

CCAP Submission on guidance to the operating entities of the financial mechanism of the Convention

August 2013

The Center for Clean Air Policy (CCAP) makes this submission in response to the invitation for Parties to submit to the Secretariat their views and recommendations on the elements to be taken into account in developing guidance to the operating entities of the financial mechanism of the Convention (FCCC/CP/2012/L.7, paragraph 7 and FC/CP/2012/L.17, paragraph 16). Although the operating entities have been tasked with providing funds for both climate change adaptation and mitigation, this submission only provides guidance for the financing of climate change mitigation actions.

Executive Summary

Many developing and developed countries are converging on a shared vision of Nationally Appropriate Mitigation Actions (NAMAs) as a way for developing countries to achieve both significant emission reductions and national development priorities. Under this NAMA vision, NAMAs are host country-driven and should have a programmatic rather than project-based approach in order to drive ambitious mitigation outcomes. By coupling policy and financial instruments to reduce key barriers to deployment of low carbon solutions, NAMAs can catalyze significant private sector investment and transform the carbon trajectory of entire economic sectors.

The Green Climate Fund (GCF) is expected to play a significant role in deploying international climate finance, and can therefore play a central role in advancing this shared vision of NAMAs and support truly ambitious, transformational actions in developing countries. The GCF can support NAMA implementation through strategic allocation of funds through both the Private Sector Facility and mitigation window. We suggest consideration of three key principles to support effective disbursement of these funds:

- 1. Use GCF funds to attract greater funding from budget outlays, development banks and the private sector:** Donor funding alone will not be sufficient to achieve global climate goals. Thus,

to maximize the impact of GCF resources, funding should be used to catalyze significant investment from other sources.

2. **Support sector- or economy-wide actions, not individual projects, with an emphasis on shifting to a lower carbon development path:** By supporting a broader scope of actions that go beyond funding individual projects, the GCF's resources can achieve greater emission reductions and change the carbon pathway of sectors.
3. **Target funds to overcome primary barriers to private investment in low carbon technology and infrastructure, in coordination with policies and measures that create demand for these investments:** By resolving barriers to low carbon investment while also fostering demand for such investments, GCF funding can create an environment conducive to low carbon projects.

The NAMA framework integrates private and public sector actions to catalyze greater ambition. This joint approach is absent from the current structure of the GCF, which is comprised of separate public and private windows without any mandate or preference for cooperation. To be successful in supporting transformational mitigation actions, both mitigation windows should at a minimum encourage coordinated public and private actions to achieve ambitious greenhouse gas reductions.

To operationalize this NAMA vision, most of the funds could be issued on a competitive basis, where the amount and type of support depend on the degree to which a proposal meets each of several selection criteria. For proposed actions under both the Private Sector Facility and mitigation window, we recommend consideration of the following selection criteria. The first four criteria are similar to those used by the NAMA Facility, while the fifth seeks to overcome the discrete nature of the funding windows within the GCF structure.

- The degree to which the mitigation action is expected to fundamentally transform the target sector to a lower carbon development path;
- Sustainable development benefits to the host country;
- Whether the mitigation action is expected to attract additional investment from development banks or the private sector, and whether the NAMA includes unilateral contributions;
- Overall GHG mitigation potential; and
- Evidence that the proposed policy change or financial mechanism is part of a larger framework that overcomes key barriers to the desired low carbon investments.

In the case of least developed countries, exceptions should be made to enable enhanced capacity support to develop NAMAs, and to facilitate funds for project-level investments.

Introduction

Under the Copenhagen Accord in 2009, and reiterated in the Cancun Agreements in 2010, developed countries pledged to mobilize \$100 billion per year by 2020 for the financing of climate change mitigation and adaptation actions in developing countries. Although bilateral and private sector financing of climate actions is expected to continue, the Green Climate Fund (GCF) – one of two operating entities of the Convention – is expected to become one of the primary vehicles for international climate financing. A key challenge facing the GCF will be how to strategically deploy funds to achieve transformational change in a manner that will drive both sustainable development and ambitious emission reductions.

The Governing Instrument of the Green Climate Fund noted the objective of the fund is to:

- cause a “paradigm shift towards low-emission and climate-resilient development pathways”;
- pursue a “country-driven approach”; and
- support actions “in the context of sustainable development”.

