Financing Pathways for Low Emissions and Climate Resilient Development

Working Paper on National Financing Pathways

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Executive Summary

Shifting the global economy onto a 2^{o}C trajectory implies a rapid shift of existing investment patterns and far reaching transformation in technology, infrastructure and practises, including the adoption of new financing and business models. A key challenge for developing countries is how to develop a national climate agenda that is fully integrated with development objectives so that the new paradigm balances social, economic and environmental objectives. This will be critical to ensuring a steady transition which will also be influenced by the structure of the economy and the wider political economy, existing institutional frameworks and priorities, domestic capacity and perceived risk for managing processes of change.

The ability to mobilise and leverage different forms of finance, public and private from domestic and international sources, will be key to delivering the steady transition to a low emissions and climate resilient development paradigm.

"National Financing Pathways" are put forward here as a concept that articulates the interdependencies between public, private and international sources of finance as a means of delivering scaled investment to support implementation of low emission and climate resilient development. The interplay between national policy objectives and institutional frameworks with various sources of finance can be considered as constituting a national finance ecosystem and so influencing the shape and pace of the financing pathway.

Based on discussions with representatives in Chile, Colombia and Peru, this working paper identifies emerging issues that may influence a NFP and considers different frameworks and tools to develop such pathways. These may help to prioritise actions over the short, medium and longer term to deliver a sustainable financing pathway to implement LECR objectives.

One of the possible outcomes of the NFP is for identifying and putting in place policy, institutional and financing mechanisms which utilise public finance, including international climate finance, to effectively mobilise and deliver scaled up private sector investment. A key finding from this scoping project is that approaches will differ in line with country specific priorities, goals and contexts, with the structure and maturity of the local financial sector being one important factor.

It is evident from the scoping phase that developing countries are taking a leadership role in considering how to draw upon available sources of international climate finance more dynamically so shifting the more traditional "supply-side" focus on climate finance to a "demand-side" or needs based approach. The process of developing the NFP can therefore be useful in helping to identify and communicate how international climate finance can be most effective in financing a new LECR development paradigm.

Introduction and Background

Low emission and climate resilient development plans (LECR) comprises a series of economy wide- and/or sector specific actions by countries to be implemented over the short, medium and long term. These plans effectively enable countries to identify options for transitioning to a low emission and climate resilient economy in the context of their national development priorities. As countries move from design to implementation of LECR plans they are recognising the importance of country leadership on the financing of these plans.

In early 2012 E3G proposed "National Financing Strategies" as a generic term to reflect the need for this leadership role. Discussions during 2012 identified a number of likely characteristics of a NFS as a robust, inclusive and iterative process. Highlighted activities were for identifying financing challenges, priorities, partners and delivery mechanisms for a sustained implementation of low emission and climate resilient development plans. In early 2013 CDKN supported this scoping study to test out the concept in partnership with representatives of the Governments of Chile, Colombia and Peru. The scoping mission in April 2013 and subsequent discussions have led to the initial conclusion that the term Pathway better reflects the evolving and dynamic nature of addressing the financing challenges. At the same time this avoids potential for seeing a finance strategy as separate to the LECR plan, where in fact it will need to become an integral component moving forward.

Financing the pathway to a new LECR paradigm requires governments to take a strategic approach in the allocation of public resources (whether domestic or international) and for mobilisation of private resources through national policy and regulatory frameworks and mechanisms. Extensive literature and case studies offer evidence that financing climate change activities poses a range of often significant challenges, which in the absence of Government attention will prevent flows of finance required for implementation (OECD, 2012; The Global Mechanism of the United Nations Convention to Combat Desertification, 2008; FONAFIFO, 2012; ODI, 2013; Asen, et al., 2011).

