Oxford Energy and Environment Comment

October 2009

Is There Room for Compromise?

The debate on institutional arrangements for climate finance

by Benito Müller[1]

The current debate on climate change finance is characterized by a divide not only on 'who is to pay how much' and 'who receives for what purpose', but also on how these flows are to be managed, i.e. on the issue of ***institutional arrangements***. While there is a broad recognition that the current system is not fit to manage the required financial transfers, opinion on how this is to be remedied roughly divides into two camps:[2]

> **The Coordination Camp:** At one end of the spectrum, there are those (mostly from developed countries) who believe that what is needed is ***enhanced coordination*** through ***existing institutions*** (possibly reformed to become ***fit for purpose***). This side rejects both the need for new institutions and for consolidating funding streams.
>
> **The Consolidation Camp:** At the other end of the spectrum, there are those (mainly from developing countries) who believe that coordination through existing institutions will not remedy current shortcomings, and that what is needed instead is a ***consolidation of funding*** under the UNFCCC financial mechanism, managed by a ***new operating entity***.

The aim of this note is to explore whether there is room for a mutually acceptable compromise between these two world views. To achieve this, it is useful to clarify the nature of the management problem to be remedied.

Two Key Purposes

While there is a general consensus that that the existing institutional arrangements for financing climate change activities in developing countries are not fit for purpose, there is less agreement on what that 'purpose' is meant to be. According to the table compiled by the UNFCCC Secretariat at the end of the third Bonn session (14 August 2009),[3] there is a common understanding that the financial system is to provide *financial resources to further enhance the full, effective and sustained implementation of the UNFCCC and fulfilment of the Bali action plan*, and that there is a *need to provide scaled-up, new, additional, predictable and sustainable financial resources*, which *would be derived from multiple sources*, in compliance with the *principle of equity and common but differentiated responsibilities*. 'Equity' appears in the Secretariat text only under *Principles to guide generation of resources*. Yet it stands to reason that distributive justice is an issue not only in the context of shouldering the burden of contributions, but also in sharing the revenue.

Distributive Justice: Official Development Assistance (ODA) traditionally neither involves obligations to pay, nor entitlements to receive. The issue of ***distributive justice*** – of contributing and/or receiving a 'fair share' – strictly speaking ***does not apply***: if 'donors' think they pay over the odds, then they are free to pay less, and if 'recipients' feel hard done by, then that is not a matter of injustice but bad luck.

In contrast, payments for climate change activities – particularly in the case of adaptation and response to climate impacts – are a matter of ***restitution.*** Hence there are both obligations to pay and entitlements to receive, which implies that equity, in the sense of either ***shouldering a fair share of the payment burden***, or ***receiving a fair share of the revenue,*** is an issue. The fact that the focus of the debate has so far almost exclusively been of the former (e.g. the Mexican and Swiss proposals) does not mean that the question of how to distribute climate finance equitably can be ignored. On the contrary, it has to be seen as one of the key challenges for any climate finance regime.

Thematic Balance: Climate finance involves a number of different themes (mitigation, adaptation, technology transfer, etc.), and the issue of 'thematic balance' relates to whether ***each of these themes receives an appropriate share of the revenue***. Given the nature of climate finance, the decision on how achieve this balance has to involve not only contributors but also recipients.

Three Descriptive Dimensions

To discuss the different proposals in a coherent and comparable manner, it is useful to introduce three descriptive dimensions as categorizing tools, the distinctions between them being (i) ***fragmented*** or ***consolidated***, (ii) ***centralized*** or ***decentralized***, and (iii) ***devolved*** or ***retained***.

The distinction between 'fragmented' and 'consolidated' refers to funding flows, and in particular, to the degree in which funding sources are channelled into intermediate collective 'pots' to be disbursed to recipients or directly used to fund them. The other two categorizations are about decision making, that is, whether or not funding decisions are taken by a central body, and whether they are devolved to the recipients or not.

