

## Workshop Briefing

### Climate Finance – How to Mobilise Finance for the Transition to a Low Carbon Economy?

Workshop November 18, 2009, Berlin – House of the GTZ

Since 2008 the German Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU) invests 120 million Euro per year of earmarked revenues from auctioned emission allowances in mitigation and adaptation projects in developing countries, emerging economies and economies in transition. These investments are made through the BMU's innovative financing mechanism, the International Climate Initiative (ICI). This year, on November 18 and 19, representatives from ICI's finance sector and carbon market-related projects gathered together with outside experts and practitioners in Berlin to discuss the question of how to mobilise private investments in sustainable solutions for a low carbon economy, especially in developing countries. On the first day, approximately 50 participants exchanged views and shared experiences related to increasing the flow of finance into low carbon projects in developing countries. This policy brief summarises some of the main results of the fruitful discussion.

#### Salient factors

#### Risks

Risk management emerged as a constant and pervasive theme.

- Investors must be able to get comfortable with the added risks associated with investing in novel or expensive technologies in less developed regulatory and legal jurisdictions. For private investors, whether of financial or strategic / industrial origins, investment opportunities in low carbon projects that are close to commercial viability contain both high project-related risks as well as region-specific uncertainties, such as those related to currencies, regulations and legal protections.
- For the private sector, these risks and the corresponding return on investment must level out when compared with more conventional investment alternatives.
- Perception of risk is as important as actual risks, and the risks of new and innovative solutions are usually hard to quantify and generally overestimated
- Risks, particularly reputational risks, can also play a *positive* role in driving low carbon investments. As awareness increases around climate change reputational risks increase for companies deploying non-sustainable practices and banks providing funds for such companies. Thus, reputation can become a driver for investments in low carbon economies and serve as a lever that policy makers and project developers can use to motivate investment.

## **Market failures**

Apart from the significant risks inherent in the projects and jurisdictions there are market failure-related barriers limiting the flow of private finance. Such barriers can be, for example, prohibitive transaction costs and inconsistent legislation or regulatory implementation.

Participants advocated in unison that interventions are necessary where market failures exist. Those market failures can be

- a lack of information on available low carbon solutions,
- a lack of (local) capacities to implement these solutions,
- prohibitive transaction costs,
- reluctance of market leaders to change business,
- external costs and the lack of policies to price those costs in and make the polluters pay,
- asymmetries of market actors like local communities to make themselves and their social and environmental concerns heard, and
- a lack of a long-term perspective.

Basically, investors might overestimate risks of innovative technologies and practices or might simply not be aware of investment opportunities in low carbon solutions.

## **Addressing Risks and Market Failures**

Solutions need to address not only lowering risks for investors – for example financial guarantees, favourable lending terms, political insurance etc. – but also market failures particularly relating to information, to reduce misperceptions of risks. In recognition of this many ICI projects incorporate education and capacity building alongside activities to attract capital to open bottlenecks throughout the finance supply chain. A key consideration, however, is that interventions must be designed carefully in order to avoid crowding out private, market-oriented initiatives. A summary of the discussion on the ways to address risks and market failures follows:

- Hedging risk guarantee vehicles might have the most immediate effect to mobilise private finance for low carbon solutions in developing countries. This, however, requires the availability of extensive public funds to pool risks. This could prove slow, costly and still be unable to address some of the projects and regions perceived as possessing higher risks. In contrast, deploying capital into many small-scale projects might have a larger impact on climate change and low carbon development, but is more difficult to operationalise at significant scale.

- Capacity building activities will be critical to improve understanding, raise awareness for climate change-related risks and opportunities, serve as interpreter between project developers and investors, develop local capacities, build investor and banker confidence and increase the demand for certain sustainable technologies and services as well as for climate-proof and climate-friendly investment opportunities.

In order to make knowledge accessible and *communicate relevant information* to pivotal actors, alliances of actors from all sectors need to be formed. Here, public

funding was discussed as being well positioned to play a valuable, catalytic role by supporting the following activities:

Technical assistance:

- *Research, internal communications*, for instance between the board in charge of strategic decisions and the CSR unit or among different ministries or departments, and *education processes* within relevant private companies and public actors.
- *Technical assistance* for developing and launching new financial products and credit lines and *capacity building* can help indirectly to enable commercial banks to calculate risks more appropriately and to provide credit lines themselves.
- In order to make investors aware of low carbon investment opportunities *marketing* of innovative financing mechanisms proved to be successful.
- *Partnering* with the few classes of businesses that take very long-term views of the world, such as energy companies, re-insurers and institutional investors. Those partners have the financial and economic leverage to establish new standards in the market and instigate changes in investment patterns.