CCAP agrees with these objectives and commends the Board’s decisions in the fourth meeting of the GCF (GCF/B.04/17) to:

- Note convergence that the Fund will seek to maximize sustainable development
- Reaffirm that country ownership and a country-driven approach are core principles of the Fund
- Note that the Board will provide for readiness and preparatory activities and technical assistance, such as the preparation or strengthening of low-emission development strategies and NAMAs
- Decide the Private Sector Facility will address barriers to private sector investment in order to mobilize private capital and expertise at scale in accordance with national plans and priorities

In this submission to the UNFCCC, CCAP describes a shared vision of Nationally Appropriate Mitigation Actions (NAMAs) that couple policy and financial instruments to reduce barriers to private sector investment, thereby transforming the carbon trajectory of key economic sectors and driving ambitious mitigation actions. This vision of NAMAs also demonstrates how sustainable development benefits and greenhouse gas emission reductions are not fundamentally separate goals, but instead that efforts to meet sustainable development priorities can generate the political support necessary to implement effective climate mitigation actions. These principles can be advanced through the financial support of the GCF for NAMA implementation by mainstreaming NAMA-like criteria in funding decisions.

A Shared Vision of NAMAs¹

Nationally Appropriate Mitigation Actions (NAMAs) offer an important mechanism by which developing countries can achieve significant greenhouse gas emissions reductions through actions that also promote national development priorities. While there currently is not a set definition for what constitutes a NAMA, a number of developed and developing countries are converging on a common understanding of the NAMA mechanism.

Based on CCAP's close collaboration with developing and developed countries on NAMA design, there is now general agreement that the following four elements are fundamental to NAMAs (and other transformational mitigation policies):

1. NAMAs must be host country-driven and incorporate the dual goals of greenhouse gas mitigation and sustainable development.
2. NAMAs should strive to be sector-wide programs that are national in scope, with the potential for regional or municipal elements.
3. NAMAs should include both policies and financial mechanisms targeted to address the main barriers to mitigation activities.
4. NAMAs that seek international support should use NAMA funding (in the form of grants or highly concessional finance) to mobilize additional climate finance from bilateral institutions, international and domestic development banks and financial institutions, and the private sector.

This NAMA vision outlines a framework for scaling up climate mitigation in ways that remain consistent with national interests. NAMAs can lead to transformational change by combining government policies with financial mechanisms to catalyze a pipeline of mitigation projects and mobilize private sector investment. Policies and regulations can drive private sector investment in low-carbon technology and infrastructure through mandates and by influencing the relative risks and returns of investment choices. Financial mechanisms can be coupled with these government policies to overcome investment barriers. By leveraging the international support available from donor governments and institutions, NAMAs can achieve the desired scale of activity. Rather than using the limited donor funds to pay the full incremental cost for one low-carbon project, a well-designed NAMA will couple government policies with financial support that together target the barriers to low-carbon investment and create a pipeline of commercial investment opportunities for development banks and the private sector. The first attachment, *Colombia's Solid Waste NAMA Proposal*, provides a real-world example of a NAMA that is designed to transform the waste sector in Colombia through policies and a financial mechanism that support beneficial reuse of waste products instead of disposal via a sanitary landfill. In addition to reducing methane emissions, the NAMA also improves the quality of life for informal workers in the

¹ This discussion borrows extensively from a July 2013 policy brief, *The NAMA Opportunity*, which can be found at <http://ccap.org/resource/policy-brief-the-nama-opportunity/>.

waste sector. Colombian officials are now seeking international financial support to implement the NAMA.

This NAMA vision represents a new paradigm for development assistance in that government policy changes are directly linked to financing mechanisms aimed at increasing the economic attractiveness of the investments to the private sector. Moreover, aligning the NAMA with core sustainable development, poverty reduction and health protection objectives will build host country political support and ensure that such policies are sustained after the international assistance has ended. The NAMA reflects a commitment from the government and a tangible plan that can attract private investors.

At COP 18, the governments of Germany and the United Kingdom launched the NAMA Facility with the goal of funding NAMAs for implementation. As part of their criteria for selecting NAMAs, the Facility identified four metrics: 1) potential for transformational change; 2) co-benefits; 3) financial ambition and 4) mitigation potential. These criteria are expected to ensure that NAMAs with the greatest impact receive funding for implementation through a process that is transparent and accountable. By the time the GCF is capitalized, the NAMA Facility will have been operational for some time, with at least one round of NAMAs selected and in the process of implementation. The NAMA Facility can impart best practices and lessons learned to the GCF in order to facilitate the effective deployment of funds.

The GCF's Role in NAMA Finance²

Current levels of support pledged for developing countries now and in 2020 may be insufficient to meet global climate targets. Given the mitigation potential of developing countries and their potential contribution to future emissions, the extent to which financial, technological and capacity building support is mobilized to support developing country mitigation efforts will have a profound effect on whether the global climate goal is met. However, a 2009 analysis conducted by McKinsey and Company³ estimates the total incremental expenditures required for clean technology investments in developing countries across all sectors, excluding agriculture and forestry, is \$292 billion in 2020. This implies that the current pledges for climate financing in 2020 for both adaptation and mitigation will cover just over one-third of the required resources for mitigation alone. A range of sources for climate financing – including the private sector – will be required to meet the financing gap and help developing countries achieve their climate change mitigation potential.