All three of these dimensions are a matter of ***degrees***, that is to say, financial systems can be more or less centralized/decentralized etc. They are also ***independent*** in that they could occur in all combinations. Indeed, even though the concepts of 'consolidation' and 'centralization' are often used interchangeably, they are clearly distinct, in that one could have a completely fragmented system that is nonetheless completely centralized, say through a 'coordinating' body with powers to decide who

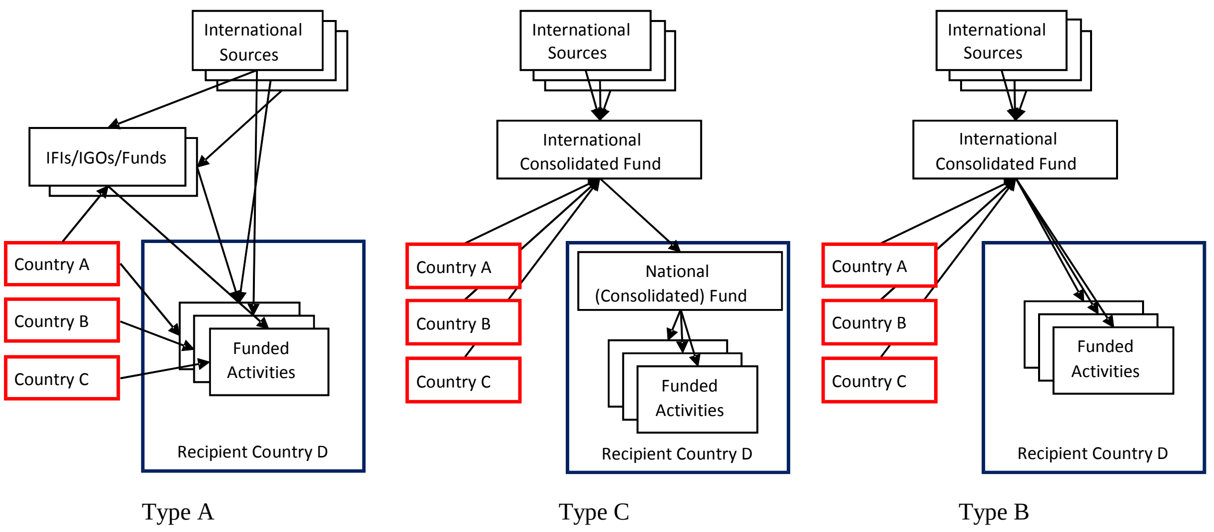

Figure1. Financial Systems Categories

has to pay whom.

Figure 1 contains graphical representations of three specific combinations which have actually been put forward. Type A represents the current ***fragmented, decentralized and retained*** system of climate change finance, meant to be enhanced through 'high lever coordination' as put forward by the Climate Registry proposal (described below). Type B corresponds to the ***consolidated, centralized and retained*** system put forward in the original G77+China submission,[4] while Type C represents the ***consolidated, decentralized, and devolved*** system of the Reformed Financial Mechanism (described below), the AWG-LCA language introduced by India, and the UK Compact model.

Calls for Coordination and the Climate Registry Proposal[5]

In his recent Statement[6] to the United Nations Summit on Climate Change, the Japanese Prime Minister Yukio Hatoyama called for establishing *an international system … under the auspices of the UN climate change regime. This system should facilitate one-stop provision of information on and matching of available bilateral and multilateral financing, while securing transparency and effective utilization of assistance*.

Japan, in other words, is firmly in what we called the 'Coordination Camp'. Probably the best worked out proposal of how such a 'one-stop information exchange and matchmaking' system would operate is the ***Climate Registry Model*** proposed in Reed *et al.*, (2009).[7]

In that model, an ***Adaptation Board*** and a ***Mitigation/Technology Transfer (TT) Board*** are to operate an ***Adaptation Registry*** and a ***Mitigation/TT Registry***, respectively. An ***Operating Body***, in turn, is meant (i) to oversee these two Boards, (ii) to set standards, (iii) to manage COP-mandated funds and (iv), to report to the COP (**Table 1**).