Generally, the introduction of new and therefore unfamiliar technologies and business models, which are commercially unattractive, requires financial incentives to mitigate associated risks. This implies a role for Governments during the early stages of a new technology and/or business model to attract private capital. Whilst the type of financial support provided will be determined by technology, sector and country contexts, a common barrier is lack of familiarity and so reluctance of public financial decision-makers to allocate public resources for such activities. Public resource for climate related actions is scarce and it also has to compete with other national development priorities where the social and economic benefits are more widely accepted. A key challenge therefore is for strengthening understanding of the potential benefits and opportunities associated with new climate related investments and for building confidence of the affordability of abatement options and measures for increasing resilience.

National Financing Pathways (NFPs) can be developed to address these challenges, including broadening considerations beyond a shorter term horizon that may be typical of financial decision-makers within the public sector. The NFPs may therefore involve a focus on enabling policy and regulatory frameworks and mechanisms to ensure public financial resources, including international climate finance, are used most effectively to overcome barriers to private sector investment and facilitate an inclusive transition. This may require additional institutional and technical capacity, particularly to ensure decision-makers from Finance Ministry, Planning entities and public agencies -including national development banks- better understand the financing challenges and investment profiles associated with low emissions and resilient investments across different sectors. In this respect a NFP framework can be a useful tool for mainstreaming climate objectives into countries financial systems and sector specific investment plans.

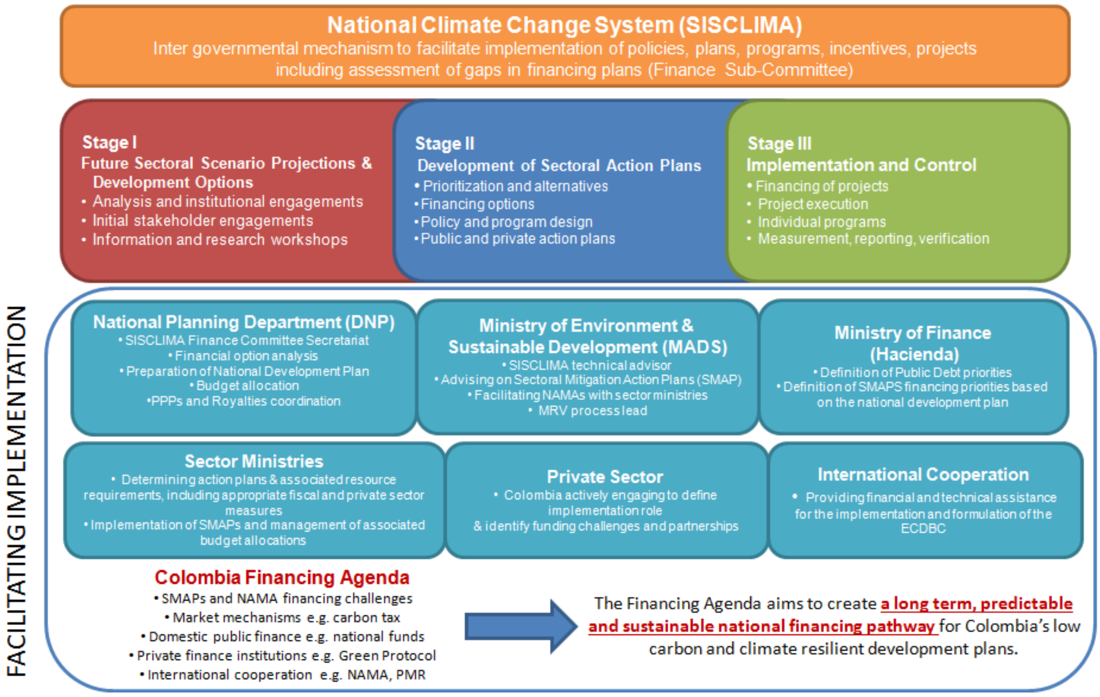
Emerging trends from Chile, Colombia and Peru

Reflecting on the experiences of Chile, Colombia and Peru, an overarching theme is a commitment to strengthen their understanding of the financing challenges and ways of mitigating risks for private sector investment. All are recognising the importance of identifying and defining complementary roles for the private and public sector, and to ensure appropriate institutional arrangements for financing the implementation of LECR plans are in place. There are common trends across these countries which will ultimately define a series of actions to be taken in financing their LECR plans, these include:

> Recognition that LECR should be framed in the context of national development priorities, specifically job creation, economic growth, maintaining market competitiveness, poverty reduction and energy security in order to attract requisite intergovernmental support for implementation.