It will be critical that the GCF deploy funds strategically to achieve significant emission reductions in the context of sustainable development. In light of the climate financing gap for developing countries,

² This discussion borrows extensively from a May 2013 CCAP paper, *An Emerging Architecture for NAMA Finance*, which can be found at <http://ccap.org/resource/an-emerging-architecture-for-nama-finance/>.

³ This analysis was prepared in November 2009 by McKinsey and Company at CCAP's request using the modeling resources developed for their January 2009 study, "Pathways to a Low-Carbon Economy." For the purpose of this analysis, developing countries were defined to include Africa, China, India, Latin America, the Middle East and the rest of developing Asia. The currency conversion from Euros to US dollars was done on November 14, 2012 based on the exchange rate 1:1.26947 listed on Oanda.com.

limited donor funds must be deployed in a manner that will catalyze significant private sector investment in low carbon technologies and infrastructure. Channeling development assistance and other forms of support into climate actions can play an important role in fostering private sector investment, as is making investments directly where private finance is weak. Central objectives in deploying international climate finance should be to attract these private sector resources and to mainstream climate goals into development finance and national budgets. The strategic deployment of funds would thus enable a scaling-up of mitigation ambition while ensuring that efforts to reduce emissions are consistent with national sustainable development priorities.

Three key principles should be considered in determining how to deploy funds strategically:

1. Use GCF funds to attract greater funding from host-country budgetary allocations, development banks and the private sector
2. Support sector- or economy-wide actions, not individual projects, with an emphasis on shifting to a lower carbon development path
3. Target funds to overcome financial and non-financial barriers to private investment, in coordination with policies and measures that create demand for these investments

Principle 1: GCF funds should attract greater funding from host-country budgetary allocations, development banks and the private sector

GCF funding alone will be insufficient to bridge the climate financing gap. Instead, GCF funds should be deployed in a manner that steers host-country budgetary outlays towards low-carbon growth, and attracts investment and financing from the private sector and development banks.

Budgetary allocations are the primary driving force in infrastructure development in developing countries. If governments continue to invest domestic resources in carbon-intensive infrastructure, such as coal-fired power plants, it will be challenging to meet national mitigation goals even with significant international and private sector support. GCF funding should thus be used to steer budgetary allocations towards low-carbon development projects. Through the NAMA model presented here, which emphasizes the sustainable development benefits of mitigation actions, policy-makers are able to secure political and public support for funding low carbon policies and programs.

Climate finance should ultimately seek to attract investment towards priority national low carbon development goals from the larger and more restricted funding sources, including from bilateral and multi-lateral development institutions, national development banks and the private sector. It is

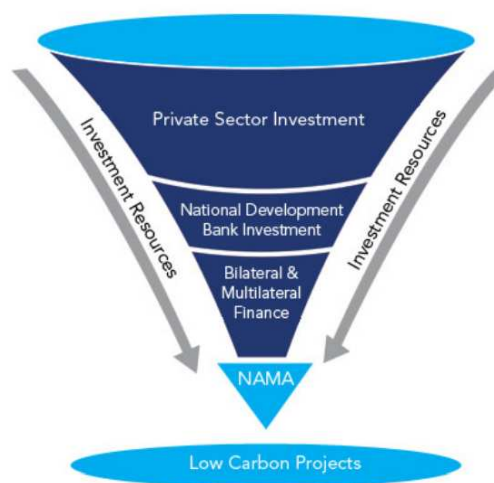


Figure 1: NAMAs funnel resources into climate policies that catalyze project implementation

important to combine government policies and international financial support to reduce risk and boost investment returns, thereby channeling these larger and disparate investment resources towards the desired low carbon technologies and infrastructure. Figure 1 illustrates how climate finance can serve as the driver to create the investment climate that will attract public and private investment to individual low-carbon projects.

The document GCF/B.04/07 on the *Business Model Framework: Private Sector Facility*, prepared by the Interim GCF Secretariat, affirms the necessity of mobilizing funds from private resources, including pension funds and sovereign wealth funds, as well as designing modalities to do so. This is consistent with our vision for the role of NAMAs in attracting such investments.