To avoid creation of new institutions, Parties could consider using the recently created Adaptation Fund Board to serve as the Adaptation Board. In equal measure, Parties could consider reforming the Clean Development Mechanism Executive Board or reforming the GEF to become the Mitigation/TT Board.

The [overall] *function of the Climate Registry is to expedite, through the public pooling and sharing of information, the* ***matching of needs*** *of country governments and the* ***availability*** *of financial resources and products offered by financing institutions. …the Climate Registry serves as an international* ***bulletin board*** *that lists developing country programs and projects.*

Countries are meant to provide their national objectives, needs and financing requests framed at national level and through national adaptation, mitigation and technology transfer plans such as NAMAs, NAPAs, Technology Needs Assessments (TNAs) and Low Carbon Action Plans (LCAP). In addition:

- The statements of national strategic plans to address climate change must be ***certified*** to be in compliance with standards set by the COP or its designated body ***so that these plans become eligible for financing***. The intention behind this requirement is to provide *assurances to investors that MRV, fiduciary and transparency standards are embedded in investment packages*.
- The plans then enter into the public registry domain where all interested parties, whether public or private, can enter into discussion or negotiation with the hosting country as regards the terms of financing.
- Through this ***pooling and posting of information process***, the Climate Registry serves as an ***international bulletin board*** that lists developing country programmes and projects as integral parts of national climate strategies.

- Once alignment between a developing country's needs and contributing country/private investor financial resources has been established, the registry will also function as a monitoring tool which displays the progress of the implementation of the agreement between the country and a funding source.

