

NATIONAL CLIMATE CHANGE ACTION PLAN



REPUBLIC OF KENYA

National Climate Change Action Plan

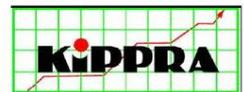
Finance

Section A: Introduction

August 2012

:viveconomics

 **Adam Smith**
INTERNATIONAL AFRICA

**KIPPRA**
The KENYA INSTITUTE for PUBLIC
POLICY RESEARCH and ANALYSIS

Reproduction of this publication for educational or non-commercial purposes is authorized without prior written permission from the copyright holders provided the source is fully acknowledged. With the exception of the funders of this publication, reproduction of this publication for resale or other commercial purposes is strictly prohibited without prior written permission of the copyright holder.

Disclaimer

The views expressed in this publication are not necessarily those of the agencies cooperating in the National Climate Change Action Plan process. The designations employed and the presentations do not imply the expression of any opinion whatsoever on the part of the Government of Kenya or cooperating agencies.

Mention of a commercial company or product in this publication does not imply endorsement by the Government of Kenya. The use of information from this publication concerning proprietary products for publicity or advertising is not permitted.



This document is an output from a project funded by the UK Department for International Development (DFID) and the Netherlands Directorate-General for International Cooperation (DGIS) for the benefit of developing countries. However, the views expressed and information contained in it are not necessarily those of or endorsed by DFID, DGIS or the entities managing the delivery of the Climate and Development Knowledge Network*, which can accept no responsibility or liability for such views, completeness or accuracy of the information or for any reliance placed on them.

© 2012, All rights reserved

* The Climate and Development Knowledge Network (“CDKN”) is a project funded by the UK Department for International Development (DFID) and the Netherlands Directorate-General for International Cooperation (DGIS) and is led and administered by PricewaterhouseCoopers LLP. Management of the delivery of CDKN is undertaken by PricewaterhouseCoopers LLP, and an alliance of organisations including Fundación Futuro Latinoamericano, INTRAC, LEAD International, the Overseas Development Institute, and SouthSouthNorth.

Contents

1.	Abbreviations.....	1
2.	Introduction	2
3.	The current climate finance landscape	3
3.1	International climate finance	3
	3.1.1 Public sources of international climate finance	4
	3.1.2 Private sources of international climate finance	7
3.2	National sources of climate finance	9
	3.2.1 Public sources of domestic climate finance	9
	3.2.2 Private sources of domestic climate finance	10
4.	Financing the Climate Change Action Plan	11

1. Abbreviations

AFD	Agence Française de Développement
AfDB	African Development Bank
CDM	Clean Development Mechanism
CERs	certified emission reductions
COP	Conference of the Parties
CSR	corporate social responsibility
DFID	Department for International Development
EU ETS	European Union Emissions Trading Scheme
GCF	Green Climate Fund
GW	Gigawatt
IFC	International Finance Corporation
KCCAP	Kenyan Climate Change Action Plan
KES	Kenyan shilling
KfW	Kreditanstalt für Wiederaufbau
MDBs	Multilateral development banks
MW	Megawatt
NCCRS	National Climate Change Response Strategy
RDBs	Regional development banks
SIDA	Swedish International Development Cooperation Agency
UNFCCC	United Nations Framework Convention on Climate Change
USD	United States Dollars

2. Introduction

The implementation of the Kenyan Climate Change Action Plan (KCCAP) will require substantial financial resources. The initial analysis within the National Climate Change Response Strategy¹ (NCCRS) suggests that the financial requirements to move Kenya onto a low-carbon, climate resilient growth path may be in the region of KES 235 billion (\$2.75 billion) per annum split roughly equally between mitigation and adaptation. Even allowing for a downward adjustment following the prioritisation exercise currently underway within the Action Plan, it is clear that Kenya is embarked on a bold and ambitious plan.

The international community is committed to supporting developing countries in providing the financial resources to realise their climate change goals. The Copenhagen Accord states that²:

“In the context of meaningful actions and transparency on implementation, developed countries commit to a goal of mobilizing jointly USD 100 billion dollars a year by 2020 to address the needs of developing countries. This funding will come from a wider variety of sources, public and private, bilateral and multilateral, including alternative sources of finance.”

This commitment was subsequently noted in the Cancun Agreements. Although delivery under this commitment is still uncertain, the scale-up of finance it implies provides important opportunities for Kenya to finance its Action Plan.

For Kenya to realise its bold ambitions, all sources of climate finance will need to be tapped – domestic action will also be crucial. Although international resources from both the public and private sector can play a key role in Kenya’s transition, they will need to be complemented by domestic financial resources both from the public and private sector. These can be targeted at the investment opportunities that most clearly both promote Kenya’s development and reduce its emissions and/or improve its climate resilience. Furthermore, the greater the efforts made domestically – both in terms of spending domestic resources and using international resources transparently and wisely – the more international resources are likely to flow.

This report provides a comprehensive package of recommendations and actions to scale up climate finance resources with Kenya. The report consists of five sections (sections A-E)³ which provide the substantive recommendations to meet this goal. These are supported by a number of background report and analyses which are included as annexes.

