Comments regarding 'Policies and Procedures for the Initial Allocation of Fund Resources'

BACKGROUND PAPER GCF/B.06/05

Review Note for the Sixth Meeting of the Green Climate Fund Board

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Contents

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This Note analyses the GCF Paper 'Policies and Procedures for the Initial Allocation of Fund Resources'[2] ('the Paper') against the background of some of the main lessons drawn in a recently completed research project ('the Project') on resource allocation methodologies, as summarized in Müller (2014).

1 Theme and activity-based allocation of resources

The Board, at its fifth meeting in October 2013, agreed to 'adopt a theme/activity-based approach to the allocation of resources'. The Paper expands on this in paragraph 9 as follows:

> 9. **Initial two-tier allocation system:** Following extensive deliberations, the Board decided to start Fund operations with a two-tier allocation system:
>
> (a) The **first tier** will set allocation targets relative to available resources for two *themes* (mitigation and adaptation) and one *modality* (the PSF[3]). Additionally, a minimum floor target will be set for *country groups* identified as being particularly vulnerable to the adverse effects of climate change: least developed countries (LDCs), small island developing States (SIDS) and African States; and
>
> (b) The **second tier** will allocate available resources to proposed *activities*. The second tier is elaborated upon in document GCF/B.06/08. In this second tier, there will be an element of competition for the use of Fund's resources both for the private and the public sectors. Proposals will be evaluated against their potential contribution to a paradigm shift and on their potential mitigation and/or adaptation benefits.[4]

It is important to be very clear about what this implies. Consider, in a first instance, the second tier, as described in paragraph 9.b. The key implication is that the proposed project approval process is to be ***competitive***, with a view to ***maximize*** potential ***contribution to a paradigm shift*** and obtain the maximum potential ***mitigation and/or adaptation benefits given the available funding***. Indeed, according to the background paper 'Initial Proposal Approval Process' (GCF/B.06/08) which elaborates on how exactly projects are to be approved, the main criteria would be ***overall size*** (***actual*** or ***potential***) and ***value for money***[5] (see Box 1).

While there are contexts − such as those described in Ghosh et al. (2012) or Müller et al. (2013) – where such competitive 'endogenous allocations' could work, two of the Project's lessons should be kept in mind in this context, namely:

(i) not all objectives lend themselves equally to this sort of competitive allocation based on ***efficiency*** considerations, and
(ii) if one decides to introduce a form of competitive allocation, then it is essential to ensure also that ***fairness and equity*** considerations are taken into account in equal measure.

[2] GCF/B.06/05.
[3] Private sector facility.
[4] GCF/B.06/05.
[5] Referred to in GCF/B.06/08 'impact potential', 'transformational potential', and 'economic efficiency', respectively (see Box 1).

Box 1. ‘Activity-specific’ decision criteria (Source: GCF/B.06/08)

29. […] Criteria could, for example, belong to six broad categories, and be differentiated between mitigation and adaptation, as appropriate:

(a) Impact potential
(b) Transformational potential
(c) Needs of beneficiary country/region
(d) Institutional capacity of beneficiary [country/region]
(e) Economic efficiency
(f) Financial viability (if revenue-generating activity)

30. These criteria* are set out in Table 1

Examples of possible criteria for the decision to proceed [from Table 1, GCF/B.06/08]

Criteria Category	***Definition***	***Example of criterion***	***Example of indicators from other funds***
Impact/result potential	Potential to contribute to the achievement of a fund’s objectives and result areas	Expected reductions in greenhouse gas emissions	Net carbon intensity of the new gas-fired power plant, or new units within an existing plant for coal-fired power plants (CIFs† CTF‡)
Transformational potential	Degree to which a fund can achieve impact beyond a one-off project or programme investment through replicability and scalability	Transformational potential	Measured by the ratio of the trajectory of reduced emissions that would result if the financed project or programme were to be replicated throughout the targeted area, region, and/or sector over emissions reduction from project or programme alone (High ratio would have more transformational potential than smaller ratio) (CIFs CTF)
Economic efficiency	Benefit-cost balance of activity: impact per US dollar delivered by a fund	Avoided deforestation or forest degradation	Number of hectares affected per US dollar (Amazon Fund)

* The Secretariat, with inputs from a possible technical advisory panel is meant to review these criteria, inter alia, ‘*to allow cross-country and cross-project/programme comparison of proposals*’[Annex I: Project and programme approval cycle. Note: in this Annex, there is no reference to ‘country/region’ as qualifying the ‘beneficiary’]

† Climate Investment Fund.

