

*Chapter 21*

**Getting Climate-Related  
Conditionality Right**

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*Key Points*

- Climate-related conditionality is an inevitable feature of many future public and private investments in developing countries.
- Climate conditionality raises two basic sets of substantive concerns, one relating to its effectiveness and efficiency, the other to conflicts between climate conditionality and broader development goals and equitable concerns.
- In order to ensure effectiveness and consistency with other objectives, publicly funded investment funds using climate conditions should provide due process to the citizens of recipient countries.

Conditionality has gotten a bad name in development finance. But it may be rehabilitated by the emerging climate change regime. Mitigating climate change by reducing emissions of greenhouse gases (GHGs) from developing countries will require substantial amounts of capital. Some of that capital will come from individuals or organizations who insist that their funds be used in ways that tend to promote mitigation. In other words, they will insist on conditionality. This raises a number of policy concerns, including several that are reminiscent of debates about conditionality in other contexts.

The first part of this paper provides an overview of existing forms of climate related conditionality. The second part sets out the main substantive issues involved. The third part considers implications for institutional design and the process by which conditions are formulated.

*The Landscape of Climate-Related Conditionality*

Climate-related conditionality can take a number of different forms, ranging from obligations for the recipient of funds to reduce emissions from its own activities, to obligations to encourage other actors to reduce emissions, to obligations for recipients to report on their own or others' efforts to mitigate climate change. Many different kinds of organizations have demonstrated interest in imposing conditionality of one sort or another on financial transfers to developing countries or to enterprises or projects located in those countries.

### *Public Funds Dedicated to Mitigation*

A number of large funds sponsored by public actors have been created to channel mitigation-related capital to actors in less-developed countries on concessional terms. These funds are dedicated exclusively to investments in mitigation. Funds created under the auspices of the United Nations Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol and through other multilateral initiatives include:

- Global Environmental Facility (USD 3.1 billion for 2006 – 2010)
- United Nations Collaborative Programme on Reducing Emissions from Deforestation and Forest Degradation in Developing Countries (UN-REDD) (USD 35 million)
- World Bank — Forest Carbon Partnership Facility (USD 165 million)
- World Bank — Climate Investment Funds (USD 6.1 billion), made up of the Clean Technology Fund and the Strategic Climate Fund

Additionally, instead of financing specific projects, the World Bank Carbon Finance Unit (CFU) uses money contributed by governments and companies in Organisation for Economic Co-operation and Development (OECD) countries to purchase project-based GHG emission reductions in developing countries and countries with economies in transition. The reductions are purchased through one of the CFU's carbon funds on behalf of the contributor and within the framework of the Kyoto Protocol's Clean Development Mechanism (CDM) or Joint Implementation (JI) program.

Bilateral initiatives by developed country governments include:

- Japan — Cool Earth Partnership (USD 10 billion)
- UK — Environmental Transformation Fund (GBP 800 million)
- Norway — Climate and Forest Initiative (€ < 600 million)
- United Nations Development Programme — Spain MDG Achievement Fund (€90 million)
- EC — Global Climate Change Alliance (€100 million)
- Germany — International Climate Initiative (€400 million)
- Australia — International Forest Carbon Initiative (AUD 200 million)

### *Other Bodies That Have Adopted Climate-Friendly Standards and Investment Policies*

While many organizations that invest in developing countries do not have funds dedicated exclusively to investments in mitigation, they have adopted policies that call for giving priority to climate-friendly investments or at least for avoiding investments that have the opposite effect. Some of these policies are legally binding, others are voluntary.

Publicly sponsored organizations that have taken steps to incorporate climate change concerns into their investment decisions include the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the World Bank, all of which include the reduction of GHG emissions among the priorities

they seek to advance in their financing of projects<sup>1</sup>. As a result, these organizations often make financing of projects conditional on the climate-friendliness of those projects.

Several associations of financial intermediaries have adopted voluntary codes of conduct that include commitments to support only climate-friendly projects. One such initiative is the Equator Principles, which have been adopted voluntarily by over 60 project finance institutions. The Principles require participating institutions to observe the IFC Performance Standards in their lending activities and to provide annual reports on their progress. The IFC's Performance Standards currently require, among other things, clients to report certain GHG emissions and encourage them to employ cost-effective measures to reduce or offset emissions.<sup>2</sup>

Another example is the Investor Network on Climate Risk (INCR), a network of more than 80 leading institutional investors with collective assets of more than USD 7 trillion. In 2008, INCR announced its Action Plan calling for investors to take nine specific steps to address the growing risks and opportunities from climate change, with a significant focus on reducing GHG emissions. The steps include the following commitments:

- Support clean technology, with a goal of deploying USD 10 billion collectively over the next two years
- Require and validate that investment managers, investment consultants, and advisors report on how they are assessing climate risks in their portfolios, including risks from new carbon-reducing regulations, physical impacts, and competitive risks
- Encourage Wall Street analysts, rating agencies, and investment banks to analyze and report on the potential impacts of foreseeable long-term carbon costs in the range of USD 20 to USD 40 per metric ton of CO<sub>2</sub>, particularly on carbon-intensive investments such as new coal-fired power plants, oil shale, tar sands, and coal-to-liquid projects
- Push the SEC to issue guidance leading to full corporate disclosure of climate risks and opportunities

### *Substantive Considerations*

The consequences of adopting any given form of conditionality can be evaluated along a number of dimensions. First, will the conditions be effective? In other words, are the expectations that climate-related conditionality will have a significant effect on the behavior of potential recipients of funding — or other actors — justified? Second, will the resulting reductions of GHG emissions be cost-effective? Third, what impact will climate-related conditionality have on economic development in developing countries? Fourth, will this form of conditionality promote or undermine the equitable distribution of wealth and economic opportunity, either across or within countries? We consider each of these questions in turn.

## Effectiveness

The idea that climate-related conditionality will exert a meaningful influence on behavior cannot be presumed. No particular form of conditionality will be effective unless it is adopted by enough investors to cause a meaningful reduction in the amount of capital available without the relevant conditions. A single bank's refusal to finance coal-fired power plants will have little or no effect on overall investment in that type of project.

Accordingly, the most successful conditions, in terms of effectiveness, are likely to be ones attached to funding provided by the multilateral and regional development banks. Those entities remain an important source of funding for many developing countries, especially when it comes to concessional funding targeted at mitigation and adaptation-related projects. Moreover, through the Equator Principles and similar initiatives, the conditions imposed by the development banks also tend to be adopted by large numbers of private actors — a form of cross-conditionality.

Of course, the effectiveness of any given set of conditions depends on whether they are actually enforced. It is not always in the interests of funding organizations to insist upon compliance with climate-related conditions. For instance, managers of profit-oriented funds that have signed on to the Equator Principles may still be tempted to invest in carbon-intensive projects that offer high economic returns. Meanwhile, employees of development banks may experience pressure to fund dirty projects, either from member states or from constituencies within their organization who have an interest in maximizing the volume of lending.

Effectiveness is a question that would benefit from empirical research. It would be useful to know, for example, whether organizations that have the right to insist on compliance with climate-related conditions either ignore instances of non-compliance or waive the right to insist on compliance. If organizations do relax their compliance or enforcement standards, it would be helpful to know when and why they do so.

## Cost-Effective Emission Reduction

To the extent that climate-related conditionality is an effective method of altering the behavior of the recipients of funding or other actors, the next question is whether the result is a cost-effective reduction of GHG emissions. There are several reasons why this outcome cannot be presumed. First, some funds may employ social or economic conditions — including sectoral or geographic limitations — that go beyond requiring emission reductions and preclude investment in projects associated with relatively cost-effective reductions in GHG emissions. Second, when a number of projects satisfy the conditions of a given fund, it may, either advertently or inadvertently, fail to give priority to the projects that offer the greatest reduction in GHG emissions per unit of capital invested.

One way to address these concerns is for funding organizations to review their conditions regularly to ensure that they are promoting cost effective emission reductions. A more fundamental response would be to abandon funding conditionality altogether and rely on economic actors to identify cost-effective mitigation opportunities using the price signals generated by, say, a cap-and-trade or credit trading system.

An additional consideration is that conditionality entails certain transaction costs — the costs that both providers and recipients of capital bear in monitoring, reporting, and verifying compliance with any given set of conditions. Those costs can be particularly significant for developing countries with limited institutional capacity. Transaction costs may also be particularly high when recipients have to comply with several distinct sets of climate-related conditions. If the benefits of conditionality were outweighed by the related transaction costs, this would weigh in favor of abandoning conditionality (although the transaction costs associated with alternatives may not be trivial). One strategy for limiting the costs of conditionality is to enhance consistency across the climate-related conditions imposed by various financial institutions, both public and private. This could be accomplished through explicit harmonization, incorporation by reference to international standards developed through the Copenhagen process, or forms of cross-conditionality where one organization adopts another's standards.

### Host-Country Development

Allocating capital in a fashion that efficiently reduces GHG emissions is not necessarily consistent with maximizing benefits to society along other dimensions. In the absence of regulation, the most climate-friendly projects are usually not the ones that generate the largest pecuniary returns for investors. Likewise, climate-friendly projects will not necessarily generate the greatest amounts of employment, the most helpful forms of technology transfer, or the most effective forms of adaptation to climate change. This raises the potential for conflicts between the interests of actors concerned primarily with climate change mitigation and the interests of inhabitants of developing countries.

