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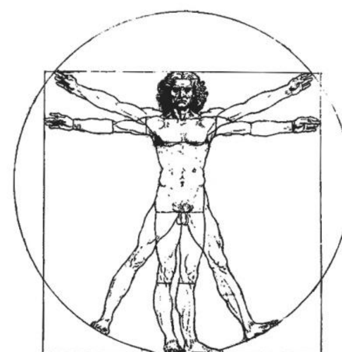

ecbi policy brief

The Financial Mechanism of the UNFCCC

A Brief History

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Introduction

In the course of 2009, negotiators from around the world will need to come to an agreement on the architecture – the institutional and governance structure – of the funding arrangements to support the post-2012 regime in the context of the financial mechanism of the Convention.[1] This is a prerequisite for the success of the ongoing international climate change negotiations. The institutional architecture to be put in place will need a) to be convincingly capable of carrying out the three general functions that ensure a well functioning and generally acceptable financing regime: ***revenue raising, revenue disbursement,*** and ***oversight***; and b) to ensure that the governance structure, the system of decisions that have to be taken to operationalize and operate the financial flows to be managed, will be acceptable to all Parties to the Convention. In the build-up to Bali and beyond, it has become self-evident that the current operational arrangements fail to meet these two requirements, leading to the conclusion that the financial architecture is in need of urgent and major reforms.

Coming to an agreement will not be easy for many reasons. Adding to its inherent complexity and strong linkage to many other on-going negotiations of substance, the financial mechanism negotiations will need to address issues of trust (or lack of it) and issues of commitment levels on both sides – developed and developing countries. The history and lessons learned over the last fifteen years of the current financial mechanism arrangements should provide the basis for building on previous successes and for avoiding previous mistakes, shortcomings, and pitfalls. Unfortunately, so far, even an agreement on how to assess this history has proven to be elusive.

The following is an attempt, not to assess the history of the financial mechanism, but rather to provide a brief background on the decisions that led to its creation and its legal basis. Hopefully, this information will help clarify some of the misconceptions about what the financial mechanism is and about its legal relation to the Convention. It is difficult, if not impossible, to talk about the history of the financial mechanism without a reference to the Global Environment Facility (GEF). To be clear: the GEF ***is not*** the financial mechanism. It is ***an operating entity*** of it. However, since it has been the sole operating entity until recently, the history of the financial mechanism cannot be discussed without reference to the GEF specifically, and to the origins of multilateral funding for the environment, in general. In Bali, the Adaptation Fund Board was created as operating entity of the Kyoto Protocol Adaptation Fund[2]

A. Brief History of Multilateral Funding for the Environment

The need for more strategic national action and need for funding to tackle climate change can be traced back as early as 1972, when the ***United Nations Conference on the Human Environment*** in Stockholm took place. It was there and then that the environment was placed at the centre of the international agenda, establishing it as one of the priorities for country action. In the years that followed, activities were carried out around the world mostly following a project-based approach from which it has been difficult to escape.

It was not until 1987 when the ***Brundtland Report*** ('Our Common Future') by the World Commission on Environment and Development made the case for the need (i) to place environmental concerns in the broader context of development and (ii) to assign significant financial resources to address them. The Report also advanced some institutional recommendations which later served as the basis for discussions and debates that followed on funding for international conventions, and

[1] The Review of the Financial Mechanism is also being undertaken and will be finalized at COP 15.

[2] A reference to Article 21 of the Convention on Interim Arrangements could clarify some of the confusion regarding the role of the GEF and a reference to it as 'the international entity entrusted with the operation of the financial mechanism' a term that was later superseded at COP 4 following the Review of the financial mechanism provided for in Article 11.4 and when the term 'an entity entrusted with the operation…' or 'an operating entity' for short, was adopted. This term implicitly leaves open the possibility for more than one entity.

funding of the global dimensions of the environment. One proposal that is particularly credited with having contributed to the creation of the GEF was an UNDP-funded WRI study which put forward the idea of an international fund for the global environment[3] The proposals that later emerged − including one from the World Bank on the creation of the GEF − were responses to this study. Those responsible for coming up with ideas on the reform of the financial mechanism today would greatly benefit from giving a close reading of this early history on funding global environmental action and the issues that influenced the early days of these negotiations. What follows is a brief summary and highlights of that history. Four observations from these early years would be relevant to the negotiations today:

(1) Despite the efforts to 'consult' broadly, developing countries at that time had little say in the decision on what was to become the GEF. The fact that the GEF was to be based on voluntary contributions and was being established at that time without any legal link or obligation to the any Convention, gave donor countries the upper hand in the final decision.