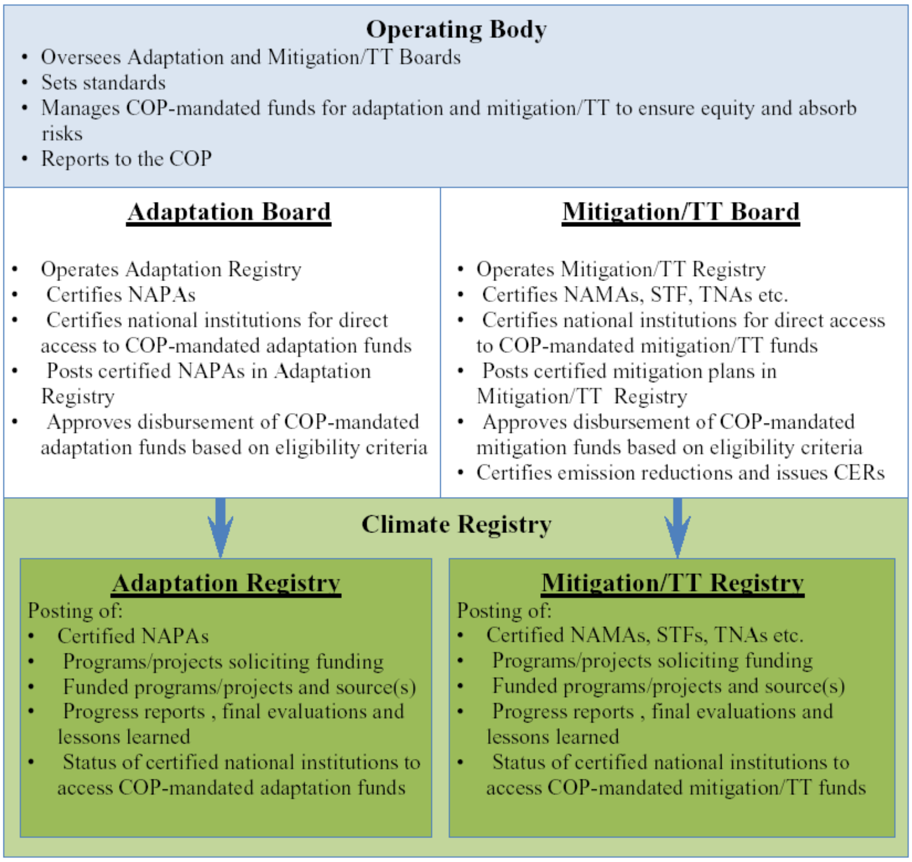

Table1. The Climate Registry Model Source: Reed *et al.* 2009

- One of the key problems for this sort of information exchange and matchmaking regime is delivery on the above-mentioned ***distributive justice*** and ***thematic balance*** issues. Short of equipping the Operating Body with the power to order who has to pay for what, it is unlikely that this sort of system can deliver on these key requirements. Indeed, the Climate Registry model itself acknowledges as much by giving the Operating Body the function to manage *the COP-mandated funds … to* ***ensure equity in the access*** *of all developing countries to financial resources to support adaptation and mitigation programs. This is a critical function because, without an* ***equalizing distributional mechanism****, past experience has demonstrated that financial resources will flow to the largest, most sophisticated developing countries.*

The Reformed Financial Mechanism (RFM)

At the heart of the RFM proposal[8] is the idea of ***consolidation*** at the international and national level and ***decentralized*** funding decisions ***through devolution*** to the recipient countries.

Key Institutional Features

Internationally, the institutional structure of the RFM is given by an ***Executive Board***, which together with a small number of ***administrative units*** (Thematic Assessment and Secretarial Units) provides the ***operating entity*** of the RFM. Other functions, such as internal and external audits and evaluations, as well as that of trustee for the consolidated RFM fund, are meant to be outsourced.