This introductory section (section A) provides a summary of the current landscape of climate finance, and its key debates, both internationally and as they relate to Kenya. It provides the context in which the specific recommendations and actions relating to the financing of Kenya’s Action Plan – identified in sections B-E – can be understood. It also explains the methodology by which the conclusions were reached.

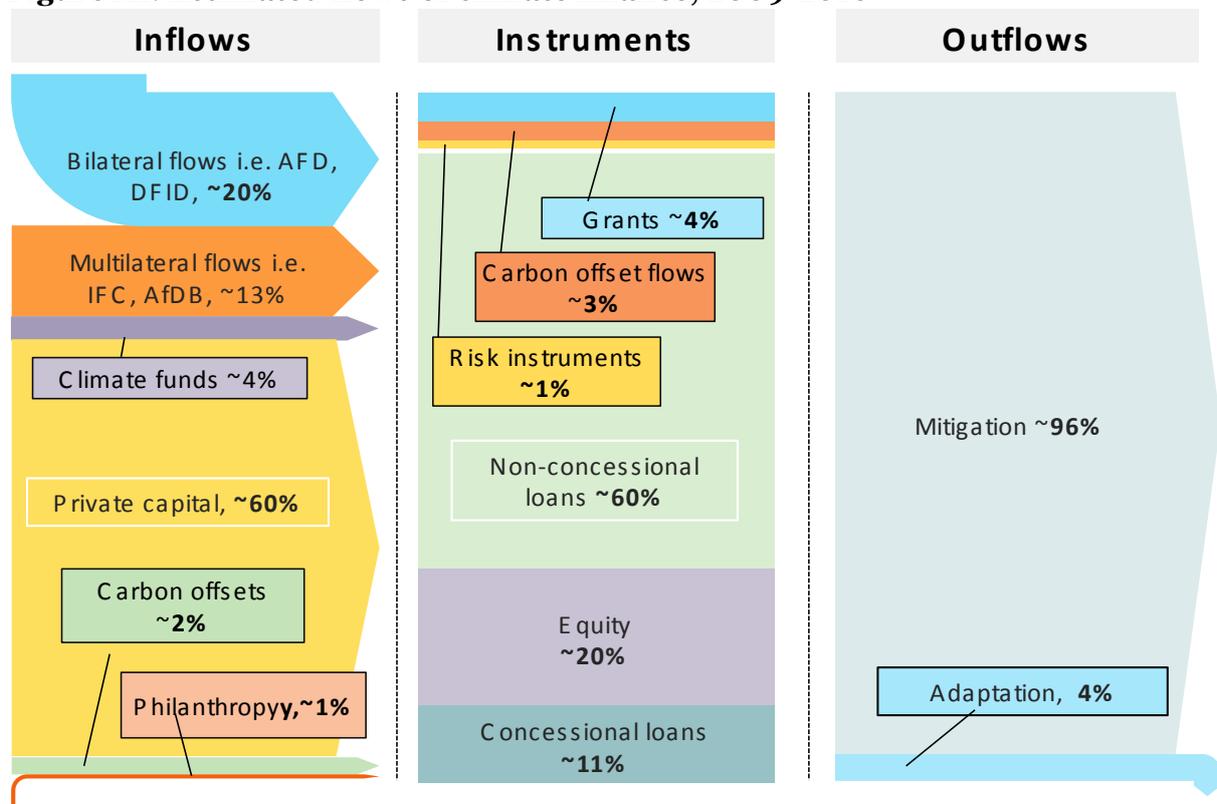
3. The current climate finance landscape

This chapter provides an overview of the current climate finance landscape, and Kenya’s existing interactions with it. It divides the analysis into international and domestic sources of finance.

3.1 International climate finance

Internationally, climate finance currently amounts to circa \$97 billion a year⁴. Figure A1 below provides a useful way of depicting the international climate finance landscape. The left hand side depicts different sources of climate finance, e.g. bilateral agencies, multilateral agencies, the private sector and philanthropy; the middle column specifies the financial instruments provided by these different parties; and the final column shows the activities that are supported by these financial resources. In other words, climate finance flows from bilateral sources account for around 20 per cent of climate finance flows, around 4 per cent of total climate finance is provided as grants and 96 per cent of climate finance flows are directed towards mitigation.

Figure A1: Estimated flows of climate finance, 2009-2010



Source: Vivid Economics (based on CPI (2011) ‘The Landscape of Climate Finance’. Analysis is based on flows over the period 2009-2010.

A number of key features can be seen from this figure:

- Private capital flows account for a significant proportion of international climate finance flows. Access to this source of finance will be crucial if Kenya is to finance its ambitions.
- Consistent with this, the majority of financial resources are provided as either non-concessional debt or equity.
- Globally, the vast majority of climate finance is flowing towards mitigation; less than 5 per cent is used to finance adaptation. This is inconsistent with Kenya's needs: the NCCRS has a much more even split of required financial resources between adaptation and mitigation.

