REDD+ Expert Dialogue 7

Results-based Finance for REDD+: Emerging approaches

Prepared by Climate Focus

December 2015

Introduction

Forests play a crucial role for our global climate. Stopping deforestation will be key to slowing climate change and protecting the essential roles of forests for our environmental, social and economic wellbeing. The problem of deforestation has received unprecedented attention in international climate negotiations. For more than a decade, parties to the UN Framework Convention on Climate Change (UNFCCC) have been negotiating REDD+, an incentive mechanism to reduce emissions from deforestation and forest degradation and several "plus"-activities including sustainable management of forests, and the conservation and enhancement of forest carbon stocks.

KfW has a particular interest in REDD+ and implements the "REDD Programme for Early Movers" (REM), an initiative of German official development assistance (ODA). REM targets countries or regions that have already taken action to protect forests, and provides finance for verified emission reductions

This brief aims to shed light on the current landscape of Results-Based Finance (RBF) for REDD+, providing an overview of concepts, rationales and key features, and discussing challenges from the perspective of recipient and donor countries. It summarizes the first of a series of studies that were commissioned by KfW and prepared by Climate Focus. The views expressed in this paper are those of the author and not necessarily of KfW.

What and why?

RBF is an innovative approach towards ODA. It conditions payments on the achievement of particular results. In the case of REDD+, finance is conditional upon a reduction of greenhouse gas emissions from forests. Rather than financing specific actions that lead to emission reductions (ERs), e.g. measures to protect forests, RBF provides an ex-post reward and therefore incentivizes a REDD+ country (the recipient) to take these actions. Arguments advanced for REDD+ RBF are that it can:

- Incentivize performance and increase ambition;
- Strengthen ownership of the recipient who is responsible for the manner of achieving results and the use of finance;
- Reduce transaction costs for donors and recipients, with donors less involved in operational details than with traditional input-based funding;
- Improve monitoring of results (emission reductions);
- Improve the efficiency of donors' funds, by transferring some of the risk, including for cost efficiency, to the recipient;
- Pilot approaches that could lead to a scaling-up of finance.

