INSTITUTIONAL FUNDING MECHANISMS: CASE STUDY REVIEW

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Institutional Funding Mechanisms: Case Study Review

Andrew Gilder BA LLB LLM (Marine and Environmental Law)
Director: IMBEWU Sustainability Legal Specialists (Pty) Ltd
Dr. Marie Parramon (LLD Environmental Law)
Senior Consultant: IMBEWU Sustainability Legal Specialists (Pty) Ltd

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Foreword

From 3 to 6 March 2009, South Africans from all spheres of life came together for the national Climate Change Summit 2009 in Midrand to initiate a consultative process to develop the South African Climate Change Response Policy. Although the Summit yielded wide-ranging consensus on a number of proposed climate change responses, it also identified various areas of divergence that required further discussion. With this, the Summit agreed, amongst others, that the National Climate Change Response Policy will be developed through a participatory, multi-stakeholder, consultative and iterative process and that issues raised during the Climate Change Summit 2009 must be addressed in a transparent manner and fed into the policy development process.

During the participatory, multi-stakeholder, consultative and iterative policy development process initiated at the Summit, certain specific issues appeared to be raised again and again in various policy development stakeholder engagements. These recurring areas of concern and/or uncertainty included: Climate Finance; Human Resources and Technology; Adaptation; Mitigation; and Governance.

In keeping with the Summit decisions and with a view to informing and enriching the debates around these issues, the Department of Environmental Affairs commissioned focussed research into these focus areas and used the findings of this research to focus and inform discussions in key stakeholder workshops on each of the topics in February and March 2011.

Although the independent research and findings contained in this publication do not necessarily represent the views, opinions and/or position of Government, the department believes that this research is an important addition to the evolving climate change discourse. Hence, the department is happy to make this work publicly available and accessible.

With this, I would like to thank everyone who contributed to the research papers presented in this book as well as everyone who contributed to the various stakeholder workshops on the topics covered by this research.

Finally, I would also like to thank our German Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU) partners and their local agent, the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), for their generous support for this research and its publication.

Peter Lukey

Acting deputy Director-General: Climate Change

Department of Environmental Affairs

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Abbreviations

COP	Conference of the Parties
DBSA	Development Bank of Southern Africa
GEF	Global Environmental Facility
IDC	Industrial Development Corporation
IPG	Inter-Agency Planning Group on Environmental Funds
LIFE+	Financial Instrument for the Environment
MRV	monitoring, reporting and verification
NAMA	Nationally Appropriate Mitigation Action
PPP	public-private partnership
REDD	Reducing Emissions from Deforestation and Forest Degradation in Developing Countries
SADC	Southern African Development Community
UNFCCC	United Nations Framework Convention on Climate Change

Summary

This paper aims to identify an appropriate institutional model for climate change finance in South Africa. It first provides a comparative case study of international and national financial mechanisms that provide financial and other resources for climate change, the environment or, more broadly, sustainable development. Five financial mechanisms and institutional models were analysed for this paper:

- The financial mechanism under the Convention on Biological Diversity (an international fund)
- The Financial Instrument for the Environment – LIFE+ (regional, European Union)
- The Slovenian Environmental Development Fund (national, a country in transition)
- The New York State Environmental Facilities Corporation (a developed local authority)
- The Environmental Funds of Moldova.

The paper then provides a brief mapping of the South African institutional framework for climate finance, followed by guidance on the identification, development and implementation of an appropriate institutional model for climate finance in South Africa (also referred to as a financial mechanism).

The overall objective is to assess current best practice in terms of environmental funds and mechanisms to draw recommendations for South Africa on the potential development of a climate change fund or mechanism, as indicated in the National Climate Change Response Green Paper of 2010.

Overview of findings: Preliminary implications for South Africa

Origin of the mechanism: The Department of Environmental Affairs, supported by the National Treasury or the Planning Commission, could introduce the concept of a climate change or environmental fund/mechanism. The government, at all levels, should support this initiative, and demonstrate its support through a Cabinet decision. The broader concept of a financial mechanism might be more appropriate for South Africa than a fund, but further stakeholder engagement is recommended in this regard.

If the government agrees to such a fund/mechanism, it should be created by statute to ensure clarity, transparency and political independence, and give confidence to donors and investors about the sustainability of the fund/mechanism.

Scope: Most national financial mechanisms/funds are not focused only on climate change – they have a broader environmental scope. South Africa could either follow this example, or it could start with a financial mechanism focused on climate change, which could later be consolidated into a broader financial mechanism for the environment. A broader scope might be more appropriate for managing climate finance within the wider objective of supporting sustainable development. This would ensure that the various sources of finance are applied cohesively, in line with national priorities. The next issue is whether the resources of the fund/mechanism should be focused on mitigation, adaptation or a combination of the two. The latter is recommended. (Note that adaptation funding should preferably be grant-based.)

Legal status: As noted, the fund/mechanism should be regulated by a statute that sets out its functioning, governance structure and decision-making process, as well as monitoring, reporting and verification (MRV) mechanisms. It may be possible to design a progressive approach for the mechanism, enabling it to be functional before being made a statutory instrument. An example of this approach is the Environmental Funds of Moldova (OECD EAP Task Force Secretariat and the Danish Environmental Protection Agency, 2002).

Aim and objectives: A common vision needs to be developed, with clear and measurable goals and objectives, linking the financial mechanism to national environmental action plans, such as the Climate Change White Paper and the National Environmental Management Act of 1996. If the mechanism is linked to existing national plans, the level of public participation to determine its aim and objectives could be restricted to the main stakeholders.

In the context of climate change, mitigation and adaptation programmes and activities should be targeted. LIFE+, which aims to combat climate change, could provide guidance in this regard. Its priority areas of action are as follows:

- Ensuring the implementation of European Union commitments under the Kyoto Protocol and developing a post-2012 strategy and implementation programme
- Adapting to and mitigating the adverse impact of climate change on the economy and society, nature and biodiversity, water resources and human health
- Ensuring the use of market-based instruments, in particular greenhouse gas emission trading, to achieve cost-efficient emissions reduction in a post-2012 framework.

Resource mobilisation: A national resource mobilisation strategy and a financial needs assessment must be developed through stakeholder engagement, following best practice in this regard. All national departments must be involved in this process, as must provinces and municipalities. (The latter could also develop their own financial needs assessments and/or mobilisation strategies, as most of the actions will be taken at municipal and provincial level. It may also be useful to have resource mobilisation focal points for each sphere of government.)

The resource mobilisation strategy should focus on a limited range of areas in which the financial mechanism can expect to achieve an impact in a reasonable period. Flexibility and adaptability are required over time.

The budgeting process needs to be managed in a transparent manner, with a budget cycle of three to five years. The three spheres of government must also commit resources from their own budgets, in a transparent and sustainable way.

There is a need for an asset management strategy and a professional asset manager.

Resource allocation and disbursement: A focused disbursement and investment strategy should include investment objectives, criteria for selecting securities, minimum asset quality, industry or sector concentration, portfolio liquidity, and asset mix objectives.

The fund must be easily accessible and governed by clear rules. Each funding product should have a specific application process, eligibility criteria, an evaluation process, timeframes and a set periodicity of calls for proposals.

It is important to distinguish between programme support costs, institution-building costs and operating costs, and to keep operating costs to about 10% of the total budget (and never above 30%).

Should the mechanism be required to have a regional scope, regional projects should be clearly identifiable in order to manage their potential implications for the mobilisation strategy.

The type of sources will evolve over time, probably starting with more public and international sources and catalysing private investors over time. The fund/mechanism might also need to use instruments like bonds or loans, which generate income, to maintain its sustainability.

The fund could finance different subfunds and various programmes. The most appropriate funding instruments for each project or programme will vary in terms of mitigation and adaptation, and will evolve over time. However, the mechanism will need to do the following upfront: define its funding scope; call for funding; determine key funding instruments; implement strict regulations regarding resource allocation and disbursement; ensure complementarity and rules to avoid double funding; allow for national, provincial and municipal priorities; determine whether it will fund private and/or public recipients; determine eligibility criteria (such as a significant contribution to combating climate change, technical and financial feasibility, and value for money); favour best-practice or demonstration projects; conduct awareness-raising campaigns and special training; and set co-financing requirements.

Governance and institutional structure: Before creating a mechanism, it is important to ensure that an existing agency cannot effectively manage the amount of funding and type of activities needed. One option is to use an existing institution until the development of a new one has been finalised. Decentralised environmental governance could be promoted with the replication of the mechanism at provincial and municipal levels.

A certain level of independence from government should be maintained, and the fund should not be managed by a single department. The government should be represented on but not control the board. The decision-making process should be as free as possible from political interference, with most board members not being political appointees. The board could include members of the interministerial and intergovernmental committees on climate change. Important issues of governance include the appropriate size and composition of the board, the term of appointments, the capacity of board members, mechanisms to involve stakeholders, the right mix of public and private partners, and how the board can continue to develop the financial mechanism.

Intermediaries for the financial mechanism's credit facilities could include the development banks, private banks, national departments, and others.

It is important to identify potential strategic partnerships to support the fund/mechanism. Specific advisory groups can assist the mechanism in the design of particular programmes, the selection of projects, and the mobilisation or disbursement strategy. Existing institutions could also support the fund, such as the Development Bank of Southern Africa (DBSA) and the Industrial Development Corporation (IDC). A private investment firm or bank that is experienced in the management of portfolios with similar objectives and of similar size should manage the assets. The asset manager should also be familiar with national circumstances and have experience in the country and, if necessary, the region.

Public-private partnerships (PPPs) could also have a role: a PPP could be developed for a specific project or programme (e.g. the implementation of solar water heaters). It could provide a cost-effective approach to the implementation of some projects and programmes, and could be useful for research and the development of specific adaptation and mitigation technology.