> Focused efforts to create appropriate governance to facilitate implementation and financing of LECR, including new government forums and capacities being created. e.g. SISCLIMA with Finance Sub-Committee in Colombia, Progenacc in Peru and Climate Finance Unit within Ministry of Finance in Chile. The example of Colombia shown below (Figure 1) represents a systematic approach that is based on comprehensive sectoral action plans that mainstream low carbon development in the national and state priorities. Financing priorities and needs would be determined at a sectoral level, and be embedded in the budget applications to the Ministry of Finance and the National Development Plan. This is a direct approach which requires holistic assessment of the fiscal measures, market mechanisms and financial instruments available from private sector and international sources to support implementation.

Figure 1 – Colombian Strategy for Low Carbon Development (ECDBC)[1]



> Recognition that ongoing engagement with national industries and private institutions will build support to implement LECR plans over long term, including understanding the structure and capacity for investment by existing commercial and development institutions as well as building up the scale of existing interventions (e.g. organisations in Peru are working with industries to deepen their understanding of sustainability issues and COFIDE in Peru is already funding green investment programmes focusing on small and medium sized businesses).

> Adoption of voluntary initiatives in the banking sector that ensure that there are sustainable banking practices to improve the quality of investment decisions by factoring in environmental, social and governance factors (e.g. Green Protocol adopted by Colombia's banking sector, sustainability training initiatives by Peru focused on its business leaders).

> Recognition that an enabling environment with risk mitigation mechanisms is essential and that this can be framed through programmes that create an investable pipeline of projects that delivers a transformative impact with private sector participation (e.g. Colombia's active engagement on financing challenges and possible financial structures for NAMAs[2] and its Sectoral Mitigation Action Plans).

> Interrogation of good practices in specific sectors and internal assessment of how these may be transferred and shared on an intergovernmental basis with other sectors (e.g.

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[1] SISCLIMA has not officially been established, it will be formalized with the signing of the decree that regulates it.
[2] Nationally Appropriate Mitigation Actions.

Chile's Ministry of Energy has extensive experience in facilitating renewable energy and energy efficiency investment and have created institutions to promote ongoing investment).

> Appreciation that international climate finance should be utilised more creatively in addressing country specific market gaps, including to catalyse domestic investment and to build absorption capacity and potential for scaled up investment by the private sector.

Defining the Approach of National Financing Pathways

Decision makers tasked with considering the means to implementing and financing their LECR development plans may draw on the concept of NFP as relevant to their national context and priorities. As the concept of NFPs emerges, it becomes apparent that financing is not a linear approach, and will be an iterative process involving policy and sectoral decisions (see Figure 2). The NFPs can help bridge the gap between LECR design and development processes and national budgeting and financial decision-making processes, with a specific focus for mobilizing local and international partners for increasing the mobilisation of private sector capital overtime. Ongoing and structured engagement with non-governmental stakeholders, including the finance sector can deepen the analysis and facilitate understanding and mitigation of barriers to scaling up investment. Through this iterative and consultative process, countries may become increasingly confident for developing a target investment range on either a sectoral or national basis (e.g. renewable energy investment targets or setting a national target for carbon emission reductions). Delivering on these investment targets, will involve public support that may be channeled through a range of policy and regulatory support measures, risk mitigation mechanisms and institutional strengthening programmes, for example to develop markets that capture the benefits of technology transfer.

Figure 2 - Iterative Elements associated with National Financing Pathways

Here it is noted that as a constant and evolving process a NFP approach will facilitate a continuous process of reflection so that the results of interventions will inform and enable refinement of subsequent interventions. Therefore monitoring and evaluation remains a valuable tool to assist developing countries in more effectively planning their resource requirements enabling them to engage private sector and international cooperation partners more dynamically.