Principle 2: Support sector- or economy-wide actions, not individual projects, with an emphasis on shifting to a lower carbon development path

In the past decade, considerable international investment in developing country GHG mitigation has been funneled through the Clean Development Mechanism (CDM), which supports mitigation on a project basis. Among the many lessons learned from the CDM experience is that project-level approvals and financing arrangements have been time consuming, and the overall scale of effort – about 1.2 GtCO₂e issued over more than seven years – has been small compared to the roughly 1-2 GtCO₂e emission reduction needed annually between now and 2020 to keep global temperature increases below 2 degrees.⁴ Going forward, as we work towards meeting the global mitigation goals, it is desirable to achieve GHG emission reductions at a broader sector-wide or national scale to increase ambition.

In addition to increasing emission reductions, climate financing should seek to transform key economic sectors by reducing regulatory and financial barriers so that emission reductions are sustained and expanded over time. Ongoing efforts to promote renewable energy in Chile suggest the potential for achieving broad sector-wide impact from coupling ambitious policy change that creates demand for renewable energy—in their case, a more aggressive renewable portfolio standard now working its way through the Congress—with a well-targeted financial mechanism. A fuller description of the NAMA design can be found on our website, *Chilean Government Takes Great Step Forward in Climate Mitigation with Unilateral Renewable Energy NAMA*⁵. Now being developed as a unilateral NAMA, the web posting explains the need to overcome wide price fluctuations in Chile’s power markets due to the reluctance of banks to invest in intermittent power given the chance that the renewable energy might be produced when electric prices are too low to make a profit. To address this risk and meet the renewable energy goal, the government is creating a Price Stabilization mechanism which will assume the spot market price risk and provide certainty to investors by guaranteeing renewable energy prices. In this way, the government is working to motivate increased deployment of renewable energy at a significant scale within the energy sector.

⁴ Estimated based on UNEP projections and estimates of the emissions gap in 2020 as reported in *The Emissions Gap Report 2012*, located at <http://www.unep.org/pdf/2012gapreport.pdf>.

⁵ See <http://ccap.org/chilean-government-takes-great-step-forward-in-climate-mitigation-with-unilateral-renewable-energy-nama/>.

The Private Sector Facility will be particularly important in mobilizing private resources in developing countries for mitigation actions. If the Facility expects to fully leverage its resources to achieve ambitious, sector-wide emissions reductions, rather than channel funds to individual mitigation projects, a significant share of the available funding should be directed to sector-wide actions through use of financial mechanisms that can foster a pipeline of individual low carbon investments. In addition, rather than foster isolated financial mechanisms, the Private Sector Facility should seek to support those that are components of broader NAMAs that include supportive policy changes, and where both the policy change and financial mechanism are carefully targeted to overcome barriers and create demand for the desired low carbon investments.

Principle 3: Target funds to overcome financial and non-financial barriers to private investment, in coordination with policies and measures that create demand for these investments

In order to achieve transformational change, NAMAs and mitigation actions generally must address the key financial and non-financial barriers to private sector investment. In most cases, this can be achieved by coupling domestic policy changes with a financial mechanism that together drive demand for low-carbon technologies and infrastructure. The design of the policy change and the financial mechanism should both be targeted to create the conditions for profitable low-carbon investments by the private sector. The NAMA design should also seek to focus development assistance towards desired low carbon actions. Specifically, the policy change should create demand for low carbon investments, and the financial mechanism should support low carbon investments by reducing risks that might otherwise impede private investment or create additional incentives that improve the investment return of projects. Before funding decisions are made, developing country governments should carefully evaluate and plan to resolve all the significant barriers to low carbon investment, not only the financial barriers that stand to benefit directly from the request for international financial support.

Document GCF/B.04/07 highlights several financial and technical barriers that can be addressed through the Private Sector Facility. It is important, however, that the Green Climate Fund facilitate support for both the development of catalytic climate policies and the financial mechanisms to eliminate the primary barriers to private sector participation. Where regulatory reform is needed to create demand for low carbon technologies, creating a new financial mechanism alone will not catalyze private sector participation.

Operationalizing the NAMA vision in the GCF

To operationalize this vision, a significant portion of the GCF could invest in NAMAs that combine government policy changes (incentives or mandates) that create demand for low carbon technology and infrastructure investments with financial mechanisms that overcome barriers to such investments. Examples of such financial mechanisms are described in the attached paper, *Overview of NAMA Financial Mechanisms*, and in our view, these and similar financial mechanisms should be eligible for international financial support through the GCF. Together, policy changes and financial mechanisms will

create a better business climate for low carbon solutions and attract larger sums of investments by development banks and the private sector.