Participation in decision-making: It is important to find the right level of participation – all spheres of government should be actively involved in decision-making, and business and non-governmental organisations also have a role.

Performance assessment: This essential function needs to provide for the monitoring and assessment of the governance of the financial mechanism, its performance and effectiveness (impact), its projects and programmes, and its cash flow. There needs to be an annual assessment of processes and funding performance. Reporting requirements include annual reporting; reporting to governments, donors and investors; and reporting by projects and programmes. An important concern is international monitoring, reporting and verification (MRV) requirements. The mechanism might need to create various categories of programmes with different MRV protocols, such as supported Nationally Appropriate Mitigation Actions (NAMAs), internally funded NAMAs, supported adaptation actions, internally funded adaptation actions, and other mitigation and adaptation programmes.

Appeal and complaints procedure: This needs to be regulated and the process needs to be transparent. If possible, it should be set by the provisions of a statute.

Other interesting factors and characteristics: The European Union principles of subsidiary and proportionality could be relevant for provinces and municipalities.

Preliminary recommendations

There seems to be a need to consolidate and rationalise climate change finance in South Africa. A rationalisation of climate change finance will facilitate the selection and implementation of cost-effective mitigation and adaptation actions in a balanced and effective way. It will limit the incidence of double funding, funding gaps or funding with low performance. It could also enable a programmatic approach and facilitate the replication of certain actions in all provinces and municipalities. Such a consolidation process would facilitate the sourcing of the level of finance required to implement the necessary mitigation actions, as per the country's pledge at the 15th Conference of the Parties (COP15).

A fund or financial mechanism could facilitate such a consolidation process. It has been noted that "the capacity and the creativity to spend these resources well will necessitate the creation of one or more new financial mechanisms at the global level and multiple national level institutions" (Ballesteros et al., 2010). Therefore, the development of a financial mechanism, including a climate change fund, would be very useful. However, at this stage, the specific characteristics of such a mechanism and institution need to be debated further. The White Paper will only set out a framework policy and will not provide details. It has to provide guidance on policy direction and indicate where further work is required. Therefore, **in the section on "Inputs and Resources Mobilisation" and especially the reference to a "climate change fund", the following amendments to the White Paper are proposed:**

8.1 Financial Resources

8.1.2 Government will conduct specific work to consolidate and mobilise sufficient, adequate and sustainable financial resources from national and international sources for climate change mitigation and adaptation actions. In this context, the Government, in collaboration with key stakeholders, will investigate the development and implementation of the most appropriate climate change financial mechanism to support the implementation of the mitigation and adaptation actions as per the priority areas determined by the Government. Such a financial mechanism should also provide a Climate Finance Tracking Facility that will have the responsibility to track the flows of climate finance in both the private and public sector, and that will also be responsible for reporting on the mitigation actions that have been implemented with international support.

Broader strategic recommendations can also be made to advise the government to investigate an appropriate financial mechanism to support the implementation of mitigation and adaptation actions as per the priority areas determined by the government.

- An inventory and assessment of all the current sources of funding (direct or indirect) for climate change response in South Africa should be conducted. Such an inventory should indicate the source, financial terms and conditions, performance, gaps and weaknesses, and potential to be integrated into a more cohesive financial mechanism/fund.
- The government should assess the level of additional finance required to implement the mitigation and adaptation programmes and actions set out in the White Paper.
- Then the government should assess whether a new mechanism or institution is required to manage such finance.
- The government should then conduct further work to assess the most relevant scope of the mechanism/institution: should it be restricted to climate change only or could it be broader and more general (environmental)? Initial discussions are needed at national level regarding the rationale for a climate change financial mechanism versus an environmental financial mechanism. A broader scope might be more appropriate in the context of sustainable development; it could facilitate a more cohesive approach to finance to facilitate such development.
- The government, including all national departments and representatives of all spheres of government, will need to provide their support to the concept of the financial mechanism, whether specific or general.
- The vision, aim and objectives should be clarified and presented to all government representatives for adoption (by a Cabinet decision).
- Further consultation should be conducted between the Department of Environmental Affairs and the National Treasury to assess the exact nature of the fiscal restrictions that could limit the efficiency and sustainability of an environmental financial mechanism or fund.
- The national level of readiness for such a fund/mechanism should also be analysed.
- The typical preliminary steps recommended by the Inter-Agency Planning Group on Environmental Funds (IPG) Handbook on environmental funds should then be followed.
- The St. Petersburg Guidelines should also be adopted.
- More specifically, the detailed guidance from best practices identified through the comparative case study and further research, as outlined in Table 2, should also be followed.
- Further research should be conducted regarding the legal status of the fund/mechanism, sources of funding (nature, level, conditionality and sustainability), priority programmes and actions for funding, and funding strategies for each priority programme and action.

The above recommendations are aimed at facilitating the conceptualisation, development and implementation of a comprehensive and sustainable climate change or environmental financial mechanism. Such a process will take time and, therefore, an interim or provisional solution will be necessary to manage climate change finance in the short to medium term. Financing for climate change adaptation and mitigation initiatives needs careful consideration to clarify what may unlock scalable interventions in the short term.

The following **recommendations are submitted to develop an interim or transitional solution to climate change finance,** which could be referred to as a climate change fund, while a consolidated financial mechanism is being developed:

- The scope of the interim approach will be focused on climate change.
- The Department of Environmental Affairs and the National Treasury should determine the most suitable interim or transitional financial vehicle to receive and manage climate change finance while a more comprehensive financial mechanism is being developed.
- The interim financial vehicle should determine and target specific priority areas in terms of mitigation and adaptation. For each priority area, an inventory

and assessment of all the current sources of funding (direct or indirect) should be conducted. Such an inventory should indicate the source, financial terms and conditions, performance, gaps and weaknesses, and potential for integration into a more cohesive financial mechanism/fund. The government should then assess the level of additional finance required to implement the mitigation and adaptation programmes and actions set out in the White Paper.

- The interim approach will have to be adopted by Cabinet and managed by one or more national department.
- The interim approach will have to be clearly explained to potential donors and investors.
- The approach to the Environmental Funds of Moldova could inform the development of an interim approach for South Africa.
- However, note that the conceptualisation, development and implementation of a consolidated financial mechanism will require time and dedication. It is not recommended that any shortcut be taken during the process, as this could affect the integrity and effectiveness of the mechanism. Therefore, these last recommendations should apply only to the development of an interim and transitional approach.

1. Introduction

There is overwhelming consensus in the global climate change discourse that the current natural resource constraints and ecosystem pressures require a shift from conventional growth path trajectories towards greener alternatives. The developing world is constrained in its ability to fast-track such a transition, owing to technology and incremental capital needs relative to resourcing existing developmental challenges. Climate change is also likely to involve a social and humanitarian crisis, as the most vulnerable will inevitably fall victim to its effects. Thus, short-term scaled-up and adequately resourced interventions are critical for societal stability. In addition, investing in research and development programmes focused on mitigation and adaptation will create a platform for advancing the technological shifts required for the transition to a climate- and environmentally conscious economy. As a regional economic hub, South Africa is well positioned to support and lead climate interventions across the Southern African Development Community (SADC).

At the 15th Conference of the Parties (COP15) of the United Nations Framework Convention on Climate Change (UNFCCC), held in Copenhagen in December 2009, the Copenhagen Accord (UNFCCC, 2009) was created. It calls on developed countries to provide new and incremental sources of funding for climate interventions to developing nations of $30 billion in the short term (2010 to 2012), with a longer-term target of raising $100 billion per year by 2020. These amounts are to be aggregated in a proposed global climate fund. It is evident that a comprehensive climate financing package combining public and private mechanisms is required; it may include market mechanisms blended with different funding sources (multilateral finance, bilateral finance, private wealth and pension funds, carbon credits and Reducing Emissions from Deforestation and Forest Degradation in Developing Countries or REDD credits) and different enabling instruments (government guarantees, risk sharing, insurance, taxes and fiscal incentives). The Cancun Agreement (UNFCCC, 2010) marked the launch of a Green Climate Fund to be established under the World Bank.

South African government policy papers recently released for comment (i.e. the National Climate Change Response Green Paper (RSA, 2010) (see Table 1) and the proposed carbon tax discussion document (National Treasury, 2010)) show a heightened awareness of green economic development, the diversification of energy sources and establishing a national strategy for climate change. Through a process of public engagement that has already started, the proposed policies will provide an enabling policy framework upon which targeted interventions can be based to address societal and behavioural shifts for sustainable livelihoods. Effective, demand-driven resource mobilisation to implement and innovate within a stable policy environment should be underpinned by a clearly defined and cohesive national strategy.

Financing for climate change adaptation and mitigation initiatives needs careful consideration in the South African context to clarify what may unlock scalable interventions in the short term. Anecdotal evidence from ongoing debates suggests both a lack of funding and institutional hurdles to creating an enabling environment. Certainty on these issues would enable the country to create a firm basis for demand-driven engagements to access international climate finance.

Table 1. National Climate Change Response Green Paper 2010: Relevant provisions

NATIONAL CLIMATE CHANGE RESPONSE GREEN PAPER 2010

8. Inputs and Resources Mobilisation

8.1 Financial Resources

The substance of this policy document has demonstrated that a successful national **response to climate change will require South Africa to invest heavily in both the development of a low carbon growth path**, as well as in a forward looking and proactive approach to identifying and managing the inevitable **impacts of climate change.**

This **imposes an additional set of costs on society.** These costs are recognised in the UNFCCC Convention and in particular, the obligation of the developed world which has primary responsibility for the emissions currently in the atmosphere, to provide resources for the adaptation and mitigation efforts of developing countries. It is in this context that the **conditionality on South Africa's mitigation announcement** in Copenhagen, namely that our efforts are conditional on the provision of finance, technology and capacity building, can be understood. Furthermore, substantial work that has been undertaken internationally has demonstrated clearly that the costs of the investments that are necessary to address the threats posed by climate change are much less if early action is taken. Delayed action in relation to both mitigation and adaptation will impose much greater burdens on the world economy overall.