Several key questions emerge which are essential considerations in developing an NFP to implement a country's LECR plan, some of which are:

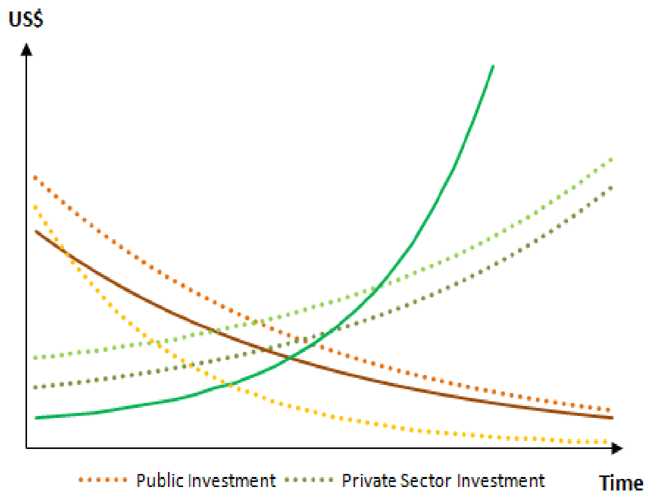
- What economic incentives and risk mitigation mechanisms are required to trigger behavioural changes and redirect investment flows into new sectors and business models?
- How can these incentives be integrated with other development and budget priorities, and what are the opportunities for integrating these?
- What is the role for specific policies and regulations for incentivising low carbon and resilient investments?

Depending on the answers to the above, the residual national public financing challenges can be identified and address further questions which would represent the core of an NFP:

- **Who** are the key domestic financial players that will need to take action?
- **What** is the role of existing or new domestic and international public financial mechanisms for mobilizing investment for financing the pathway to LECR?
- **How** are existing or new financing mechanisms and instruments to be deployed, and what is the interaction with public policy and regulatory frameworks, for catalyzing the scale and pace of investment required?

A number of tools may be useful in helping to unpack these key questions. For example, the NFP may also include pathway scenario analyses that will be customized to individual country circumstances. Figure 3 illustrates how pathway scenarios can be developed to identify potential flows of public finance versus private finance. Forthcoming work by E3G will consider these in greater detail to draw out how differing variables can initiate and crowd-in private capital. Similarly, the role of international climate finance in catalyzing public and private sector sources of finance is a key variable in defining the financing scenario to be pursued by a country as its preferred pathway.

Figure 3 – Potential Financing Scenarios that impact National Financing Pathways



A NFP that is developed in close consultation with national stakeholders, particularly the private sector, can create greater transparency and confidence over the countries investment pathway in a way that can crowd-in private sector investors. The NFP can therefore provide a useful basis for allocation of public resources, both domestic and international, to programmes that integrate LECR priorities into key sectors of the economy. It can also serve as a tool for identifying and facilitating a dynamic pipeline of scalable and replicable projects for financing. Inevitably an NFP would be an iterative process of "learning-by-doing" amongst all key stakeholders involved in financing and implementation of LECR strategies and plans.

Discussions with country partners highlighted the value of developing a diagnostic tool for helping think through key issues in design of a NFP. Box1 highlights some of the issues that are useful to consider in developing a potential financing pathway, over time. These insights emerged through reflections[3] following involvement in developing a resource mobilization strategy as part of South Africa's National Climate Change Response Strategy; a key outcome of which was the decision by South Africa to create a new National Green Fund as an interim mechanism to mobilise finance. The Green Fund also provides a platform for multi-stakeholder engagement on financing needs, gaps and capacity requirements for delivering a long-term financing pathway.

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[3] Box 1 reflects the insights developed by Chantal Naidoo during her role as Director Environmental Finance at the Development Bank of Southern Africa (DBSA).