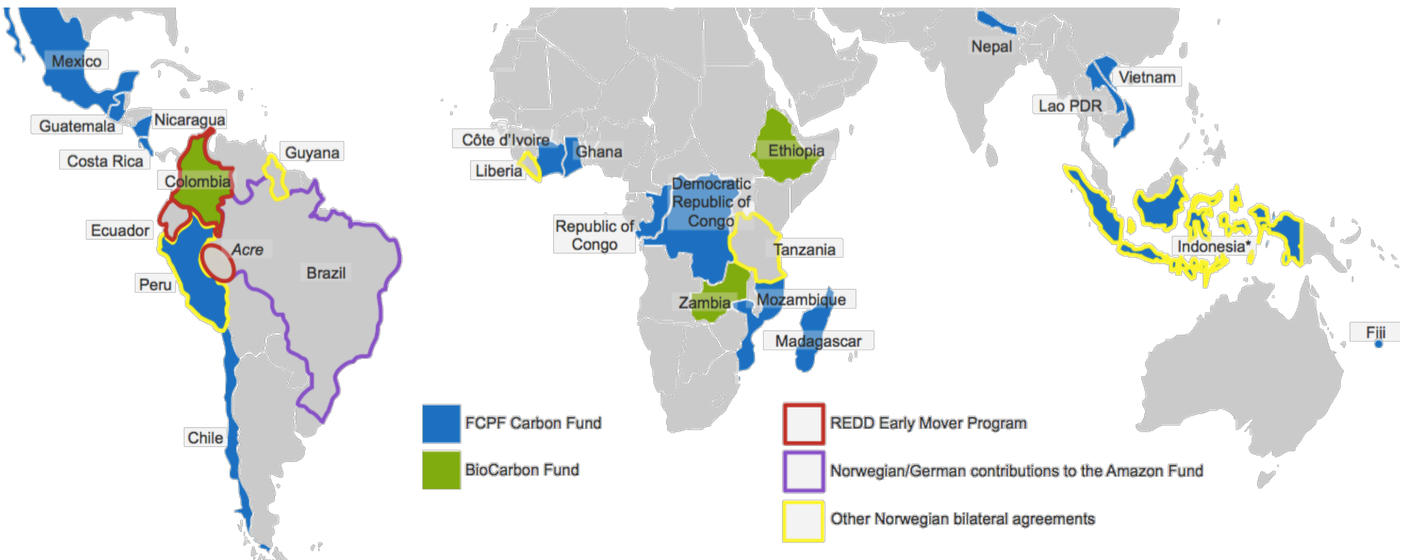
Landscape of initiatives

Internationally agreed rules for REDD+ RBF adopted under the UNFCCC have been agreed relatively recently, and do not provide operational levels of detail. As such, donor programs for results-based REDD+ have mostly developed outside of UNFCCC negotiations, yet strive for consistency with UNFCCC decisions.

The map below shows the landscape of initiatives and existing agreements for RBF:

- The **Norwegian International Climate and Forests Initiative** (NICFI). To date, approximately USD 2.7 billion has been pledged in RBF to Brazil, Indonesia, Guyana, Peru and Liberia. Just over USD 1 billion has been disbursed, mostly through contributions to Brazil's Amazon Fund (with additional contributions from Germany and private sector).
- The **German REDD for Early Movers Programme** has a current volume of EUR 56.5 million, expected to increase significantly during the coming year. Additional financing is committed by Norway and the UK, and other donors are expected to join. The Brazilian State of Acre was the first jurisdiction to receive RBF from REM, so far amounting to more than USD 23.5 million. Other partnerships are in preparation.
- Two large-scale multilateral initiatives, the **Forest Carbon Partnership Facility** (FCPF) through its **Carbon Fund** and the **BioCarbon Fund's Initiative for Sustainable Landscapes** (ISFL). To date, there have not been any RBF transactions or payment agreements. Participants of the Carbon Fund recently expanded its pipeline to 18 candidate countries (The map includes countries that were at least provisionally included.). The ISFL so far accepted three countries.

Several other bilateral and multilateral initiatives provide REDD+ finance (e.g. the Forest Investment Program administered by the World Bank), supporting countries in the preparations of systems to access and manage RBF, as well as in investments for forest protection and sustainable use.



Rationale for results-based REDD+ finance

Early thinking on REDD+ was that reducing tropical deforestation would provide a quick and cost-effective way to reduce global greenhouse gas emissions. Its role would be to contribute towards the costs of reduced deforestation, expressed variously as a combination of opportunity costs (e.g. forgone profits from agricultural commodity producers), enforcement and transaction costs.

Greater experience engaging with the complexities of deforestation as well as the non-emergence of a forest carbon market at scale however prompted a shift in thinking. Evidence from Brazil's successful reduction in deforestation indicates that domestic political will and substantial investments have been key factors. REDD+ incentives have been just one (though important) incentive within a complex mix of political-economy considerations leading to this outcome.

Current RBF initiatives therefore build on the self-interest of recipient countries that intend to transition toward low-deforestation development. REDD+ RBF provides an additional incentive to embark on this transition. Across all initiatives assessed for this brief, none consider RBF as compensating opportunity costs, but rather incentivizing and rewarding results.

Key features of existing REDD+ RBF initiatives

While all RBF programs seek to create incentives for reducing forest-based emissions, there are important differences as to how REDD+ finance is expected to support the transition of developing countries towards a low-deforestation pathway. In the following we compare key features of bilateral agreements (Brazil with Norway and Germany through the Amazon Fund, Guyana and Indonesia with Norway, and REM financed by Germany, Norway and UK) and the Carbon Fund. Modalities for the ISFL and other bilateral partnerships are still in preparation and are therefore not included in this comparison.

Defining results. REDD+ results are expressed in tons of greenhouse gas emissions, calculated from changes in forest cover and assumed emission factors. To date, all disbursement has focused on gross deforestation results, and no payments have been made for afforestation, reforestation or reduced degradation of forests. Some initiatives finance "older" results or "early action" ERs achieved several years before the RBF agreement. Some also provide finance, against interim results, such as political milestones. It is important to distinguish such results from the central REDD+ results of achieved emission reductions.