South Africa **accepts the need for early and decisive action** and in that context is **committed to mobilising the resources that are necessary to address both mitigation and adaptation.** It is accepted that this financing must come from a **range of sources** and that our **own domestic efforts** to create, allocate and mobilise finance for the necessary investments **must be met by substantial resources flowing from the international community.** In line with the requirements of the UNFCCC Convention, it is important that a significant element of these resources be obtained from **international public sources** and are additional to existing Overseas Development Assistance. It is also clear that the element of the resources that comes **from private sector sources** is likely to be largely made up of **concessional loan financing.** The **mobilisation of the scale of resources necessary to address the climate challenge is currently a subject of negotiation internationally.** South Africa has an opportunity at the present time to develop a coherent approach to climate financing and to do the preparatory work necessary to be able to mobilise the appropriate scale of resources at an early stage. At the same time, South Africa also recognises that as a middle-income developing country and given the current global economic downturn, the **quantum of resources there is likely to be a limited degree** of funding that is likely to be able to be mobilised from the international community and that **much of this is likely to be either concessional loan financing or financing flows channelled through the private sector.** It is also likely that there is likely to be a weighting towards mitigation finance in this scenario. The mobilisation of national sources of financing and the integration of climate plans into the work of government and their resourcing as such is therefore of utmost importance.

South Africa also recognises that our existing financial institutions in both the public and private sector are increasingly aware of climate change issues and are considering how to engage in providing finance for climate related activities. This should be actively supported and encouraged.

Furthermore, South Africa recognises that **economic and fiscal incentives and disincentives** can both support climate change policy objectives and also can be structured so as to generate a revenue stream that can allow fiscal decisions to be made over time to support climate change policy objectives.

Specifically:

8.1.1 Government will undertake work to **determine the economic and fiscal costs and benefits of the proposed Climate Change Response Strategy.** This work will specifically address the costs and opportunities resulting from a low carbon growth strategy, including on jobs and livelihoods and specific economic sectors. The work will also address the impacts of climate change through an assessment of the costs of action versus those of inaction and will address the **costs of priority actions for specific sectors.** This work will, to the extent possible, be incorporated into the National Climate Change Response Strategy White Paper.

8.1.2 Government will **consider establishing a National Climate Change Fund** that will **mobilise resources from national and international sources for investment in both climate change mitigation and adaptation actions.** Feasibility in this regard will be undertaken and its conclusions incorporated in the National Climate Change Response Strategy White Paper.

8.1.3 Government will establish a **Climate Finance Tracking Facility** that will have the responsibility to track the flows of climate finance in both the private and public sector and that will also be responsible for reporting on the mitigation actions that have been implemented with international support.

8.1.4 Work closely with **South Africa's Development Financing Institutions** to ensure that climate change information and climate change risk is factored into their planning and that their lending portfolios support the country's climate change objectives.

8.1.5 Collaborate with the **private banking and insurance** sector to ensure that it has adequate information to make informed decisions on risk management measures and lending decisions that may be affected by the impacts of climate change

8.1.6 Work with and support the banking sector in mobilising and making available finance for climate mitigation initiatives.

8.1.7 **Provide information** that would support the banking sector to consider carbon implications in financing and investment decisions.

8.1.8 Carbon trading schemes will be investigated as a medium- to long-term policy response to climate change and will focus on the scope and administrative feasibility of trading schemes for South Africa.

This paper forms part of a composite research agenda to support the formulation and finalisation of the National Climate Change Strategic Framework, as commissioned by the Development Bank of Southern Africa (DBSA). The outputs of the research will be synthesised with technological submissions and research submissions on climate science and governance to achieve a holistic framework to shape actions towards a sustainable and climate-conscious development agenda.

The focus of the research is on creating an institutional environment in which climate mitigation and adaptation are accessible to a broad stakeholder base and funds are applied where they are most needed. Thus, the study to determine the precise funding requirements is ancillary to ensuring that there is an enabling environment to match the demand for and supply of funds on a programmatic basis. Against this backdrop, the paper aims to:

a. Diagnose the hurdles that limit or even prevent the financing of initiatives related to climate change.

b. Identify what solutions could be developed to overcome these difficulties and allow South Africa to benefit from the climate change momentum (and, more broadly, from the perspectives offered by the green economy).

c. Identify an appropriate institutional model for South Africa.

The paper comprises four main sections, namely:

- Scope and methodology
- Theoretical background and premises of the research
- Overview of best practice and implications for South Africa
- Preliminary strategic recommendations

1.1 Scope of the paper

This paper aims to identify an appropriate institutional model for climate change finance in South Africa. It first provides a comparative case study of international and national institutional financial mechanisms that provide financial and other resources for climate change, the environment or, more broadly, sustainable development. Five financial mechanisms and institutional models were analysed for this paper:

- The financial mechanism under the Convention on Biological Diversity (2004) – an international fund
- The Financial Instrument for the Environment – LIFE+ (EC, 2011) – regional, European Union

- The Slovenian Environmental Development Fund (Vidič , 2007) – national, a country in transition
- The New York State Environmental Facilities Corporation (Jefferies & Company, JP Morgan & Morgan Stanley, 2010) – a developed local authority
- The Environmental Funds of Moldova (OECD EAP Task Force Secretariat and the Danish Environmental Protection Agency, 2002).

The paper then provides a brief mapping of the South African institutional framework for climate finance, with a preliminary analysis of the following:

- The role of key (public and private) financial institutions in the economy (specifically development finance institutions)
- Governance and operational (including implementation) guidelines, requirements and obligations
- Types of funding and resources available in terms of best practice (private and public)
- Primary recipients of financial interventions

This is followed by guidance on the identification, development and implementation of an appropriate institutional model for climate finance in South Africa (also referred to as a financial mechanism).

The overall objective is to assess current best practice in terms of environmental funds and mechanisms to draw recommendations for South Africa, especially in relation to the potential development of a climate change fund or mechanism, as indicated in the National Climate Change Response Green Paper of 2010.

1.2 Methodology

1.2.1 Overview

The evaluation methodology was based on an evaluation framework (using a set of assessment criteria) that facilitated a structured approach for collecting, evaluating and presenting information. The methodology can be summarised as follows:

- Identification of the funds/mechanisms to be included in the comparative analysis
- Development of the evaluation methodology (assessment criteria)
- Assembly and assessment of initial data (collected through desktop research only)
- Evaluation of key qualitative data
- Drawing of preliminary recommendations.

1.2.2 Selection of the funds to be included in the comparative study

The paper adopts a wide scope for the comparative study of the funds, in order to get as much information as possible without limiting the scope of the research. In this context, it was decided to include in the assessment different types of funds/mechanisms, based on the following criteria:

- Local, national, regional and international funds
- Funds from developed and developing countries
- Specific (biodiversity management) and general (environmental management) funds

Taking such a broad approach has enabled the research to determine which characteristics are common to environmentally related funds (or financial mechanisms), irrespective of their scope and objectives, and to determine trends or effective approaches for specific funds, scopes or objectives.

The selection of the funds/mechanisms was based on a desktop review of existing research. Only the funds/mechanisms on which a certain level of information was available were selected. Preference was given to funds/mechanisms with a proven track record, that have been in existence for a certain period and have undergone performance assessment evaluation. The funds/mechanisms were selected from developing and developed countries, with a specific and general scope, and covered international, regional, national and local funds/mechanisms.

1.2.3 Determination of assessment criteria

In order to ensure the highest level of objectivity, consistency and comparability of the study, it was decided to develop a set of assessment criteria to direct the critical appraisal of each fund/mechanism. The assessment criteria were selected based on an analysis of existing comparative studies on environmentally related funds (see, for instance, Ballesteros et al., 2010; Gutman & Davidson, 2007; LIFE+, 2010g; Streck, 2009; Zou & Fu, 2010). The assessment criteria are as follows:

- Origin of the fund/mechanism (decision to create the fund, by whom, rationale, motivation and initial process)
- Scope (general or specific)
- Legal status (how the fund was created, from a legal perspective)
- Aim and objectives
- Resource mobilisation
  - Reliability and sustainability of sources (including level) of financing
  - Adequacy and appropriateness (of the level and sources of financing to achieve the set aims and objectives of the fund/mechanism)
  - Transparency
  - Types of sources
  - Budgeting process (how the resource mobilisation is guided and informed)
  - Mobilisation process
- Resource allocation and disbursement
  - Accessibility/eligibility criteria
  - Equity
  - Transparency
  - Types of financing instruments (grants, loans and guarantees)
  - Spending categories and investment portfolios
  - Investment strategy (determination of priorities and financing approaches)
  - Timelines
  - Selection and approval process
  - Development of standards and performance matrix to select priorities and projects to be funded
  - Financial management
- Governance and institutional structure
  - Structure and composition
  - Functions (oversight, operation and management)
  - Powers of the governance structures
  - Financial independence in terms of the operation of the funds (separate operational budget)
  - Political independence
  - Accountability
  - Efficiency
  - Transparency
  - Decision-making and management process
  - Administrative costs
- Participation in decision-making
- Monitoring, reporting, verification and performance assessment
- Appeal and complaints procedure
- Other interesting factors and characteristics

