OECD Submission to the Transitional Committee, May 2011
Workstreams I and III

Contents

Work stream I: Scope, guiding principles, and crosscutting issues

Question 2. Broad objectives and guiding principles

Some broad objectives and guiding principles of the GCF have been agreed in the decision 1/CP.16, Cancun Agreements (see annex below) How can these be further developed, enhanced and operationalized?

In order to operationalize its guiding principles (manage a large scale of financial resources, achieve a balanced allocation between adaptation and mitigation, complement other institutions and mechanisms, and evaluate the fund's performance), the TC may wish to identify criteria for the allocation of GCF funds that are transparent and supported by country partners. A key goal may be to integrate NAMAs and NAPAs into national development plans and so as to eventually address a significant portion of a country's mitigation potential at least cost, or in the case of adaptation, a large share of the exposure and vulnerability to climate changes in a particular country context.

The TC may wish to establish a clear strategy for disbursement of funds from the GCF, and eligibility and selection criteria, based on cost-effective and equitable solutions to climate change policy priorities so as to ensure that the allocation of limited public financial resources delivers lasting mitigation and adaptation benefits (Karousakis and Corfee-Morlot 2007).

OECD analysis suggests that public financing should primarily target cost-efficient activities unlikely to attract sufficient private funding on their own (see Workstream III, Q6 for a discussion of private financing). This includes capacity building to strengthen enabling environments for investment and integration of climate change concerns into sector and other economic policies, investing in education and training as well as technology research and development. Other priority uses include protecting forests and other natural resources, and adaptation. Policy dialogue on such priorities for development assistance, and targeted capacity building to support policy reforms, are an important part of development co-operation activities and can lead to strengthened, country-driven policies for low-carbon development (CDDE 2010; OECD and AfD 2011 forthcoming).

Past OECD work has advanced good practice principles for environmental fund management that may be relevant in the context of the Green Climate Fund. The "OECD Council Recommendation on Good Practices for Public Environment Expenditure Management" (OECD, 2006) highlights the need for environmental expenditure programmes to guide disbursement decisions, including the appraisal, scoring, ranking and selection of projects. Use of such criteria and priorities also enhance transparency and accountability in the operation of environmental funds, which are essential for avoiding ad-hoc political influence and mismanagement of public funds (e.g., safeguarding against corruption and fraud, and identifying and eliminating conflicts of interest) (Karousakis and Corfee-Morlot 2007; Kim and al., 2009). In recent OECD work, we have also surveyed current practice in this area to understand and build on how these issues are being approached in different international climate funds today (see Annex 1).

Based on this analysis, we have suggested a number of key principles, goals and possible performance criteria to guide disbursements where international public support is sought to implement NAMAs and/or NAPAs (Kim et al. 2009; Karousakis and Corfee-Morlot 2007). According to this OECD work, relevant questions and criteria could include:

- Are proposed policy reforms and actions consistent with and mutually supportive of domestic development priorities?
- Are they aiming to achieve medium-term to long-term policy reforms that can alter the emissions and/or impact and vulnerablity trajectory of the country?

- Are the actions clearly embedded in and part of national strategies for low carbon/climate resilient development?
- Are measures designed in a manner that delivers on other key policy performance criteria, e.g.
    - least-cost mitigation and provision of dynamic innovation signals;
    - maximising the performance of necessarily limited public support by leveraging private sector investment;
    - building capacity and institutional reforms to better mitigate and adapt to climate change over time;
    - potential to replicate and more widely diffuse measures taken if/when they are shown to be successful;
    - extent to which they target and address fairly the most vulnerable sectors and segments of the population;
    - whether measures address procedural and equity concerns, building on broad stakeholder consultation and engagement?

It may be especially important to build capacity for ongoing institutional reform in countries, such that mitigation and adaptation are integrated into broad development strategies and national policy frameworks over time (Clapp et al. 2010; OECD 2010b). Highlights of a recent survey of the status and lessons learnt from countries experimenting with or developing "low emission development strategies" is summarised in Box 1.

Finally to build trust and enhance transparency, the GCF might also wisht to aim to accurately measure and report on its financial flows (commitments and disbursements) and the goals targeted (*ex-ante*) to support climate action, while also working with partner countries to monitor and report on results. Early adoption of a robust monitoring and reporting framework will help to assess progress and boost performance of the fund while also build trust, transparency and accountability about how funds are being used. Any framework for MRV of climate finance should begin with a clear definition of "what is climate finance" and also be designed to track both the flows of international public funding as well as to what extent these funds leverage private investments (Buchner et al. 2011). Recent OECD work in this area recommends that bilateral and multilateral donor organizations begin to systematically measure and report on both international public funds disbursed and "leveraging ratios" of these funds via an internationally agreed methodology for the latter; in parallel recipient countries may also want to do the same thing providing a system for cross-checking (Buchner et al. 2011).

Box 1 Low Emission Development Strategies: Technical, Institutional and Policy Lessons

A LEDS can provide value-added to the myriad of existing climate change and development related strategies and reports that already exist by providing integrated economic development and climate change planning. A LEDS may serve a range of domestic purposes for government, the private sector and the general public as well as other institutions and stakeholders. For example, the process of establishing a LEDS can enhance co-ordination across different ministries, improve communication with other stakeholder groups such as businesses and civil society, and increase public awareness of climate change science and policy. A LEDS can help guide the diversification of an economy (e.g. away from fossil-fuels). Clarification on economic development and climate change priorities can in turn help provide early signals to the private sector for possible directions for investment, research and development.

Beyond the domestic functions that are served by a LEDS, such strategies can also inform the international community in a variety of ways. For example, LEDS can provide information to better assess global climate change impacts and actions and how mitigation actions are expected to impact emission trajectories. Another important purpose of a LEDS could be to highlight gaps and identify priority actions for funding to the international community. From an aid donor's perspective, financing for climate change programmes that also contribute to poverty reduction and development objectives can reduce the risk of fragmenting funding sources. Although very few reports that specifically refer to themselves as LEDS have actually been prepared to date, many elements of national climate change strategies exist today. Where these are aligned with economic and development priorities and could be incorporated into a LEDS.

Many countries agree that preparing a LEDS should not hinder progress on implementing nationally appropriate mitigation actions (NAMAs). Although a LEDS could help attract financing, the preparation of a LEDS should not be a precondition for financial support. Rather, preparing a LEDS is an enabling exercise that can help prioritise NAMAs and is useful for considering how NAMAs can work together towards a national strategy in the longer-term.

Countries should carefully consider how LEDS fit with other existing planning tools and strategies to minimise the risk of additional burden and overlapping or conflicting strategies. LEDS can integrate, and build on, existing strategies including national sustainable development strategies, national climate change strategies and technology needs assessments. It is also important to consider how information contained in a LEDS (e.g. policy priorities, funding and capacity needs) could be best communicated to the international community. This could involve making LEDS publically available, or voluntarily including some elements of a LEDS in a National Communication.

Source: Adapated excerpt from Clapp et al. (2010) "*Low Emission Development Strategies: Technical, Institutional and Policy Lessons*", COM/ENV/EPOC/IEA/SLT(2010)2, OECD//IEA, Paris

Thematic scope - suggested questions/issues:

Question 3. Thematic windows and their scope

How many and what thematic funding windows should be adopted? What activities should be covered by each thematic window? Regarding different thematic windows:

If such thematic windows are to be adopted for adaptation, technology and/or REDD+ in addition to mitigation, OECD analyses provide some guidance on what might be covered in such windows. Some suggestions are outlined below.