Both the Private Sector Facility and the mitigation window should be supportive of transformational NAMAs over other types of mitigation investments, as this approach offers significant benefits and helps make the most of the limited funds available for international climate finance. Through NAMAs, it is possible to leverage donor funds by attracting additional investments from development banks and the private sector. Further, the sector-wide focus and combination of policy change and financial support results in greater emissions reductions than is normally possible through investments in individual projects, or through policy change or financial support undertaken independently. Additionally, the central focus on sustainable development ensures that poverty reduction and other nationally important policy objectives are optimized within the support framework.

The Private Sector Facility could invest in implementing the financial mechanism part of the NAMA when this is done through a private entity (such as a local bank). The mitigation window could support government policy development within the same NAMA, or could fund both the financial mechanism and government policy components where implementation of the financial mechanism is through a public entity.

In both cases (whether the support comes through the Private Sector Facility or the mitigation window), most of the funds could be issued on a competitive basis, where the amount and type of support depend on the degree to which a particular proposal meets each of several selection criteria. Use of well-defined selection criteria will help promote transparency, objectivity and ambition in funding decisions by creating a framework to guide decision making. Proposed actions that meet all or most of the criteria might receive higher total amounts of funding and more concessional funding, whereas those that meet fewer criteria could receive support in the form of non-concessional loans or have larger co-financing requirements.

We recommend consideration of the following selection criteria for proposed actions under both the Private Sector Facility and mitigation window. These criteria are similar to those used by the NAMA Facility established by the governments of Germany and the United Kingdom.

- 1) The degree to which the NAMA is expected to fundamentally transform the target sector to a lower carbon development path;
- 2) Sustainable development benefits to the host country;
- 3) Whether the NAMA is expected to attract additional investment from development banks or the private sector, and whether the NAMA includes unilateral contributions; and
- 4) Overall GHG mitigation potential.

In addition, when the financial mechanism is supported through the Private Sector Facility, the amount and type of support should also be conditional on whether there will also be broader policy reform within the target sector as part of a NAMA. This way, the Private Sector Facility supports climate mitigation that is fundamentally consistent with the host country's low carbon development priorities as

expressed through its NAMA. Such an approach ensures that Private Sector Facility funds are distributed in a way that is carefully integrated with developing country policies, which is much stronger than an approach that simply gives developing countries the right to object when private sector projects do not align well with their objectives. Similarly, policies supported under the mitigation window might receive preference if they are coupled with a financial mechanism that targets investment barriers as part of a NAMA.

Finally, we support carving out exceptions for Least Developed Countries (LDCs) from a competitive proposal process. While we believe that transformational NAMAs still represent a preferred approach for LDCs as they do for middle income developing countries, LDCs may need more capacity support to develop NAMAs, and project-level investment may be appropriate on an interim basis.

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Attachments:

Colombia's Solid Waste NAMA Proposal

Overview of NAMA Financial Mechanisms

Colombia's Solid Waste NAMA Proposal

Strengthening the Solid Waste Sector while Reducing Emissions

April 9, 2013

Colombia has achieved a high standard of solid waste disposal with about 94 percent of urban solid waste being disposed in sanitary landfills. Despite this success, Colombia faces challenges in the future due to an increase in waste generation resulting from high economic growth and increased urbanization. In addition to more waste generated, Colombia must work to increase the working and living conditions of its vast network of informal recyclers, who currently collect 50 percent of total waste recycled and work in difficult conditions. In the coming years, Colombia seeks to move into the next generation of waste management which incorporates the goals of waste reduction, reuse and recycling rather than disposal. In doing so, Colombia can achieve multiple objectives of reducing greenhouse gas emissions, achieving sustainable economic growth, ensuring environmental protection, improving urban life and uplifting socially and economically vulnerable citizens.

Colombia aims to reduce solid waste sector emissions (which comprise 5.7 percent of total greenhouse gas emissions) by undertaking integrated solid waste management programs and creating incentives for the private sector that could catalyze actions to: divert organics from landfills (thereby reducing methane emissions as part of landfill gas), increase recycling (thereby reducing indirect emissions by avoided production of recyclable material), generate refuse-derived fuel (thereby displacing conventional fossil fuel use) and promote alternative uses of landfill gas.

Overcoming Barriers and Promoting Alternative Treatment Technologies

A nationally appropriate mitigation action (NAMA) will support the Colombian government in reducing the carbon footprint of its solid waste sector by overcoming existing policy, financial, market and social barriers. The cornerstones of the NAMA are regulatory changes, the promotion of new technologies, creation of appropriate financial mechanisms, and integration of informal recyclers into the formal sector.