1.2.4 Determination of best practices

Additionally, various international reports (Ballesteros et al., 2010; Federal Ministry of Agriculture, Forestry, Environment and Water Management, Austria and REC, 2006; Gutman & Davidson, 2007; LIFE+, 2010g; Norris (ed.), 2000; Streck, 2009; Zou & Fu, 2010) were consulted in consolidating the results of the comparative case study. The latest developments related to environmental funds were also reviewed. One example is the Amazon Fund, which provides incentives for preservation through conservation sponsorships that any individual or organisation can undertake.[1] Various national environmental funds/mechanisms have also been developed around the world. The following were reviewed for the comparative study (Convention on Biological Diversity, 2011): United Kingdom: Darwin Initiative, Flagship Species Fund, International Sustainable Development Fund and Overseas Territories Environment Programme; Germany: Allianz Foundation for Sustainability and German Environment Foundation; Madagascar Trust Fund for Sustainable Protection of Nature

1 The Amazon Fund established a strategic alliance with the Amazonia Association (www.amazonia.org), which has a 15-year-old established ecopreserve of 450 000 acres. The preserve is a cooperative where the locals are co-owners and work to preserve the acreage in exchange for the preservation of their local culture and education, economic and health benefits for their families. The Amazon Fund, in cooperation with the Amazonia Association, will preserve one acre of rainforest for a minimum of 20 years for a sponsorship contribution of US$50, and each conservation sponsorship is registered on the Amazon Fund website. The purchase price of Amazon land is only a fraction of the cost. Once acquired, land must be protected against poachers and fire. This approach is relevant in terms of the simplicity of its governance and management structure. It is aimed at addressing one specific issue (deforestation), and has various socio-economic and environmental benefits. It also addresses issues of adaptation and mitigation. The sponsorship approach also enables the fund to grow organically, and promotes private sector involvement. However, note that such a focused scope is relevant for Brazil and the Amazon, in terms of climate change adaptation and mitigation.

Reserves; Arab Environment Facility; Financial Mechanisms for Canadian Biodiversity; Honduras Environmental Funds; Uganda's National Environment Fund (UNEP, 2011); and the Environmental Fund of Thailand (UN ESCAP, 2011).

1.2.5 Limitations

It is important to note that that this research was conducted under a very strict time constraint, which represents a key limitation. Consequently, this paper does not strive to determine an ultimate answer but rather provides a set of recommendations and further considerations to guide the identification, development, refinement and implementation of an appropriate financial institutional model for climate finance in South Africa, and possibly more generally in terms of environmental management (including environmental finance).

The limitations of comparative research must also be noted. Local circumstances will have to be taken into consideration in the comparative assessments and related recommendations; this was done in the final strategic recommendations of this report.

It is also important to note that the engagement with relevant stakeholders (including government) and other experts was restricted owing to the time constraints and, therefore, their inputs are very limited.

The various options to design and develop a financial mechanism are so diverse that it was impossible to assess all of them or recommend one in particular. Further work is required to determine the best option for South Africa. However, this research provides preliminary guidance on the conceptualisation, development and implementation of an environmentally related financial mechanism.

2. Theoretical background and premises of the research

The notion of an environmental fund is actually a complex and rather vague concept (see Norris (ed.), 2000; GEF, 1999). There are various categories of environmental funds, namely (WIOMSA, n.d.):

- **Endowment funds:** The capital is invested and the interest is used to finance activities. A percentage of the interest earned must be reinvested to keep pace with inflation. These funds are most appropriate for long-term continuous funding needs.
- **Sinking funds:** The entire principal and investment income are disbursed over a fixed period. Such funds are most useful for large, urgent conservation issues and where there is enough capacity to use the funding rapidly and effectively.
- **Revolving funds:** These receive new resources on a regular basis, such as proceeds of special taxes (or fees or levies earmarked for conservation work), which replenish the original capital of the fund and provide a continuing source of money. These only work if the source of funds is regular and predictable.

The categories can also be combined. Funds can be specific (i.e. dealing only with climate change or renewable energy) or they can be general (i.e. environmental funds).

It has been stated that "environmental funds are appropriate when the threats to the environment that are being addressed are long-term and require a sustained response over a number of years. They are not the solution when the environmental issue in question faces major, urgent threats requiring mobilization of significant amounts of funding in a short time" (Norris (ed.), 2000).

Important factors involved in setting up a successful environmental fund and mechanism, identified by the Global Environmental Facility or GEF (GEF, 1999), include clear and measurable goals and objectives, linkage between the fund and any national environmental action plan, a strong executive director, government support, high levels of stakeholder involvement and financial and administrative discipline.

The GEF evaluation concluded that two conditions are essential for the success of an environmental fund. "First, there must be active government support – not just acquiescence or agreement – for a mixed, public-private sector mechanism in which the government actively participates but that operates beyond its direct control. The most effective funds enjoy broad-based government support at all levels – from senior political leaders to regional and local bodies, extending beyond environmental departments to include ministries of finance and planning. Second, there must be a critical mass of people from diverse sectors of society – [non-governmental organisations], government, the academic and private sectors, and donor agencies – who can work together despite what may be different approaches to conservation and sustainable development."

It is important to note that the concept of an environmental fund can be regarded as restrictive. The terminology "environmental financial mechanism" has been used to describe a broader concept. The mechanism terminology is commonly used at the international and regional level. It has not been widely used for national financial "structures". Unfortunately, there is no internationally agreed definition of the two concepts, and they have often been used interchangeably. However, based on a review of international literature, the following working definitions can be proposed in the context of this report:

- **Fund:** An institution or instrument to raise funds from various sources and then invest or spend them on specific eligible projects.
- **Financial mechanism:** A broader concept that includes the same functions as a fund but also additional ones. A financial mechanism is directly aimed at facilitating a broad objective, by providing finance and additional supporting services (e.g. strategic guidance, capacity building, performance assessment, policy recommendations, a clearing house mechanism and networking facilitation). It is an institution that plays several supporting roles, apart from channelling funds.

Even if the difference between the two concepts is not always clear in practice, and is often deemed "only semantic ", it is submitted that the difference is important and should be carefully considered. In the South African context, a fund may not be the most appropriate as it may be limited and not address needs such as capacity building, information sharing or policy research. It may be preferable to develop a national financial mechanism that will have a broader scope and aim, and will not be limited in its functions. However, such a question needs to be debated further in a constructive way, depending on the government's priorities and needs. In this report, the word financial mechanism is used.

3. Overview of best practices and implications for South Africa

The basic vision for the financial mechanism and its strategic focus should be in place before decisions on design issues are made. It seems that the most successful environmental financial mechanisms rely on a variety of different funding sources, including international donors and in-country sources, both public and private. The financial mechanism should be country-specific, flexible and responsive. It should be closely linked to relevant policy and budget allocation processes. The financial mechanism could provide various types of funding, including:

- Small grants (for solar water heaters, greening of buildings or water conservation): individuals and small to medium companies
- Micro-finance (small investments): individuals and small to medium companies;
- Medium-sized grants: large companies, provinces and municipalities;
- Large grants: governments or public-private partnerships (PPPs);
- Programmatic approaches (multi-year): governments or PPPs;
- Contingent grant or loan guarantee;
- Contingent loan;
- Performance grant;
- Partial credit guarantees; and
- Alternative bankable feasibility studies.

It could also provide the following assistance:

- Facilitate strategic partnership;
- Provide technical assistance;
- Provide capacity building;
- Facilitate the exchange of experience and good practice (clearing house mechanism); and
- Engage in other specific activities.

In terms of disbursement, the financial mechanism should encourage co-financing and complementarity, and should focus on incremental cost financing in terms of mitigation.

"It is recognized that perceptions of a financial mechanism's legitimacy will also depend upon an institution's performance – its demonstrated capacity to commit funding to investments that reduce greenhouse gas emissions and build resilience to climate change. Most of the climate finance mechanisms studied have not been operating at a scale or for a time period that would allow a full assessment of their performance" (Ballesteros et al., 2010).

In accordance with the needs of African nations expressed in Algeria's submission to the UNFCCC in April 2008, the following criteria should be met when creating a future financial mechanism (at the international level, but such guidance can also apply to a national financial mechanism):

- **Adequate:** Recognising the need significantly to increase the amount of money for mitigation and adaptation, funding, in particular for adaptation, must be massively increased.
- **New and additional:** Any assistance provided by developed countries under climate change needs to be additional to existing official development assistance.
- **Equitable:** Funding should be in accordance with common but differentiated responsibilities and respective capabilities.
- **Predictable:** Ensure that flows can be sustainable in the long term.
- **Accountable to the COP:** Ensure that representation is equitable and transparent.
- **Monitoring, reporting and verification (MRV):** Finance support should be monitored, reported and verified in order to assess progress.
- **Coherent:** There is a need for coherence in the climate change financial architecture.
- **Direct access:** Provide direct access to any new financial mechanisms with minimal management by intermediaries.
- **Address adaptation:** Responding to adaptation is a major priority for African governments.
- **Appropriate:** Grants versus loans debate: There should be no cost or conditionality attached to adaptation funding.
- **Efficient and cost-effective:** Funding must be used in order to trigger the maximum impact.
- **Transparent:** The procedure for allocating funding must be transparent.
- **Linkages:** It should facilitate linkages with different existing funds/financial mechanisms.

- **Sustainable:** The mechanism should be able to generate its own resources.
- **Leverage:** The mechanism must leverage maximum additional funding, be it public or private.

Such principles will have to guide the development and implementation of a climate change financial mechanism. The notions of participation in decision-making, efficiency in the administration and use of resources, general accountability and transparency are central to defining the institutional requirements and good governance aspects of a financial mechanism (Streck, 2009).