Changes in forest cover are measured against a reference level, i.e. a performance benchmark against which to compare current deforestation rates. Reference levels can be set based on historical average rates, generally the most conservative approach. Historical average rates can be adjusted to account for a projected increase in deforestation, or simply fixed according to negotiations between donor(s) and recipient.

Conditionalities. In theory, RBF is conditional upon ER generation, with the manner of achieving ERs left to the recipient. However, donor restrictions on the use of resources, plus adherence to international safeguard standards mean that there are often conditionalities attached to REDD+ RBF. Such conditions generally fall in the following categories:

- Safeguards to ensure that REDD+ programs do not cause harm (internationally agreed in the Cancún agreement on safeguards);
- Planning to outline how results will be achieved and risks managed;
- Benefit sharing and financial management, which includes fiduciary standards and rules for how proceeds will be spent.

Timing of payment. Results-based payments are commonly made ex-post upon the verification of results. However, recipient countries need to invest – financially and politically, requiring significant own investment and often donor support to implement measures for achieving results. Donor strategies to overcome investment gaps include RBF for results from "early action" for ERs already achieved (see above), negotiating advanced payments in contracts, providing initial, non-performance based grants or partnering with 'readiness' funds, which go some way to covering up-front, capacity building costs.

Status of ERs. There is currently no global framework for trading REDD+ ERs at scale, though in theory, REDD+ ERs could be used to offset obligations in a national cap-and-trade market, or be purchased by countries to count towards an emissions target in an international treaty. This would require the transfer of ER title. Currently, only the Carbon Fund requires the transfer of ER titles, while other initiatives ask for the retirement or cancellation of ERs or leave the right to dispose of ERs with the recipient.

Managing risks. Initiatives set different requirements as to how to deal with and the risks of leakage or non-permanence of ERs. Such risks can generally be addressed through:

- Buffers or the set-aside of ERs;
- Program design, e.g. for leakage, including areas at high risk for shifted deforestation pressure in the ER accounting area;
- Accounting for uncertainty in ER and reference levels, e.g. through adjustments and conservative estimations.

Attribution rules would require evidence of a causal link between specific transfers of RBF and ERs achieved. Some donors implicitly consider it as part of their intervention rationale. However attribution requirements are not a feature of existing RBF initiatives for two main reasons. First, attribution is very difficult to prove with any level of confidence, and second, such a requirement would be at odds with the premise of ex-post payments for results already achieved.

Additionality can be understood to comprise to main components:

- Financial additionality, i.e. that the activity would not have taken place in the absence of a specific investment. No RBF initiatives require evidence of financial additionality beyond a common understanding that REDD+ RBF should not displace existing financial commitments, and recipients may have to be transparent about existing funding sources. It is understood that REDD+ results will require multiple investments and RBF should therefore not be counted as double funding of other input-based investments (e.g. the FIP).
- Environmental additionality, i.e. that ERs would not have occurred in the absence of the program. This component is tackled through the setting of the reference level (see above).

Scale. To date, the main REDD+ RBF programs have been designed at large geographic scales, with agreements at the national or regional level, and accounting at national, regional or biome level. The advantages of larger scale agreements are that they reduce donor and recipient transaction costs, are technically more straightforward to design, and influence decision-makers at national or jurisdictional level where key decisions influencing forest cover trends are often taken. It is possible to provide incentive payments at the local level through the 'nesting' of smaller projects, though there are no examples of this in existing RBF programs.

The table on the next page compares the main features of the different initiatives.

