

Financing for Climate Change

BIAC Thought Starter

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Introduction

To take decisive action against climate change, a coherent global response is essential. The provision of sufficient financing for addressing climate change across the world is a critical dimension of such a response. One notable achievement which emerged from COP 16 in Cancun was an agreement to set up a Green Climate Fund, which will channel money to developing countries to help them with their efforts in reducing emissions and countering the impacts of climate change. However, the vast investments that are necessary in greener technologies and infrastructure cannot be initiated through public financing alone. The role of private financing and investments is crucial, and well recognised by the business community. However the important role for these private sector investments is still underestimated or misunderstood by too many countries. Hence an investment-friendly framework is essential to create suitable incentives for businesses and institutional investors.

In this paper, the term “financing” refers to investments where the investor, e.g. shareholder or financial institution, provides capital with the expectation of making a return on their investment. “Funding” can be provided through a financial arrangement, but also includes direct contributions from governments and others in the form of grants, subsidies and loan guarantees.

Private sector interest in financing for climate change

A shift towards environmentally-friendly business models should reward companies in the long term through opportunities on both the supply side and the demand side. As consumers become increasingly aware of, and responsive to, the environmental impact of products and services, it can be profitable to respond to these preferences. Businesses themselves are interested in developing more sustainable production patterns, as more efficient use of resources is important for their long-term profitability and viability.

Business has already allocated significant resources towards developing greener solutions. The 2010 OECD publication, *‘Transition to a Low Carbon Economy: Public Goals and Corporate Practices’*, is useful in highlighting the vast range of measures that have been employed by the private sector in recent years. Many companies across a wide variety of

sectors have made major capital investments in infrastructure and low-carbon technologies, in order to remain at the forefront of their fields. Additionally, some have taken the lead in establishing research and manufacturing centres in emerging and developing countries, often in conjunction with schools and universities, thereby contributing to the upgrade of local manufacturing and technological capacity.

There has also been increased interest, in recent years, among institutional investors, such as pension funds, insurance companies, asset management companies and banks, which are all considered major potential sources of financing. This is due to increasing recognition of the potential of innovative companies and sectors as attractive long-term investment targets. However, capital availability in a range of low-carbon technologies, including offshore wind, nuclear, CCS and their required energy infrastructure is often still a constraint that leads to implementation delays.

Although there should not be an over-reliance on 'green funds', these have become increasingly instrumental in directing investment to companies and sectors, resulting in greater funding support for green projects. The remaining challenge is to create a framework that encourages and incentivises business and institutional investors alike to increase the scale and the quality of their investments.

Challenges to be addressed

- **Lack of globally effective commitment on climate change policy**

The unequal application of climate change policy, given the complex value chain structures of a globalised economy, has raised competitiveness issues, which can result in carbon leakage. Great variation in regulation across regions can push companies, especially within energy-intensive sectors, to shift to markets which do not have a CO₂ price.¹ The consequence of this is that global carbon emissions are not reduced, or can even increase if the shift leads to increased transportation requirements to deliver products to their original markets. In many instances, the carbon leakage is also increased as the production shifts to countries with substantively more carbon intensive infrastructures. The opportunity to relocate dampens the incentive to invest in climate change solutions and creates unintended consequences for net global GHG emissions.

It is important that businesses have the information they need to plan and initiate the large-scale capital investments in infrastructure and cleaner technologies necessary to increase energy efficiency and to substantially reduce carbon emissions. In recognition of the importance of national policy, international agreements should enable clear and inclusive frameworks for execution in national systems. Without any realistic estimate of the potential long-term value that an investment made by a company in low carbon technology can provide, it will be difficult for companies to justify major investments. Likewise, institutional investors often lack a clear indication of the expected return of these investments if rules change in the future. A coherent and long-term policy framework to address climate change

¹ See BIAC 2010, 'BIAC Thought Starter – Competitiveness Impacts and Carbon Leakage' (Oct 2010).

is particularly important for the planning and implementation of large-scale investment projects, both domestically and abroad.

