Why linking the CDM with the GCF is a good idea

Combining the forces of public and private actors to scale up climate action in a post-2020 climate framework

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While the CDM has been suffering from neglect in the last years, the Green Climate Fund (GCF) has been prospering. We make the case that by combining their strengths, both institutions together could reach the scale that is necessary to deliver on the ambition of the Paris Agreement (PA)[1]. The GCF is poised to become the key UNFCCC vehicle for large-scale, public international climate finance, but it is still at an early stage of its institutional evolution and can benefit from approaches developed under the UNFCCC's CDM for over a decade. Linking the two institutions can strengthen the results-based focus of climate finance, help leverage private capital, and pave the way for future demand for carbon offsets both pre-2020 and under the Paris Agreement. Formal discussions should be initiated between the CDM Executive Board (EB) and the GCF Board, showing commitment from both sides to progress on harnessing synergies, and communicating confidence to carbon market participants and host country governments.

The PA has redefined the global climate policy architecture. It provides a new universal, legal framework that strengthens the global response to the threat of climate change (Art. 2) by establishing that all Parties contribute to climate change mitigation and adaptation. At the same time, it builds on the vast landscape of existing institutions and experience that have evolved within the UNFCCC process over the years.

To achieve the huge ambition of the PA – keeping global warming "well below" 2°C, or even 1.5°C, rapid implementation of large-scale mitigation action is urgently needed. Leveraging existing carbon markets and strengthening climate finance institutions is vital to achieve the scale of finance needed to trigger the transition towards low carbon development. Recognising this, Parties decided that successful elements of existing market mechanisms should serve as the foundation for the future mechanism established under Article 6.4 of the PA.

The CDM – one of the flexible mechanisms introduced under the Kyoto Protocol (KP) – has generated over 1.6 billion CERs and became the unexpected early success story among the Kyoto Mechanisms. The mechanism successfully attracted private sector investment in projects hosted in developing countries and created an internationally recognised framework for realising mitigation action. While the lack of Annex I mitigation ambition, among other factors, led to a crash in Certified Emission Reduction (CER) prices, the CDM's methodological toolbox has evolved significantly over time, broadening its sectoral scope and introducing programmatic and standardised approaches. The

1 *This article summarises the findings of an ongoing research initiative supported by the German Federal Ministry for the Environment, Nature Conservation, Building and Nuclear Safety (BMUB) that explores the possibilities of supporting CDM activities on the African continent.*

Harnessing the synergies – experience gained with the CDM could serve the GCF in many ways.

mechanism delivers unique experience on implementing mitigation action in developing countries in a transparent, verifiable and independent way. It can also serve as a framework for results-based climate finance when linked to voluntary CER cancellation, thereby moving beyond its original role of providing CERs for Annex I countries.

As such, the potential for harnessing synergies between the CDM's measurement, reporting and verification (MRV) framework and climate finance is emerging. We argue that the CDM's MRV standards can support the GCF in demonstrating the mitigation impact of its interventions. This is becoming even more relevant, as host countries are expected to report their national contributions to the PA in a transparent and comparable manner. Moreover, the market-based design of the CDM and familiarity amongst private sector investors can also support the GCF in leveraging private capital.

Status Quo

While the rise and fall of the CDM is well documented, the mechanism should not be written off prematurely. While uncertainty with regard to its role in the post-2020 climate landscape impairs the marketability of CERs, initiatives are underway to revive the mechanism. 2016 is set to be an important year in this respect, as the discussion of linking the CDM with climate finance has become a formal agenda item set by the CMP.

In Paris, the CMP11 encouraged the CDM EB to explore new opportunities for the CDM through international climate financing channels, and report back to CMP12 in Marrakech.[2] The UNFCCC Secretariat has in the meantime identified four main areas in which the CDM can contribute to global mitigation efforts, including linking the CDM with NDCs and positioning the mechanism as an MRV tool to enable credible and transparent results-based climate finance, including from the GCF.[3] In March 2016, the CDM EB issued a call for public input on these options. Furthermore, the CDM EB hosted an in-session workshop to further explore the topic during SB44 in Bonn.