(2) The decisions taken at that time were heavily influenced by developments taking place in major international organizations, namely UNDP and the World Bank, which had little environmental capacity within their organizations.

(3) The GEF became an operating entity of the financial mechanism of the UNFCCC to a certain extent by default, as there appeared to be, in the eyes of many, no alternative.

(4) During these early years, the sources and types of funding available for the activities related to the global environment were few and scarce.

None of this applies in today's negotiations to reform the institutional and funding arrangements under the financial mechanism. The UNFCCC Conference of Parties (COP) has a free hand in establishing whatever it considers adequate and appropriate to the needs and conditions of today. By definition, these needs and conditions are totally different from the early years of the Convention and consequently, the present arrangements are in urgent need of reform.

B. Brief History of the Global Environment Facility (GEF)

As the UNFCCC publication *The First Ten Years* points out, developed countries many years ago 'agreed that they would need to support the efforts of developing countries, but they argued against establishing a new financial mechanism believing that the Global Environment Facility, established in 1991, could serve the purpose.' Recently, it has become evident that most Parties feel that the scale of funding and the current operational arrangements are inadequate and that the financial mechanism is in need of major and urgent reform. This should not diminish the enormous contribution that the GEF has made to the UNFCCC in the last fifteen years. Ignoring this fact would create a blind spot regarding the many good lessons that can be learned from the GEF when embarking on the review and on the negotiations for a much needed reformed financial mechanism.[4] Ignoring this fact would also be to deny the contribution that GEF has made to introduce environmental concern in nations around the world. The following is an attempt to highlight some issues that may be useful to the current discussion of the reformed financial mechanism.

Responding to calls for the creation of a facility to fund additional activities in the environment by Germany and to a more concrete proposal from France during the Annual Meeting of the ***Development Committee***[5] of 1989, the GEF idea began to take shape in the form of a World Bank

[3] Natural Endowments: Financing resource conservation for Development. International Conservation Financing Project Report, commissioned by the United Nations Development Programme, 1989.

[4] It should be noted that when referring to reform of the Financial Mechanism throughout this document and its 'sister' document, what is meant is the reform of the architecture needed for the operationalization of the Financial Mechanism

[5] Joint Ministerial Committee of the Boards of Governors of the World Bank and the IMF on the Transfer of Real Resources to Developing Countries.

proposal with the aim to provide additional funding (separate from funding for development) that would be used to work with countries interested either in starting up new projects or incorporating environmental components in on-going projects with some measurable impact in four areas of global concern: depletion of ozone layer, greenhouse gas emissions, biodiversity, and pollution of international waters. The Facility was to help build in-country capacities and promote the introduction of projects that address global environmental concerns throughout the developing world, and also promote international cooperation and sharing of knowledge. Some of these aims have unfortunately been weakened, severely compromised, or annihilated by the ill-fated Resource Allocation Framework introduced by the GEF in its latter years. This was *de facto* an effort by the GEF to fine-tune its interpretation of the concept of incremental costs, based on World Bank indicators designed without consulting the UNFCCC COP.

The GEF began as a pilot facility in 1990, and in 1992 became an interim operating entity of the financial mechanism for the UNFCCC and the Convention on Biological Diversity and was confirmed as 'an operating entity' at COP 4.[6] It was set up to explore ways to address global environmental problems and as an experiment in governance. Its mandate, to support action with 'global' environmental benefits, *de jure* precluded its involvement with actions such as adaptation. The original idea was in many ways novel and bold. The intention was not to create yet another international agency that could duplicate what others were doing. Instead, the original idea was to create a small secretariat that would depend on the three global institutions that, at that time, had or were creating a capacity to deal with environment and development. In many ways, it was an extraordinary experiment and achievement in global environmental governance.

