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# INTEGRATING CLIMATE FINANCE AND CARBON MARKETS

Carbon markets represent a tool for mobilizing investment in mitigation activities, driving progress towards achieving NDCs and raising ambition in global climate action, through results-based payments. As such, they are distinct, but complementary to climate finance. Defined in this context as transboundary finance to support mitigation and adaptation activities in developing countries

In Sub-Saharan Africa, including many West African countries, neither carbon markets nor climate finance alone have been effective in mobilizing sufficient investment and resources into GHG mitigation and adaptation activities. This is due to general barriers to investment in the region, such as insufficient market development and infrastructure, high interest rates, currency risk, inflation and political instability. This hinders the effective provision of climate finance, as climate finance instruments usually have explicit co-finance requirements and require pre-existing investment (e.g. new renewable energy installations require an extensive grid). In addition, the climate and carbon finance is fragmented which is a barrier in particular for countries that lack capacities and track record to access funding.

Despite these challenges, both instruments will likely continue to play a relevant role in the future, i.a due to the need for large scale investments in mitigation activities with high sustainable development and adaptation benefits, combined with increasing recognition of the role of private sector for such investments and evolving technologies. The “blending” carbon markets and climate finance can be explored as an opportunity to leverage synergies between both instruments if key conditions, in particular with regard to attribution, are met.<sup>1</sup>

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<sup>1</sup> Hoch, Stephan; Ombuya, Sherri; Waweru, Peris; Greiner, Sandra; Andreo Victoria, Gema; Della Maggiore, Marco; Kelly, Roberts; Cowman, Tim; Owino, Thomas; Sosis, Karin; Dunod, Alexandre; Goret, Harold (2022): Financing sustainable energy access in African NDCs. Enhancing ambition

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In essence, carbon and international climate finance sources can be "integrated", although practical experience thus far is limited. This integration makes conceptual sense when the revenue from carbon credits alone cannot render an activity financially viable, and international climate finance steps in to cover the remaining gap, or vice versa. Such an approach enables a movement up the marginal abatement cost curve, facilitating the pursuit of increasingly 'high-hanging fruit'.

There are two ways in which integration of finance (so-called 'blending') can occur, namely indirect and direct integration<sup>2</sup>:

## **1. Indirect Integration: Implicit International Climate Finance Through the Share of the Mitigation Remaining in the Host Country**

Under the Clean Development Mechanism (CDM), mitigation outcomes were entirely transferred to the buyer in the form of emissions credits. Conversely, some European Union (EU) host countries, under Joint Implementation (JI), opted to issue credits for only a portion of the mitigation outcomes, retaining the remainder towards their targets. It is anticipated that, under the Paris Agreement (PA), host countries may wish to retain a share of the mitigation outcomes for their Nationally Determined Contributions (NDCs). This can be achieved through measures like authorising only a partial transfer of verified mitigation outcomes or indirectly through crediting baselines more stringent than Business-As-Usual (BAU) and aligned with the PA's long-term temperature goal. Regardless of the approach, if it results in a reduced volume of emissions credits transferred, it represents implicit international climate finance, mobilised indirectly by the international buyer of Internationally Transferred Mitigation Outcomes (ITMOs).

The economic consequence of retaining a share of the mitigation is that, at the margin, the price per ITMO must increase proportionally to the percentage of the mitigation retained. For instance, if the host country retains 30% of the mitigation, the price needs to increase by 42.8% (1 divided by 0.7) at the margin, assuming the host country does not share a part of these costs. This price increase compared to the situation without retaining mitigation in the host country constitutes the mobilised international climate finance.

Cancelling a share of ITMOs for Overall Mitigation of Global Emissions (OMGE) does not generate the same effect since the mitigation benefits the atmosphere, not a specific country. Hence, it is inappropriate to allocate the implicit finance

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through linking carbon markets and climate finance; Climate Finance Innovators, Freiburg, Germany, <https://climatefinanceinnovators.com/publication/financing-sustainable-energy-access-in-african-ndcs/> (accessed April 22, 2024),

<sup>2</sup> Espelage, Aglaja; Ahonen, Hanna-Mari; Michaelowa, Axel (n.a.): The role of carbon market mechanisms in climate finance, In: Michaelowa, Axel; Sacherer, Anne-Kathrin. Handbook of International Climate Finance. Cheltenham UK: Edward Elgar Publishing Online, 352-378.

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generated by the price increase to developing countries. However, a proxy calculation could be done by considering the "share" of developing countries in the global total of economic or other parameters, such as population.

## **2. Direct Integration: Combining Sources of Carbon and Climate Finance for Distinct Activities/Policy Instruments**

In principle, integration can occur at an activity-specific level, where part of the investment in an activity generating carbon credits comes from public sources. In this approach, climate finance not mobilised through carbon markets acts as a "subsidy" to carbon finance. This may take the form of direct financial disbursement for monitoring an activity or subsidised loans. For example, a public entity may offer international climate finance to support the enabling conditions of a mitigation activity, such as financing the reporting and accounting infrastructure. Simultaneously, a private actor contributes the remaining investment and, in turn, receives the carbon credits. In principle, the entity providing both elements of finance can be the same, such as a buyer country government overseeing both financial aspects and receiving the credits. In a scenario incorporating blending, the availability of carbon credits increases, potentially leading to a decrease in the credit price if demand remains constant.

Carbon crediting mechanisms can channel diverse financial resources to facilitate and monitor the efficacy of mitigation actions. This applies both to fulfilling conditional NDC targets and fostering ambition-raising. It's important to note that climate finance need not be limited to activities easily measurable through MRV, as certain supportive actions, can yield significant indirect mitigation benefits. To optimise the utilisation of climate finance, carbon finance, and OMGE finance, alignment of all financial flows with the long-term objectives of the Paris Agreement must be conducted. For countries seeking to attract carbon and climate finance for NDC implementation and enhancement, transparent communication of target conditionalities is crucial.

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