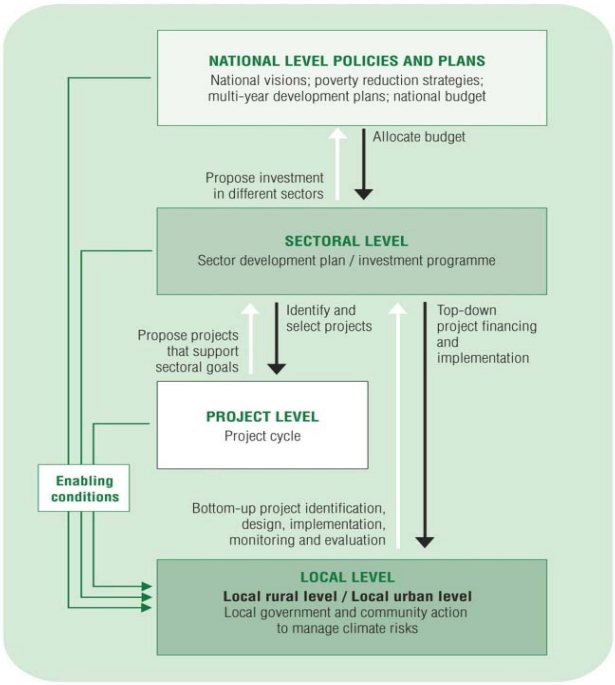
1. Adaptation financing

In 2009, the OECD released a policy guidance on *Integrating Adaptation to Climate Change into Development Co-operation* [see: www.oecd.org/env/cc/adaptation/guidance]. This guidance takes an integrated or "whole-of-government approach" to adaptation from a partner country perspective. As adaptation affects all sectors, the policy guidance suggests co-ordination mechanisms that bring together relevant government ministries and agencies.

To analyse needs and options for adaptation, the guidance developed a tool known as "climate lens". In its use, four questions are asked about any proposed or existing measure: (i) How vulnerable is the measure to the impacts of climate change?, (ii) To what extent have climate change risks already been taken into account?; (iii) Can the measure be adjusted to better take into account the risks posed by climate change?; (iv) Does the measure inadvertently increase vulnerability to climate change?

When disbursing funds, GCF might wish to examine the extent to which recipient countries co-ordinate across the different decision levels of government and action (see Figure 1).

Figure 1. Decision Levels Examined in Policy Guidance



2. Technology financing

2.1 R&D and direct support

The latest OECD analysis shows that carbon pricing that stabilises GHG concentrations even at moderate levels could lead to a four-fold increase in world energy R&D spending by 2050 (Bosetti *et al*. 2009; OECD 2009a). However a significant increase in public spending is also needed to support climate-friendly technology R&D.

The GCF may therefore wish to consider supporting some R&D actions either at national or international levels of action. Yet in a world of imperfect information and uncertainty, a key policy challenge relates to the allocation of R&D support across fields and technologies. Work undertaken at the OECD on innovation in renewable energy technologies suggests it is more efficient to target 'generic' general purpose technologies such as energy storage and grid management than to seek to support particular generating technologies. Figure 2 presents the results of a simulation that allocates a 10% increase in public R&D expenditures two different ways: allocating the increase to generating technologies in line with past trends versus allocating the increase to energy storage technologies. The results – measured through patenting activity levels – indicate that governments would generate more innovation capacity in intermittent renewable energy generation technologies if they targeted R&D spending to storage technologies rather than trying to "pick winners" by targeting specific generating technologies directly (Johnstone & Haščič, 2009; Johnstone *et al.*, 2010a,b).

Figure 2. Simulated effect of a 10% Increase in Public R&D Expenditure in two different technologies

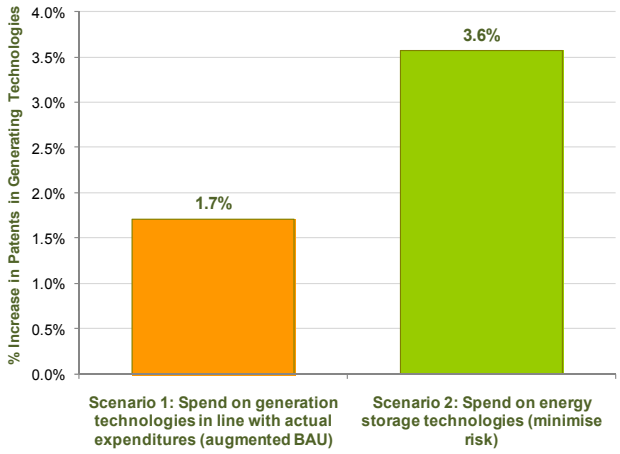
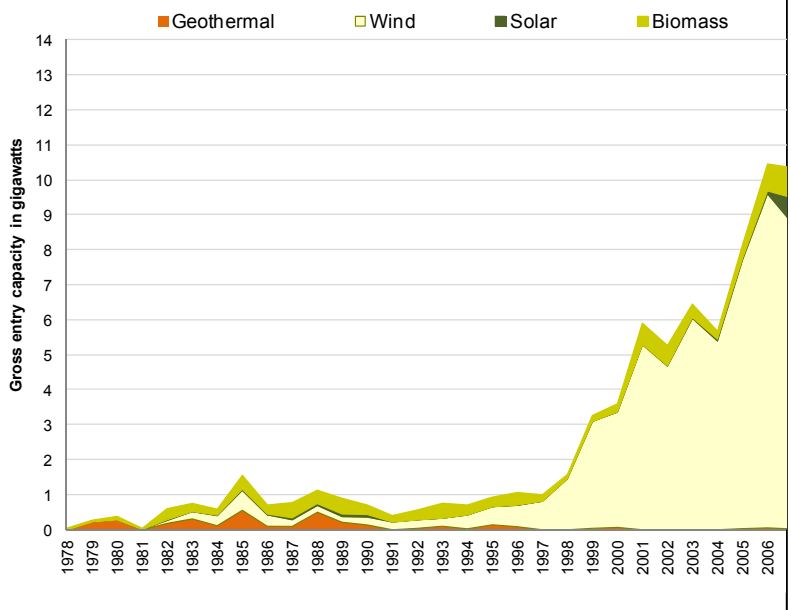


Figure 3. New plant entry by type of renewable energy (measured in MWs) in North America, Pacific and EU-15 regions



Source: Kalamova *et al.* 2011

There will also be a need to provide time-bound direct public support for investment in renewable energy and other new, clean technologies. In recent years OECD governments have intervened directly in energy markets in order to promote increased investment in low emission technologies, such as renewable energy power

generation. Such measures appear to have had some success (Figure 3), where total plant entry capacities (measured in megawatts electric) for major renewable energy sources – wind, solar, biomass and geothermal – grew rapidly in the period 1978-2008. At the same time, the rate of entry of coal and oil plants plummeted in these countries. A number of lessons for policy can be drawn from this experience (Kalamova et al. 2011).

The increasing trend for investment in renewable energy power generation facilities in all regions since 1997 coincides with the agreement and implementation of the Kyoto Protocol. In this period, developed country governments also provided targeted support for renewable energy investment, which can be justified by the relative immaturity of these technologies. This immaturity makes it more difficult for lenders to accurately price relative risk of investments in "clean" energy, and thus for investors in the sector to obtain financing at reasonable cost. Moreover, in some cases there can be important learning and demonstration effects, which will not be realized in the absence of initial financial support from the public sector (Kalamova *et al.* 2011).