The early years of the GEF as a pilot facility were unavoidably tangled with the early negotiations in preparation for the ***UN Conference on Environment and Development*** (UNCED). In these negotiations, developing countries called for the creation of a ***Green Fund*** and many saw the creation of the GEF as an attempt by developed countries to pre-empt this. It was during these early days that developing countries fought hard and obtained agreement on the principle of 'common but differentiated responsibilities' that is today at the heart of the UNFCCC.[7] What followed were intense political negotiations that led to the restructuring of the GEF and, that in March 1994, allowed for the conversion of the GEF from an interim operating entity to an operating entity of the financial mechanism of the UNFCCC. The restructuring was designed to transform the GEF; to incorporate features in its design that had been demanded by developing countries such as universality, transparency, and participation in the decision-making. However, despite the parity in the number of seats between developed and developing countries, the current mixed voting system (proportionate to the number of countries and the size of the contribution) gives *de facto veto* power to the largest donors in the thus far exclusively consensus-based decision-making of the GEF.

A legal instrument of establishment elaborated on the link between the GEF to the Conference of the Parties of the UNFCCC, among others. The institutional linkage between the GEF and the COP was made prior to this date by an MOU (agreed at COP2), and an Annex to it in COP 3. The instrument for the establishment of the restructured GEF provided for a Trustee; a Participants Assembly that would convene every three years;[8] a Council; a Secretariat; the Implementing Agencies, and the Scientific and Technical Advisory Panel (STAP). Surprisingly, there was little discussion or concern at that time on how an operating entity of the financial mechanism of the UNFCCC (serving also other conventions), with its own governance structure, would reconcile its decisions and objectives with those of the Conference of the Parties of the UNFCCC in the case of climate change. If more thought had been given to this factor, more would have been done in the design to prevent what later became the greatest weakness of the present arrangement: (the perception

[6] COP decision 9/CP.1, paragraph 1, stated that the GEF would continue to operate on an interim basis until the review to be conducted within 4 years. This review took place at COP 4.

[7] Principle 7 of the Rio Declaration: 'Principles on Environment and Development'.

[8] Despite the Instrument Provisions for the Assembly convening every three years, it has gradually moved to convening every four years, in violation of the Provisions.

of) there being of two sets of 'bosses' making divergent demands on the same institution. The reality of this weakness became more apparent than ever with the introduction of the ill-fated Resource Allocation Framework. It is also evident in some of the negative assessments that have been made regarding the GEF performance vis-à-vis the guidance of the COP. To be fair, the relationship between the GEF and the COP has been disappointing due as much to the failure of the COP to provide explicit guidance, (thus leading to more discretionary powers by the GEF Secretariat and Council) as it has been due to the differences in vested interests represented on the GEF Council and the COP.[9]

C. The Changing Context of Finance

Negotiations of the reform of the financial mechanism are being carried out in a world facing a breakdown of the global financial system, the most severe financial crisis in several decades, and a global economic slowdown that is bound to last several years. This situation should not in any way interfere with the negotiations on the reform of the architecture and governance of the financial mechanism. The main drivers for these negotiations should be a) the severity of the climate change challenge; b) the need and urgency to act now rather than later in order to avoid even higher costs and hardship, and c) the mandates of the Convention.

Negotiations are also being carried out in a world that is in many ways fundamentally different from that of the late 80s and early 90s when the present arrangements were put in place. Not only has the global political landscape changed dramatically, but the number of actors also increased in the same degree. International institutions and countries around the world are better equipped to absorb resources and use them effectively in programmes and projects that address climate change. Further, a large number of countries have strategies and programmes that incorporate climate change into their development strategies. The funding sources have multiplied several-fold. The carbon market, as well as investment and financial flows in carbon friendly technologies and clean energy have also increased dramatically, well beyond initial expectations. But so have the needs.

The UNFCCC Report *Investment and Financial Flow to Address Climate Change* 'gives a good review and analysis of the existing and projected investment flows and financing relevant to the development of an effective and appropriate international response to climate change, with particular focus on the needs of developing countries.' One of the main conclusions is that the additional estimated amount of investment and financial flows needed in 2030 to address climate change is immense and much larger that the funding currently available under the Convention and its Kyoto Protocol, but small when compared with global Gross Domestic Product (GDP) and investments. Another important conclusion relevant to this Brief is that 'if the funding available under the *financial mechanism* of the Convention remains at its current level and continues to rely on voluntary contributions,[10] it will not be sufficient to address the future financial flows estimated to be needed for mitigation and adaptation.' The Report goes on to suggest other options for generating additional funds. But as Parties address these questions, the UNFCCC also needs to urgently address the present inadequacy of the architecture and governance of the financial mechanism. A new reformed financial mechanism should not only be able to receive, disburse and oversee the application of the funds but also create the environment for more innovative financing and mobilization of resources.