- **Country and region-specific challenges**

Many businesses have contributed very positively towards the development of green technology in emerging and developing economies, yet various barriers have been identified which limit the full impact of this technology contribution. Many of these barriers are not specific to green technology. Direct protectionist barriers can serve to limit the freedom of investment, though there may also be indirect barriers that would necessitate further capacity-building or regulatory reform. For example, some regions lack organisational capacity to deploy significant capital and to organise major infrastructure delivery, as well as having a shortage of skilled labour. Sound policy and regulatory frameworks to guide commercial operations are frequently lacking. Many regions also suffer from a lack of sufficient intellectual property right (IPR) protection, which discourages innovation and the spread of technologies. The absence of local markets limits the development of competition, customer bases, price signals, and therefore investment more generally. Where this market barrier is impacted by the size of the country, regional solutions that increase the potential market should also be encouraged.

- **Uncertainties in financial investment environment**

Businesses and institutional investors are highly influenced by the dominant market conditions. Overall investor confidence remains fragile due to the continued volatility in financial markets. The uncertain economic outlook adds to the risks faced by companies when making major investment decisions. The business community appreciates progress made concerning financial sector reforms as requested by the G20. However, additional risks need to be addressed, such as companies' access to the long-term financing they need to invest and innovate. Financial institutions are dealing with additional uncertainty with respect to global regulatory and governance issues (e.g., capital availability as a result of upcoming Basel III regulation, in particular for long maturity capital). There are also concerns about possible impacts on trade finance. At the same time, too much and too stringent international regulation could cause financial institutions to withdraw investment from certain markets or projects, some of which may be particularly important for climate change solutions.

A forward-looking policy framework

Looking ahead, a framework that offers clear signals and incentives is required. BIAC has identified the following elements that should be taken into account in such a framework.

- 1. Secure an effective global commitment on climate change**

The discussions in Cancun have demonstrated progress and highlighted the importance of both public and private sector financing for climate change. While these discussions are

positive, a globally effective agreement should continue to be pursued. The clarity provided by greater global commitment, transparency and coordination would give an enormous incentive for businesses and institutional investors alike to undertake substantial investments in low-carbon solutions. Such commitment needs to be backed up with standardised approaches to carbon pricing and accounting. In this respect, particular attention should be paid to options to globalise carbon markets, by introducing and linking regional emission trading schemes (ETS). Timely global action is also necessary to combat the possibility of carbon leakage.

2. Improve overall investor confidence

Investor confidence is critical to drive financing into climate friendly technologies, and a sustainable economic recovery. Longer-term policy certainty, macro-economic stability, good governance, transparent legal systems, sound competition policies, effective anti-corruption measures and secure taxation regimes are all desirable to create this basic investor confidence. In this context, governments should build on the OECD Policy Framework for Investment and do more to design and implement the strong, stable, transparent and coherent policies required to increase overall investment flows. At the same time, behavioural barriers, such as lack of awareness and understanding of climate-friendly technologies, need to be addressed. High-quality information needs to be available for institutional investors to commit substantial sums of money.

3. Support regions in capacity-building

In emerging markets and developing economies, government policies designed to increase technological capacity are critical. These could range from having sound domestic economic and investment policies that can advance the development of local markets, to committed health and education policies that foster a strong and skilled workforce. Countries that have already reached a certain level of technological capacity are likely to attract more technology transfer from abroad, and therefore governments should place innovation and skills development as high priorities. Some pre-existing demand for technology within a country is important to initiate further investment. The UNFCCC Clean Technology Centre and Network (CTCN) should be designed to provide greater information on which technologies are most appropriate for the local context, how these can be accessed, and how technological capacity can be increased. The mechanism should not undermine intellectual property considerations. Business involvement in all aspects of the CTCN, globally, regionally and within countries, as well as in the development of CTNC arrangements, is essential.

4. Use public funding to leverage private financing

Relatively small steps taken by governments have the potential to initiate vast quantities of private investment in green projects. According to OECD, experience with the Global Environmental Facility (GEF) shows that public funding on climate change mitigation can leverage private investment by a factor of 7:1 or more.² One of the most crucial elements of public funding is therefore to consider how it can be targeted to effectively leverage greater private financing. A forward-looking policy framework must pay significant attention to this.

² Corfee-Morlot, Jan.(2011). "Financing Climate Change Action and Boosting Technology Change". OECD Policy Brief. 2011.

The Green Climate Fund should be developed to maximise the potential to leverage private sector financing. Due attention should also be given to the role of public procurement.

