



POLICY PAPER

No. 18 (120), June 2015 © PISM

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Financing Climate Actions: Key to a Paris Agreement?

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The Paris Climate Conference to be held in December may be the last chance to deliver a global agreement on tackling climate change. One issue that could be a game-changer for the negotiations and one that is inevitable to achieve global climate goals is so-called climate finance. The existing framework does not provide enough predictability and capacity to limit global warming to a maximum of 2°C. A clear mechanism for gathering public funds from developed countries and the inclusion of private investments is needed to secure reliable post-2020 climate actions.

The clock on the timeline towards a global climate agreement is now ticking very fast. In half a year the Climate Change Conference in Paris will be held. There are only three negotiating sessions left and the first of these will end on 11th June in Bonn. In July there will also be the Third International Conference on Financing for Development, held in Addis Ababa, at which decisions should be made in parallel to the climate negotiations, especially regarding goals for adaptation to climate change. There is common understanding that the issue of climate finance regarding climate action is of utmost importance, for as French President Francois Hollande stated during the Sixth Petersburg Climate Dialogue in Berlin, “without any financial commitment, there won’t be an agreement in Paris.”¹

The United Nations Framework Convention on Climate Change (UNFCCC) provides no official definition of climate finance, but its Standing Committee on Finance (SCF) proposed to see it broadly as all efforts aimed at a reduction in the emissions of greenhouse gases (mitigation) or reducing vulnerability (and increasing resilience) to climate change impacts (adaptation).² However, more commonly that phrase refers to finance flows from developed to developing countries in order to help them to mitigate and adapt to the changes.³

In Copenhagen in 2009, developed countries pledged to reach \$100 billion in annual funding by 2020 to help developing countries adapt to climate change and invest in low-carbon technologies. Leaders of developed economies pledged also to mobilise a package known as Fast-Start Finance (FSF) of \$30 billion between 2010 and 2012. The report by the SCF shows that the developed countries fulfilled this pledge, exceeding it by \$33 billion, but the problem of how to build a mechanism for steady flows to reach the \$100 billion annual goal is far from solved.

¹ “No Paris climate deal without finance for poor nations—French president,” 19 May 2015, www.trust.org.

² “2014 biennial assessment and overview of climate finance flows,” Standing Committee on Finance, UNFCCC, 2014.

³ “What is climate finance and where will it come from?,” *The Guardian*, 4 April 2013.

Therefore, the issue of climate finance should and probably will be at the centre of the Paris conference. Certainty on delivering the pledges made in Copenhagen could be a trust-building exercise and is very much needed in these negotiations. Without providing predictability on the climate finance regime, developing countries cannot make commitments regarding mitigation and adaptation actions. The public sector is also a key driver of private financing, so a clear mechanism would better serve to attract private investments, which are required to achieve the goal of limiting global warming to 2°C. Although not all of the problems can be tackled in such a short time, the Paris agreement needs to be backed by a strong message of intent from developed countries.

Financing Needs and Actual Flows

According to a World Bank study, annual funding of \$28 to \$100 billion is needed for adaptation by 2030 and \$139–\$175 billion for mitigation to meet the objective to limit climate warming to 2°C.⁴ The World Economic Forum estimates that the total cost of additional, incremental infrastructure investments required by 2020 to secure the 2°C emissions path is \$700 billion per year.⁵ The International Energy Agency predicts that achieving the UNFCCC climate target requires \$5 trillion more than in the core scenario for global energy supplies. Flows of funds will have to be designed differently—less money should be spent on extraction and transportation of fossil fuels and much more on energy efficiency, particularly in the field of transport or the building industry.⁶

The current level of funding falls short of these needs, but the goal is still within reach. According to SCF, global total climate finance amounted to between \$340 and \$650 billion per year between 2011 and 2012. Looking at some other studies, e.g., the Climate Policy Initiative (CPI), climate finance was \$359 billion in 2012 and decreased to \$331 billion in 2013.⁷ Going deeper into these numbers, most of the investments are made in the country of origin. Flows from developed to developing countries were much lower: public institutions contributed from \$35 billion to \$50 billion and private institutions from \$5 billion to \$125 billion per year.⁸