D. The Mandates of the Convention

On the financial mechanism, it is curious that there are no Articles in the Convention that establish the mechanism itself. Instead, several articles define what it should be or do. Article 11.1 provides for 'a mechanism for the provision of financial resources on a grant or concessional basis, including for the

[9] There are more than 40 COP decisions providing guidance to the COP which would be useful to assess vis-à-vis performance and response.

[10] Although formally, there is no 'burden sharing' agreement among donors, in practice their contributions have remained proportionally the same resulting in a virtual cap, being established by the largest donor.

transfer of technology'. The article also states that 'its operation shall be entrusted to one or more existing international entities' and that 'it shall function under the guidance of and be accountable to the Conference of the Parties, which shall decide on its policies, programme priorities and eligibility criteria related to this Convention', but not on the approval of projects, a task which is left to the GEF as operating entity. Article 11.2 states that the financial mechanism 'shall have an equitable and balanced representation of all Parties within a transparent system of governance'. And Article 11.5 provides that 'developed country Parties may also provide and developing country Parties avail themselves of, financial resources related to the implementation of the Convention through bilateral, regional and other multilateral channels.'

The text of the Convention makes provision for the commitments of all Parties in Article 3 and 4, and also provisions for the financial mechanism in Article 11. They provide the core of the mandate of the Convention and of the Kyoto Protocol (given that the text of the earlier applies to the latter *mutatis mutandis*) on the financial mechanism. The agreements under the Bali Action Plan are also relevant since they establish the level of ambition (including ambition on the level of resources) and the conditions and modalities for funding climate change measures by developing countries, such as the MRV system which will require a more robust Financial Mechanism than what we have at present.

In addition to the core mandate, some of the other UNFCCC articles have also influenced the evolution and history of the financial mechanism: Article 2 (Objective), for example, should have had an enormous influence on both the level of resources that should be allocated as well as the magnitude and the type of the response, (which includes having a proper Financial Mechanism). Article 3.1 establishes the principle of 'common but differentiated responsibilities', Article 4.1 reinforces it and makes reference to the need to take into account the specific national and regional development priorities, objectives, and circumstances, and Article 4.7 provides the balance by stating that 'The extent to which developing country Parties will effectively implement their commitments under the Convention will depend on the effective implementation by developed country Parties of their commitments under the Convention related to financial resources and transfer of technology…' Others, such as Articles 12.4 and 12.5 give developing countries greater flexibility – perhaps too much flexibility − in the preparation of National Communications, which, in theory at least, should have had some influence in guiding the funding needs in developing countries.

Three Articles of the Convention make provisions regarding resources: ***who the providers*** are and ***where the resources are needed***. Article 4.3 deals with resources for implementation of general commitments and reporting; Article 4.4 with adaptation costs, and Article 4.5 with technology transfer. The Convention is clear about who the ***providers*** of the resources should be: developed country Parties and other developed County Parties listed in ***Annex II*** of the Convention. Article 11 of the Kyoto Protocol also addresses the obligations of Developed Country Parties listed in Annex II of the Convention.[11] In practice, pledges to the GEF have also been made by countries not listed in Annex II of the Convention.

The level of resources to be provided and the burden sharing by developed country Parties is not mentioned in either the Convention or the Kyoto Protocol. Instead, Article 4.3 of the Convention and Article 11.3 of the Kyoto Protocol make reference to 'the need for adequacy and predictability in the flow of funds and the importance of appropriate burden-sharing among developed country Parties'. Article 11.3 (d) calls on the COP to work together with the GEF in the determination of the funding necessary. The provisions of this Article were later complemented by agreements reached at COP 2 and were included in the Memorandum of Understanding (MOU) between the COP and the GEF and an Annex to that MOU, a year later.[12]

[11] The following countries are listed in Annex II of the Convention: Australia, Austria, Belgium, Canada, Denmark, European Economic Community, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, and the US.

[12] For a number of political and technical legal reasons, including the fact that neither the GEF nor the COP has an independent legal personality, an imperfect compromise of a rather loosely worded MOU emerged.