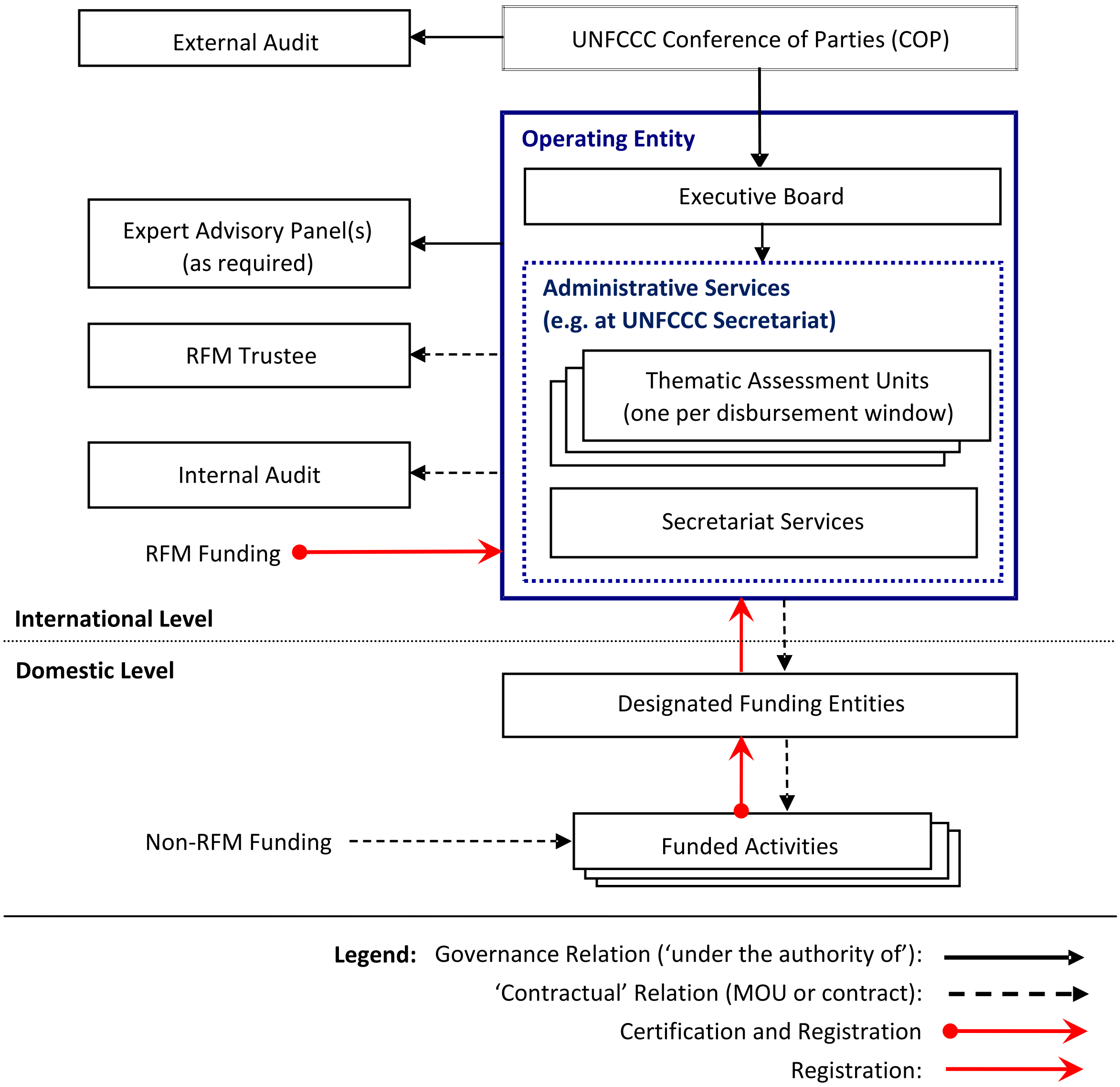

Figure 2. RFM: Disbursement, Certification & Registration

Nationally, funding is to be consolidated in ***Designated Funding Entities*** (DFEs), with transparent governance and representation from all key national and sub-national government agencies as well as civil society representatives. There are already a number of such climate change national funds and mechanisms (Bangladesh, Indonesia, Brazil/Amazon) which could serve as templates for the envisaged DFEs. Under the RFM, ***funding decisions*** − that is to say decisions on (country) ***priorities,*** and ***approvals of projects and programmes*** are taken in-country by the DFEs.

The RFM Operating Entity, in turn, does ***not*** to fund in this sense, but ***disburses*** ('channels') revenue to the DFEs to enable their funding activities. The key point here is that the RFM proposes a ***genuine devolution of funding decisions***, and not just some half-way measure as in the case of the NAPA process, where such entities were merely given the right to make plans, but not to decide what is to be funded.

In the Climate Registry model, ***eligibility for funding*** depends on ***certification of national strategic plans*** by the international thematic Boards. This is decidedly ***not*** the case for country disbursements under the RFM; not only because this would unnecessarily duplicate work already undertaken at the national level, but also because it is very unlikely that any country − developing or developed! – would actually agree to having nationally approved plans or strategies submitted to such a procedure. This would touch at the very core of national sovereignty.

Governance: The RFM Executive Board is ***accountable to*** and ***under the authority and guidance of the COP***. Being 'under the authority' in this context simply means that the ***COP (s)elects the EB members*** (has the authority to 'hire and fire').

Following standard domestic practice, there is to be a well defined ***separation of powers*** between the COP and the EB, in the sense that the COP delegates certain operational powers to the EB. Among the powers retained by the COP are − apart from the right to select the EB members − (i) the power of setting of ***RFM revenue levels*** (ii) of approving ***thematic disbursement criteria*** (iii) approving ***certification criteria*** (see below) and (iii) approving overall ***revenue allocation to themes***.

To be delegated to the EB are the tasks of (i) operational management of the disbursement entity, (ii) oversight over any other operating entity of the RFM, (iii) preparation of ***proposals for thematic disbursement criteria***, and regular ***thematic budgets*** both for approval by the COP

Certification and Registration: As mentioned above, the COP is to approve criteria on what payments ***are to count against compliance*** with financial commitments under the UNFCCC. These criteria will be operationalized in a system of certification and registration under the RFM. As illustrated in Figure 2, contribution to the RFM consolidated fund will be certified and registered by the RFM secretariat. Other payments − if permitted by the certification criteria − will be ***certified and registered in-country by the Designated Funding Entities***. The key here is that, in order to avoid double counting and pledge non-deliverance, payments are to be counted (certified and registered) ***at the recipient end***.

