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The future of climate finance: a new approach is needed

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'Climate aid is set up for failure: sums are inadequate and unpredictable, and commitments are unlikely to be met'

Developing countries are being short-changed by the rich industrialised North for the costs of putting right the damage caused by climate change. Current estimates suggest that the global costs of climate change may exceed $100 billion each year (UNFCCC, 2008). Despite the recent proliferation in climate funds, the amount pledged to tackle climate change so far has averaged around $3.9 billion each year, and actual disbursements have been much lower – far below the amount needed by developing countries to mitigate against, and adapt to, climate change impact.

Current funding remains rooted in the Official Development Assistance (ODA) approach that has defined the relationship between the industrialised countries and the developing world for many years: voluntary contributions from the rich to the poor. Climate aid is set up for failure: sums are inadequate and unpredictable, and commitments are unlikely to be met. What is more, climate aid is not backed by proper operational arrangements.

Small wonder there is lively discussion about climate finance in the context of the United Nations Framework Convention on Climate Change (UNFCCC). Many developing countries are hoping for an entirely new approach to financial flows from North to South, based on the principle of 'common but differentiated responsibilities' and the obligations spelled out in Article 4 of the UNFCCC, whereby developed countries have pledged to support developing country efforts. Agreement on how to address this obligation is seen as critical for the success of the UN Climate Change Conference in Copenhagen later this year.

What is being negotiated?

The UNFCCC discussion on the future of climate finance has three strands:

- **Revenue raising:** who pays, and how?
- **Governance:** how are the funds managed?
- **Revenue disbursement:** how are funds distributed and used?

The first strand is receiving a great deal of attention. So how do we raise revenue to support developing countries in a way that is adequate, predictable, and based on the 'polluter pays' principle? Several innovative models move away from conventional ODA, where the funds come from public expenditure, funded from domestic revenue streams as part of national budgets. The widespread use of these innovative mechanisms would mark a shift in political thinking in the North, with climate finance seen as obligatory rather than voluntary. Three models – which are not mutually exclusive – could have potential:

1. The international auctioning of emission allowances;
2. Levies/taxes on emissions from international shipping and aviation (a levy on CO_2 emissions from fuels), or on air travel (related to passenger travel and levied on airline tickets); and
3. A levy on market-based mechanisms under the Kyoto Protocol.

The auction of emission allowances (the Norwegian proposal)

All Annex I countries (industrialised countries that are signatories to the UNFCCC) receive a number of greenhouse gas units to release and/or trade. These are known as Assigned Amount Units (AAUs) in line with the Kyoto Protocol of the UNFCCC. The underlying funding principle is to auction a share of these AAUs at the international level to generate revenue, rather than giving them out for free to companies in Annex I countries. This is the basis for the Norwegian proposal – noteworthy because the money raised is 'international' and generated outside national governmental budgets. While some estimates suggest that this could raise $20-30 billion each year, the actual yield is uncertain, because the price paid for the AAUs held back for auctioning would be determined by the international carbon market. This uncertainty could be overcome if a reserve price were set to guarantee a minimum level of finance. The principle of holding back AAUs may well become part of the EU's negotiating position for Copenhagen (EC, 2009). But reserve prices established to deliver greater and

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more predictable levels of finance will face resistance from developed country governments, as costs would be passed on to their consumers, while rents would be captured elsewhere (Pendleton and Retallack, 2009). Therefore, while there is strong political support for the auctioning of AAUs, it would be wrong to assume that predictability problems will be overcome by setting a reserve price.

Levies/taxes on emissions

Charges or levies could be applied to air travel, aviation emissions, and/or maritime emissions. There are a few proposals that fall under this model; two of the most widely discussed are the International Maritime Emissions Reduction Scheme (IMERS) and the International Air Passenger Adaptation Levy on fuels (IAPAL). Similarly to the Norwegian proposal, these proposals are innovative in that the funds raised are 'non-national' and cannot easily be traced back to any single Annex I country. Funds estimated for the IAPAL and IMERS proposals may well be significant (ranging from $8 billion to $10 billion per year). Currently, international aviation and shipping are not considered to be part of any particular country's CO_2 emissions, and are completely outside the remit of the Kyoto Protocol. However, levies and taxes on emissions from international maritime and aviation transport may be affected by the global financial slowdown. There has already been a global fall in shipping and air travel, reducing the potential revenue from such a levy. However, these proposals may be more reliable than proposals that tie the revenue to the carbon market, which is likely to fluctuate even more than passenger travel (Muller, 2009).

A levy on carbon market-based mechanisms under the Kyoto Protocol

Climate finance can be generated by applying a levy to the Kyoto Protocol's tradable units of CO_2 generated from the Clean Development Mechanism (CDM), Joint Implementation (JI), or emissions trading. The 2% CDM levy mechanism used to raise funds for the Adaptation Fund is one example. The level of revenue generated from mechanisms linked to the carbon market depends on (a) the evolution of the carbon market in terms both of quantity and price, and (b) on the level of binding commitments made by Annex I countries. The higher the commitments, the more revenue that can potentially be raised from the carbon market for developing countries.

Carbon market-linked mechanisms are likely to experience major fluctuations in revenue generation, corresponding with fluctuations in the price of carbon. There have been very sharp drops in the price of carbon as a result of the global economic downturn. The fall in prices stems from concerns over liquidity, with struggling companies selling their emissions permits to bring in much-needed cash, and reduced economic activity leading to a reduction in CO_2 emissions, which has caused a decline in carbon prices. There has been a reduction in industrial activity. Steel production in the European Union, for example, has halved in the last year. This means that carbon traders have slashed their forecast for emissions under the EU Emissions Trading Scheme (ETS) by 500 million tonnes for the 2008-2012 period (GTZ, 2009). Any levy on international emission trading is bound to be affected by this precipitous drop as recent information on the level of revenue generated for the Adaptation Fund shows. As of March 2009, the Adaptation Fund has 5.3 million Certified Emission Reductions (CERs) in its accounts. These are likely to be worth far less than originally forecast, given (a) the recent drop in the price of CERs, and (b) overly optimistic assumptions about the sale of CERs. To date, 265 million CERs have been sold annually, far below the UNFCCC estimate of 300-450 million. Such fluctuations are likely, therefore, if funds are raised through another levy on carbon market-based mechanisms.

Conclusion

Each of these three revenue models has different implications in terms of reliability, predictability and equity. Whatever future scenario emerges, developing countries face a major challenge on climate funding. If no international agreement is reached at Copenhagen, donor governments are likely to continue to rely on the current voluntary 'band aid' funding model, and the needs of developing countries will not be met. This would represent a very poor global outcome. What is needed is a significant shift in the political thinking of the North, with industrialised countries acknowledging their financial obligations to the developing world by taking up one or more of these innovative financial mechanisms. This would unlock significant new funding that developing countries need, as a matter of urgency, to adapt to climate change.

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References and useful links

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Pendleton, A. and Retallack, S. (2009) 'Fairness in Global Climate Change Finance'. London: Institute for Public Policy Research (IPPR).

UNFCCC (2008) Investment and financial flows to address climate change: an update. FCCC/TP/2008/7

Useful links:

Certified Emission Reductions:
http://cdm.unfccc.int/Issuance/SOPByProjectsTable.html

Climate change funding:
www.climatefundsupdate.org

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