy and predictability*** in the flow of funds" (Article 4.3). The determination of what is "adequate" requires an evaluation of:

- What funding is "necessary" to implement the Convention?
- What funding is "available" to implement the Convention?
- How does "available" funding measure against what is "necessary" – is it "adequate"?

Measured against any reasonable standard the $100 billion per year that Annex I countries have pledged to "mobilize" by 2020 fails to meet the standard of adequacy. A more systematic basis involving ***assessed contributions for developed countries is thus required***, reflecting the Convention's call for "appropriate burden sharing among the developed country Parties" (Article 4.3). This should address financing on at least three levels:

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[9] Sarma, K. Madhava. *Lessons from the Success of the Montreal Protocol*, in "The Montreal Protocol: Celebrating 20 Years of Environmental Progress" Cameron & May, 2007, p. 134

[10] Global Humanitarian Forum, *Human Impacts Report: Climate Change – The Anatomy of a Silent Crisis*, 2009, p. 20

[11] Ramanathan and Feng, "On avoiding dangerous anthropogenic interference with the climate system: Formidable challenges ahead". *Proc. Natl. Acad. Sci.* 105 (38): 14245–14250 (noting that the Earth is likely already committed to warming of 2.4 degrees C, surpassing the threshold for several tipping points)

[12] See, Lenton, Timothy, H. Held, E. Kriegler, J. Hall, W. Lucht, S. Rahmstorf "Tipping elements in the Earth's climate system" *PNAS,* Vol. 105, pp. 1786-1793 (2008). See also, *Major Tipping Points in the Earth's Climate System and Consequences for the Insurance Sector,* World Wide Fund for Nature Gland, Switzerland, and Allianz SE Munich, Germany, 2009, p. 37

- *The scale of financing required in aggregate.* Based on factor such as those above, the Conference of Parties should assess the scale of funding necessary for the implementation of the Convention in accordance with Article 11;
- *The contribution of individual developed countries to the aggregate amount*. Based on the requirement for "appropriate burden sharing among the developed country Parties" in Article 4.3 the Conference of Parties should establish a scale of contributions for each responsible Party; and
- *The role of "innovative sources" of financing in contributing to the aggregate amount*. Recognizing that traditional budgetary sources are constrained, the Conference of Parties should consider the role of other "innovative" sources.

Funds raised through "***innovative sources" could contribute to meeting assessed contributions***. Some innovative sources – such as special drawing rights – offer considerable promise.[13] Some others – such as international transport levies – may shift the financing burden to developing countries. The appropriateness of each requires consideration on a case-by-case basis. Ultimately, assessed contributions drawing on both traditional sources and "innovative sources" will be required to scale up financial resources to cope with the adverse effects, and to curb emissions by 2015 or 2020 to avoid further dangerous interference with the climate system.

Uses of finance

Ensuring clarity about how financial resources will be accessed and applied in practice and the results they will achieve is a principal concern of donors and recipients alike:

- How to ensure direct access to funds?
- What activities should be covered?
- Which countries are eligible?
- How should different entities be involved?
- What arrangements are needed at the national level?

Developing countries have identified the need for ***direct access to funds***. Among other things this demand reflects many developing countries' experience with the GEF and the challenges of accessing financial resources through the participation of "implementing agencies". The Adaptation Fund allows eligible Parties to submit their project proposals directly to the Adaptation Fund Board, and offers host countries the flexibility to access funds directly, to use the services of a multilateral entity, or to nominate an appropriate regional or sub-regional entity to support them.

The Fund Instrument or subsequent guidelines will need to provide ***direction on covered activities***, including the plans, programmes and projects that are eligible for financial resources in each of the thematic areas. Simplified criteria and procedures should be agreed for small-scale activities. To streamline access funding approvals should be made on an intercessional basis and communicated via mail or other media, as is the case with the Climate Investment Funds.

Under the Convention ***all developing countries are eligible to receive financial resources***. Any attempt to formally narrow the category of countries eligible for financing runs counter to the letter and spirit of the Convention. At the same time, the Convention calls for consideration of the specific needs and concerns of countries in certain situations including vulnerable countries and LDCs. Striking a balance between these requirements – i.e. the rights of all developing countries and the needs of those in specific situations – is best achieved at an operational level through fund guidelines and other modalities.

[13] Instrument for the Establishment of the Restructured Global Environment Facility (Annexing International Bank for Reconstruction and Development, Executive Directors' Resolution No. 2006-0008), p. 89 at paragraph 5. S*ee also*, ActionAid, *What are Special Drawing Rights and how can they be used to finance climate adaptation and mitigation?* (June 2010) and ActionAid/TWN, *Fruit of the Crisis: Leveraging the Financial & Economic Crisis of 2008-2009 to Secure New Resources for Development and Reform of the Global Reserve System* (January 2010)

The Fund Instrument or associated guidelines should define the ***entities eligible*** to submit proposals and to receive, manage and spend financial resources.