Financial assistance:

- *Credit lines* of development banks can help directly to lower transaction costs,
- However, so far there are little incentives for those actors to invest in developing countries where projects and markets are simply too small. Thus, *large infrastructure projects* are needed to *attract institutional investors and energy companies* to environmental markets.

## What are possible solutions?

### Pivotal Activities

Beyond the question of how projects must be designed to mobilise private finance, there were several discussions about the types of projects required to further leverage financing and develop more robust solutions for achieving a transition to a low carbon economy. To this end, a whole range of obstacles must be overcome:

- There was consensus that *microfinance* will have a role to play and that *bundling* of small-scale projects and *programmatic CDM* might contribute to the attractiveness of low carbon investments. On the one end, the finance sector is not yet ready to absorb and deploy large funds for low carbon development, on the other end, many sensible projects for a low carbon development are rather small-scale and thus of limited bankability. The challenge is to create an enabling investment environment to foster climate finance. Before institutional investors will deliver scale, quality and rules of the markets must be developed and instruments be tested with the support of public finance.



- Apart from such structural limitations to mobilise private finance, there are regional limitations as well. One participant introduced a four quadrant matrix:

FDI-eligible	yes / no	yes / yes
	no / no	no / yes
	CDM-eligible	

Experience showed that only countries, and more specifically sectors, which scored in the upper right quadrant are capable to attract and leverage private climate finance. This experience, however, was argued must not lead to the conclusion to focus regionally merely on the countries that already attract funds successfully in the marketplace, but that different regions require different solutions. Public finance must be harnessed to support the development of Low Carbon Growth Plans and National Appropriate Mitigations Actions (NAMAs), and for gathering data and drafting monitoring methodologies thereby moving countries to the upper right quadrant. From here the private market is likely to take over the provision of funding for a low carbon economy.

### **Innovations**

While only small shares of private finance go into financing for innovations, innovations nevertheless ensure companies to survive in the market and stay competitive. Hence:

- Companies which are *innovators* in their markets – “which allow themselves innovations” as one participant phrased it – must be identified and supported to spur a development of whole markets toward low carbon growth. Such innovation process must be very timely. Supporting this process is an art of timing rather than of financial scale. Innovative proposals *must be properly developed*, however, before obtaining financing from commercial lenders.
- Deals must *generate profits* for all involved sides and have *large demonstration effects* in order to bring innovative solutions to the market and be *replicable* to allow for economies of scale. Here, it surfaced that there is a chicken-egg situation: *policies* react to *successful innovations* and adjust incentives, but innovations themselves need supportive policies like feed-in tariffs. Hence, *funding for pilots* is salient for low carbon development.

## Workshop Briefing

### Carbon Finance – How to Contribute to the Development of the Carbon Market?

Workshop November 19, 2009, Berlin – House of the GTZ

For the second day of its two-day series of workshops on enhancing climate-related investment flows to developing countries, the German Federal Ministry for the Environment's International Climate Initiative invited its carbon market-related projects to discuss how to improve the efficiency of carbon market mechanisms and the quality and sustainability of project activities. Approximately 60 participants, including several private sector and academic experts, exchanged views and shared experiences.

This policy brief summarises some of the main results of the fruitful discussion. At a high level, there was consensus that it is essential to design the offset market in a manner that enables more sustainable projects to be developed and carried out. There was also consensus that it is possible to design the offset market in such manner by setting the right regulatory framework. One important element to help sustainable projects is the phasing out of certain project types of industrial gases and of certain other large project activities. This may contribute to more private funding becoming available for other, more sustainable, small-scale projects.

### Salient Factors

#### Carbon Market

There was agreement that the carbon market will have to play an important role in future but that it will have to grow and to change. If the carbon markets serve as the principal instrument for the mobilisation of private markets for a low carbon development, then many improvements are required in quality of the carbon markets as they exist today.