‡ Clean Technology Fund.

2 Cumulative Commitments and Allocation 'Targets'

The Paper recommends that:

> 'initial allocation targets be specified and monitored in terms of cumulative commitments, i.e. the resources committed by the Fund, including through the Private Sector Facility (PSF), to specific themes, as a percentage of the Fund's total cumulative resources available for financing of proposed activities over comparable periods.'[Paragraph 7]

This is indeed quite unusual, if not unique. The general practice is to make allocations to themes (and countries, for that matter) in terms of funding 'envelope' figures (not 'targets'). In other words, indicative upper limits – specified either in relative (percentage) or absolute ($, €) terms – of the funding available are given, rather than a figure representing 'funding committed'.

It is not immediately clear what the advantage of this novel formulation should be, and the Board may wish to insist that this be clarified, not least because there is a serious practical shortcoming: cumulative commitments, by their very nature, will change over time, and any allocations defined in these terms will inevitably become running targets, with serious practical negative consequences (see, for example, Section 3.1 below).

3 Geographical Balance: A question of distributive justice

Somewhat surprisingly for a document on resource allocation, the Paper has only one single reference to equity (paragraph 20, quoted here), namely in the context of a universal single-country limit to ensure geographic balance.

> 20. **Geographic balance**. The Governing Instrument (paragraph 52) stipulates that the "*Board will aim for appropriate geographic balance*." While there is no further Governing Instrument or Board guidance on geographical balance, the Board may introduce a universal *single-country limit* to ensure that Fund resources are deployed equitably across eligible developing countries. This ceiling would cap the Fund's total cumulative commitments to one country, in grant-equivalent terms, at <u>five per cent</u> of the Fund's total cumulative commitments. ... The single-country limit is an important part of the overall allocation system and should be reviewed by the Board from time to time. In the event that the Fund introduces a third-tier, country-based, allocation system in the future, the third tier would replace the single-country limit.

Unfortunately there are a number of serious problems with this proposal, technical ones as well as substantive ones, the latter relating in particular to a failure to give due attention to the exigencies of equity.

3.1 *The Single Country Limit: Technical Problem*

As recommended in paragraph 7, the Paper's Single-Country Limits (SCLs) are defined as a percentage of the Fund's total cumulative commitments. The technical problem with this is that a country's share in these total cumulative commitments could vary day by day – quite outside the control of the country. Unlike the case of a traditional country cap, where each country knows how far it has exhausted its allocation for the funding period in question, the constraints imposed by the proposed SCLs are likely to vary over time in a way which may not be particularly helpful to country planning.

3.2 *The problem with ‘grand unified approaches’*

One of the Project’s key lessons was that, if there are different funding objectives, then it is better to give up the idea of a ‘grand unified approach/formula’. Instead, one should differentiate theme/objective-specific funding envelopes, each with specific allocations.

This lesson also applies to the use of ‘universal’ country limits. In particular, if one thinks that some form of country cap is required for the sake of avoiding inequitable geographical imbalances, then it is better to opt for theme-specific caps rather than a cap fixed at some percentage of the grand universal pot. Having said this, it must be emphasized that, following the conclusions of the Project, I do not believe such caps are really warranted, or even effective in avoiding the said imbalances.