Budgeting and Disbursement:[9] 'Disbursement' as used here is not to be confused with 'funding'. The latter, as emphasized above, refers to the traditional activities involved in the selection and approval of projects, programmes and other 'on the ground' activities. 'Disbursement', on the other hand, refers to the allocation of funds to the Designated Funding Entities by the RFM on the basis of theme-specific disbursement criteria, and the amount of revenue allocated for the relevant budget period to the respective themes. Disbursement criteria will vary from theme to theme. For example:

- ***Mitigation disbursements*** could be on made on a performance basis, with a flat up-front country component: *x* million + *y* million for the MRV reduction in the previous period.
- ***Adaptation disbursements*** should be carried out through a very simple disbursement formula, e.g. a flat country component + a component proportional to the number of poor inhabitants.

The Budgeting Process will involve the ***preparation of an overall budget*** − based on general needs assessments carried out by the different thematic assessment units – to be presented to COP. Based on this information, the COP will decide on the overall revenue level, as well as the theme allocations. Once these decisions are taken, the EB takes over and carries out the disbursements as prescribed in the relevant criteria, within the constraints given by the COP budget decisions.

The Extended Reformed Financial Mechanism (RFM+)

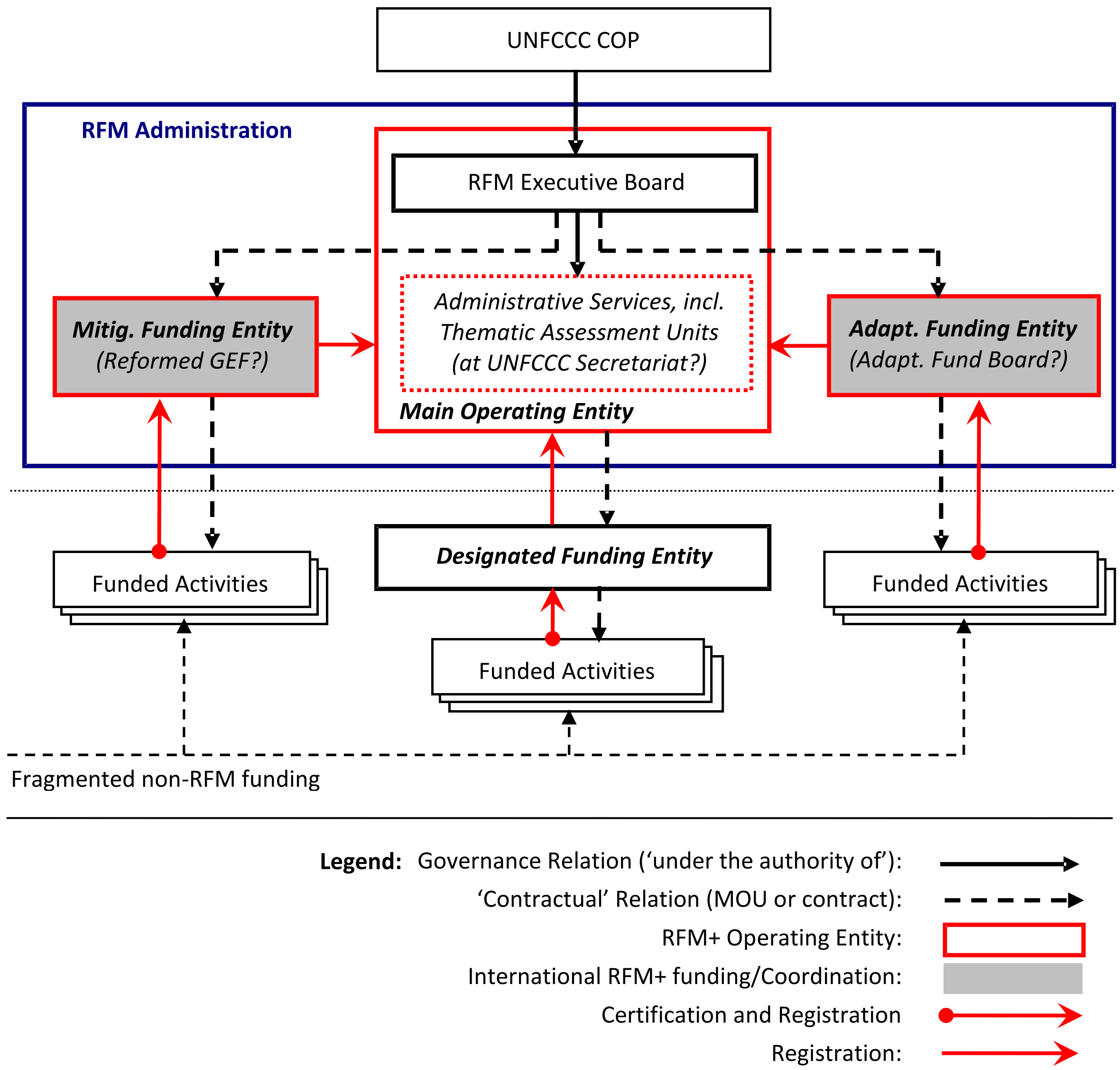

Figure 3. RFM+: Disbursement, Funding, Certification & Registration

The Continued Need for International Funding: As originally conceived, the RFM was purely a disbursement mechanism. While the bulk of the RFM transactions is (ultimately) still meant to be carried out through 'money-in-money-out' disbursements to Designated Funding Units, it has to be acknowledged that there will still be a need for international funding in the more traditional sense, such as currently developed under the Adaptation Fund.

- For one, ***not all funding purposes lend themselves naturally to be devolved*** to the country level. While mitigation and adaptation *per se* would seem to be prime candidates for such devolutions, funding decisions for certain types of capacity building and technology transfer activities may be better kept at the international level.
- Even with respect to the prime candidates, there will be the need for some time to retain a more traditional international funding capacity, for it will take time before all countries will be able to participate in the devolved disbursement regime.