Box 1:
An Evolving Diagnostic to Aid Strategic Decisions for Public Policy Financiers

- What are the constituent elements of the LECR plans and their financing needs?
- What resources are required and available for the different stages of implementation?
- What specific resources are needed to finance these sectors, i.e. where are financing gaps?
- Which national and international development partners are best suited for implementation?
- What is the desired role of the financial intermediaries?
- How should risk be allocated between these intermediaries to catalyse investment?
- What are the support structures and institutional mechanisms available and required?
- How do existing international climate finance mechanisms such as NAMAs, GCF Readiness programme and similar initiatives bridge existing gaps within national finance landscape?
- How are these resources accessed by those that require them most?
- What monitoring mechanisms would be best suited to track country's progress?
- What are the key variables that may influence different financing scenarios for LECR implementation relative to competing national priorities?

To summarise, a NFP can provide a continuous learning mechanism for countries to test what resource requirements are needed for implementation of LECR objectives and identify access modalities most effective within the country context. A NFP will require country leadership in defining financing priorities which would help position developing countries in their discussions with providers of climate finance on specific resource requirements in line with country needs, circumstances and priorities.

Using this approach, developing countries would provide clearer "demand" signals for climate finance as compared to the more traditional supply-driven focus on resource mobilisation. As clearly articulated pathways develop, interim mechanisms such as Green Funds can be created to attract and mobilise resources for LECR priorities identified. Whilst there is no blueprint for a NFP, various tools may be useful for assisting countries in design of a NFP, two of which are introduced here and will be further developed in the coming months.

Designing National Financing Pathways

Based on the processes observed in Chile, Colombia and Peru, it is evident that in developing a NFP a fluid approach is necessary which can evolve over time as new priorities, circumstances and resourcing requirements emerge. In addition, provisions for evaluating and integrating lessons learnt, particularly those generated through pilot and demonstration activities should be explicit. As such it is useful to consider three main stages for developing a NFP, in terms of immediate/short-term outcomes (0 – 2 years); medium term outcomes (1 - 5 years) and longer term outcomes (5 + years).

A primary goal will be for ensuring the enabling environment and investment framework evolves in a way that ensures most effective use of public finance – whether domestic or international – in scaling up and mobilizing different forms of private finance. Whilst activities may proceed in tandem, they are likely to be overlapping and so in many cases non-distinct, it is useful to consider a NFP as having three main phases:

Shorter term focus (0 – 2 years):
Building a sustainable support base to finance the implementation

A cornerstone of the short term focus is for consensus-building between National Treasuries, Central Banks and National Planning Agencies through a process of learning and reflection. This will help to identify financing approaches that may be necessary over the medium to long term so that "sustainability" factors are increasingly prioritized.

Such consensus building also enables a "reality check" on the opportunities, barriers, restrictions and resource requirements for both public and private finance. Ultimately, this process should facilitate discussion on priority mitigation and resilience measures to be financed.

An open and transparent dialogue with government, business, investment and commercial institutions, long term investors, microfinance and development institutions is also important to create a unifying vision of the financing challenges. This should also form the basis of a deep and long-lasting partnership with financiers and identify potential roles for different financial actors and maintain their engagement in the implementation over time. Establishing effective dialogues with multiple stakeholders will also help ensure a broad understanding of national climate objectives and financing requirements in a way that can deliver wider social, economic and environmental benefits.

Therefore, this component would include elements that focus on:

i) Engaging Ministries of Finance and Planning, Environment and Sector Ministries on integration of low emission and resilience objectives.
ii) Strengthening and/or establishing institutional arrangements for consideration of financing issues.
iii) Developing a structured dialogue across the public and private finance sectors to create a unifying vision and identifying opportunities, financing instruments and risk mitigation mechanisms, early demonstration of LEDS and climate resilient plans.

Medium term focus (1 – 5 years):
Piloting and building benchmarks to facilitate investment decisions

Prior to mainstreaming LECR into broader development, financial decision-makers will wish to see a period of demonstration to learn about the feasibility of new types of investments as well as to generate understanding of their risk-reward profiles. This is a prudent response, as it would be premature to embed within national systems poorly understood options and alternatives. Hence, the medium term focus should be on developing and piloting sectoral plans and programmes that can demonstrate potential for scaled up and transformational investments. Collectively, these initial learnings would be "fedback" into the ongoing processes and contribute towards the longer term focus and strategy to mobilise new resources.