The success of the Montreal Protocol has in no small part had to do with strong support for ***effective national cooperation***. The Global Fund's "country coordinating mechanism", similarly, provides an effective model to enhance national cooperation. Both experiences suggest that a constellation of formal and informal institutions – involving different stakeholders, sectors and levels of organization – is a key ingredient of success.

Governance of finance

Effective climate action requires ***effective climate governance***. Well-designed institutions can help to catalyze action, support cooperation, align the interests of donors and recipients, and integrate actions at different levels. Operationalizing the UNFCCC financial mechanism will require a constellation of effective institutions, including:

- Fund board;
- Specialized funds and funding windows;
- Trustee or trustees;
- Secretariat of professional staff;
- Expert group or committee and technical panels;
- Consultative group of stakeholders;
- Independent assessment panel; and
- Modalities for existing funds and entities.

In relation to the fund board, its ***composition*** should reflect an "equitable and balanced representation of all Parties within a transparent and efficient system of governance", as called for by the G77 and China. The Adaptation Fund allocates membership in a balanced manner to regional groups (i.e. two members from each of the five UN regional groups) while also ensuring that particular groups, such as the small island states and least developed countries are equitably represented.

Fund instruments of various funds provide examples of ***board functions***, which generally include: strategic planning and policymaking; financial operations; management and administration; securing expert support; ensuring transparency and participation; ensuring evaluation and reporting; ensuring coherence. The basic functions of the Board must at a minimum reflect the requirements of Article 11.

The ***selection of officers*** – including its Members and its Chair (and co- or vice-Chairs) – is crucial to the success of the mechanism. The Adaptation Fund and the Multilateral Fund require members once nominated to be elected or endorsed by their respective superior bodies (i.e. the Meetings of the Parties to the Kyoto Protocol and the Montreal Protocol, respectively). Other funds, such as the SCF, provide a permanent role as co-chair to a World Bank Vice President.

Most fund instruments require ***decision-making*** by consensus, although the definition of consensus differs in different funds. Most fund instruments include references to decision-making by voting in order to address situations in which consensus is not possible. In addition to consensus and voting, other means for decision-making are possible. The Global Fund's board, for example, may take decisions on a "no-objection basis". Its chair may also take decisions inter-sessionally, subject to review by the board.

The ***role of observers*** is defined differently in different fund instruments. Generally, discretion to invite additional observers (i.e. those not explicitly listed in the fund instrument) lies with the board. Existing fund instruments also provide models for rules on ***transparency, confidentiality and conflict of interests***.

The Fund will require a range of ***specialized funds or thematic windows*** to address financing in the different areas required by the Convention, including:

- Adaptation (Article 4.1, 4.3 and 4.4);
- Mitigation, including forests (Article 4.1 and 4.3);
- Technology development and transfer (Article 4.1, 4.3 and 4.5); and
- Communications, capacity building and other actions (Article 4.1, 4.3 and 12.1).

Such an approach is reflected in the Climate Investment Funds, which address technology (via the CTF), as well as renewable energy, forests and climate resilience (via the SCF), and are supported by dedicated resources and sub-committees. A similar approach can be adopted under a new fund, recognizing that the Climate Investment Funds are scheduled to "sunset" once "a new financial architecture is effective".

The G77 and China has proposed that the ***trustee*** should be selected through a process of open bidding to ensure resources are managed as efficiently as possible. Its role should be clearly and narrowly defined to avoid conflicts of interests of the kind that arise where one institution is entrusted with multiple and overlapping functions including those of secretariat, trustee, implementing agency and/or co-financier.

The function of a ***secretariat*** is to support the Parties and the Fund Board to discharge its functions and achieve the objectives of the Fund. In the case of the Multilateral Fund, an independent secretariat was established to support the fund board. In designing an effective Secretariat consideration should be given to its relationship with other entities, its scale and its leadership. It should retain functional independence of other entities such as the trustee; it will need to be of significant scale reflecting the scale of financial resources and activities required (e.g. the World Bank disburses around 7 billion from trust funds and employs around 9000 people); and it should be headed by a senior official, such as a former finance minister, with appropriate experience.