It is therefore envisaged that a number of operating entities will be introduced which, in contrast to the Main Operating Entity, are involved in international funding of activities. The exact number of these additional operating entities will depend on a number of factors. From a purely organizational perspective, it would probably be best to use just one such funding entity, but politically it may be necessary to introduce two, not only because of a general reluctance to take on 'new institutions,' but also because it is politically very difficult to remove functions from existing institutions, let alone to disband them as part of a 'Grand Compromise'.

Consolidation *and* Coordination: The Grand RFM+ Compromise?

Two of the 'existing entities' have the status of being *an operating entity* under the current international climate change regime: the ***Adaptation Fund Board*** (AFB) under the authority of the COP/MOP, and the ***Global Environment Facility*** (GEF) under the guidance of the COP. Politically, it might therefore make sense to retain them under an Extended Reformed Financial Mechanism (RFM+) as ***Adaptation Funding Entity*** and ***Mitigation Funding Entity***, respectively.[10]

Guidance, Authority and Oversight: In the case of the AFB this may not be too controversial, but a great deal of resistance to having the GEF involved in any capacity (even when 'reformed') is likely to come from developing countries, which – as the Adaptation Fund negotiations have clearly shown − have been less than happy about the manner in which the GEF has operated, particularly in its implementation of COP guidance. However, part of the problem with the GEF and COP guidance seems to be systemic, in that the COP itself is not the sort of institution well suited to carry out any oversight, and guidance without proper oversight tends to be ignored. It is for this reason that the COP is meant to delegate oversight and guidance of operating entities to the Executive Board, which will meet more than just once a year, and hence be in a better position to follow up its guidance on a regular basis.

Coordination under the RFM+: In the light of the institutional suggestions put forward for the Climate Registry 'enhanced coordination' model (see above), the proposed institutional architecture of the RFM+ model will fit perfectly with the Climate Registry ideas, with the Executive Board performing the role of the 'Operating Body', and the two other operating entities taking on the role of the two Boards, operating the two thematic registries.