Therefore, this component would include elements that focus on:

i) Learning-by-doing approach towards attracting and deploying climate finance, for example through sector focused NAMAs.
ii) Creating monitoring and evaluation processes for tracking finance and assessing progress.
iii) Creating a Platform for continuous and deep dialogue with domestic and international financial actors from both the public and private sectors, on priorities for investment and match-making with resources (i.e. enhancing coordination between different financial stakeholders and creating greater visibility of financeable pipeline of projects).
iv) Capturing learning within the policy design process and ensuring effective channels for communicating these widely across relevant stakeholders.

Longer term focus (+5 years):
Create sustainable finance framework to promote a steady long-term transition

Parallel to the consensus building, demonstration and continuous learning processes, it will also be important to draw together different finance providers through a dialogue designed to attract sources of long-term capital. In particular, decision-makers within Ministries of Finance and Planning entities should take the lead in bringing national and international development banks, commercial and investment banks together with institutional investors, financial regulators and the central bank.

Early and appropriate engagement of institutional investors in order to identify potential barriers and solutions for ensuring long-term finance becomes available scaled-up investments in LECR. Working jointly with financial providers, the Government can ensure that the NFP presents a vision and measures for a comprehensive long-term investment strategy that will be necessary to leverage relatively low cost capital from institutional investors.

Therefore, this component would include elements that focus on:

v) Building on stakeholder dialogue to partner with investors on a critical analysis of the ability of the domestic financial sector to finance the pathway.
vi) Financial regulations that may hinder or foster financing of long-term objectives.
vii) Allocating resources to facilitate private sector opportunities in underfunded areas (e.g. natural resource management).

viii) Identifying and testing risk-sharing instruments based on learning generated during the short-medium term phases.

Emerging Lessons for the International Financial Ecosystem

As a NFP will be determined by country specific priorities and circumstances there is unlikely to be a “rule book” to create a national climate finance strategy. However, some common challenges are likely to feature across most if not all countries. Drawing out these common challenges, as well as what has worked in differing country and sector contexts can be valuable information for all.

An overarching feature of NFP is the emerging government leadership in drawing upon available sources of international climate finance more dynamically. In the past the narrative for international climate finance has largely been “supply” driven based on either the priorities of providers of climate finance and criteria for accessing these resources. The NFP represents a “demand” driven approach whereby recipients identify and communicate how international climate finance can best support the implementation and financing of their transition to a LECR development paradigm.

A proliferation of multilateral and bilateral climate finance initiatives have emerged since COP17[4]. Whilst welcome, the multitude of differing procedures for accessing, deploying and reporting of climate finance makes it challenging for countries to benefit from the range of sources of available. The confirmation of the Green Climate Fund as a primary financial mechanism of the UNFCCC[5] in December 2011 triggered a focus on readiness of developing countries for climate finance. A missing link is how these differing international initiatives can provide a coherent and comprehensive package of support at the national level.

A NFP can bridge this gap by providing a country led approach for ensuring that differing international initiatives and sources of climate finance deliver national priorities for LECR development. A NFP can also be useful in identifying and articulating the roles of different financial actors, including how mechanisms such as Green Funds, NAMAs, NAPAs[6], and readiness support can complement and catalyse public and private sector resources from the wider domestic financial system. A NFP would therefore help to contextualize sector and project specific financing mechanisms within a sustained and inclusive financing approach for implementation of LECR objectives over the short, medium and longer-term.

A forthcoming E3G publication will build upon these initial findings and present more in-depth analysis and elaboration of these key emerging elements and specific tools for development of a NFP framework.

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[4] 17th Conference of the Parties
[5] United Nations Framework Convention on Climate Change
[6] National adaptation programmes of action

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