In terms of climate change, the following three matters are often referred to as the priorities to be financed: the costs of mitigation, adaptation and technology transfer. Note that each priority area has different funding needs and, therefore, each of them will require specific and customised financial assistance and instruments, taking into consideration national circumstances. Such particularities will inform the disbursement and investment strategy of a climate change fund/financial mechanism.

Based on a comparison of several environmentally related funds or financial mechanisms and an analysis of international best practices in this area, this paper provides preliminary guidance on the design, development and implementation of an environmental mechanism/fund. The following table gives an overview of the preliminary implications of the findings for the South African national circumstances.

Table 2. Overview of best practices in terms of environmental financial mechanisms

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
Origin	It should be created by national law. There is a need for initial and strong government support. The idea is normally conceptualised by one or two national departments, which then introduce the concept to the whole government for further debate and consideration. In practice, it seems better if the concept of the fund/financial mechanism is initially supported by two national departments.	The entire government, including all national departments, provinces and municipalities, need to provide official support to a climate change or environmental fund/mechanism. Initial buy-in by the relevant authorities can be achieved through an official statement by the relevant ministers. To demonstrate national support, a Cabinet decision should be taken in this regard. The Department of Environmental Affairs, supported by another department, such as the National Treasury or the Planning Commission, could introduce the concept of the fund/mechanism. It might be premature to agree on a financial mechanism at this stage, as the scope, aim and objectives of the fund or mechanism have not yet been clearly determined. The broader concept of a financial mechanism might be more appropriate for South Africa than a fund, as it is more comprehensive in scope (see section 2). However, additional information is required to inform the decision-making process. Further stakeholder engagement is recommended, at least at government level. If the government agrees to such a fund/mechanism, it is highly recommended that it be legally created by a statute. (It may be created by one statute, whether by the National Environmental Management Act or by the Treasury, and another statute may be used to regulate it, such as a Climate Change Financial Mechanism Act.) This approach would ensure clarity and transparency, and give confidence to international donors and other investors about the sustainability of the fund/mechanism. It would also ensure a certain level of political independence.

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
Scope	It can be an umbrella environmental fund/ mechanism that manages subfunds (as does the New York State Environmental Facilities Corporation, for example). Generally, financial mechanisms that focus their goals and objectives on activities selected for strategic impact, feasibility and ability to be carried out quickly to build a track record do better than those that start out with an "open door" policy based on reacting to whatever is proposed. The scope can be broadened later if appropriate. Alternatively, if a financial mechanism starts out with a broad mission and purpose, it can declare a "pilot phase" in which it focuses on a specific area before beginning to accept proposals from other areas.	Most of the current national financial mechanisms/funds are not focused only on climate change – they have a broader environmental scope, within which a funded programme is related to climate change. Which approach would be the most suitable for South Africa? One possibility would be to start with a financial mechanism focused on climate change, which could later be consolidated into a broader financial mechanism for the environment. Another is establishing a cohesive environmental financial mechanism, with a specific subcomponent dealing with climate change. A broader scope might be more appropriate in the context of sustainable development; it could facilitate a more cohesive approach to finance, managing climate finance within the broader objective of supporting sustainable development. A broader scope could also facilitate the cohesion and linkage of the various sources of finance, ensuring that they are applied consistently and in line with national priorities. In the South African context, climate change has always been considered within the broader context of sustainable development. The main policy options related to disbursement are whether resources should be prioritised for mitigation activities, adaptation activities or a combination of the two. It is recommended to focus on a combination of the two. A main priority for Africa, including South Africa, could be to ensure that adaptation funding is grant-based.
Legal status	Optimally, it should be created by national law.	It is recommended to have a statute/act regulating the fund/mechanism, setting out its functioning, governance structure and decision-making process, as well as MRV mechanisms. As noted, this will improve clarity and transparency, and ensure a certain level of political independence. However, it may be possible to design a progressive approach for the mechanism, enabling it to be functional before being made a statutory instrument. An example for this approach is one of the Environmental Funds of Moldova (see www.oecd.org/dataoecd/24/13/35155199.pdf).
Aim and objectives	A common vision is needed. Developing this support and vision may require substantial encouragement through broad consultations and advocacy, often over long periods. However, the comparative case study demonstrates that the level of participation will vary in each case. When a fund is directly linked to the implementation of a policy or law, the level of participation can be reduced, as it would already have taken place for the adoption of the policy or law in question.	A common vision needs to be developed, with clear and measurable goals and objectives, linking the financial mechanism to a national environmental action plan. The mechanism could be directly related to the implementation of the National Environmental Management Act of 1996 or the National Climate Change Response White Paper. If so, the level of public participation to determine the aim and objectives could be restricted to the main stakeholders. In the context of climate change, mitigation and adaptation actions, programmes and activities should be targeted. LIFE+ could provide guidance in this regard. The main objective of LIFE+ relates to climate change: to stabilise greenhouse gas concentration at a level that prevents global warming above 2°C. Its priority areas of action are as follows:

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
	Even if linked to a national plan, a financial mechanism needs **flexibility** to focus on selected subareas within the overall framework and to set its own priorities, investing time and effort at the design stage to help reach a consensus that will "hold" for several years. **Involving donors in the discussion allows financial mechanism designers to be aware of their interest in financing specifically targeted types of activities.** The financial mechanism needs to have broad national purposes related to a national plan, strategy, policy or legislation. There is a need for clear and measurable goals and objectives, and a link between the financial mechanism and the national environmental action plan.	- Ensuring the implementation of European Union commitments under the Kyoto Protocol to the UNFCCC and developing a post-2012 strategy and implementation programme - Ensuring the adaptation of the European Union economy and society, of nature and biodiversity, of water resources and of human health to the adverse impacts of climate change and mitigating such impacts - Ensuring the implementation and use of market-based instruments, in particular greenhouse gas emission trading, in order to achieve cost-efficient emissions reduction in a post-2012 framework.
Resource mobilisation - Reliability - Adequacy - Appropriateness - Transparency - Types of sources - Budgeting process - Mobilisation process	There is a strong need for financial and administrative discipline. Resource mobilisation focal points should initiate the process of preparing country-specific resource mobilisation strategies by collecting the necessary funding information and preparing an initial draft of their country resource mobilisation strategies. Initial drafts of these strategies should be sent to all relevant stakeholders, including various sectors of government, non-governmental organisations, indigenous peoples and local communities, environmental financial mechanisms, businesses and donors for their comments. Their views and interests should be taken into consideration in the revision of these strategies. When necessary and feasible, national workshops should be organised to finalise the strategies, with the participation of all relevant stakeholders. Regional or subregional workshops may also be organised to facilitate consideration of the strategies by regional and subregional partners and international donors. The resource mobilisation strategies will be more coherent and successful if they focus on a limited range of areas in which the financial mechanism can expect to achieve a discernible impact in a reasonable period. The financial needs assessment should consider operating costs, institution-building costs and programme support costs. One of the problems to address is fiscal policy, which might prevent the creation of extra-budgetary funds through earmarked taxes. Successful fundraising generally requires a well-considered strategy involving programme planning and financial needs assessment, as well as research on the various potential sources to determine which ones may actually be available to any given financial mechanism. A focused mobilisation programme is crucial. A resource mobilisation strategy must have:	A national resource mobilisation strategy needs to be developed, which will include a financial needs assessment. All national departments will have to be involved in this process, as will provinces and municipalities. It could also be an option for provincial and municipal authorities to develop their own financial needs assessments and/or mobilisation strategies, as most of the actions will be taken at municipal and provincial level. Such a process will require stakeholder engagement. It might also be useful to have resource mobilisation focal points for each sphere of government. The priority and most cost-effective areas for funding need to be determined to influence the resource mobilisation strategy. The strategy will be more coherent and successful if it focuses on a limited range of areas in which the financial mechanism can expect to achieve a discernible impact in a reasonable period. Flexibility and adaptability are required over time. A resource mobilisation strategy must have all the elements promoted by best practices in this context. The three spheres of government also need to commit resources from their own budgets, in a transparent and sustainable way.

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
	• Support and time commitments from all key groups, such as the board of directors, the president of the board, the national government through the corresponding ministries, and the grantee or beneficiary community • A clear vision and a sound strategic plan for growth and improvement of the funding or grant-making programme • Objectives based on clear priorities and accurate plans, budgets and needs • A compelling and authentic case for support (case statement), properly documented and supported • A market survey of potential national or international donors whose giving priorities are in line with the profile of the financial mechanism • Identification of potential funding sources: - Bilateral sources: direct grant contributions - Bilateral sources: debt conversion - Multilateral sources - Private foundations - Private corporations and individuals - Other sources, such as national governments operating potential financing mechanisms like privatisation fees, conservation easements and carbon sequestration. The first place to look for in-country sources of revenue for an environmental financial mechanism is a country's national or provincial governments. There are two basic options: a one-time government grant to endow the financial mechanism, or a government commitment to make annual budget allocations. Other potential in-country revenue sources for an environmental financial mechanism include: • Donations from individuals in the country • Donations from local or international corporations operating in the country • Donations from established local philanthropic foundations • Money from pollution fines • Money paid as part of judicially approved out-of-court settlements in pollution cases • Conservation fees • Innovative sources of funding, such as imposing a tax on airline tickets, which is earmarked for a national environmental financial mechanism (as is done in Egypt and Algeria) • Earmarking the revenues that the government collects as payment for offshore oil drilling leases for an environmental financial mechanism The professional investment management of an environmental mechanism can significantly affect both its capital and its attractiveness to future donors.	There is a need for an asset management strategy and a professional asset manager. The budgeting process is crucial and needs to be managed in a transparent manner. There is a need to determine a budget cycle of between three and five years.