The European Union and its Member States account for over 56% of the provided climate finance total (over \$16 billion). The biggest single donors worldwide are Germany, Japan, Norway, United Kingdom and the U.S. Of the \$29 billion contributed per year by the public sector from developed countries and reported to the UNFCCC, only \$17 billion was climate-specific (the rest was classified as core/general, such as support to multilateral institutions). Of the \$17 billion, 65% was invested in mitigation, 17% for adaptation and the rest for both or other areas. That shows clearly that adaptation to climate change is still underfunded.

Existing Climate Finance Regime

There are a few different channels in which the flow of funds occurs. One of these channels includes multilateral climate funds, which received overall \$12 billion in pledges (\$10 billion deposited and only \$1.5 disbursed). In total there are 11 multilateral climate funds and they can be divided into three categories: adaptation funds, mitigation funds and REDD-plus funds (Reducing Emissions from Deforestation and forest Degradation).

⁴ In 2005 prices, constant. For more, see: “Generating the Funding Needed for Mitigation and Adaptation,” World Development Report, 2010.

⁵ “The Green Investment Report: The Ways and Means to Unlock Private Finance for Green Growth,” World Economic Forum 2013.

⁶ For more details on how investment flows should be changed, see: “World Energy Investments Report 2014,” International Energy Agency, 2014.

⁷ “The Global Landscape of Climate Finance 2014,” Climate Policy Initiative (CPI).

⁸ According to the “2014 Biennial Assessment and overview of climate finance flows” by the UNFCCC Standing Committee on Finance.

Four of the eleven are administered by Climate Investment Funds (CIF), which was established in 2008. Its stakeholders include multilateral development banks (MDBs), the UN, UNFCCC, bilateral development agencies and two other climate funds. It was designed as an interim institution that would engage MDBs in efforts to tackle climate change. The biggest initiative by the CIFs is the Clean Technology Fund, which received financial pledges exceeding \$5 billion since 2008 and invests in mitigation.

The second-biggest institution administering climate funds is the Global Environmental Facility (GEF), which is a “financial instrument of the Convention” and therefore directly supervised by UNFCCC. It was established in 2002. Under GEF, there is one fund investing in mitigation efforts, the GEF Trust Fund (since 2010), which received \$1.4 billion in financial pledges. Since 2002, GEF also manages the Least Developed Countries Fund, which invests in urgent adaptation projects in vulnerable countries (almost \$1 billion in financial pledges received) and the Special Climate Change Fund, which finances adaptation, transfers of technology, sectoral developments such as those in transport or energy, and it invests in the diversification of the economies of countries dependent on fossil fuels.

UNFCCC has also one more fund to administer: the Adaptation Fund. The idea was to create a fund independent from financial pledges but based on a market mechanism. It was to be financed by a 2% share of Certified Emissions Reductions (CER) issued for the Clean Development Mechanism project. As the price of carbon credits has plummeted, the fund lost its source of reliable and required financing. Therefore, it receives financial pledges from countries. Overall, it has received financial pledges amounting to \$416 million.

Another multilateral source of financing comes directly from MDBs, which reported about \$27 billion in annual financing in the form of grants, loans or other instruments.⁹ Two of the biggest donors were the World Bank and European Investment Bank, together accounting for more than half of the financing. Another potential source of financing is bilateral channels (BDBs) and bilateral climate funds. The former is more significant in terms of size as the CPI estimates that developed countries committed \$14 billion through these formations in 2012.

The existing financial framework has been built only in the 21st century, but it has already become very complicated. It does not really work in parallel with development aid and it has difficulties in mobilising private capital. It has become clear that the system lacks the capacity to deliver the \$100 billion annually from developed countries by 2020.