The MOU and its Annex define the legal relationship between the COP and the GEF and determines that 'the COP and the GEF shall jointly determine the aggregate GEF funding requirements for the purposes of the Convention.' The concept of incremental costs, included in the Convention and made operational through the GEF, was to determine the basis under which the GEF Secretariat and the Council would decide what would be funded. The MOU also calls on the COP 'to make an assessment of agreed full costs of preparing national communications and the agreed full incremental costs of implementing other commitments… and for the COP and the GEF to carry out a reiterative process to review the amount of funding necessary and available in accordance with Article 11.3 (d).' In practice, this has not really worked. In reality, it has been the GEF Secretariat and the Trustee who make assessments and funding scenarios on the basis of estimates of what the donors are willing to contribute. Paragraph 12 of the MOU states that the COP will 'periodically review and evaluate the effectiveness of all modalities established in accordance with Article 11.3. Such evaluations will be taken into account by the COP, in its decision pursuant to Article 11.4, on arrangements for the financial mechanism.' Needless to say, in the new reformed financial mechanism, the manner in which funding needs are determined, would need to be totally transformed as with many other arrangements.

Reference to new and additional financial resources for developing country Parties is mentioned in Article 4.3 of the Convention and Article 11.2 of the Kyoto Protocol. The provisions of these Articles, along with Articles 4.1, 4.4., 4.5, and 4.7, establish the obligation of developed country Parties toward developing country Parties in their efforts to comply with their obligations under the Convention. Article 4.7 in particular makes it clear that 'The extent to which developing country Parties will effectively implement their commitments under the Convention will depend on the effective implementation by developed country Parties of their commitment under the Convention related to financial resources and transfer of technology…' In referring to the obligations of developed country Parties, the Kyoto Protocol makes reference to the above-mentioned articles of the Convention. The provisions of these Articles take on a new meaning with the agreement of the Bali Action Plan on MRV finance. Under the present arrangements, there is no real practical venue to respond to this new provision. The reformed financial mechanism would need to establish a mechanism to implement this agreement.

E. Conclusions

The success of the on-going round of climate change negotiations is directly linked to the role that developing countries decide to play in the post 2012 regime. As per the Convention and the Bali Action Plan, action on the part of developing countries is tied to the financial resources and technology transfer support received from developed countries. The scientific evidence provided by the Fourth Assessment Report of the IPCCC, as well as more recent and alarming scientific evidence suggest that the level of resources now being allocated and the process by which they are allocated are totally inadequate and out of sync with what is required. In the sections above, references have been made to the fact that the resources currently made available under the Convention are grossly inadequate; that existing funding arrangements suffer from inadequate governance; that the relation between COP guidance and implementation of it is less than perfect, and that funding arrangements suffer from slow and cumbersome procedures. This is, therefore, the appropriate time to embark on a major reform of this financial architecture.

In embarking on reform, the COP has two options: First, of making incremental improvements on arrangements that were made when the world was a much different place, at a time when we did not have as much knowledge as we do today and when there were not as many alternatives. We have a world today in which there is greater emphasis on market mechanisms, where resources mobilized are not from 'donors', where this is more hesitation over the merits of straightforward ODA, and a greater desire to move towards 'innovative' financing. The second option is to design a whole new financial architecture to fit the needs of the climate change challenge of the 21st century. There are no constraints whatsoever on the COP from doing as it wishes. Some articles of the Convention set

certain conditions and definitions. But there is nothing in those articles to stop the COP from making the major revision that is required.

Unlike fifteen years ago, when the present financial mechanism arrangements were put in place, most developing countries today have climate change as one of their major priorities. Most are eager and keen to strengthen existing activities and to introduce new measures to address the major challenges that confront them. Most have developed capacities to implement them. But the major constraint in the majority of the cases is the scarcity of resources with which to act. The agreements to be reached in Copenhagen in December of 2009 will have little meaning for developing countries if the issues of resources and the financial architecture are not resolved..

Furthermore, the issues of resources and resource allocation will not be resolved unless there is a financial mechanism in place with proper architecture and governance markedly different from what exists today. The Bali Action Plan agreements call for more ambition but also more accountability. A mechanism that can inspire trust and is seen as really assessing and responding to the needs of developing countries − one indeed that motivates action with accountability on all sides (those providing the financial and technical support, together with those taking action) − would transform the face of the climate change action around the world.

For many, this is a chance of a lifetime to take advantage of the small window of opportunity that the IPCC Fourth Assessment Report tells us we have. This it is a matter of the greatest urgency, to take a bold step in creating a financial architecture that really fits the needs of the 21st century. During the last few years, the Convention has been making the gradual transition to a phase characterized by action and implementation. The post-2012 regime will need to make a leap in quantity and quality of action around the world. This way forward will have implications for the various institutions of the Convention − including for the UNFCCC Secretariat − that will be difficult to escape.