Overview		
Assessment criteria	**Identified international best practices**	**Key preliminary implications for South Africa**
Resources allocation and disbursement - Accessibility/ eligibility criteria - Equity - Transparency - Types of financing/ funding - Spending categories/ investment portfolios - Investment strategy (determination of priorities and financing approaches) - Timelines - Selection and approval process - Development of standards and performance matrix - Financial management	A focused disbursement/investment programme is crucial. A country resource mobilisation strategy may contain national baselines, priorities for funding, a near-term financing plan, medium-term funding estimates, and considerations relating to monitoring, evaluation, reporting and improvement. The financial mechanism needs a portfolio of strategically selected activities. There is a need for **financial and administrative discipline.** It needs to be **easily accessible;** therefore, for each funding product, an **accessibility strategy** will have to be developed (including a **specific application process, eligibility criteria, an evaluation process, timeframes and a set periodicity of calls for proposals).** If using an existing institution, it is also important to ask whether existing operational procedures are appropriate for the kinds of activities needed or whether new ones are required. Some financial mechanisms have been able to overcome administrative bottlenecks and develop alternatives to bureaucratic procedures that kept money from reaching the field in a timely manner. Financial mechanisms that function as private institutions offer an opportunity to bring to bear a more businesslike system of financial management and controls, while maintaining transparency and accountability to contributors and other stakeholders. There is a need for prudent investment and careful management of financial mechanisms. Optimum performance depends on the financial mechanism's ability to enforce contracts with project implementers, technical assistance providers and others. There is also a need for well-established systems of banking, auditing and contracting, including appropriate legislation and oversight. When these systems are absent or cannot be depended upon, a project approach that includes other kinds of conditions and safeguards would usually be preferable. There is a need to establish: • Rules on how monies can be invested and how they can be expended • Accounting procedures and provision for outside auditors • The categories of activities and programmes that can (and cannot) be funded. There is a need for clear criteria for project selection. The selection processes needs to be transparent and fair.	A focused disbursement and investment strategy must be developed. The fund/mechanism needs a portfolio of strategically selected activities. The strategy should include a statement of investment objectives, criteria for selecting the securities, the minimum asset quality, the industry or sector concentration, and portfolio liquidity. It should also include asset mix objectives (between fixed income assets, such as bonds or certificates of deposit, equities and cash). The fund needs to be **easily accessible**. Therefore, for each funding product, an **accessibility strategy** will have to be developed (including a **specific application process, eligibility criteria, an evaluation process, timeframes and a set periodicity of calls for proposals**). There is also a need to establish rules for the investment process. It is important to distinguish between programme support costs, institution-building costs and operating costs, and to keep operating costs (for the operation and management of the fund) low in relation to programme support. According to the comparative case study, operating costs should be around 10% of the total budget of the financial mechanism and never more than 30%. Should the fund only be for national intervention or could it consider regional intervention? This question needs to be addressed by the government. However, if it is decided that the fund should have a regional scope, it should be clearly stated and the programmes or projects funded should be clearly identifiable to manage their potential implications for the mobilisation strategy (according to the sources of finance and their respective priorities). The type of sources will evolve over time, probably starting with more public and international sources and catalysing private investors over time. The fund/mechanism might also need to use instruments like bonds or loans, which generate income, to maintain its sustainability. The fund could finance different subfunds and various programmes. The most appropriate funding instruments for each project or programme need to be determined and will vary in terms of mitigation and adaptation. This will also evolve over time. However, the mechanism will need to: • Define funding scope: projects, programmes and actions. • Call for funding (frequency?). • Determine key funding instruments: grant agreements, public procurement contracts and loans (?)

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
	There should be a written investment strategy (adopted by the board) and at least an annual evaluation of the portfolio and asset manager's performance. The funds and asset manager must balance maximising the financial mechanism's annual income with minimising the risk to its portfolio and long-term capital. The strategy should include a statement of investment objectives, criteria for selecting the securities, the minimum asset quality, the industry or sector concentration, and portfolio liquidity. It should also include asset mix objectives (between fixed income assets such as bonds or certificates of deposit, equities and cash).	• Implement very strict regulations regarding resource allocation and disbursement: clear projects and programmes, criteria for selection and assessment, and funding agreements. • Ensure complementarity and rules to avoid double funding. • Allow for national, provincial and municipal priorities. • Determine the recipient: private and public, only South African entities? • Determine eligibility criteria (must be a South African interest): making a significant contribution to the achievement of the general objective in terms of climate change, being technically and financially coherent and feasible, and providing value for money. • Favour best practice or demonstration projects? • Conduct awareness-raising campaigns and special training. • Set co-financing requirements.
Governance and institutional structure - Structure/ composition - Powers and functions (oversight/ operation/ management) - Financial independence - Political independence - Accountability - Efficiency - Transparency - Decision-making and management process - Administrative costs	Environmental challenges often require new institutions to provide long-term financial stewardship and to pioneer participative and inclusive approaches to defining priorities and evaluating project proposals. In these cases, the public-private structures typically adopted by financial mechanisms can provide advantages, including the ability to time disbursements for effective use. It has **to be controlled or overseen by the government.** Most of the time, the fund/mechanism will use **intermediaries for the its credit facilities.** Developing and implementing a fund/mechanism requires **considerable investment in terms of staff time.** Where existing agencies already operate in participative and transparent ways, there may not be a need to create a new institution. However, when there is a need for a new institution that will be accountable to its stakeholders and bring in leaders from various sectors to create open and inclusive mechanisms, an environmental fund can be an effective approach.	An important question to ask when considering the creation of a fund/mechanism is whether an existing agency can effectively manage the amount of funds and type of activities needed to address the problem, such as the Department of Environmental Affairs, the National Treasury or the DBSA. It is recommended that a certain level of independence from government be maintained. The fund should not be managed by a single department. The government should be represented at board level, but it should not control the board. The decision-making process of the financial mechanisms should be as free as possible from political interference. It would be better if the board members were not political appointees. A progressive approach could be to use an existing institution until the development of a new one has been finalised. The board of directors could include members of the interministerial and intergovernmental committees on climate change. Intermediaries for the financial mechanism's credit facilities could include the development banks, private banks, the Industrial Development Corporation (IDC), the Department of Trade and Industry, and others.

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
Governance and institutional structure - Structure/ composition - Powers and functions (oversight/ operation/ management) - Financial independence - Political independence - Accountability - Efficiency - Transparency - Decision-making and management process - Administrative costs	Most financial mechanisms are traditionally managed by a **board of directors or trustees** selected through a participatory process involving beneficiaries, local non-governmental organisations, community groups, the private sector, donors and the government. The board should be selected in a participatory manner, with **good representation by beneficiaries, the government, donors and the private sector,** so that stakeholders can have confidence in the decisions taken. The roles and responsibilities of board members must be very clear, and they should meet regularly (at least annually) to set the financial mechanism's direction, provide leadership and create a vision. There will also be a level of executive management, and there is a need for a strong **executive director.** The quality of the board and executive director and the way in which they are selected and interact are key factors for success. The composition of the board of trustees (or board of directors) of the financial mechanism; its powers; the procedures for appointing and replacing board members; their responsibilities, term of office and remuneration (if any); the required frequency of board meetings; the number of board members whose presence is required in order to constitute a quorum; and the number of board members whose vote is required in order to approve of any proposed action must all be determined. The mode of appointment and responsibilities of the executive director and other staff of the trust financial mechanism also need to be decided, as well as the mode of establishment and functions of any non-voting advisory committees or councils. The fund/mechanism will also need a **financial manager** and may require **technical staff** to assess the validity of activities to be funded. Some funds/mechanisms also set up technical advisory bodies. Technical advisory committees are useful to add expertise to the financial mechanism's staff.	Decentralised environmental governance could be promoted with the replication of the mechanism at provincial and municipal levels. In order to address the governance issue, key questions need to be addressed: • What is the ideal composition of the financial mechanism's board of directors? • What is the most appropriate size for the board? • In what capacity should board members serve? • What mechanisms can a financial mechanism employ to involve stakeholders and tap important areas of expertise? • What is the right mix of public and private partners? • How can a board continue to develop the financial mechanism, the scope or the level of finance? It is highly recommended to have specific advisory groups to assist the mechanism where required. They could assist the fund in the design of specific programmes, the selection of projects and the mobilisation or disbursement strategy. Existing institutions could also support the fund, such as the DBSA and the IDC. In this context, it is important to identify and assess potential strategic partnerships and collaborations to facilitate the impact and performance of the fund/ mechanism. A private investment firm or bank that is experienced in the management of portfolios with similar objectives and of similar size should manage the assets. The asset manager should also be familiar with national circumstances and have experience in the country and, if necessary, the region. The governance structure will need to be transparent and, to some extent, reduce political interference. Issues to consider is the nomination of directors and committee members, who should preferably not be political appointees, and the duration of the mandate.

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
	Bodies such as **board committees, review panels and advisory committees** allow financial mechanisms to broaden ownership and participation by important constituencies. Board members from different backgrounds, professions and sectors of society often enable a board to fulfil a broader set of leadership functions. Such boards also bring specialised areas of expertise – for example, business management – to help meet the financial mechanism's in-house organisational needs. The participation of donor organisations can be problematic and this will have to be considered carefully. There is a need to determine the potential for strategic partnership and collaboration to enhance the impact and performance of the fund/mechanism. As with all organisations, the leadership and decision-making mechanisms of a fund have much to do with its future effectiveness. In fact, it could be argued that they constitute the most important ingredients of fund success. Careful consideration of several key components of a financial mechanism's governance structure early in its development can significantly enhance the prospects for the fund's long-term performance. Day-to-day management and administration of a financial mechanism's activities are generally carried out by a management unit headed by an executive director. The unit is responsible for: • Preparation of annual work plans and budgets • Development and implementation of systems for recruiting, receiving, reviewing and selecting proposals • Development and implementation of systems for financial management and administration • Supervision of project activities • Identification of needs for capacity building and the development of strategies to meet those needs • Audits and other transparent systems for financial accountability • Regular reporting to the board on programme and project implementation • Development and implementation (in conjunction with the board) of strategies for fundraising. A private sector investment firm or bank that is experienced in the management of portfolios with similar objectives and of similar size as the environmental fund should manage the assets. There is a need for high levels of stakeholder involvement, especially in the development of the financial mechanism. Best practices for investment management call for the use of a professional portfolio manager as well as in-house financial expertise – ideally on the board – to supervise the asset manager.	PPPs could also have a role on the implementation side of the financial mechanism. A PPP could be developed for a specific project or programme (e.g. the implementation of solar water heaters). It could provide a cost-effective approach to the implementation of some projects and programmes, and could be useful for research and the development of specific adaptation and mitigation technology.