The Project furthermore concluded that if one wishes to introduce competitive allocations with an efficiency objective (within a theme) − as the Paper suggests − then that should be done in a dedicated (sub-) envelope (for that theme). The fairness of the allocation within that competitive funding envelope should be determined only by the fairness of the competition. It should not be mixed up (say though some artificial country caps) with the other equity issues, such as geographical balance. These issues (of distributive justice) need to be dealt with under a separate sub-envelope. In other words, if one is intent on getting the most ‘bang for the buck’, then one should dedicate a funding stream solely for this objective, while ensuring that sufficient funds remain to address other equally important objectives, such as geographical balance, using other more appropriate allocation methods (such as needs assessments). Trying to combine distributive justice and efficiency in one single mechanism is bound to lead a lose-lose outcome, one that is neither efficient nor equitable.

3.3 *The problem of empty eligible hands*

Another of the Project’s outcomes, to be kept in mind in the context of ‘geographical equity’, is that no eligible recipient should end up empty handed. It is for this reason that both the IDA and the GEF allocation systems have a country floor allocation. To be quite clear, this is not the same as having a floor allocation for groups of countries, as envisaged in the Paper, particularly if resources are allocated on a competitive basis. To have a PVC-floor allocation does not meant that certain PVCs will end up (relatively) empty-handed, something that must be avoided.

3.4 *The need for needs-based country allocations*

Last, but by no means least, the lessons learned from the Project suggest that the GCF will, sooner rather than later, have to introduce the ‘third-tier, country-based, allocation system’ referred to in paragraph 20 on geographical balance, particularly given the suggested competitive endogenous allocations. Indeed, to fulfil the demand of distributive justice, these country-based allocations will have to be based on some sort of needs assessments (complementing the funding floors discussed in the preceding sub-section).

As it happens, such country needs are already part of the proposed initial project approval process (see Box 2) although with indicators that the Project has shown to be quite problematic.

Box 2. Examples of possible [country/region based] criteria for the decision to proceed [from Table 1, GCF/B.06/08]			
Criteria Category	***Definition***	***Example of criterion***	***Example of indicators from other funds***
Needs of beneficiary [country/region]	Degree to which a beneficiary needs the finance more than others, or is relatively less capable than others to fulfil this need through other funding sources	Relative vulnerability of a population to climate change impacts (e.g. populations living in low-lying flood-prone areas)	Country's ranking in the Human Development Index (CIF PPCR*)
Institutional capacity [of beneficiary country/region]	Beneficiary's capacity to implement a funded project or programme (policies, regulations and institutions)	Supportive country policy and institutional framework (both ambition and outcome)	Scoring of country policies and institutions; additional weight given to environment-related policies and institutions (GEF†)
* Pilot Programme for Climate Resilience. † Global Environment Facility.			

4 Recommendations

The Lessons learned in the Project (see Appendix) recommend the following general revisions of the Policies and Procedures for the Initial Allocation of Fund Resources proposed in GCF/B.06/05

(a) Define all thematic and country allocations in the traditional terms of funding envelopes (indicative minimum or maximum levels of funding available), and not in terms of 'cumulative commitments'.

(b) Examine carefully whether, in a given context (theme, type of activities), competitive, efficiency driven activity approvals are appropriate or not, and if they are, then use a dedicated funding envelope (stream/pot) without any further restrictions (i.e. no floors or ceilings, just fair competitive tendering).

(c) Ensure that there is complementary funding allocated on the basis of equity and distributive justice. This could be achieved by using an approach which starts with country floor allocations (in absolute terms, as practised in other multilateral funds), to be supplemented, sooner than later, with adequate needs-based ('third-tier') country allocations.

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OPINION: How will the Green Climate Fund allocate its money? All you wanted to know but were afraid to ask

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The Green Climate Fund (GCF) was launched in late 2013 and is set to play a key role in disbursing some of the $100 billion per year pledged to flow annually to developing countries by 2020 in support of climate action. A key question for the GCF Board concerns the rules for allocating its funds, as Benito Muller, Managing Director of Oxford Climate Policy, explains.

Resource allocation is a very tricky business, both technically and politically. However, it is by no means a new one. Considerable experience has been accumulated not only by other international funding institutions, but also in domestic contexts, and the GCF can draw lessons from this experience. During the past six months, I've worked with other analysts to pull together some of these lessons, and form recommendations for the GCF Board. Here is a summary of our findings and recommendations.