The Role of other Existing Institutions: The RFM+ proposal may take care of two of the 'existing entities' − the Adaptation Fund Board and the (suitably reformed) GEF − as additional ***operating entities***. This still leaves out other multilateral institutions that the Coordination Camp would like to involve – such as UNEP, UNDP, and the Multilateral Development Banks. These institutions can take on the role of ***implementing entities*** – although with direct access, this will no longer be the exclusive route to access funding. Moreover, there will be a need for ***trustees***, and it stands to reason that most of these other existing entities, when fit for purpose, should not have to worry about participating in competitive tenders for performing these functions.

Raising the Necessary Revenue

The proposed compromise, however, will fail if the consolidated disbursement arm is treated as just another placebo fund to buy in developing countries during a crucial phase of the negotiations, but subsequently to be essentially left empty. Establishing the institutional infrastructure will not be sufficient. There will have to be agreement that a significant share of (national/international) public sector finance will be channelled through the RFM, so that the mechanism stands a fair chance of proving itself.

The problem is that to prove itself – not only in ensuring the fairness and thematic balance of the overall financial regime, but also as more efficient than the traditional fragmented funding model – the proposed extended RFM will require a significant amount of (consolidated) revenue which developed country treasuries are unlikely to provide if they lack faith in the mechanism. This potential Catch 22 situation can be overcome by following the example of the Adaptation Fund: using innovative financial instruments to raise sufficient funds. There are a number of proposals for such instruments on the table (in the AWG-LCA negotiations text):

- the LDC Group proposal of an ***International Air Passenger Adaptation Levy*** (IAPAL);
- the Norwegian proposal of a ***set aside reserve of emission allowances*** to be auctioned internationally (akin to the monetization of the share of CERs set aside for the Adaptation Fund);
- the Indian proposal of a *levy* ***on international financial market transactions***.

The advantage of these instruments is that they do not involve transfers of funds from the domestic consolidated funds (budgets. There are also ways in which direct competition with budget items can be avoided even for revenue collected domestically: for instance, declaring certain (new) revenue sources, such as carbon permit auctioning, 'off-budget' so they can be earmarked without infringement of general budgeting principles.[11]

The envisaged RFM compromise will not only have to contain an agreement on the relevant institutional arrangements, but also on a significant level of revenue for the (consolidated arm of the) RFM to be (i) supplied by innovative international finance instruments and assessed contributions, and (ii) reviewed together with the overall financial commitments of developed countries.

Once the mechanism has a chance to show it can work, it is likely to become the vehicle of choice – like the Montreal Protocol Multilateral Fund, where most Parties choose to channel their full commitment through the fund, even though they are entitled to spend up to 20 percent of their commitments bilaterally.

Endnotes

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[2] This polarized characterization is not exhaustive - that there are a number of intermediate positions that can and have been put forward.

[3] http://unfccc.int/files/meetings/ad_hoc_working_groups/lca/application/pdf/finance140809.pdf

[4] Philippines on Behalf of the Group of 77 and China, *Financial mechanism for meeting financial commitments under the Convention*, 25 August 2008, FCCC/AWGLCA/2008/MISC.2/Add.1, pp. 35-8.

[5] This section is based on the description of the Climate Registry model prepared for an ongoing Climate Strategies project on *Oversight in the Reformed Financial Mechanism.*

[6] New York, 22 September 2009, http://www.mofa.go.jp/u_news/2/20090923_003732.html

[7] David Reed, Andrea Kutter, Athena Ballesteros, Edward Fendley, Maria del Socorro Flores Liera, Jochen Harnisch, Saleemul Huq, and Hans Olav Ibrekk, *The Institutional Architecture for Financing a Global Climate Deal: An Options Paper*, June 2009 (available at www.usclimatenetwork.org/resource-database).

[8] More detailed descriptions of the RFM proposal are available at: http://www.oxfordclimatepolicy.org/publications/mueller.html

[9] This section is based on preliminary findings of the Climate Strategies project on *Oversight in the Reformed Financial Mechanism.*

[10] This comes out of the idea that they would also cover funding for technology transfer and capacity building in their themes.

[11] For more on this, see Bento Müller, *To Earmark or Not to Earmark? A far-reaching debate on the use of auction revenue from (EU) Emissions Trading*, Oxford: Oxford Institute for Energy Studies, EV 43, November 2008.