The Colombian government (through the Ministry of Housing and the Ministry of Environment and Sustainable Development) is in the process of reforming solid waste management regulation that currently favors landfill disposal over treatment alternatives such as recycling, composting, and refuse-derived fuel. The most important of these changes concerns the method by which the solid waste tariff is calculated. The tariff sets the price that waste companies can charge to collect, transport, and dispose of waste in landfills. Under the current tariff structure, it is much more profitable for waste companies to dispose of waste in landfills instead of diverting waste to recycling or composting plants. CCAP is assisting the national regulatory agency with determining the true economic cost of alternative waste treatment methods in order to devise a new tariff structure.

As part of the NAMA, Colombia is also proposing the promotion of new technologies that divert waste away from landfills to produce commodities such as recyclables, compost, and refuse derived fuel, which can be reincorporated back into the economy and/or generate energy. For example, material recovery facilities receive mixed waste to sort out recyclables, which can be sold to middlemen or directly to industries to be recycled into new products. A more advanced technological option is mechanical-biological treatment facilities, which in addition to sorting recyclables introduce a biological treatment such as composting and/or the production of refuse-derived fuel.

Compost made from mixed waste can be used in public parks or for land reclamation while refuse-derived fuel can be sold to cement kilns or other industrial consumers to replace fossil fuels.

The NAMA proposal also includes appropriate financial mechanisms that leverage internal public resources of Colombia, plus NAMA finance from donor countries to maximize private sector investment. As the final aspect of the solid waste NAMA, policies and business models are being designed in order to include informal workers in the modernization of the sector, allowing them opportunities to work in the formal economy and increase the standard of their working and living conditions.

Equity Fund as Financial Mechanism

In order to implement material recovery or mechanical-biological treatment facilities at the municipal level, the NAMA proposes creating public private partnerships. At the municipal level, the partnerships will be designed as special purpose entities that could opt to contract out the building and/or the operation of alternative waste treatment infrastructure.

To attain financing, these special purpose entities will be able to apply to a national fund to receive support in building or operating the facilities that divert waste away from sanitary landfills. As equity investments are usually the most difficult to attract in such projects, the fund will provide equity financing to special purpose entities and returns gained will be put back into the fund in a revolving manner.

In addition to equity financing, the NAMA could include additional support for early projects in the way of capacity building to municipalities/plant operators, or support for informal recyclers entering the formal economy.

Support Requested

The design of the Colombian Solid Waste NAMA incorporates international donor support to partially finance the equity fund described above. National and sub-national contributions would also be required to fund the balance of the equity fund, provide project development support, provide land, and create awareness programs in municipalities to encourage source separation of waste. The finance provided will also maximize the involvement of private sector investments in next-generation waste management infrastructure and processes.

A number of technical and economic studies supporting the design of the NAMA and quantification of the support requested are now being finalized, but early estimates indicate a need for approximately 20 million USD from international donors. It is anticipated that this international support along with national funding and regulatory changes will allow for two to three pilot facilities to be built in Colombia. The proposed regulatory reforms, coupled with financial mechanisms and early pilot projects, would facilitate an enabling environment that would help transform the Colombian solid waste sector and meet NAMA goals.

Since 1985, CCAP has been a recognized world leader in climate and air quality policy and is the only independent, nonprofit think tank working exclusively on those issues at the local, national and international levels. Headquartered in Washington, D.C., CCAP helps policymakers around the world to develop, promote and implement innovative, market-based solutions to major climate, air quality and energy problems that balance both environmental and economic interests.

For more information about Colombia's solid waste NAMA, please contact Program Coordinator Michael LaGiglia at mlagiglia@ccap.org. For more information about CCAP, please visit www.ccap.org.

Overview of NAMA Financial Mechanisms

July 2012

Introduction

Developing countries have started to pursue nationally appropriate mitigation actions (NAMAs) to reduce greenhouse gas (GHG) emissions in conjunction with national sustainable-development goals. Because NAMAs have the potential to receive international financial support, designing a successful NAMA therefore requires careful integration of climate policy actions, sustainable development goals, and financial mechanisms. This policy brief provides an overview of a number of financial mechanisms and design elements to consider in developing NAMAs that can effectively mobilize investments in mitigation projects.

At the outset it should be noted that there are major differences between NAMA financial mechanisms and carbon credits. While carbon credits are project specific, NAMA financial mechanisms are program based and made available to an entire sector or industry. In this regard, NAMA financial mechanisms are somewhat similar to Global Environments Facility (GEF) projects but with a greater focus on integration of policy actions and financial incentives.