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
Participation in decision-making	The consultative arrangement should have a clear mandate endorsed by the relevant government institutions at the appropriate level, and be composed of different ministries, development partners, civil society organisations and private sector representatives. Information on the process should be communicated to the range of relevant stakeholders to promote understanding, ownership and engagement.	It is important to obtain the right level of participation. In the South African context, it seems essential for all spheres of government to be actively involved in decision-making. Business and non-governmental organisations are also important.
Monitoring, reporting, verification and performance assessment	Monitoring and evaluation are important at different levels – the financial mechanism, its programmes and its projects. The most effective financial mechanisms have defined a clear role for themselves and established measurable indicators for the achievement of identified impacts. Accountability to contributors and the public requires rigorous record keeping and regular independent audits. The implementation of country resource mobilisation strategies should be reviewed every two years. Strategies may be revised or updated to take into account changes in domestic and external circumstances and new opportunities, experiences and lessons.	This will be essential for the mechanism/fund, and needs to provide for the following: • Monitoring of the governance of the financial mechanism (making sure that it is transparent and effective, and adheres to the principles of good governance) • Monitoring and assessment of the performance and effectiveness of the financial mechanism (impact assessment) • Monitoring of the projects and programmes over their lifecycle (including their results in terms of emissions reduction) • Monitoring of cash flow for programmes and projects • Independent auditing and monitoring to give investors confidence • Performance assessment of processes (annual performance assessment and funding cycle performance assessment) • Reporting obligation to government, donors and investors • Reporting of projects and programmes to financial mechanism • Annual reporting • International MRV requirements: Might need to create various categories of programmes with different MRV protocols, such as supported Nationally Appropriate Mitigation Actions (NAMAs), internally funded NAMAs, supported adaptation actions, internally funded adaptation actions, and other mitigation and adaptation programmes. One recommendations could be to have a specific MRV protocol, depending on the type of programmes and actions, that is, supported NAMAs, NAMAs, mitigation actions and others.

Overview		
Assessment criteria	Identified international best practices	Key preliminary implications for South Africa
Appeal and complaints procedure	There needs to be a suitable appeal and complaints procedure.	This needs to be regulated and the process needs to be transparent. If possible, it should be set by the provisions of a statute.
Other interesting factors and characteristics	Initial capacity building is required. Capacity building is an important function of financial mechanisms and involves capacity assessment during the selection process, the development of a strategy, and providing services to grantees. The Online Network on Finance could promote the sharing of information, knowledge, experiences and best practices; capacity building and cooperation; and policy development and consensus building. It provides a central portal.	The European Union principles of subsidiary and proportionality could be relevant for provinces and municipalities.

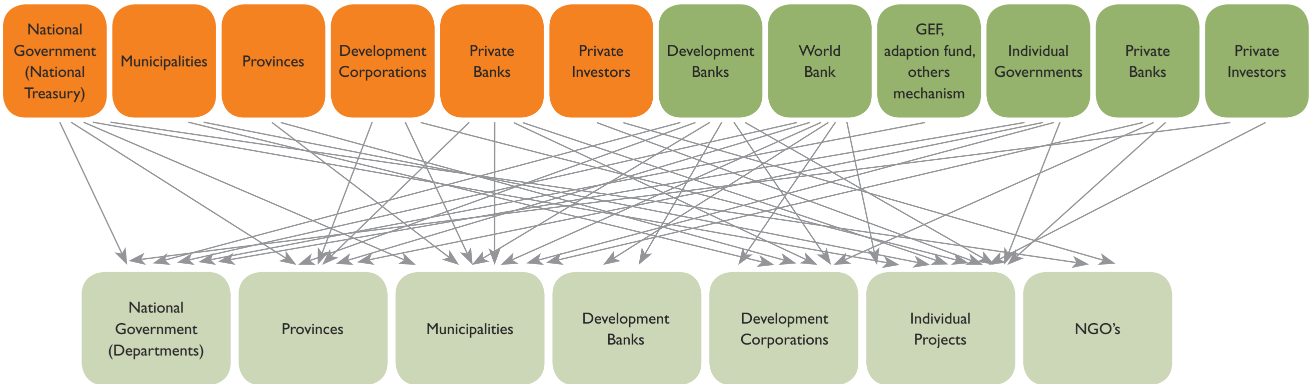
4. Preliminary strategic recommendations

Based on the above information and considering the aim of this report, some preliminary strategic recommendations can be made.

4.1 Strategic recommendations for the White Paper

At this stage, there seems to be a need to consolidate and rationalise climate change finance in South Africa. The current situation in South African is depicted in Figure 1.

Figure 1. Climate change finance: Current situation in South Africa

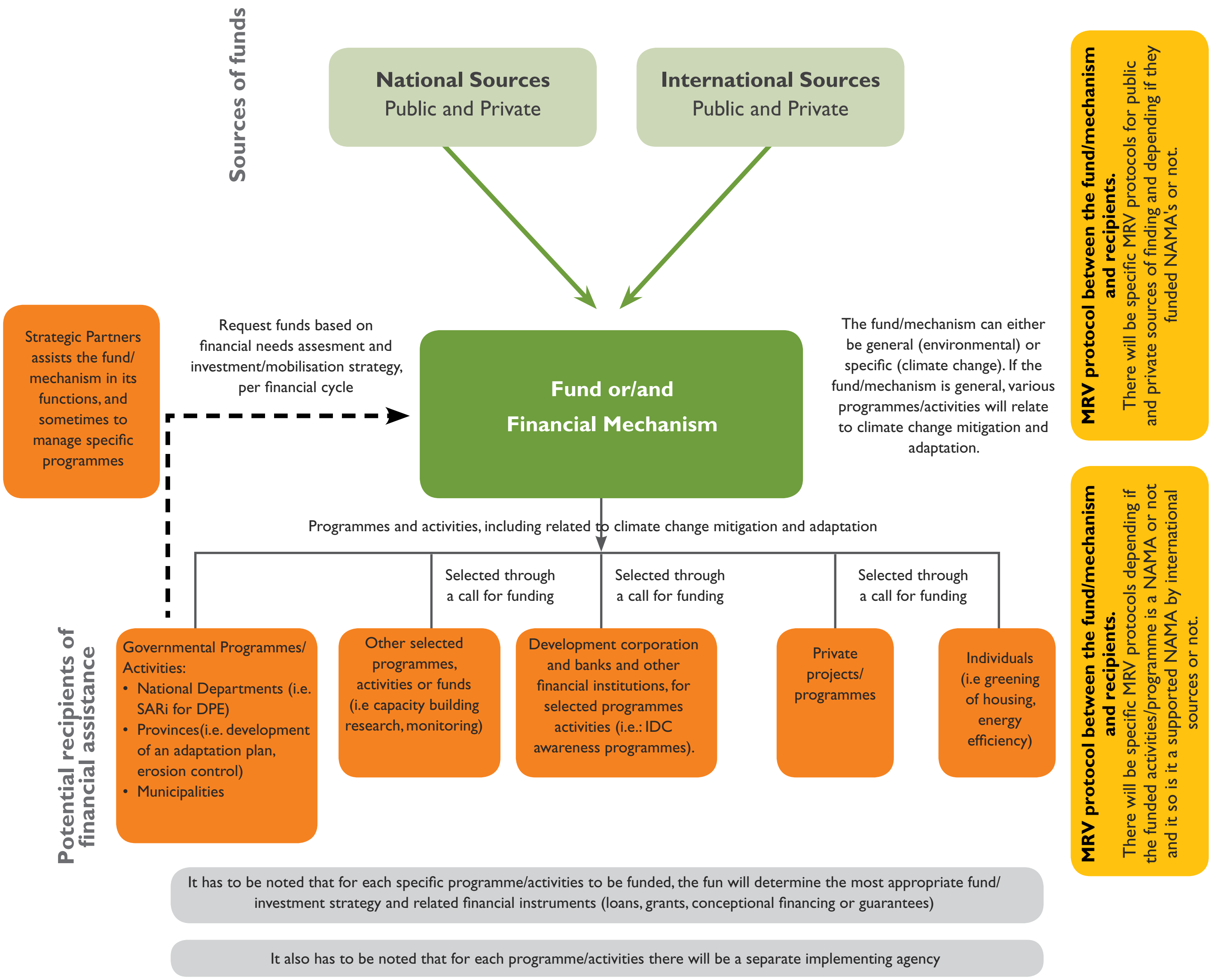


It is submitted that a rationalisation of climate change finance will facilitate the selection and implementation of cost-effective mitigation and adaptation actions in a balanced and effective way. Such an approach may limit the incidence of double funding, funding gaps or funding with low performance. It could also enable a programmatic approach and facilitate the replication of certain actions in all provinces and municipalities. It is also submitted that such a consolidation process would facilitate the sourcing of the level of finance required to implement the necessary mitigation actions, as per the country's pledge at COP15.