		Norwegian and German Contributions to the Amazon Fund (Brazil)	Other Norwegian bilateral agreements with Guyana and Indonesia	REDD Early Mover Program (German program with contributions from Norway and UK)	FCPF Carbon Fund
CONDITIONALITY	**Safeguards**	Safeguards of the Brazilian Development Bank	***Guyana:*** Disbursement is subject to World Bank, IDB & UNEP safeguards ***Indonesia***: Initially subject to UNDP safeguards	Cancun REDD+ Safeguards; Promotes establishment and reporting of country systems; KfW Safeguards; BMZ human rights guidelines.	World Bank safeguard policies and processes (Strategic Assessment and Management Framework) with special attention to integration of relevant stakeholders
	Planning	Logframe and results framework	Feasibility and financial structures are assessed for investment of RBF ***Guyana:*** Progress required against 10 verification indicators (e.g., governance indicators "transparent and effective multi-stakeholder consultations continue and evolve") ***Indonesia***: TBD	REM Criteria need to be fulfilled. Requires submission of REM template. Feasibility and financial structures are assessed for investment of RBF.	Requires formal application process, including submission of ER Program Idea Note and Program Documents that follows the requirements of the Methodological Framework.
	Benefit sharing/ financial management	Programmatic approach implemented through the Amazon Fund; Fiduciary standards of the Brazilian Development Bank; Project logic;	***Guyana:*** Contributions to National Low Carbon Development Strategy, Fiduciary standards of multilateral development banks ***Indonesia***: Transparent and equitable benefit sharing mechanism to be developed, between different government levels; Initially UNDP fiduciary standards	Programmatic benefit sharing and investment plan are set in bilateral agreement; Requires that at least 50% of RBF reaches local level and strongly recommends application of "stock-and-flow" approach	Requires elaborated Benefit Sharing Plan according to broad principles set by FCPF (effectiveness, transparency etc.)
DEFINING RESULTS	**Reference level**	Historical average rates, updated every 5 years	***Guyana:*** Mean value of historic average rate and developing country average, with downward adjustment option ***Indonesia***: TBD	Historical average rates	Historical average rates but allows for limited adjustment for "high forest low deforestation" (HFLD) countries with justified changes in deforestation trends
	Interim results	Excluded	***Guyana:*** Payments against interim performance indicators ***Indonesia***: Payments for preparation/transformative activities based on milestones	Offers an "incentive mechanism" that rewards forest conservation based on hectare proxy, but this has so far not been implemented.	Excluded
	Early action results	Provides retroactive payments for ERs achieved since 2006	***Guyana:*** Excluded, but initial non-results based payment for early action ***Indonesia:*** TBD	Provides payments for retroactive ER from "early action" for 1-2 years	Excluded
STATUS OF ERs		No transfer of ERs; ERs will not be used as offsets	No transfer of ERs	No transfer of ERs; ERs are retired and cannot be used for offsets, but recipients may report ERs to UNFCCC	Requires transfer of ERs, formalized through emission reduction payment agreements (ERPAs)
MANAGING RISKS	**Permanence**	Emissions exceeding reference level are deducted from future payments	Mitigates risks through setting conditionalities for governance (see planning)	Mitigates risks (permanence, leakage, uncertainty) by requiring country contribution of one additional ER for each compensated ER; Protocol for verification process	Requires a reversal risk assessment, identification and accounting using either a country designed reversal management mechanism or Program buffer
	Leakage	Not explicitly addressed, but accounting at national scale assumed to prevent in-country leakage	Leakage issues must be addressed in design, e.g. scale of accounting area at national level	See above; Leakage issues must be addressed in design, e.g. scale of accounting area	Requires a displacement risk assessment and mitigation strategies designed and implemented by the time of verification; Requires no discount or buffer

Operational challenges

In order to access RBF and produce REDD+ results, **recipients** face several challenges:

- **Complexity of the deforestation problem**. REDD+ countries often lack capacity, political will and investments to address the drivers of deforestation. Constraints include the lack of capacity to enforce laws or exercise jurisdiction; a lack of clear rights regimes, particularly land tenure insecurity; corruption risk; unconducive business environments; lack of capacity to engage and regulate the private sector. Some constraints can be addressed by targeted readiness finance, yet for some constraints no level of international incentives will be sufficient to address what are major internal political and economic questions.
- **Lack of institutional and technical capacity for REDD+ RBF systems.** Establishing the systems to access and manage RBF can be challenging. Reasons include the lack of institutional capacity as well as policy coherence between ministries and between different levels of government, a lack of technical capacity to monitor forest cover, and a lack of operational capacity for financial management.
- **Uncertainty of funding streams over the medium to long term.** Funding is uncertain where deforestation is not fully within the government's control and results are uncertain or hard to anticipate. Ideally, countries will have existing investments that can be supplemented by REDD+ RBF as results materialize. The continued uncertainty about the scale of finance makes it harder for recipient governments to design and make the political case for long-term development strategies that incorporate low-deforestation pathways.
- **Complex bureaucracies and ODA procedures.** The fragmentation of REDD+ RBF into multiple funds with sometimes divergent requirements makes it harder for REDD+ countries to access RBF. Delays are more likely when rules for accessing REDD+ RBF are complex, and review procedures are lengthy. The partnership between Germany, Norway and the UK (GNU) contributes to improved donor coordination.

Donors also face challenges to disburse RBF:

- **Limited availability of results to finance.** Deforestation is a complex problem and it takes time to build political momentum behind measures needed to effect change. The example of the Amazon Fund is one in which results have far exceeded available finance. In other cases however (e.g. the Indonesia-Norway agreement), delays in moving from preparation stages to implementation and RBF disbursement indicate that even where finance is promised, potential beneficiaries may struggle to introduce the reforms and undertake the actions necessary to generate verifiable results. In addition, only a very limited number of countries are currently producing emissions reductions from deforestation that can be rewarded in an ex-post manner.
- **Working with hybrids of results-based and input-based financing systems.** Donors have limited experience with REDD+ RBF. In practice, it has been challenging to design a new purely results-based system that is compatible with existing input-based operational frameworks, ODA procedures, planning and reporting requirements. For example, most donors will have annual budget allocations for ODA, but in the RBF context, the amount to be disbursed each year is uncertain, requiring more flexibility.
- **Diverging donor approaches.** Donors differ in their understanding of results-based finance and its justification in the context of ODA. To avoid diverging requirements for recipient countries, different initiatives need to align their modalities. This alignment of ODA procedures and political agendas requires high level cooperation and flexibility.
- **Accountability *versus* country ownership.** Getting the balance right between accountability and aid effectiveness on the one hand, and ensuring country ownership and swift disbursement on the other, remains a challenge.

Future prospects and lessons

A number of donors and recipient countries are firmly committed to results-based financing of REDD+. In September 2014, 36 developing and developed country governments endorsed the New York Declaration on Forests, one of the goals of which is to "[r]eward countries and jurisdictions that, by taking action, reduce forest emissions, particularly through public policies to scale-up payments for verified emission reductions.". Recently, the UK joined Germany and Norway in declaring their readiness "to scale up results-based finance for large-scale, REDD+ emission reduction programmes".

Parties to the UNFCCC have made considerable progress in negotiating a framework for RBF, with the 2013 Warsaw Framework for REDD+ establishing a number of modalities for financing, reference levels and monitoring, among others. Further guidance on non-market approaches, non-carbon benefits and safeguards has been agreed in 2015. The Green Climate Fund meanwhile has adopted a logic model and performance framework for ex-post REDD+ results-based payments though it is likely to be some time before the GCF is in a position to operationalize REDD+ RBF.

REDD+ RBF is still in a relatively nascent phase, and a variety of funds with differing modalities are emerging with distinct terms of engagement. Variety is useful to the extent that it allows for the piloting of different approaches. To achieve scale and deliver finance that is both adequate and predictable, REDD+ RBF programs will require a greater degree of alignment than is currently the case. High level cooperation between donors, and emerging norms established by the UNFCCC and Green Climate Fund does suggest movement in this direction.

CONTACT

KfW

Dr. Christiane Ehringhaus, Coordinator, REDD for Early Movers Programme

Christiane.Ehringhaus@kfw.de

Climate Focus:

Dr. Charlotte Streck, Director

C.Streck@climatefocus.com

Publisher:

KfW Group
KfW Development Bank
Palmengartenstrasse 5-9
60325 Frankfurt am Main, Germany
Telephone +49 69 74310
Fax +49 69 7431 2944
info@kfw-entwicklungsbank.de
www.kfw.de