At the same time, the COP requested the GCF to actively collaborate with other UNFCCC bodies.[4] In response, the Fund has acknowledged the need to develop an engagement strategy with "relevant thematic bodies established under the Convention" to draw on expertise and lessons learned to date.[5] The CDM already features as one of the four potential financing instruments that the Fund's Private Sector Facility (PSF) – the Fund's arm for mobilising private sector action – could use to leverage private sector capital. The GCF furthermore recognises that the mechanism has created a 'credible and transparent framework for results-based financing of low cost mitigation activities'.[6] The PSF Business Model Framework also proposes the use of CER price guarantees for certain types of CDM activities (e.g. energy access). Elaborating these options would certainly strengthen confidence in the CDM and direct private sector investment to low carbon development.

Aside from this reference to the CDM released in June 2013, the GCF has been cautious in formally taking a position. This reservation is surprising as the Fund's Governing Instrument, adopted during COP 17 in Durban in 2011, clearly recognises the value and necessity of building on established UNFCCC mechanisms. Specifically, it calls on the Board to "develop methods to enhance complementarity between the activities of the Fund and the activities of other relevant bilateral, regional and global funding mechanisms and institutions, to better mobilise the full range of financial and technical capacities".[7] The GCF already embraces results-based climate finance in support of forestry and land use activities. Operational guidance is under development to be discussed during the 14th GCF Board meeting in October 2016. This presents a timely opportunity to open a broader discussion on results-based finance and the role complementary UNFCCC mechanisms including the CDM can have in it.

Merits of collaboration

Having currently received pledges of USD 10.3 billion, the GCF is committed to award up to USD 2.5 billion in funding annually from 2016 onwards. Despite this ambitious objective, no coordinated approach to methodologies for assessing the mitigation impact of GCF-supported activities exists to date. The Initial Results Management Framework (RMF) of May 2014[8] lays the foundation for the Fund's MRV requirements and includes indicators to measure progress toward results, yet lacks concrete baseline and monitoring methodologies. Insufficient clarity on how GHG mitigation impact will be tracked in GCF funded projects and programmes undermines the effectiveness of the appraisal process and may lead to ambiguous outcomes regarding mitigation benefits of funded projects. The current lack of a unified and recognised standard for implementing MRV can also discourage participation of specialised investors that require credible proof of the achieved mitigation. Furthermore, de-politicised approach to eligibility ingrained within the CDM is one important factor that has helped to encourage the private sector's interest to engage with mitigation activities in developing countries.

The CDM's tried and tested MRV system is available 'off the shelf'. With over 200 methodologies, it can cover the vast majority of mitigation projects potentially submitted to the GCF. While these may need to be simplified in some cases, they can provide the quality needed to support the GCF with achieving credible mitigation results. By incentivising project implementers to apply CDM MRV standards, or directly supporting "high-quality" CDM activities with scale-up potential and clear sustainable development co-benefits, the GCF can achieve four objectives:

2 *UNFCCC. Guidance relating to the clean development mechanism. December 2015*
3 *CDM. Options for using the clean development mechanism as a tool for other uses. March 2016*
4 *UNFCCC. Report of the Conference of the Parties on its seventeenth session. March 2012*
5 *GCF. Relationships with Relevant UNFCC Thematic Bodies, as well as Other Climate Finance Entities and External Bodies. October 2014*
6 *GCF. Business Model Framework: Private Sector Facility. June 2013*
7 *GCF. Governing Instrument for the Green Climate Fund. December 2011*
8 *GCF. Initial Results Management Framework. May 2014*

Into the light – the CDM's MRV toolbox offers transparency and recognition.

I. Strengthen the results-based focus of climate finance

Compared with the current application of "home-baked" mitigation methodologies by Accredited Entities under the GCF, use of the CDM's robust MRV framework can demonstrate the mitigation impact of climate finance channelled through the GCF. Ongoing efforts to standardise and simplify CDM methodologies and procedures will further enhance the value of this UNFCCC-approved framework to the needs of climate finance. By strategically collaborating with the CDM on the MRV issues, the GCF can achieve results-based finance without spending a huge amount of time and resources to 'reinvent the wheel'.

II. Leverage the existing CDM pipeline

Demand for CERs has dropped precipitously in recent years as a result of insufficient mitigation ambition, and the CDM is struggling to stimulate new mitigation investments. By extending revenue support to additional, high quality CDM activities that have stalled operations or are at risk of discontinuation due to the lack of CER revenues, the GCF can rapidly generate a pipeline of GHG mitigation activities commensurate with its high ambition to mobilise mitigation action.