The other factor to keep in mind while designing NAMA financial mechanisms is that due to the lack of definition and precedence in the subject (the world is yet to formally recognize the first NAMA), there exists a tremendous scope for flexibility, customization and innovation. This represents another diversion from the Clean Development Mechanism (CDM) and other offsets-based financing programs where stringent process-based rules related to financial additionality and monitoring, reporting and verification (MRV) made it difficult for both developers and financiers to design financial mechanisms which were tailored to their respective circumstances. The various donor-driven sources of NAMA finance that exist right now are a combination of development banks, specific climate finance programs (mostly related to fast start finance), and multi-lateral institutions among others. Some of these financing programs are in the process of being designed such as the Green Climate Fund (GCF) and hence are also in the “learning-by-doing” mode.

In this interim period, while NAMAs are yet to be defined and financing programs such as the Green Climate Fund are yet to be formally launched, exists the opportunity for developing countries to work in

close collaboration with contributing countries to take advantage of their specific climate finance programs.

NAMA Financial Mechanisms

NAMA financial mechanisms should be designed to mobilize and leverage additional investments in mitigation projects. There are a variety of financial mechanisms and programs that can be used to achieve this goal. These financial mechanisms, however, should be tailored to the unique financial markets conditions in the host country. A comprehensive review of existing financial market conditions is therefore a crucial first step in designing a NAMA financial mechanism. This analysis should identify specific financial barriers to NAMA-related projects and identification of uses of NAMA resources to support local financial intermediaries and/or borrowers to overcome these barriers.

The table below lists some typical financial barriers that developing countries face while implementing NAMAs and what financial instruments could be used to overcome them.

Financial Mechanisms To Address Impediments

Risks/Barriers	Instrument
Perceived credit quality of borrowers or entering a new sector	Partial Credit Risk Guarantee – but not helpful in high interest rate environments
High transaction costs of smaller-scale projects	Creation of Special Purpose Entity (SPE) for project implementation
Lack of familiarity with technology	Performance Guarantee
High interest rate environments and/or lack of project revenues to cover market- terms of financing	Extension of lending maturities Soft loans
Lack of capacity in local banks	Special Funds

Detailed below are a number of financial mechanisms that could be incorporated into a NAMA proposal. All of these financial mechanisms serve as credit enhancements for private sector financing of NAMA projects. It is important to emphasize that in the design on a financial mechanism, credit enhancements are not designed to make “bad projects” financially viable. Rather, they are designed to mitigate or remove certain risks to investors/lenders who serve to catalyze investments in NAMA projects.

Partial Credit Risk Guarantees

Partial credit risk guarantees protect lenders from loan defaults for up to a specified portion of the loan. Donor funds are placed in an account to cover a portion (50 percent in many cases) of a project’s credit

risk to banks. This mitigates risk to the lender and should reduce the costs of borrowing. Projects will nevertheless need to meet bank credit quality requirements as banks will sustain losses if a project fails.

Debt Service Reserve Accounts

Debt service reserve accounts are similar in many respects to partial credit guarantees. Donor funds are placed in an account to cover a specified number of months of debt service payments. The difference however is that the reserve account is accessed in the event a project fails to generate sufficient revenues to meet debt service payments. This prevents default on a loan if a project runs into short-term operational difficulties. Funds are taken from the reserve account to make timely debt service payments while the project operator seeks to remedy operational problems. Once the project is again financially viable, the operator is required to replenish the reserve account.

Performance Guarantees

Many of the NAMAs being discussed internationally have financial and performance risks. While banks are fully capable of assessing the credit quality of a borrower they often do not have the skills to properly assess performance risk. This is uniquely a challenge for energy efficiency projects where energy and cost savings from investments are expected to be sufficient to cover debt service payments. For large energy projects, banks can retain outside experts to conduct a performance risk assessment of a project but for most energy efficiency and smaller-scale renewable projects this is not cost effective.

To address this impediment, donor funds could be used to capitalize a performance risk guarantee program that provides bankers with assurances of performance (generation of sufficient revenue to meet debt service payments). This is often done by setting up an energy services company (ESCO) which is responsible for providing performance due diligence for the banks and backing up the assessment with a guarantee. If a project fails to meet performance levels, the donor funds are used to make up the difference for banks. The third-party ESCO administrator is selected based on extensive knowledge of the type of projects covered. If properly structured, this guarantee mechanism can achieve much higher leverage than a partial credit guarantee.

Extension of Lending Maturities

Local banks in most countries will not issue loans with maturities greater than 7-10 years, however, many renewable energy projects have useful lives of 15-30 years. Short-term lending is often not a viable financial arrangement because the annual debt service payments on such loans are often prohibitively high. Extension of loan terms can dramatically reduce annual debt service payments and make a project financially viable.

For example, by extending the maturity of a \$100 million loan from 7 years to 15 years, the annual debt service payment would be reduced from \$21.8 million to \$15.2 million, assuming a commercial interest rate of 13 percent (See Table Below).