This issue is coming to a head in the debate over whether the multilateral development banks and other financial institutions should finance coal-fired power plants. The World Bank has a goal of having 50% of its energy portfolio dedicated to low-carbon investment (which includes clean coal with several conditions attached). If enforced, this policy will reduce the supply of capital for new coal-fired power plants to some extent. Is this in the best interests of countries that desperately need cheap energy to sustain their economic development? These concerns are particularly pressing for the Least Developed Countries, which desperately need growth and are only minimally responsible for past and present GHG emissions, and yet are also most vulnerable to the negative consequences of global warming.

### Equity

The benefits of GHG emissions reductions will be distributed globally, though not necessarily uniformly. Meanwhile, to the extent that individual projects create jobs, transfer technology, or support adaptation to climate change, the costs and benefits are likely to be concentrated in the projects' host countries, and even among particular segments of society. Conditions that preclude financing for coal-fired power plants are one example: they may provide global benefits at the expense of the inhabitants of developing countries. As another example, conditions that promote investments in REDD may produce globally diffused benefits in the form of climate change mitigation and

locally concentrated benefits for governments or private landowners who receive cash transfers to encourage forest conservation. But these conditions may simultaneously impose substantial costs on indigenous groups prevented from using forests in traditional ways.

Another important issue is whether it is appropriate to impose conditions that are inconsistent with the distribution of mitigation-related costs agreed to by states in international negotiations. In other words, is Copenhagen-plus conditionality acceptable? This question is likely to be a particularly pressing one for the multilateral development banks, whose conditionality arguably should not deviate significantly from international law.

### *Implications for the Process of Implementing Conditionality*

The processes by which conditions are formulated and enforced also raise some extremely important concerns. Due process in conditionality — in the colloquial rather than the legal sense — is intrinsically worthwhile, and may also, to the extent that it enhances legitimacy, tend to induce both providers and recipients of capital to adopt and comply with conditions. As we have already argued, widespread adoption and compliance is important if conditionality is to be effective and implemented with minimal transaction costs.

In the context of climate-related conditionality, the central procedural questions revolve around the roles that different parties, especially the inhabitants of recipient countries, ought to play in formulating conditions. These questions are particularly important for conditionality imposed by publicly sponsored actors. It seems intuitive that local constituencies affected by the decision of a public actor ought to be entitled to benefit from well-designed accountability, transparency, and participation mechanisms. In other words, to the extent that a fund's investment decisions affect the level or distribution of wealth in a society, it ought to be accountable to members of that society who in turn ought to be able to participate in those decisions, observe the processes by which they are made, and hold the decision-makers accountable.

The difficulty, however, with granting procedural entitlements to actors from recipient countries is that they may favor different substantive outcomes than providers of capital. For instance, they may prefer projects that generate local employment to projects that efficiently reduce emissions. Or they may prefer projects that support adaptation over those that support mitigation. Consequently, granting local actors robust procedural entitlements risks alienating financiers with opposing preferences. Generating this kind of local ownership of the process of formulating and enforcing conditions, without undermining other objectives, is one of the central challenges associated with all forms of conditionality.

### *Conclusion*

Climate-related conditionality in development finance is probably inescapable. The challenge going forward will be to fashion conditions that balance potentially competing interests in effectiveness, cost-effective emissions reductions, development,

and equity. Formulating institutions and processes capable of resolving these issues in a legitimate fashion ought to be a central concern in designing a global regime to address climate change.

### F u r t h e r R e a d i n g

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<sup>1</sup> See IFC, “Performance Standards on Social and Environmental Sustainability,” Standard 3, [http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/pol\\_PerformanceStandards2006\\_full/\\$FILE/IFC+Performance+Standards.pdf](http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_full/$FILE/IFC+Performance+Standards.pdf); and World Bank Group, “Environmental, Health, and Safety Guidelines” (known as the “EHS Guidelines”), section 1.1, “Air Emissions and Ambient Air Quality,” [http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/gui\\_EHSGuidelines2007\\_GeneralEHS/\\$FILE/Final+-+General+EHS+Guidelines.pdf](http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/gui_EHSGuidelines2007_GeneralEHS/$FILE/Final+-+General+EHS+Guidelines.pdf). IFC, “Performance Standards on Social and Environmental Sustainability,” Standard 3(11).

<sup>2</sup> IFC, “Performance Standards on Social and Environmental Sustainability,” Standard 3(11).