Green Climate Fund and New Prospects

Because of the complexity of climate finance options and the \$100 billion annual need, the idea of creating a new institution emerged. Developing countries were also not fully satisfied with their role in managing existing funds such as GEF. Therefore, the Green Climate Fund (GCF) was established at the UN Climate Change Conference in Cancun. It works like GEF and is directly under the UNFCCC as a financial instrument of the Convention, but the number of members of the board from developed and developing countries must be equal. GCF was intended to play a leading role in achieving the target of \$100 billion in annual climate financing and increasing the level of adaptation finance. However, developed countries are not bound to deliver their pledge through GCF.

As of 21 May 2015, only \$10.2 billion has been pledged to the GCF and hardly 60% of this sum was confirmed through signatures on contribution arrangements.¹⁰ With the ones it has in hand, though, GCF can start allocating resources to developing countries. The GCF board decided to aim at investing equally in mitigation and adaptation—at a 50-50 ratio. Experts believe that GCF should function as a standard-bearer among the whole climate change finance framework. GCF, by developing guidelines on investments in

⁹ *Ibidem*.

¹⁰ GCF press release from 21 May 2015, www.news.gcfund.org.

adaptation and mitigation, can contribute to a harmonisation of selection criteria and can create transformational impact indicators.¹¹

With a view on the difficulties arising in front of the \$100 billion goal, the UN Secretary-General's High Level Advisory Group on Climate Change Financing suggested finding new sources for funding climate actions. Their ideas were to establish an international aviation and sea-transport tax, Financial Transactions Tax or to redeploy fossil fuel subsidies.¹² The EU was closest to implementing a carbon tax on emissions from airlines, but it suspended the plan in front of strong opposition from countries such as China and India. The case for carbon taxation could return during the negotiations in Paris, as hinted by European Leaders during the Petersburg Climate Dialogue, but India and China likely will still be against such schemes.¹³

Mobilising Private Sector Financing

The biggest opportunities to reach the financial pledges are to be found in the inclusion of the private sector into the climate change financing effort. Business is already contributing more to global climate finance than the public sector, but it is dominated by investments concentrated on bringing returns. Therefore, they are placed mainly in developed countries where the risk is lower. As mentioned above, SCF estimates annual flows from developed countries' private sectors to be from \$5 billion to \$125 billion in 2011–2012. These investments are also directed mainly to mitigation as it is more difficult to gain profit from adaptation actions.

Mobilising private climate finance lies at the centre of the pledge to deliver the \$100 billion annually by 2020. During the COP19 Climate Conference in Warsaw and UN climate summit in New York last year, the need to include business into climate actions was stated strongly. During the latter, financial institutions (pension funds and commercial banks) pledged to invest in low-carbon initiatives and some manufacturers stated their willingness to use energy only from renewable sources. Although the growing understanding of business about the need for a common approach to countering climate change is of utmost importance, a more comprehensive and predictable public finance scheme is required to leverage private sources.

The GCF Private Sector Facility aims to attract additional private sources, and although its final design is not confirmed it will probably be based on intermediaries—existing national and international climate institutions and funds. The focus of this fund will be to offer grants, concessional loans, equity and guarantees. The goal of the facility will be to provide risk-bearing capacity and concessional resources so that it would be feasible for companies to mobilise their own resources for climate projects. But it is far too little to tackle the barriers connected to low-carbon and climate-resilient investments. They are more capital-intensive, and face more competition from energy sources such as fossil fuels, their technology risk is higher, they are dependent on grid capacity and need a reliable legal framework. These barriers have to be tackled in order to generate more private investments and it could be done through tax incentives, more risk-taking mechanisms to support companies, develop schemes for supporting local governments in planning infrastructure and environmental regulations.¹⁴

There is also a need to attract more participation from private financial institutions such as commercial banks, pension funds and insurance companies. So-called green bonds are a vital contribution from commercial banks to climate change financing. In New York, banks have pledged to issue green bonds worth \$30 billion by the end of 2015. Pension funds have declared to invest \$31 billion by 2020 in low-carbon, climate resilient portfolios. Their participation in climate action can be extremely valuable as their investments are long-term and not oriented on quick turnaround in revenues. Insurance companies should

¹¹ L. Gallagher, A.-L. Amin, "Aligning Finance to Deliver Climate Ambition and Climate Resilience in a 2015 Climate Agreement," ACT, 2015.