III. Attract new sources of (private) climate finance

Given its decade-long track record, private sector investors have become acquainted with the CDM and value its de-politicised modus operandi. By directly supporting high-quality CDM projects, the GCF can strengthen its capacity to leverage private sector investment. Furthermore, institutional investors are increasingly interested in understanding the impact their funding has on GHG emissions. Lack of internationally accepted definitions and unified standards for green investments and achieved GHG mitigation impact are one reason green investment opportunities fail to materialise. The CDM can support the GCF in delivering an internationally recognised MRV framework that enables investors to link investments to GHG mitigation.

IV. Pave the way for future demand

If governments are serious about the high ambition of the PA, all sensible mitigation options need to be mobilised. This means that market mechanisms and climate finance need to work "hand in hand" to increase mitigation supply by an order of magnitude. Only by building on each other's strength can the Paris Mechanisms and international climate finance institutions achieve this quantum leap.

Engagement models

How can the GCF and the CDM be 'married'? Our study has identified five potential engagement models that build on the GCF's funding instruments: grants, concessional debt, green bond financing, equity finance, and price guarantees. Depending on the model, CERs are either used as financial instruments or proof of realised mitigation benefits.

I. Grant financing

This first model, which is particularly relevant for small activities with high co-benefits, would build on a straightforward financing arrangement between the GCF and CDM project implementers. Grant disbursements would be linked to projected GHG impact when delivered upfront or directly to the volume of issued CERs. Grant-based seed capital support could be applicable to the early development stage (e.g. targeting feasibility assessments, initial exploration activities, etc.) or during the financial structuring of the activity, where a funding gap prevents the project implementer from reaching financial closure.

II. Debt funding

The second model – which is attractive for mitigation actions that are able to mobilise a substantial volume of equity – pegs the debt terms and conditions to CER generation. The GCF could extend loans to CDM activities with a variable spread that is linked to CER volumes and affects the concessionality of the finance. Following an initial grace period, the offered interest rate would be adjusted annually based on the amount of CERs that are cancelled by the project implementer. This would create a 'win-win' situation: the project implementers could use the option provided by the GCF to monetise CERs through a discounted interest rate. Still, they could also revert to selling CERs to the market should the monetary benefit exceed that of the concessionality of the GCF's funds.

III. Green bond financing

For very large projects, the GCF could support credit enhancement by extending a credit guarantee to cover a portion of the debt marketed through a green bond. As a result, the risk of default would be reduced and the credit rating of the bond could be improved, allowing institutional investors to engage. Similar to the standard debt model, the issuance success rate of CERs could be used to determine the level of a floating coupon rate. As typical institutional investors are unlikely to accept a variable coupon rate linked to GHG mitigation results, the GCF could step in to 'top-up' the coupon payments in the event of CER cancellation. When monetised on the market, issued CERs would not impact the coupon rate and the GCF's involvement would be restricted to the original credit guarantee.

IV. Equity financing

For projects of various sizes, the GCF could deliver 'concessional equity', whereby it foregoes its portion of the dividends paid out in cash and in turn accepts payment in CERs, which are cancelled upon issuance. Any remaining CERs could be sold to the market. CER issuance success could also be linked to the GCF's exit strategy. To maximise impact of invested capital, the GCF could invest its funds under the condition that it can withdraw its contribution if CER underdelivery on the portfolio level exceeds a certain percentage. In the event of long-term underperformance, the GCF could revert to an exit clause to avoid tying its funds to an investment that fails to deliver on the promised impact potential.

V. Price guarantees

For experienced CDM project developers, it would be attractive if the GCF provided a put option for CERs, thereby de facto establishing a floor price which enhances investment certainty. If the market price is higher than the option, developers would sell the CERs on the market. This model, already applied by the World Bank's Pilot Auction Facility, has proven its ability to revive stalled activities, and is very close to the PSF model described above.

Looking ahead

In this article we argue that greater engagement between the GCF and the CDM can scale-up mitigation action, both leading up to 2020 as well as in the new climate framework. We believe the debate between national governments, accredited entities, project implementers and other stakeholders on linking the CDM and the GCF is a key success factor for delivering on the urgent need for far-reaching mitigation action as agreed in the PA. We argue there are clear reasons why linking the two institutions would be mutually beneficial, and offer engagement models for how this can be done in practice.

This debate is currently still at an early stage and would benefit from a wide exchange of views and actual practical experience. Today there are still no precedents on how the GCF may leverage projects and methodologies of the CDM. As part of our research initiative we are both exploring top-down models of engagement (a study is underway) as well as initiating bottom-up proposals to the GCF in support of high-quality CDM activities in Africa.