Recent OECD analysis includes a preliminary survey of measures that draw down the costs of investment in renewable energy in three countries (Australia, Germany, Japan), providing some evidence of investment trends in each country (as measured through the proxy of physical plant entry). Two main categories of policy instruments are found and several examples within each category (Kalamova et al. 2011):

1. Direct Financial Transfer
    - Capital grants (e.g. Subsidy Programme for Residential PV Systems in Japan)
    - Government-funded/run venture capital funds (e.g. Australian Renewable Energy Equity Fund)
    - Low-interest loan and loan guarantees (e.g. low-interest loans by KfW in Germany)
2. Preferential Tax Treatment
    - Accelerated depreciation (e.g. Modified Accelerated Cost Recovery System in the US)
    - Investment tax credit (e.g. US)

Predictability of government programmes is necessary if investors are to initiate a project in clean energy; however, predictability should not be mistaken for permanence. It is also important to 'sunset' those policies which support investment directly, since over time the financial markets will price risk efficiently and learning benefits will be exhausted. The GCF might want to build on these lessons as they may assist in the design of policies to promote the uptake and investment in developing countries (Kalamova et al. 2011).

2.2 Accelerate international transfer of 'clean' technologies through international cooperation

The GCF may want to examine how to complement international research co-operation in order to play a role in encouraging the international transfer of 'clean' technologies. Clearly, market factors are important and countries with close economic ties are most likely to transfer technologies between themselves. However, OECD analyses demonstrate that high technological capacity in the recipient country is a key factor in encouraging transfers. That is, countries that innovate themselves are more likely to benefit from innovations originating elsewhere. As such, actions by developing countries to put in place policies that constrain emissions and drive local innovation supported through capacity building will also be critical to encouraging more transfer of low-carbon technologies (Johnstone & Haščič, 2009; Johnstone *et al.,* 2010a,b).

In addition, special mechanisms may be needed to accelerate technology transfer to developing countries. These will need to balance the interests of businesses as well as governments. A first step would be to lower existing barriers to trade in lower carbon goods. OECD work has examined some of the measures

governments can take to facilitate trade in climate mitigation technologies for the energy supply, buildings and industry sectors (Steenblik & Kim, 2009), and is currently looking at facilitating trade in climate mitigation services. In specific circumstances, such as where transaction costs for transfer are very high, for example due to overlapping patents on complementary technology components, it may also be of interest to use international financing to buy-down intellectual property related costs (e.g., application, examination, registration fees) so as to increase technology transfer. Support for education and training may also be helpful to protect intellectual property rights, which in turn provides incentives for innovation (Johnstone & Haščič, 2009; Johnstone *et al.,* 2010a,b).

3. REDD +

3.1 Develop capacity building and experience to reduce emissions from deforestation and forest degradation in developing countries

The GCF may also wish to target programmes and initiatives for reducing emissions from deforestation and forest degradation (REDD) in developing countries. A key area for support is capacity building (e.g., institutional and monitoring capacities) and as well as investment actions to reduce emissions directly (Karousakis and Corfee-Morlot 2007). Recent OECD/IEA work in this area identifies four key features critical to an effective REDD plus financing mechanism are:

(i) establishing clear goals and objectives;

(ii) ensuring sufficient and long-term sources of finance;

(iii) developing eligibility and prioritisation criteria; and

(iv) ensuring accurate and consistent monitoring and performance evaluation.

Ultimately, market-based approaches to finance REDD are likely to generate significantly larger, more sustainable finance, than fund-based approaches (Karousakis & Corfee-Morlot, 2007). Nevertheless a fund based mechanism in the near-term could help countries and donors to gain experience in this important area. Regarding possible eligibility criteria and priorities for provision of international funding, Karousakis and Corfee-Morlot (2007) provide a number of relevant recommendations (see Box 2 on eligibility criteria for funding or eventually, access to markets).

In addition, the Karousakis and Corfee-Morlot (2007) review a number of issues on how to disburse payments to REDD projects or programmes, with an emphasis on making payments to forest owners or users directly and use of "payments for environmental services". Notably the authors state:

> *"Payments for RED(D) should ideally be made directly to the forest owners/users making the land-use decisions. This would provide an incentive to individual forest owner/users to make informed decisions on the land use choices, given full information on the opportunity costs of alternative land uses. The transaction costs associated with engaging individuals are likely to be higher than making payments at the government level. Examples from Payments for Environmental Services programmes in Costa Rica/Mexico which compensate land users directly indicate that transaction costs are about 18% of total costs. The possibility of bundling smaller land parcels may help to reduce these costs. The level at which emissions reduction incentives may be devolved however will depend crucially on the monitoring abilities of a particular country. If there is accurate monitoring at the forest owner/user level, then payments could be made directly to these individuals (or communities).*
>
> *To ensure that a financing mechanism is performance-based, payments would need to be made ex-post. This is especially true for a baseline and credit mechanism, rather than a cap and trade mechanism with adequate non-compliance measures. Though ex-post payments may disadvantage small-landholders who are poorer, ex-post payments increase the environmental integrity of the mechanism. Ex-post payments is the methodology used in the Mexican Payments for Environmental Services schemes, the CDM and JI, among others."*

The paper also contains a review of available data on emissions from deforestation at country level and land ownership regimes in key developing countries focusing on those countries with high deforestation rates. More recent work from the OECD has reviewed experience to date and provides policy recommendations for good practice for "payment for environmental services" (OECD 2010a). Although the analysis was targeted to biodiversity, many of the policy recommendations are relevant to financing REDD+ activities.

Box 2 Identifying eligibility criteria and priorities for REDD + funding

Eligibility criteria and methodologies to grant access to the mechanism are necessary and, in the case of funds, priorities for fund allocation are needed. Clear criteria would help make the selection process transparent. The notion of eligibility criteria will differ depending upon whether the mechanism has mitigation or capacity building as the goal.

If the goal of a financial mechanism is specifically mitigation, then the eligibility requirements for access to financing would presumably be based in part on the ability to document historical GHG emission trends and demonstrate real reductions in emissions from deforestation. In this case, a RED(D) financing mechanism could be designed to have similar eligibility requirements as for Annex I country participation in the Kyoto mechanisms (UNFCCC 2007b). If so, they might need to include:

a) Annual inventories and reporting of emissions and removals of greenhouse gases, in this case for a minimum of 10 years;

b) A national system[1] for estimating and reporting emissions and removals of greenhouse gases;

c) Calculation of a historical baseline and/or a future reference scenario, in terms of tonnes of CO_2-equivalent emissions (similar to assigned amount) for emissions from deforestation.

d) For a market based mechanism, a national registry for tracking the transfer of any assigned amount (this will only be necessary if it is a sector cap and trade programme since allowances would be distributed ex-ante; if it is a baseline and credit system, a single registry, similar to the CDM registry managed by the Executive Board, could be used instead).

In the case of a fund, it is likely that a number of developing countries will wish to benefit from such funds, whether they are for capacity building or for mitigation purposes, and that the financial resources available will not be able to meet all the needs. Without a clear spending strategy and eligibility and selection criteria based on cost-effective solutions to environmental priorities, the allocation of financial resources becomes sub-optimal and wasteful. This is also raised in the OECD Council Recommendation on Good Practices for Public Environment Expenditure Management which highlights the need for expenditure programmes, including the appraisal, scoring, ranking and selection of projects (OECD, 2006). Such criteria and priorities also enhance transparency and accountability in the operation of environmental funds, which are essential for avoiding ad-hoc political influence and mismanagement of public funds (e.g., safeguarding against corruption and fraud, and identifying and eliminating conflicts of interest).