Numerous international and multilateral funding institutions are using a formula-based or 'formulaic' approach to country resource allocation. They are setting country funding 'caps' and 'floors': that is, minimum and maximum indicative amounts of funding a country can expect to receive during a funding period. With CDKN support, I have released a paper, Performance-based formulaic resource allocation – A cautionary tale, which looks at the Performance-Based Allocation (PBA) system of the World Bank International Development Association (IDA), probably the longest-serving, and certainly the most influential, methodology of its kind. The paper also assesses two of the World Bank's 'climate change progenies': the Resource Allocation Framework of the Global Environment Facility (GEF), and its successor, the System for Transparent Allocation of Resources (STAR). The experiences of these forerunners have yielded some important lessons for the GCF.

Lesson 1: Multiple funding objectives

The first lesson is about how to deal with different funding objectives. Most funds pursue different objectives, even within thematic funding windows. The Global Environment Facility's current resource allocation methodology, STAR, has four objectives: first, to ensure global efficient use of the funds, ie, maximum global environmental benefits for the available money; second, to provide performance incentives; third, to satisfy the relevant capacity building needs; and, last but not least, to avoid being seen as inequitable because of a disproportional concentration of funding, which was a cause for the downfall of the earlier Resource Allocation Framework methodology.

STAR uses funding floors and ceilings to address its fourth objective: concerns around inequitable distribution. Its other objectives are addressed via a single, compound allocation formula: a first-order parameter is used to estimate potential global environmental benefits (first objective), and is modified by a performance factor (second objective) and a prosperity indicator (gross domestic product per capita), used as a proxy for estimating capacity building needs (third objective).

It comes as no surprise that the introduction of funding ceilings was found to limit the global efficiency with which funds were allocated, and so somewhat undermined STAR's primary objective of delivering maximum environmental benefits. In light of this experience, my recommendation for the GCF is simple:

- Different objectives are best served through different funding envelopes (i.e., different 'pots of money'). In other words, abandon the idea of a grand unified formula. What is needed is something rather more pragmatic: first determine a funding envelope for each of the objectives, and then allocate each of these envelopes in the most appropriate manner.

Lesson 2: Measures of funding need

My analysis of the IDA's Performance-Based Allocation demonstrated that the metric for determining a country's poverty levels, which in turn determined a country's funding need (or eligibility), was inappropriate. The IDA determined poverty by a measure of overall population size adapted by a per capita gross national income factor, whereas it would have been more appropriate to use the number of poor people as the base parameter.

The GEF's Resource Allocation Framework (RAF) and System for Transparent Allocation of Resources (STAR) were also found to use an inappropriate funding need metric, namely the GEF Global Benefit Index. This allocates mitigation funding to countries with the aim of achieving maximum global benefit, ie, emissions reductions, for the available funding envelope. The analysis demonstrated that for certain objectives, an exogenous formulaic allocation may simply not be appropriate. For allocations to provide best value for money, they are best decided endogenously through competitive financing tools such as the Quantity Performance Instruments (as discussed below). The key recommendations to arise from this experience are therefore:

- Ensure that the 'country funding needs' to attain the objective in question can actually be estimated

by way of an exogenous formula; and
- Ensure that the metric chosen is as direct as possible (try to avoid high-level proxy estimates).

Lesson 3: Some money for all eligible applicants

All these case studies confirmed that it is necessary to avoid the perception of inequity, should countries that are eligible to receive funding feel that they are left empty-handed (a lesson also drawn by a second study Lessons from fiscal transfer mechanisms, below). All three allocation systems have, or had, some funding floor. However, in the case of the GEF's Resource Allocation Framework, this floor was not sufficient to avoid perceived inequity. That is why its successor followed the IDA's Performance-Based Allocation system by introducing funding ceilings. These ceilings aimed to reduce the concentration of funding in few countries, but they also had the effect of reducing the cost effectiveness (efficiency) of the funding.