5. Foster transparency and equal treatment of technologies

Public funding should be used with care and in a way that does not violate the key principle of technology neutrality, i.e. maintaining all technology options open. It is important not to 'pick winners' by targeting specific generating technologies directly. For example, in order to leverage private financing for specific National Appropriate Mitigation Actions (NAMAs) or part of the activities under a country-specific NAMA, it is important to first identify why this activity is not already financed on commercial terms, and whether other investment barriers need to be addressed. Funding mechanisms should contain clear, objective eligibility criteria for financing, project selection and linkage to NAMAs.

Public funds should be used as efficiently as possible and in a transparent manner. This is especially important in the emerging and developing country context where the risk to private investment may be greater. It is the traditional role of the private sector to accept such risks and benefit from the rewards of successful commercialisation. Procedures will be needed to assure that firms from different countries can compete for resources that promote actions in any nation, operating companies and suppliers from firms in donor countries are not penalised, and countries respect contractual commitments.

6. Improve the effectiveness of existing mechanisms

Important offset mechanisms such as the Clean Development Mechanism (CDM) have undergone a number of developments and continue to be part of the solution. The CDM has, during its existence, provided investment/financing for several thousand large and small-scale emission reduction projects in developing countries, brought about local community involvement as well as led to the development of monitoring, reporting and verification methodologies. It has initiated an avenue for the investment and financial community to invest in climate change mitigation and provide new sources of financing. With several thousand new projects in the pipeline, it is essential that these opportunities are not lost and that the CDM continues. The CDM process should be maintained irrespective of whether there is a second phase of the Kyoto Protocol. We should also encourage additional innovative financing mechanisms and explore how new approaches such as the bilateral mechanisms set up by Japan can be used more broadly.

7. Foster clarity concerning international financial regulation

For the private sector to meet investment expectations, stable financial institutions and a clear policy framework for these institutions are essential so that they can provide effective financing opportunities. The business community appreciates the progress made on the reforms requested by G20 concerning financial markets. Clarity concerning international financial regulation is crucial. The G20 can play an important role in this respect in order to restore confidence to investors while also strengthening the long-term sustainability of the global financial system. However, there are additional risks that need to be addressed, including the impact of reforms on companies' access to the long-term financing that is needed to be able to innovate and make the necessary investments to address climate

change. The impacts on access to financing, including for small and medium-sized enterprises, need to be carefully evaluated.

8. Improve effective financing and risk mitigation instruments

Improvements can be made to the framework conditions for business investment and by offering a portfolio of capital and risk mitigation instruments. A range of different methods, including public-private partnerships (PPPs), mixed credits, tax credits, grants, equity, soft loans, public concessionary loans or equity, loan guarantees, 'green' procurement, and other suitable instruments can be used. Loan guarantees can close financing gaps giving businesses greater confidence when considering new sustainable projects, and this can reduce risks that may be more profound in the emerging and developing country context. Mixed credit schemes, which mix traditional grant aid and commercial loans, help mobilise funds for projects that are financially non-viable and would therefore not be carried out without financial subsidies. A mixed credit facility can enable development projects that cannot be financed under normal market conditions to be carried out at the lowest possible cost.

9. Foster public-private partnerships

PPPs are particularly useful in ensuring a fair risk allocation among public and private partners. Additionally, they can be used to stimulate investments in large infrastructure that will be a prerequisite to enable the dissemination of climate change mitigation technologies, such as carbon capture and storage. There are a number of ways where PPPs can address a specific challenge in a pro-active and cooperative way. For instance, PPPs could be used in expanding the electricity grid infrastructure, which is essential in almost all parts of the world to accommodate for a higher degree of intermittent energy sources, which are not continuously available. PPPs can also play a key role in facilitating investment in capital intensive renewable energy such as wind, hydro and solar and nuclear power.

Conclusion

Climate change and the policies designed to address this major challenge have an inevitable impact on investment decisions. The correct incentives need to be in place for greater climate-friendly investment to emerge. Beyond the scope of pure financing, business should work with government and research communities to assist them in: providing feedback to identify effective policies; ensuring an appropriate market framework is in place; developing local markets; aligning regulatory systems to attract investment; assessing technology needs; as well as planning of clean infrastructures. BIAC encourages the OECD to work with the business community to address the above-mentioned priorities to help address the risks faced by businesses and institutional investors and ensure that the necessary funding can be mobilised through an enabling investment framework.