¹² "Report of the Secretary-General's High-level Advisory Group on Climate Change Financing," 5 November 2010.

¹³ "Javadekar raises concern on feasibility of carbon market mechanism," *Hindustan Times*, 19 May 2015.

¹⁴ For more, see: B. Buchner, M. Stadelman, J. Wilkinson, "Operationalizing the Private Sector Facility of the Green Climate Fund: Addressing Investor Risk," CPI, April 2014; "Demystifying Private Climate Finance," UNEP, December 2014; "Climate Finance: Engaging the Private Sector," IFC.

not only be attracted to participate in climate investments but they can also contribute to adaptation financing by delivering risk insurance to companies and households in vulnerable countries.

The European Union and Poland support the ideas of inclusion of the private sector into the climate finance regime. Poland wants the strong participation of business because it can provide negotiators with a competitiveness perspective and can direct funds where there is the possibility for an increase in efficiency. Poland also lacks resources to contribute to climate finance. The European Union and EU Member States are already the biggest donor to developing countries, so there is little room left to increase public funding. That is why the private sector is seen as a potential additional donor from developed countries.

Creating a More Predictable Climate Finance System

We should not expect that the Paris agreement can solve all the problems with climate finance. It will not give direct solutions that would make climate finance achieve the level required to limit global warming to 2°C. However, COP21 can and should deliver a level playing field for climate finance, enabling progress in this field.

First of all, the main barrier to both climate change action and private sector investment—lack of predictability in public climate finance—needs to be tackled. The current mechanism of national pledging to funds has not yielded enough capacity to deliver stable and reliable financing for climate actions. The sources and timeframe for achieving the goal of \$100 billion in climate finance should be clarified before or during COP21. Developing countries should be open to include private sector (directly catalysed by public financing) in this effort. Governments could develop long-term climate finance obligations, such as Official Development Assistance in OECD (a commitment of 0.7% GNI to ODA).¹⁵

Building synergy between the new model of financing for development set to be specified in Addis Ababa this year and the climate negotiations is a way to gain on the effectiveness of development and climate finance. This particularly concerns adaptation. Building low-carbon infrastructure and the promotion of energy efficiency in non-infrastructure investments, avoiding deforestation and protecting fragile resources can be in both agendas and should be developed in parallel. That course should be included in the Paris agreement.

Simplification of the existing climate finance framework under the lead of the GCF can make it more transparent. Common guidelines for funding initiatives and indicators for measuring the level of climate finance and its results will help make that field more transparent. Although it is the aim of the GCF, its role has to be clarified and accepted by international actors.¹⁶

The Paris negotiators have to foresee some sort of new or innovative financing sources. Both mitigation and adaptation efforts in developing countries are still underfunded. Business is open to such things as taxes on carbon emissions from sea transport and aviation, but there is reluctance on the part of India and China. Although the notion of transferring tax revenues to least developed countries will give the EU a strong ally in the Paris conference, leaders must build consensus among all the parties. It may be found in using another source of financing such as an FTT or redeployment of fossil-fuel subsidies.

Last but not least, the finance regime that is being built must be clear, predictable and directed at leveraging public finances through private investments in order to achieve the level of financing needed to limit global warming to 2°C. Without business, a Paris agreement will not deliver on its goal because business are the actors who develop new green technologies, invest in renewable energy sources and build infrastructure that is adapted to climate change. Private financial institutions also have to be included into the climate finance regime as they have more capacity than national governments to deliver on the required financial sources.

¹⁵ L. Gallagher, A.-L. Amin, *op. cit.*

¹⁶ *Ibidem.*

The EU may be the biggest donor, but its leaders are not ready to pledge any additional funds before the Paris conference. In that case, the agreement must give new value to the climate finance regime without new money from public sources on the table. Poland and the EU both want to make the development agenda “climate sensitive” so that current flows can be directed to both primary objectives—climate and development. The EU is also open to exploring the possibilities to tax carbon, but it is a controversial source of funding for the biggest developing countries.