A fund or financial mechanism could facilitate such a consolidation process. It has been noted that "the capacity and the creativity to spend these resources well will necessitate the creation of one or more new financial mechanisms at the global level and multiple national level institutions" (Ballesteros et al., 2010).

Therefore, the development of a financial mechanism, including a climate change fund, would be very useful. A fund or financial mechanism could facilitate the consolidation process in the manner described in Figure 2.

Figure 2. Possible institutional structure of the financial mechanism



However, at this stage, the specific characteristics of such a mechanism and institution need to be debated further and, therefore, it is not recommended to be too specific. It is important to note that the White Paper will only set out a framework policy and will not provide details. It has to provide guidance on policy direction and indicate where further work is required to determine both the direction and how such work will be undertaken. Therefore, in the context of the section on "Inputs and Resources Mobilisation" and especially the reference to a "climate change fund", amendments to the White Paper are proposed, as set out in Table 3.

Table 3. Proposed amendments to the White Paper

8.1 Financial Resources *8.1.2 Government will conduct specific work to consolidate and mobilise sufficient, adequate and sustainable financial resources from national and international sources for climate change mitigation and adaptation actions. In this context, the Government, in collaboration with key stakeholders, will investigate the development and implementation of the most appropriate climate change financial mechanism to support the implementation of the mitigation and adaptation actions as per the priority areas determined by the Government. Such a financial mechanism should also provide a Climate Finance Tracking Facility that will have the responsibility to track the flows of climate finance in both the private and public sector, and that will also be responsible for reporting on the mitigation actions that have been implemented with international support.*

4.2 Broader strategic recommendations for an climate change financial mechanism

These recommendations are aimed at advising the government to investigate an appropriate financial mechanism to support the implementation of mitigation and adaptation actions as per the priority areas determined by the government. However, as underlined in the previous analysis, such a mechanism should ideally not be limited to climate change but should encompass all the environmental challenges.

- An inventory and assessment of all the current sources of funding (direct or indirect) for climate change response in South Africa should be conducted. Such an inventory should indicate the source, financial terms and conditions, performance, gaps and weaknesses, and potential to be integrated into a more cohesive financial mechanism/fund.
- The government should assess the level of additional finance required to implement the mitigation and adaptation programmes and actions set out in the White Paper.
- Then the government should assess whether a new mechanism or institution is required to manage such finance.
- The government should then conduct further work to assess the most relevant scope of the mechanism/institution: should it be restricted to climate change only or could it be broader and more general (environmental)? Initial discussions need to take place at national level regarding the rationale for a climate change financial mechanism versus an environmental financial mechanism. A broader scope might be more appropriate in the context of sustainable development; it could facilitate a more cohesive approach to finance to facilitate such development.
- The government, including all national departments and representatives of all spheres of government, will need to provide their support to the concept of the financial mechanism, whether specific or general.
- The vision, aim and objectives should be clarified and presented to all government representatives for adoption (by a Cabinet decision).
- Further consultation should be conducted between the Department of Environmental Affairs and the National Treasury to assess the exact nature of the fiscal restrictions that could limit the efficiency and sustainability of an environmental financial mechanism or fund.
- The national level of readiness for such a fund/mechanism should also be analysed (i.e. internal capacity to manage, government coherence about the role and function, government willingness, undertaking to conceptualise and develop such a fund within strict timeframes).
- The typical preliminary steps recommended by the Inter-Agency Planning Group on Environmental Funds (IPG) Handbook on environmental funds (Norris (ed.), 2000) should then be followed (see Table 4).

Table 4. Typical steps in the creation of an environmental financial mechanism

IPG HANDBOOK ON ENVIRONMENTAL FUNDS

Typical steps in the creation of an environmental fund

1. **Define general vision** – who and what the fund will support, and why. This is usually done in a consultative process in which the proponents of the fund convene a series of meetings with potential stakeholders and stakeholder groups.

2. **Organise a steering committee.** It needs to include both "workers" – people who have the expertise and time to work out the detailed design – and people with clout, who can secure the necessary high-level agreements and meetings (government ministries, international donors, etc.). The committee should also be representative of stakeholders.

3. **Develop a list of potential donors and begin meetings.** They should be approached by the government, together with influential members of the steering committee.

4. **Secure financial support for the planning and development phase.** Expenses generally include consultant and legal fees, meeting expenses, and travel for fundraising and other purposes.

5. **Develop a more specific vision and strategy.** This should be done by the steering committee in an open process where stakeholders can participate. Questions to address:

   - Role of the trust fund in the national context – relation to national plans and strategies, the government, the private sector, and the like
   - Legal structure of the fund (trust, foundation, etc.)
   - Governance (structure and composition of governing body)
   - Focus of the grant-making programme – purpose, objectives, who is eligible to receive grants, criteria for selecting them. Obviously, this will change and develop over time but a well-developed starting point is essential.
   - Financial projections – how much money will the fund need? What percentage will be endowment, what percentage long-term sinking or replenishing funds? This should be commensurate with the objectives of the grant-making programme – enough to achieve a reasonable percentage of the objectives. If that calculation runs into an impossible figure, narrow the objectives.

6. After thorough discussion of the above points, **draft conclusions into a proposal for the establishment of the fund.** Consultations with donors should have been ongoing throughout the process. The committee is now ready to present the proposal to them. This may involve meetings with in-country officials, as well as at the donor's own national or international headquarters.

7. After there is a reasonable expectation of a donation (it is in process with the donor), hire a lawyer to draft papers of incorporation and statutes or by-laws. These will define the processes for electing the governing body.

8. **Incorporate the fund and elect the governing body** (which should include mostly people who have served on the steering committee).

9. **Receive initial funding, hire staff, open the office, and initiate the grant programme.** If there is a delay between steps 8 and 9, and if there is sufficient start-up money, this period can be spent developing the board, preparing the operating manuals, drafting the terms of the first call for proposals, developing application forms, and the like. Public meetings for interested parties and potential recipients explaining what the fund is all about should also be ongoing during this period.

- The St. Petersburg Guidelines should also be adopted, as per Table 5.

Table 5. St. Petersburg Guidelines

The St. Petersburg Guidelines on environmental funds in the transition to a market economy (OECD/GD(95)108, Paris 1995), adopted by the OECD EAP Task Force in 1995, recommend the primary internationally recognised good standards for institutional setup, management and performance of environmental funds. The criteria set forth in the Guidelines have been used as a benchmark in assessing the performance of a number of environmental funds in Central and Eastern Europe. This framework was also used in the voluntary review of the National Environmental Fund of Moldova and the Chisinau Municipal Fund.

Main recommendations of the St. Petersburg Guidelines:

- To avoid or minimise the long-term economic inefficiencies inherent in the earmarking of funds, expenditure should be targeted to environmental priorities and projects with large environmental benefits relative to their costs.
- Environmental funds should play a catalytic role in financing environmental improvements, and support, not compete with, emerging capital markets.
- Environmental funds should reinforce other environmental policy instruments.
- Environmental funds should develop an overall financing strategy, follow clear procedures for selecting projects in order to ensure cost-effective use of resources, adopt effective monitoring and evaluation practices, and make effective use of internal and external expertise to enhance administrative efficiency.
- Environmental funds should leverage increased private sector resources and capital market financing for environmental investments.
- In designing and evaluating fund revenue mechanisms, environmental authorities should ensure environmental effectiveness, economic and administrative efficiency, equity and acceptability.
- Environmental funds should ensure transparency and should be accountable to the government, parliament and the public for their actions.

- More specifically, the detailed guidance from best practices identified through the comparative case study and further research, as outlined in Table 2, should also be followed.
- Further research should be conducted regarding the legal status of the fund/mechanism, sources of funding (nature, level, conditionality and sustainability), priority programmes and actions for funding, and funding strategies for each priority programme and action.

The above recommendations are aimed at facilitating the conceptualisation, development and implementation of a comprehensive and sustainable climate change or environmental financial mechanism. Such a process will take time and, therefore, an interim or provisional solution will be necessary to manage climate change finance in the short to medium term. Financing for climate change adaptation and mitigation initiatives needs careful consideration to clarify what may unlock scalable interventions in the short term.

The following recommendations are submitted to develop an interim or transitional solution to climate change finance, which could be referred to as a climate change fund, while a consolidated financial mechanism is being developed:

- The scope of the interim approach will be focused on climate change.
- The Department of Environmental Affairs and the National Treasury should determine the most suitable interim or transitional financial vehicle to receive and manage climate change finance while a more comprehensive financial mechanism is being developed.
- The interim financial vehicle should determine and target specific priority areas in terms of mitigation and adaptation. For each priority area, an inventory and assessment of all the current sources of funding (direct or indirect) should be conducted. Such an inventory should indicate the source, financial terms

and conditions, performance, gaps and weaknesses and potential for integration into a more cohesive financial mechanism/fund. The government should then assess the level of additional finance required to implement the mitigation and adaptation programmes and actions set out in the White Paper.

- The interim approach will have to be adopted by Cabinet and managed by one or more national department.
- The interim approach will have to be clearly explained to potential donors and investors.
- The approach to the Environmental Funds of Moldova could inform the development of an interim approach for South Africa.
- However, note that the conceptualisation, development and implementation of a consolidated financial mechanism will require time and dedication. It is not recommended that any shortcut be taken during the process, as this could affect the integrity and effectiveness of the mechanism. Therefore, these last recommendations should apply only to the development of an interim and transitional approach.

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315 Pretorius street
cnr Pretorius & van der Walt Streets
Fedsure Forum Building
North Tower
2nd Floor (Departmental reception) or
1st Floor (Departmental information center)
Pretoria, 0001.

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