To be effective the financial mechanism, and the UNFCCC more broadly, must galvanize the expertise and engagement of experts through ***expert and technical panels***. These should include specific panels in each thematic area and sector, as well as appropriate linkages to the Convention's other thematic bodies including new adaptation and technology bodies. The Montreal Protocol's experience with "technical options committees" and a "technical and economic assessment panel" can be built on, focusing on relevant mitigation and adaptation sectors as defined by the IPCC.

A number of fund instruments establish panels designed to provide a forum for engaging and ***consulting with stakeholders and other partners***. The GEF and Climate Investment Funds provide relatively limited consultation. The Global Fund, by contrast, has embraced more active stakeholder participation. Effective participation at different levels helps to broaden understanding and support for the Fund's activities.

Independent assessment of the fund, fund entities and fund operations and projects plays a key role in enhancing decision-making, accountability and effectiveness. Assessment is required at the fund level, the entity level (e.g. of the secretariat, trustee etc), the thematic level (e.g. of the performance of different areas) and the project level. This requires a set of mechanisms for assessment reporting variously to the COP and the fund board. Existing fund instruments – including for the Global Fund, Multilateral Fund and GEF – provide models to build on.

Parties have discussed a "new body" of the financial mechanism, such as a ***standing committee or subsidiary bodyon finance***. Such a body would provide the function of strengthening coordination and coherence, improving the delivery of climate finance to developing countries, seeking to help mobilize financial resources, and otherwise help to streamline and improve implementation of the UNFCCC financial mechanism. Its functions should be carefully defined to complement those of the COP and the fund board, and to enable more effective implementation of financial commitments under the Convention.

The ***relationship of the fund and standing committee to the COP and other entities*** must also be defined. Developing countries have emphasized that the fund must remain under the authority to the COP, in part due to their experiences with the GEF, which is merely accountable to the COP, and has failed to adequately respond to COP guidance. The Adaptation Fund provides and alternative model and demonstrates that the COP/CMP are empowered to establish entities directly under their authority through COP/CMP decisions.

The Convention recognizes funding "related to" implementation may be provided through "***bilateral, regional and other multilateral channels***" (Article 11.5). Parties have recognized the need for consistency between the financial mechanism and "activities relevant to climate change undertaken outside the framework of the financial mechanism" (Decision 11/CP.1). The Montreal Protocol ensures coherence by providing that an agreed proportion (currently 20%) of assessed contributions can be provided directly through bilateral and regional cooperation.

Monitoring and evaluation

Effective monitoring and evaluation of financial and other commitments is essential if Parties are to ensure effective implementation of commitments and achieve the ultimate objectives of the Convention and its Kyoto Protocol. Developed countries are required to communicate to the Conference of Parties a detailed description of policies and measures for mitigation and a specific estimate of their effects (Article 12.2) as well as information on measures to transfer finance and technology (Article 12.3)

Part of the fund's functions should be to ensure that developed countries "measure, report and verify" the provision of financial resources and technology, and register in an appropriate registry their contributions under the financial mechanism as well a the provision of financial resources related to the implementation of the Convention through bilateral, regional and other multilateral channel.

Operationalizing the financial mechanism: next steps

Enhanced action to implement the Convention's finance commitments is likely to be more effective – both politically and practically – if it avoids a range of obvious pitfalls. It should, among others, distinguish clearly between public and private finance, maintain the Convention's balance of rights and obligations and avoid the undue politicization of financial resources in the negotiations. In terms of next steps, parties should:

- *Enhance the transparency of short-term financing* to be provided by developed countries in accordance with the provisions of the Convention. Increased transparency can help to build trust and provide the basis for the development of more robust measurement, reporting and verification procedures.
- *Focus on the institutional arrangements* necessary for determining the level of longer-term financing necessary for the implementation of the Convention and the process for agreeing it.
- *Establish working group under the COP*. Parties may wish to establish a working group or standing committee in the context of the AWG-LCA to elaborate key elements of the financial mechanism for discussion by all Parties and inclusion in a draft COP decision and Annexes.
- *Agree framework decision (in line with G77 and China proposal).* In Cancun, Parties could agree a framework decision establishing key elements of the enhanced financial mechanism, including the Board and other entities. The basic institutional arrangements would be defined and established in this decision, with the details of these arrangements to be elaborated further through discussions during 2011.
- *Define details of fund instrument through further discussions of working group*. Parties would continue discussions of the working group during 2011 and invite participation by both climate and finance experts. This group, which should be open to all Parties, will draft the detailed Fund Instrument and any related documentation for consideration by the COP.
- *Secure final approval of fund instrument by the COP***.** Parties could agree to finalize the detailed Fund Instrument and related documentation at COP 17 in Johannesburg in December 2011. The enhanced financial mechanism would be launched and made fully operational before the 20^{th} anniversary of the UNFCCC in 2012.