- Improved rules and methodologies are needed to ensure that “a ton must be a ton” (of reduced emissions), as Deputy Director General “Environment and Energy” Franzjosef Schafhausen phrased it, and that emission reductions are sustainable and of high quality.
- *Social and environmental concerns of local communities* must be considered. Those can provide useful information to cross-check in the process of issuing certificates.
- More sectors must be included as well as the demand must increase with ambitious targets set in the framework of a post-2012 agreement and the emerging emission trading systems. And more activities must become marketable. To this end, barriers to the market like prohibitive transaction costs, complicated and self-contradictory regulatory requirements and

uncertainties must be overcome. Regulation must *balance simplicity with integrity*.

- One benefit of the institutional design of the Clean Development Mechanism so far is its transparency compared to other international mechanisms and their internal decision-making procedures. This *transparency* can contribute to the sustainability of projects.
- The compatibility of certain policies with the Clean Development Mechanism is also critical; a theme that re-emerged through the day. Whether *feed-in tariffs* contradict additionality requirements of the Clean Development Mechanism, creating thereby perverted incentives for countries to limit their efforts to introduce ambitious renewable energy targets, may differ from country to country. This fundamental conflict has to be resolved in order to align domestic policies with international efforts to foster low carbon development globally.
- The development of the carbon market calls for short-term incentives for long-term investments. *Partnership models* in general and incentives for private collaborative action in particular can provide them and develop projects as well as the market environment as a whole, for such collaboration enables actors to pool resources and coordinate individual activities forming the market.
- Although cap-and-trade systems already instigated considerable emission reductions, experiences showed that the Clean Development Mechanism will hardly mobilise funds for stand-alone investments. It rather serves to cover incremental costs (of approximately 10%). Hence, it was recommended to help private actors to *identify opportunities* to reduce emissions within their applied business models and offer them *project development support*.

### Programmatic CDM and Sectoral Approaches

- Sectoral approaches were often mentioned as one possible means in the future for addressing the present deficiencies of the carbon markets. The Programme of Activities (PoA) under the CDM is the first advanced mechanism to gain experiences for the design of more comprehensive mechanisms. Sustainability requirements could be addressed as well as small-scale activities can be bundled and become financially viable.
- PoAs aim at this goal, too. Thus it was discussed if they can serve as a stepping stone towards sectoral approaches. Indeed, PoAs and sectoral approaches both have similarities in requirements and designs of their frameworks.
- However, sectoral approaches range from a Clean Development Mechanism project type for one technology with numerous small-scale applications to public policy approaches which avoid distortions of international competition in one sector.
- Hence, PoAs might rightly serve as bridge to the inclusion of new small-scale technologies over individual sectors and/or regions in the Clean Development Mechanism but less for sector-wide public policies.
- PoAs allow for economies of scale but they are difficult to monitor and reduced emissions to verify. Therefore, PoAs imply high upfront costs in the

development of methodologies and the set-up of management. As, however, there is a shortage of funding, PoAs represent the only realistic funding option. The design and management of PoAs need therefore public sector support and depends on *partnerships with public actors and multilaterals* while *private companies implement the Climate Partnership Agreements*.

## Pivotal Activities

Carbon markets depend on clear methodologies for monitoring and accounting and to ensure sustainability of reduced emissions. In order to develop the carbon market those public goods need to be provided and their design needs high up-front investments.

Carbon markets also require regulatory and institutional linkages of different regional markets, offset markets, compliance and voluntary markets. These linkages can facilitate the transfer of experiences across distinct markets, thereby increasing efficiency gains and promoting certificate trade

- To this end, *first movers in regions and sectors* should be supported in the development of their PDDs through targeted capacity development.
- As most methodologies are project-specific, a role for public finance could be to *identify opportunities* where which project type and which methodology could be applied and applicability improved.
- In order to foster investments in the market development, *facilitation and interpretation* for programmatic Clean Development Mechanism between finance sector and the climate change mitigation activists need support.
- *Government purchase programmes* for high quality credits were suggested to back demand and price for the quality segment of the carbon market.
- The carbon market development will also expand the range of project types and sizes. There must be ways established to *bring smaller projects to the market* and develop programmatic Clean Development Mechanism as the development of microfinance is a key question for the future of the carbon market. On the other end of the scale, *much larger projects must be created*.
- One of the most important issues for the successful implementation of programmatic CDM projects is to provide *seed money*, especially for project activities able to provide a sufficient return on investment during the 10 years CDM accounting period.

The leverage of private finance and the provision of public goods for the development and expansion of the carbon market might be a pivotal catalyst for scaling-up financial investments in a low carbon economy.