If the ultimate objective of the mechanism is capacity building to mitigate emissions from deforestation, priorities should include a range of needs from the development of inventories to the creation and refinement of national systems for monitoring, reporting and review. However, a number of legal issues may also be relevant. These include building capacity to ensure sufficient jurisdiction over the geographic area where the programme would be implemented as well as the development of a system of private contracts and property rights. Both monitoring and legal capacity are critical ingredients for the ability to enforce a law or regulation; both are necessary to support implementation of a market mechanism.

An additional eligibility criterion that may be worth considering given the multiple services that derive from forests, is some form of sustainability criteria to avoid perverse social/equity outcomes in the disbursement of funds. The international body could include sustainability criteria in prioritization of fund allocation.

Source: Excerpts from Karousakis and Corfee-Morlot 2007 http://www.oecd.org/dataoecd/15/10/39725582.pdf. Extensive footnotes from original text have been removed here to keep this brief.

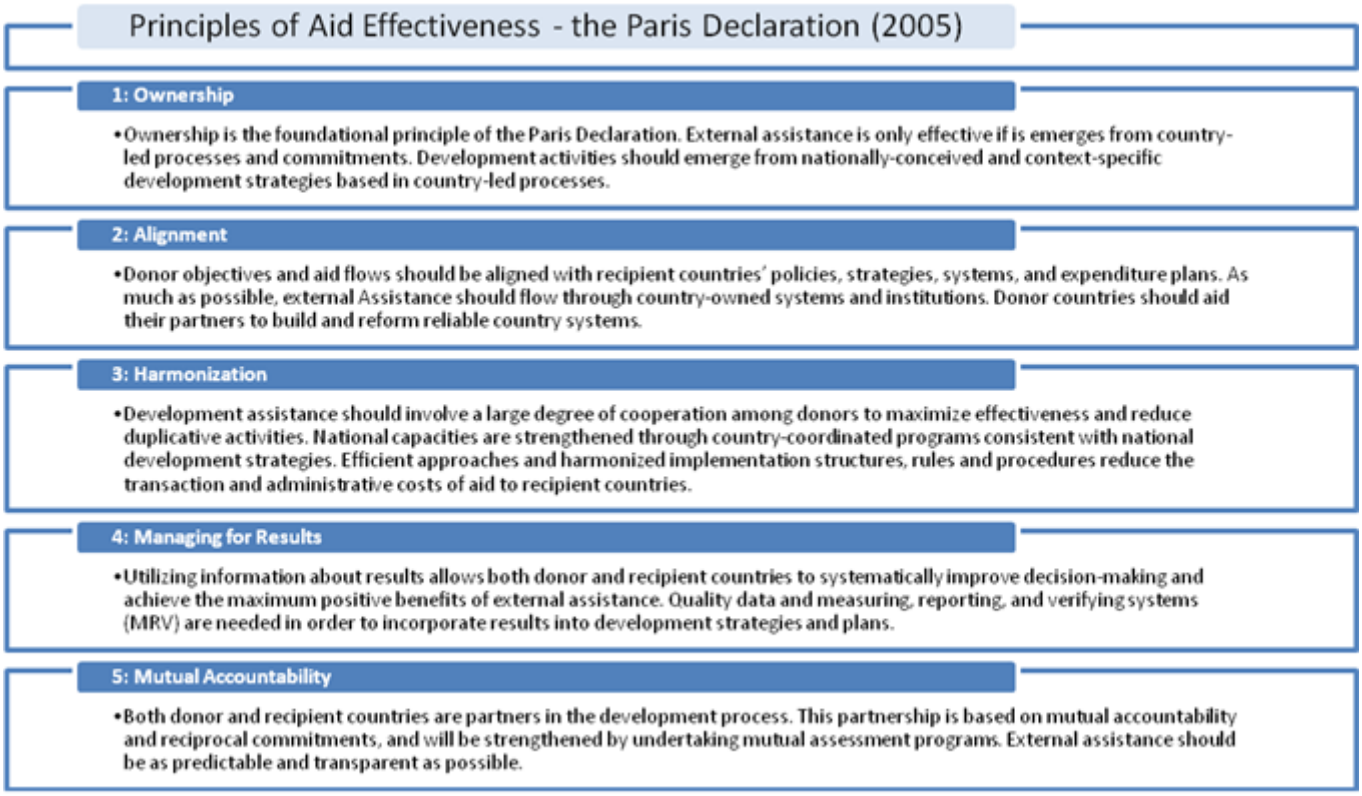
Country-led and results-based approaches

Question 9. Application of the country led principle

How could the GCF encourage the application of the country led principle?

Lessons from development experience highlight that what countries do matters a great deal more than what donors do. Countries themselves must own climate-related activities for them to be effective. Therefore, the Transitional Committee may wish to ensure that country ownership is a key part of the overall vision for the Fund and its guiding principles (CDDE 2010, OECD and AfDB 2011 forthcoming)

The Paris Declaration, which is a set of agreed principles between developing countries and donors on how to manage aid and points to ownership as one of the five key principles.



Source: OECD (2011)b

There are already some nationally-owned climate change mitigation and adaptation strategies such as NAPAs and NAMAs and/or low emission development strategies (for a recent review of the latter, see Clapp et al. 2010). In light of the ownership and country-led principles, the Fund's operation should fully respect these strategies (including strategies other than NAPAs or NAMAs). At the same time, countries themselves would need to incorporate climate change mitigation and adaptation objectives into their mainstream development strategies and budgets.

The Transitional Committee may wish to learn from experiences with the Paris Declaration to ensure that the GCF funding is country-led. In the regular survey that the OECD conducts to monitor the implementation of the Paris Declaration, ownership (or country-led) is measured by the number of

countries that have operational development strategies, including Poverty Reduction Strategies, with clear strategic priorities linked to a medium-term expenditure framework and reflected in annual budgets. Similar methodology could be employed by the GCF to identify countries that stand ready for country-led climate mitigation and adaptation.

In addition, the Fund's operation could be accompanied by capacity development activities of the recipient country to manage and to track the climate finance (see Buchner et al 2011 and Ellis et al 2011). Recent studies in Southeast Asia and Africa show that, even where national climate change strategies are in place, enabling legislation and action plans are not yet established in most countries（CDDE 2010, OECD and AfDB forthcoming). Weak domestic policy frameworks can be an obstacle to climate change mitigation and adaptation. For example, it may lead to competition for political attention and funding among different government ministries and agencies related to climate change. In addition, the imperative to designate different government officials for the multiple policy areas relevant to climate change (i.e. forestry, UNFCCC negotiations) can create tensions between ministries and agencies. Therefore, strong inter-ministerial co-ordination and strong political commitment are pre-requisites to the effective use of the received climate finance.

Question 10. On country led principle, safeguards, fiduciary standards and financial management

What is needed to ensuring the country led principle alongside the application of environmental and social safeguards as well as internationally accepted fiduciary standards and sound financial management?

Environmental and social safeguards are important instruments to ensure that the fund's operation is consistent with non-climate environmental and social objectives. Environmental safeguards should be applied not only at the project level as Environmental Impact Assessment, but also at higher tiers including policies, plans and programmes level (OECD 2006). Such assessment ensures that the funded activity is a country-led process aligned to the country's development objectives. Strategic Environmental Assessment (SEA) is an effective tool to conduct such high-tiers assessment by combining stakeholder consultation and expert judgments on the possible environmental and social impacts from funded activities. OECD-DAC's Guideline on Strategic Environmental Assessment as well as the review of the implementation of the guideline may be consulted (OECD 2006, OECD forthcoming; see Box 3)

Box 3: DAC Guidance: Strategic Environmental Assessment

Development assistance is increasingly being provided through strategic-level interventions, aimed to make aid more effective. To ensure environmental considerations are taken into account in this new aid context, established environmental assessment tools at the project level need to be complemented by approaches fully adapted to policies, plans and programmes. Strategic Environmental Assessment (SEA) meets this need.