Comparative Debt Service Table on a \$100 Million Loan

Term	Interest	Annual Payment
7 years	13%	\$21.8 million
7 years	6%	\$17.5 million
15 years	13%	\$15.2 million
15 years	6%	\$10.1 million

Maturity extension programs can be designed in many different ways. One example used in the Philippines involved an agreement between the government and local banks that allowed banks to make 7-year loans with a 15-year payback period. Under this arrangement a balloon payment for the balance of the loan was due in year 8. If a bank decided not to renew the loan up to 15 years, the government made the balloon payment to the bank and the borrower made annual debt service payments to the government for years 8-15.

Co-Financing with Local Banks

In high interest rate environments many renewable projects are unable to generate sufficient revenues to meet high annual debt service payments. A project that produces a given amount of annual revenue may be financially viable when interest rates are at 5 percent but would not be viable if rates were at 12 percent. In addition to the soundness of a project, the costs of financing can have a major impact on the credit-worthiness of a project. In these circumstances, NAMA grants could be deployed in the form of below-market rate co-financing with local banks. The banks would conduct the financial analysis and lend at prevailing rates (e.g. 12 percent) for 50 percent of the loan amount and the NAMA loan would be provided at below market (e.g. 2 percent) for 50 percent. The resulting blended rate of 7 percent could make a project financially viable. As the NAMA loans are repaid, the reflows are used to co-finance future projects.

Special Purpose Entities

Many renewable and energy efficiency projects are often too small to be effectively financed on an individual basis. The transaction costs relative to loan amounts are such that banks don't find the projects attractive.

Special Purpose Entities (SPE) which bundle multiple projects for financing through one debt instrument have been established in many countries to address this barrier to finance. The SPE uses standard

eligibility requirements, financial analysis and legal agreements to lower the transaction costs of projects and reach critical mass of financing to attract private sector lenders/investors. A NAMA proposal could create an SPE for this purpose and use any of the above mentioned mechanism to finance NAMA projects on affordable terms.

Principles of NAMA Financial Mechanisms

There are several overarching principles to consider when designing NAMA financial mechanisms. Effective financial mechanisms can catalyze additional investments from the private sector and lead to significant transformation in the target sector in reducing GHG emissions and achieving sustainable development goals.

Sustainability

Donor funds should be deployed in a sustainable fashion. NAMA financial mechanisms that are designed to be self-funding (i.e. returns from investment are re-invested in the mechanism to fund more NAMAs) are preferable to those that simply buy down project costs or interest rates. Donor grants, for example, can be used to co-finance local bank lending to eligible projects. Even if the donor portion of the loan is at 0 percent interest, the repayment of loan principle can be used for future projects. This mechanism can mobilize private sector funds on affordable terms in high interest rate environments.

Leverage

Public climate finance interventions often demonstrate the extent to which other public and private money has been “leveraged” or catalyzed as a result of their investment. It is often argued that the higher the ratio, the more effective the use of limited public funds and the more attractive an investment. The amount of private investment leveraged by public funding instruments varies considerably according to the barrier being addressed, location, instrument used, and project specific characteristics. High leverage ratios can demonstrate that public finance was used to de-risk investment and overcome barriers to encourage greater flows of finance to climate-friendly areas.

NAMA financial programs should seek to leverage as much private sector investment per dollar of donor assistance as possible. Leveraging can be accomplished through co-financing programs, partial risk guarantees, insurance programs, concessional loans etc. The amount of private investment leveraged by public funding instruments varies considerably according to the barrier being addressed, location, instrument used, and project specific characteristics. A 3-1 ratio of private funding to NAMA dollars is a good starting benchmark for partial credit risk guarantees. Insurance and guarantee mechanisms can reach higher leverage ratios if they focus on a specific project risk. As programs become more successful, leverage can increase accordingly.

Private sector acceptance

Extensive consultation with local and international financial institutions is critical to designing a financial mechanism that works. During the design stage, an overview of the proposed financial mechanism should be shared with potential investors to ensure private sector receptiveness. Bankers/investors will provide important insight on the value of the financial mechanism in the private market. After the initial consultation, appropriate revisions should be made to reflect private sector input while being mindful of donor requirements and host country acceptance. A second round of consultations should then take place with the private sector to provide a final “ground testing” of the proposal.

Affordability

Effective NAMA financial mechanisms would not only have to meet leverage benchmarks for private sector capital but also mobilize private investments at the lowest possible costs. High financing costs can reduce the viability of a sound project. Consultations with local project developers will be critical to achieving this objective. In some cases, for example, partial guarantees have been provided to banks for clean energy projects, but were not utilized because interest rates were too expensive for local developers.