These equity demands – which can be interpreted as reflecting the principle of sovereign equality − could have been satisfied without compromising the efficiency objective in question by simply assigning to each of the objectives a separate funding envelope. By not mixing equity and efficiency with a single formula in a single envelope, it would have been possible, in particular, to defend more easily the idea that under a competitive distribution of funding, the outcome, no matter how concentrated, is fair – as long as the competition was fair. This would not have impinged on the equity-based allocation, and the overall concentration of funding could have been managed by varying the relative sizes of the two envelopes. The recommendation in this context is thus:

- Ensure that equity considerations are adequately reflected. In particular avoid 'empty eligible hands', for example, by introducing appropriate funding floors.
- If there are funding objectives requiring (globally) efficient outcomes, then it is important that there is an explicit equity-based funding envelope that is distinct from the envelopes concerned with efficient outcomes.

Lesson 4: Adaptation funding needs

The next set of lessons for the GCF comes from experience with fiscal transfers from national to subnational governments. My paper on The Allocation of Adaptation Resources presents four short, illustrative country experiences – China, India, Switzerland, and the USA – chosen for the diversity in their underlying political systems and for the lessons to be learned. My analysis led to two recommendations that concern adaptation funding:

- Funding under an adaptation envelope should be allocated in proportion to funding needs, possibly with a prior division of eligible countries into categories with respect to their poverty intensity of gross domestic product (measured by the number of poor people per unit of GDP).
- Adaptation funding needs could be estimated in terms of vulnerability-adjusted numbers of people exposed to climate change impacts.

Lesson 5: QPP instruments as a competitive way to allocate resources

Finally, the GCF has a much to gain from scrutinising other funds' experience with Quantity Performance Payments for mitigation funding. These could be used as part of enhanced direct access to the GCF. A paper by Samuel Fankhauser, and Maya Forstater and I looks into this experience in some depth: Quantity Performance Payment by Results. The paper describes in detail the main design options and issues regarding QPPs, in particular the issue of resource allocation and four core elements of QPP transactions: namely counterparty (vendor) selection, definition of results, price setting, and the setting of transaction quantities.

There are different ways in which these features can be determined, transaction by transaction. For example, counterparties and price could be determined competitively through auctions, or they could be set through negotiation on a first-come-first served basis, or by using a standard formula. Similarly, QPP transactions may be micro in structure (in other words, they could be structured as the aggregation of performance measured in smaller, decentralised activities, perhaps led by the private or third sector) or macro (rewarding performance measured at a national, sub-national, or sectoral level). The way in which these elements are determined fundamentally defines the nature of a QPP instrument. The GCF will have to develop a view on the design features that are most suitable for its purposes.

This paper considers some early experiments in using QPP instruments at a macro- and a micro-level. Examples of the former are the Norwegian International Forest Climate Initiative (NICFI), the Energy+ programme, and a scheme to reward accelerated transition pathways proposed by the Center for Global Development. The Global Energy Transfer Feed-in Tariffs (GET FiT) program and a proposal for a Clean Development Mechanism (CDM) Stabilization/Capacity Fund are examined as examples of QPP models involving micro-level results. We conclude that all these examples provide useful starting points, but none of them yet offers a fully operational approach to enhanced direct access.

The paper then carries out an evaluation of QPP instruments in the context of enhanced direct access, with respect to three key objectives of the GCF, namely, to promote a paradigm shift towards low-emission and climate-resilient development pathways, to achieve economic efficiency in directly securing emission reductions at cost, and to support equity in the distribution of resources.

- Based on this evaluation, the paper concludes that enhanced QPPs can be used in conformity with these objectives, provided they are used as a complement to other funding instruments.
- Finally, the paper puts forward two models − building on the example of the NICFI and the idea of a CDM Capacity Fund − as illustrations of how enhanced QPPs could be structured in the context of macro- or micro-level results.

Read the papers in full:

- Performance-based formulaic resource allocation − A cautionary tale
- The Allocation of (Adaptation) Resources
- Quantity Performance Payment by Results

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