SEA provides a practical and direct means of progressing MDG 7 on Environmental Sustainability (agreed at the UN General Assembly in 2000). This calls for the "integration of the principles of sustainable development into country policies and programmes". Secondly, SEA also helps further the Johannesburg Plan of Implementation agreed at the World Summit on Sustainable Development in 2002, which stressed the importance of "strategic frameworks and balanced decision making […] for advancing the sustainable development agenda".

The Paris Declaration on Aid Effectiveness, adopted in 2005, commits donors to reform the way in which aid is delivered to improve effectiveness, by harmonising their efforts and aligning behind partner countries' priorities. It also calls upon donors and partners to work together to "develop and apply common approaches for strategic environmental assessment at sector and national levels".

Application of SEA: The shift of emphasis away from development projects to programme and policy support has created a number of particular entry points for the application of SEA. This guidance outlines the benefits of using SEA in a range of different circumstances, and sets out 12 key "entry points" for effective application of SEA to development co-operation. It points to key questions to be addressed for each of them, accompanied by specific checklists of these questions, and illustrative case examples. The entry points for SEA can be grouped into 3 areas:

1. Strategic planning processes led by a developing country: These include national overarching strategies, programmes and plans; national policy reforms and budget support programmes; sectoral policies, plans and programmes; infrastructure investments plans and programmes; national and sub-national spatial development plans and programmes and transnational plans and programmes.

2. Development agencies' own processes: These include donors' country assistance strategies and plans; partnership agreements with other donor agencies, donors' sector-specific policies, and donor-supported public-private infrastructure support facilities and programmes.

3. Other related circumstances: These include independent Review Commissions and major private sector-led projects and plans.

Source: Excerpted from OECD 2006. *Applying Strategic Environmental Assessment: Good Practice Guidance for Development Co-operation*. OECD: Paris. http://www.oecd.org/dataoecd/4/21/37353858.pdf. Another report on SEA best practice guidance is forthcoming in 2011.

Question 11. on results based approaches

How could the GCF encourage results based approaches among different thematic areas? What are the options for implementing result based approaches? Is there a need for taking different approaches for each thematic area?

There has been to date a wide variety of approaches used in international development finance to ensure results which should be considered, although none of them is a panacea. For example these include:

- **Challenge funds** (rationing through competitive bids) is well suited to innovation and piloting, but should be avoided for sustained partnerships, particularly where recurrent costs are high. This is because challenge funds are generally unpredictable and fragmented. Proposals for funding may be wasted if they do not get taken up. Countries with small populations can get significantly more financing per capita compared to middle-sized or larger countries. Richer countries – with higher-cost projects – also tend to get more finance per capita.
- **Results-based approaches** such as output-based disbursements has good incentive effect, but does not guarantee the maximization of results in a long run.
- **Ex-ante country envelopes** allocation funding to countries in advance. For example, IDA or GEF-type allocations that take account of population, environmental importance (for mitigation), poverty, and predicted returns (based on indicators of past performance). These country envelopes can readily be adjusted to give more support to so-called "donor orphans".

Critical to all these approaches is the principle of mutual accountability as included in the Paris Declaration and the Accra Agenda for Action. A key objective for donor and recipient countries is to enhance mutual accountability and transparency in the allocation of aid and execution of development activities. The process itself also helps strengthen legitimacy and support of the recipient country's public as well as the international community.

Question 14. on complementarity

How will the GCF ensure complementarity between the Fund's activities and those of other bilateral, regional and multilateral funding mechanisms and institutions?

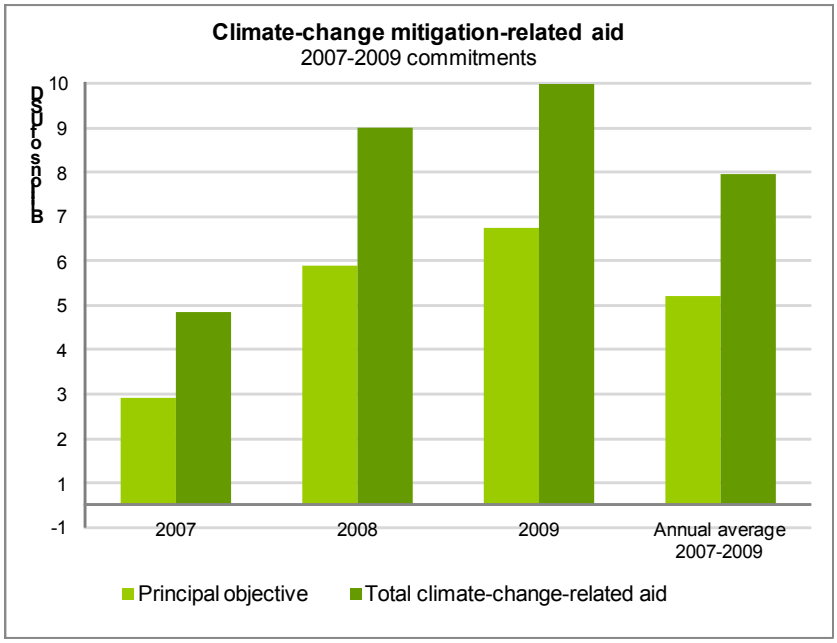
To ensure the complementarity of the Fund's activities with other funding mechanisms, two key points might be considered:

1) **The Fund might wish to seek to fund activities jointly with other donors and multilateral institutions.** In the development community, there is an increasing emphasis on "harmonised" activities and the use of general and sectoral budget support, as opposed to activities that create scattered mechanisms. As the scale of the Fund is likely to be significant, its activities need to be well-coordinated with other actors and not add additional administrative burdens for the recipient countries.

2) **The fund might wish to employ a measurement, reporting and verification (MRV) mechanism compatible with other funding actors.** Such compatibility is essential to track the progress towards the committed amount in the Cancun agreement. Although there is no universally agreed methodology to track climate finance, OECD-Development Assistance Committee's statistical markers on climate mitigation and adaptation are most comprehensive to date. They cover all major bilateral donors in OECD countries as well as the World Bank, and the OECD is in consultation with regional development banks to employ compatible methodologies such that multilateral finance is comprehensively brought into the system. For a review of the strengths and weaknesses of the system and of how it might fit into a broader system for MRV of climate finance (for public and private sources, multilateral and bilateral channels). More information is provided below on the need to track flows and on key messages from recent work.

At the international level, current systems to measure, report and verify (MRV) financial support are limited, and no single system provides a complete picture of climate-specific finance flows. Tracking climate finance is difficult, as flows come from different sources (national and international, public and private), are provided via different channels (bilateral or multilateral) and have different aims (mitigation- or adaptation-specific vs. mitigation- or adaptation-relevant) (Corfee-Morlot *et al.,* 2009; Buchner et al 2011). Issues relating to confidentiality of data can also impede accurate tracking of export credits and private-sector flows. It is also unclear how to assess what is "new and additional" to pre-existing levels of finance. Developing a more comprehensive framework for MRV of climate change support in future may usefully build on the UNFCCC National Communications and review process, as well as the statistical systems of the OECD's Development Assistance Committee (DAC) (Ellis *et al.* 2009, 2010; Buchner et al 2011).

Figure 3. Creditor Reporting System



Source: OECD DAC CRS system 2011

The OECD-DAC has a robust system for measuring climate change aid (Figure 3). It is based on activity-level reporting to the DAC's Creditor Reporting System (CRS), which covers over 90% of all aid flows from OECD countries and multilateral organisations (OECD, 2010c). The system for measuring climate change aid is to mark each aid activity that serves climate objectives as either principally or significantly targeted at mitigation or adaptation. So a project can be marked as principally targeted at mitigation, principally targeted at adaptation, significantly targeted at mitigation, or significantly targeted at adaptation. Data on mitigation-related aid have been collected since 1998. The adaptation marker is newer; agreed at the end of 2009, so data using this marker will be collected from 2010.

The OECD DAC approach is the result of extensive negotiation among aid providers, in consultation with UNFCCC. With the possible exception of carbon capture and storage, all aid projects that reflect climate concerns are also development projects in traditional sectors for aid, such as agriculture, forestry, energy, or water supply. It provides a solid foundation to build a more comprehensive monitoring system over time.

Work stream III: Operational modalities Suggested questions for the first technical workshop of the Transitional Committee on issues related to sub-workstream

III.1: Finance entry points

Question 2. Finance entry points – raising funding

What processes and sources might be used to raise funding? If there is a regular process for raising funds, how would such a process be managed? What would be the comparative benefits and costs of periodic compared to ongoing funding receipt? What systems would the Fund need to manage different processes that may be used for receipt of funding?

In a context of tight governments budgets, market mechanisms could provide new sources of public funding

Market instruments are essential to put a price on carbon and to steer private investment to low carbon development, but they can also provide a large and stable source of public finance, some of which can be used to support climate change action. OECD research shows that if all industrialised countries were to use economy-wide carbon taxes or auction all emission trading permits to achieve the emission reductions they originally pledged in Copenhagen, they could raise about 1% of GDP ($400 billion) in revenue per year by 2020 (Dellink *et al.,* 2010). Just a fraction of this would make a significant contribution to the financing specified under the Cancún Agreements.

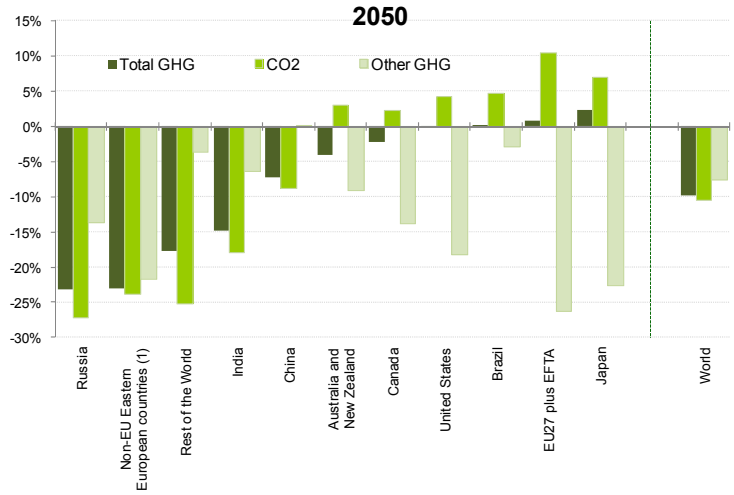
There are a wide variety of other possible sources which could be used to scale up public finance to support climate change in this time frame (OECD 2011b; APF 2009). However in the context of a cash-strapped public sector, the use of domestic market instruments and policies could generate a stable source of revenues to bolster economic growth, compensate for reductions in other taxes (e.g. on labour), and/or to help provide financing to support mitigation and adaptation action in developing countries.

Putting a price on carbon emissions through taxes or cap-and-trade schemes, will penalise carbon-intensive technologies, create markets for low-carbon investments and technologies such as energy efficiency, solar, wind energy and carbon capture and storage; and stimulate action in the energy, industry, transport and agriculture sectors. Recent OECD analyses demonstrate that carbon taxes can be very effective in triggering patenting and other innovations while also providing new sources of public revenues (OECD, 2010a).

Shift public financing away from activities that encourage GHG emissions

Even before pricing carbon and other emissions directly, an important first step can be to remove environmentally-harmful subsidies to fossil fuel energy consumption or production because these subsidies amount to a *de facto* reward for carbon emissions. OECD analysis finds that removing energy subsidies would save money for governments and taxpayers, shift the economy away from activities that emit CO_2, encourage energy efficiency, and promote the development and diffusion of low-carbon technologies and renewable energy sources. Removing these subsidies would lower the global cost of stabilising GHG concentrations.

Figure 4: Long term impact of a multilateral phasing-out of fossil fuels subsidies on GHG emissions



The OECD, together with the IEA, OPEC and the World Bank, have prepared analysis of the scope of energy subsidies and the opportunities for phasing-out fossil fuel subsidies for the G20 Leaders' Summits in 2010. According to IEA data, fossil fuel consumption subsidies in 37 developing and emerging economies amounted to an estimated $558 billion in 2008, and $312 billion in 2009 (IEA *et al*., 2010). OECD estimates that phasing-out these subsidies could reduce global GHG emissions by 10% globally by 2050, compared with business-as-usual, and by over 20% in Russia, Eastern European countries and oil exporting countries (Figure 4). Removing subsidies would also increase the efficiency of these economies (lEA *et al*., 2010; OECD, 2010a).

Phasing-out subsidies is often politically challenging, and can in some cases have negative impacts on low-income households. Such policy reforms must be implemented carefully to ensure that any negative impacts on household affordability are mitigated through appropriate measures (*e.g.* means-tested social safety net programmes). To achieve intended social benefits, it is preferable to target the support directly to those who most need it, rather than to maintain an across-the-board subsidy to all fuel users. Working with partner countries, the GCF could looks at how to target lasting reforms in this area.

Question 3. Private Finance

How can the GCF best 'crowd-in' private finance at scale, including foreign and domestic sources? What incentives may be provided to engage stakeholders, especially the private sector both at the national and international levels?

As noted by the recent report of the UN High Level Advisory Group on Finance (AGF), delivering new and additional international finance to support climate action will not be easy, particularly given the tightening of government budgets coming out of the financial crisis. While public finance can jump-start the motor, private investment in low-carbon infrastructure and solutions will be needed to keep it running.

OECD work points to the importance of domestic policy frameworks and reforms to "level the playing field" and shift both public and private funds into climate-friendly investments. Key messages and instruments are highlighted briefly below:

Design policies to leverage private investments and use limited public finance to target areas where private funding will not be available

Public finance will necessarily be limited and should be used as a catalyst to leverage private investments wherever possible.

The key issue for the private sector today is the lack of 'investment grade' policy regimes with the clarity, stability, predictability and long-term visibility that will help companies make the appropriate investments to transition to a low-carbon economy and attract private finance. From a corporate perspective, as shown in OECD (2010c), clearer policy signals would help companies go beyond the low-hanging fruit of energy conservation and engage in more ambitious investments to reduce their emissions. Similarly, in the current context of uncertainty, the risk-return profile of low-carbon or adaptation projects is frequently not attractive. Environmental or 'green' projects are currently often not viable on a stand-alone basis due to mispricing in the carbon markets which makes traditional or 'brown' projects more attractive, due to climate change and public health externalities not being priced into these technologies or mispricing due to government policies, such as fossil fuel subsidies.

In developing countries, the basic framework of a sound investment policy is often lacking. Building on the OECD *Policy Framework for Investment* and the *Principles for Private Sector Participation in Infrastructure (*OECD 2007b; see discussion below*)*, the OECD is advancing policy guidance on climate-investment policy frameworks that can facilitate and leverage private sector investment in low-carbon, climate resilient infrastructure and technology (forthcoming 2011).

In all countries, the use of national low-emission strategies or plans can also be an effective tool to provide a vision of the future and "set the course" for a wide variety of governmental and non-governmental stakeholders, including the private sector (Clapp et al. 2010).

Develop appropriate investment incentives to encourage private pools of capital to invest in low-carbon development projects

There is a need to involve private sources of funding to meet the financing challenges of low-carbon technologies and climate-proofed development both in industrialised and in developing countries. Investment incentives should build on "good practice", for example, on the OECD Principles for Private Sector Participation in Infrastructure (OECD, 2007b). At present, the absence of positive incentives and weak regulatory frameworks limit much needed investments by institutional investors (such as pension funds) into the sector and obstacles to international investment flows to low carbon options still remain (Inderst, G., 2009; OECD, 2009b).

The incentives can be enhanced in a number of ways. Judging by the risk-adjusted financial success of infrastructure investment funds more generally, tax incentives can be very powerful. The OECD is currently exploring various options, including targeting the debt capital markets through the use of tax-

incentivized bonds and other types of green bonds (Della Croce et al., 2011 forthcoming). To qualify for the status of "climate change" or "green" bonds, projects would have to meet certain requirements for low-emission performance. The projects that are invested in also need to have proper governance mechanisms and to be structured in ways that generate stable cash flows in order to make them attractive to investors. A sound institutional and regulatory framework, including the phasing out of unnecessary obstacles to capital movements and restrictions on access to local markets, is essential. Bilateral and multilateral finance institutions can play a role through providing risk-mitigation instruments and mechanisms (e.g., insuring against political or currency risk) that could result in enhanced credit ratings and greater investor confidence.

Put a price on carbon and use carbon markets to send a clear market signal for private investment in clean technology and innovation

A further deepening and extending of the carbon market also creates the scope for substantial transfers of private funds from developed to developing countries. In the near term, the main channel for such transfers may be based on scaled-up versions of existing crediting mechanisms such as the Clean Development Mechanism (CDM). Improving the CDM framework and supporting institutions, and addressing barriers to investments through this mechanism, could increase the potential for financed mitigation in developing countries (Ellis and Kamel, 2007). Further, in a rapidly urbanising world, choice of urban infrastructure and policies can help deliver low carbon development, however access to financing remains a challenge. Offset market mechanisms (such as CDM and Joint Implementation) might be designed to provide better carbon market access to urban mitigation projects and programmes so as to tap the potential for cost-effective mitigation in this area (Clapp et al, 2010). If more ambitious GHG emission cuts were pursued and offset and crediting mechanisms were scaled-up at the same time, the amount of transfers through emission crediting – or "offsets" – could rise rapidly. This could support mitigation efforts in developing countries and in rapidly developing locations such as urban city centres. Well-functioning offset or crediting mechanisms also reduce the cost of mitigation (OECD, 2009b).

Export Credit Guarantees may also play a role

Export credit agencies provide funds (direct loans) or guarantees to facilitate exports. In recent years, the majority of medium and long term official export credit flows that go from OECD governments to developing countries support greenhouse gas emitting sectors: transport (37%) and industry (26%) sectors, followed by energy projects (11%) of which about 1% is estimated to go to renewable energy and energy efficiency in the power sector (Buchner et al 2011; OECD 2011 – see http://www.oecd.org/dataoecd/34/44/46534686.pdf). Special liberalised rules governing the provision of export credit support for renewable energy and water projects were agreed by the Participants to the OECD Arrangement on Officially Supported Export Credits in June 2009 [see: http://www.oecd.org/document/42/0,3746,en_2649_37431_40898090_1_1_1_37431,00.html]. A further strengthening of the rules of export credit agreements in this direction could strengthen their role to support action against climate change, particularly as they are designed to promote commercial activity and private investment.

Microfinancing can help contribute private financing to support adaptation

OECD has a major workstream on private sector action and climate change adapatation. One report from this work last year was on the possible role of microfinance ["Assessing the Role of Microfinance in Fostering Adaptation to Climate Change";

see: http://www.oecd-ilibrary.org/content/workingpaper/5kmlcz34fg9v-en.]

The abstract for that paper is provided below:

Assessing the Role of Microfinance in Fostering Adaptation to Climate Change

*Much of the current policy debate on adaptation to climate change has focussed on estimation of adaptation costs, ways to raise and to scale-up funding for adaptation, and the design of the international institutional architecture for adaptation financing. There is however little or no emphasis so far on actual delivery mechanisms to channel these resources at the sub-national level, particularly to target the poor who are also often the most vulnerable to the impacts of climate change. It is in this context that microfinance merits a closer look. This paper offers the first empirical assessment of the linkages between microfinance supported activities and adaptation to climate change. Specifically, the lending portfolios of the 22 leading microfinance institutions in two climate vulnerable countries – Bangladesh and Nepal - are analysed to assess the synergies and potential conflicts between microfinance and adaptation. The two countries had also been previously examined as part of an earlier OECD report on the links between macro-level Official Development Assistance and adaptation. This analysis provides a complementary "bottom-up" perspective on financing for adaptation. Insights from this analysis also have implications for OECD countries. This is because microfinance is also being increasingly tapped to reduce the vulnerability of the poor in domestic OECD contexts as well and may therefore have the potential to contribute to adaptation. The paper identifies areas of opportunity where microfinance could be harnessed to play a greater role in fostering adaptation, as well as its limitations in this context. It also explores the linkage between the top-down macro-financing for adaptation through international financial mechanisms and the bottom-up activities that can be implemented through microfinance. (*Agrawala and Carraro, 2010)

To enable partners to monitor progress, MRV will also need to extend to private climate finance

It will also be necessary to improve the accountability and transparency of private climate finance and investment as a complement to the efforts of countries to mobilise it. Recent decisions from the UNFCCC COP in Cancun highlight the importance of adequate Measurement, Reporting and Verification (MRV) processes. But while significant effort and progress have been made to account for public flows, the scale of private sector flows in support of a low-carbon economy remains largely unknown (Buchner et al. 2011). Some initiatives are developing in this area. In particular, through the OECD countries have started trying to assess the share of foreign direct investment (FDI) going in green areas, including low-carbon (see Golub, S., C. Kauffmann and P. Yeres, 2011 forthcoming). A first step to advance this agenda will be to develop internationally accepted methodologies and statistical data collection efforts. The goal should be collect data on "green FDI" and to provide all stakeholders open access to it; this will in turn facilitate monitoring and the tracking of progress to shift private investment to climate-friendly options.

Question 4. On the role of capital markets

Should GCF resources be deployed to raise funds from the capital markets, whether through bond issues or some other vehicle that could be considered to mobilize significant amounts of funding from institutional investors?[1]

Pension funds already invest through fixed-income debt instruments and there has been appetite for investing in the emerging asset class of "green bonds. OECD work in this area suggests that there may be opportunities to access some of the $28 trillion USD in assets under management of OECD pension fund monies to support climate change action via green bonds.

OECD work[2] currently underway examines how pension funds, along with other institutional investors, potentially have an important role to play in financing green growth initiatives. With USD 28 trillion in assets held by private pension funds in OECD countries, and annual contribution in-flows of around USD 850bn, pension funds could be key sources of capital. Pension funds are looking for long-dated assets with inflation protection, a steady, attractive yield, lower risk and which have a low correlation to the rest of their portfolio. If the sizable assets under management by pension funds are to be directed to green projects, financing instruments which meet the needs of this universe of broad, conservative pension funds will have to be created.

Pension funds are 'buy and hold' debt and equity investors and their main focus is on long term income rather than capital accumulation. As such, they already invest through fixed-income debt instruments and there has been appetite for investing in the emerging asset class of "green bonds".

Green bonds can be defined as fixed-income securities issued (by governments, multi-national banks or corporations) in order to raise the necessary capital for an environmental project. These have been issued by the World Bank and other development banks and other entities in order to raise capital specifically for climate change and green growth related projects. Offering these bonds with a comparable interest rate as other instruments, and with at least the same or a higher credit rating, while ring-fencing the financing for green projects has resulted in strong demand among institutional investors for the issuances to date. It is through these bonds that significant pension fund assets could be directed towards green projects. Green bonds have been designed to attract capital from institutional investors, including those with Socially Responsible Investing (SRI) mandates, such as the Danish pension fund ATP, the UN Join Staff Pension Fund and the Norwegian Global Fund. These bonds have also been directed towards the retail sector, whilst sovereign wealth funds and hedge funds are also seen as important sources of demand.

The market size for all green bond issuances to date is approximately $11 billion (with $1.9 issued by the World Bank alone), a drop in the ocean (0.012%) of the capital held in the global bond markets, estimated to be worth $91 trillion globally. There is scope for scaled up issuances of green bonds but if this capital is to be raised through a thriving and liquid green bond market, transparent policies based on long term, comprehensive and ambitious political commitment are needed. The recent UK political commitment to a Green Investment Bank with the ability to potentially issue green bonds by 2015 is an encouraging step in the right direction.

It is important to note the need for some sort of 'rating agency' or standard setter to 'approve' green projects underlying bond issuances, to ensure that funds are used for green investments and that insurance and guarantees can therefore be reliably offered.

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[2] **"The Role of Pension Funds in Financing Green Growth Initiatives" DAF/AS/WD(2011)7** OECD (2011, forthcoming) Della Croce, Kaminker and Stewart

A green fund that issues bonds in different tranches could invest in the first tranche or “equity tranche” in green infrastructure projects, which would allow institutional investors to then invest alongside the public sector, or as a risk mitigation measure to enhance the risk/return profile.

Question 5. On modalities for public-private engagement

How can the modalities of public-private engagement be optimised, including timing of engagement, aligning project cycles, pre-investment activities, linkages to the carbon markets and other operational issues?

The OECD *Principles for Private Sector Investment in Infrastructure* (OECD 2007) outline how governments can enhance their investment environment to promote infrastructure development through private sector participation.They are a relevant conceptual framework to encourage investment in green growth and climate-friendly projects, which are mainly about infrastructure projects. According to the *Principles*, policy makers should focus on five main areas to make the most of private sector involvement in the development and management of infrastructure:

- The *Principles* put a strong emphasis on a sound institutional and regulatory environment for infrastructure investment, as the centerpiece of any business environment to ensure the sustainability of the relationship with the private partners. This includes removing regulatory barriers, alining the incentives of various responsible authorities, phasing out unnecessary obstacles to capital movements and restrictions on access to local markets. In the case of climate investment, this translates in providing a stable policy environment that helps put a price on carbon and clarify government's expectations in terms of climate performance of private investment;

- The existence of institutions in itself is not sufficient to ensure the expected mobilization of private investment. The OECD *Principles* also put a strong emphasis on the actual public and institutional capacity and resources to carry out the task of regulating and supervising the partnership with the private sector in an efficient manner;

- Ensuring the financial sustainability of projects through an assessment of long-term revenue flows, affordability for government and the costs and benefits of alternative modes of financing is also a key area of consideration for governments. Often long-term projects – as in the case of low-carbon infrastructure – fail for lack or uncertainty of financial sustainability over time. In this context, some kind of government incentives and guarantees may be necessary to make returns on low-carbon projects;

- PPPs in infrastructure typically lead to long-term contracts, which by nature cannot be exhaustive (i.e. cover all potential events that may arise in the lifetime of projects). In such a context, the OECD *Principles* insists on the accountability mechanisms that can help policy makers ensure the long-term viability of contracts. Making the co-operation between the public and private sectors work involves promoting transparency and leveling the playing field between diverse private competitors – notably by clarifying government expectations in the field of climate change (in the competitive bidding and in the performance-based contractual arrangements).

- Beyond establishing the enabling environment for climate-friendly private investment, promoting responsible climate conduct of business partners, including through greater corporate reporting of climate performance and reviews of environmental impacts of activities, can be important trigger /awareness factors to incentivize further companies' investment towards a low-carbon economy.

Question 6. On delivery of private finance in weak financial markets

How can the delivery of private finance be improved in regions with poorly developed financial markets?

Impediments to Green Infrastructure Investment in Africa[23]	Potential Solutions
High costs of and lack of access to finance Limited access to funding Poor or non-existent sovereign credit ratings Limited access to international credit markets Under developed domestic capital markets	Strengthen local financial markets Improve banking sector (encourage microcredit banks) Phase out obstacles to international capital movement *Funds and other finance sources to support private actors* Political risk mitigation tools (possibly provided by African Development Bank) Other regional and global guarantee facilities)e.g. World Bank, MIGA, *Agence Française de Développement* developing the BOAD (Banque Ouest Africaine de Développement) Infrastructure Guarantee Facility)[4] Currency risk mitigation tools (possibly provided by African Development Bank, also G8 initiative)
Cumbersome regulatory and policy environment	Overcome cumbersome economic legislation and a lack of transparency via business-

[2] IFC-sponsored survey, foreign investors cited three key factors as impeding their involvement in Africa - OECD African Economic Outlook 2005-2006 p394
3rd IFC inadequate infrastructure, especially electricity and roads

[3] OECD report on *Increasing Private Investment in African Energy Infrastructure*http://www.oecd.org/dataoecd/44/46/43966848.pdf

[4] This facility offers three types of guarantee instruments which cover both commercial and political risks, thus providing flexible guarantees to small and medium infrastructure projects in the WAEMU. *Matsukawa, Tomoko and Habeck, Odo. "Review of Risk Mitigation Instruments for Infrastructure Financing and Recent Trends and Developments". Trends and Policy Options, No.4. World Bank and Public-Private Infrastructure Advisory Facility (PPIAF), p.33*

lack of independent or impartial regulators in some countries Weak procurement laws Inefficient or non-transparent tendering processes that result in cancelled, postponed or disputed tenders Poor contract laws	friendly reform and transparency of information (AU Convention on preventing and combating corruption and EITI, OECD Anti-Bribery Convention and the Stolen Assets Recovery (STAR) Initiative) Strengthen competition laws Institute formal dispute resolution mechanism Tackle weak property rights and contractual law via reinforcing governance-monitoring units to guarantee fair competition in bidding Monitor projects (independent regulatory authorities – move from traditional government bodies to performance-based agencies)
Capacity impediments Lack of skills among public officials to manage Public Private Partnerships (PPPs) Most local judicial systems do not have the capacity to handle complex contracts or disputes Regional and sub-national regulatory frameworks are not harmonized, which poses problems for projects that cross borders. Bureaucratic procedures that effectively halt or delay a project; Change in administrations and consequently different rules for investors; Nationalization or expropriation.	Stream public agencies to minimize bureaucracy; Hire and develop individuals who have experience in PPPs Strengthen regional PPP capacity and cooperation Political risk mitigation tools Enhancing AfDB's capacity to use coverage mechanism and catalyse private investment for infrastructure financing

Source Della Croce R. et al., 2011 *forthcoming*

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