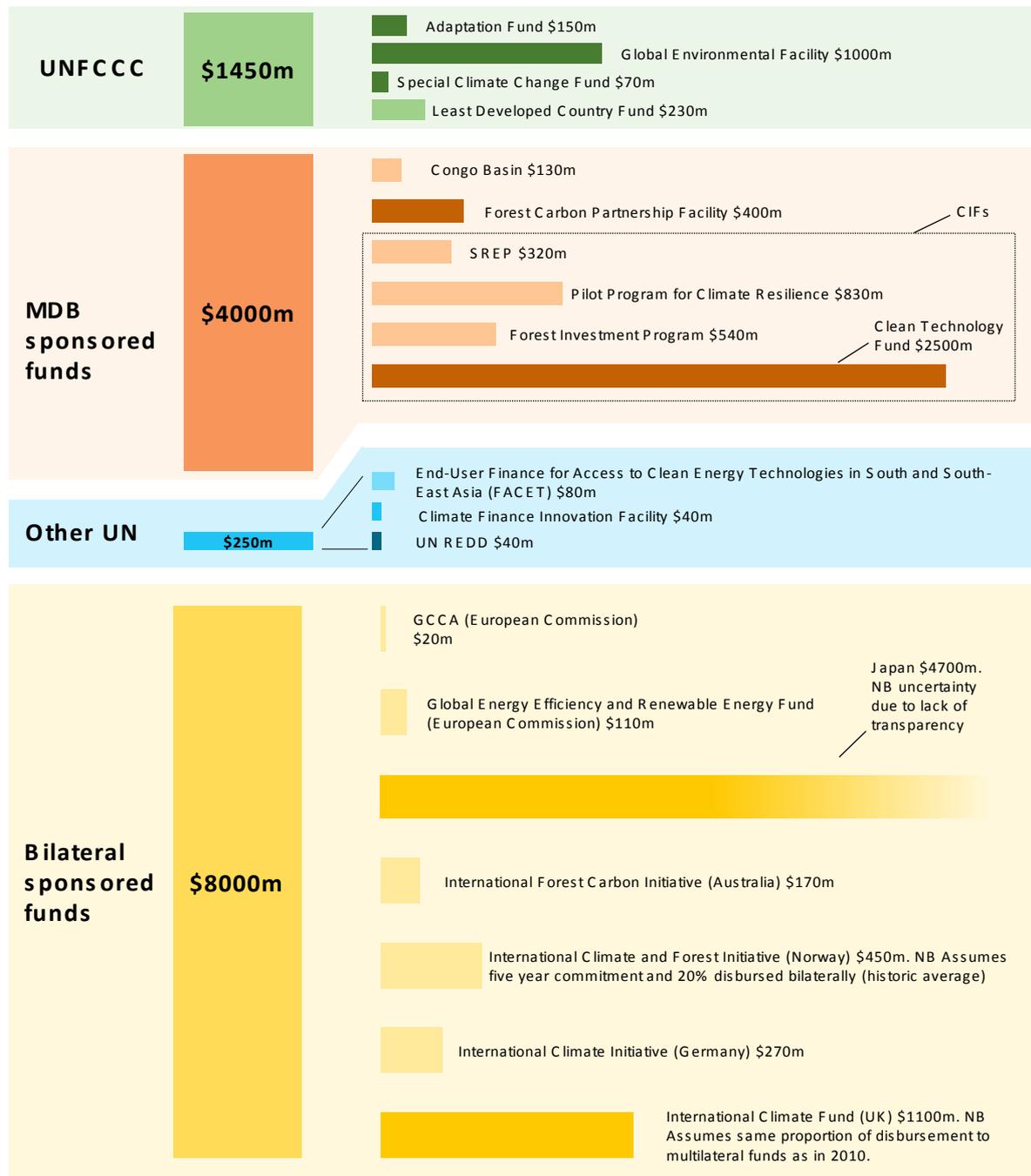
The two following sub-chapters go into more detail on public and private international climate finance in more detail.

3.1.1 Public sources of international climate finance

There are three sources of international public climate finance:

- Finance from bilateral agencies such as the Agence Francaise de Développement (AFD) or the UK Department for International Development (DFID), who support mitigation or adaptation activities as part of their broader development activities.
- Support from international financial institutions including Multilateral Development Banks (MDBs, i.e. the World Bank and regional development banks) and United Nations agencies, which likewise support mitigation or adaptation activities as part of their broader remit.
- International climate finance funds: international funds dedicated to supporting climate change activities. These, in turn, can be sub-divided between those explicitly linked with the United Nations Framework Convention on Climate Change (UNFCCC, e.g. the Adaptation Fund), those associated with MDBs (e.g. the Climate Investment Funds (CIFs)), those associated with UN agencies and those that are dedicated bilateral funds. The diagram below breaks down a range of different international climate funds according to this depiction and gives a sense of their relative level of capitalisation at present.

Figure A2: There are a large number of international climate funds



Source: Vivid Economics based on www.climatefundsupdate.org. The list of funds is largely taken from www.climatefundsupdate.org supplemented by additional research as necessary. Carbon funds purchasing compliance credits are excluded.

Relatively speaking, Kenya has done well from this architecture to date, with a number of high profile on-going programmes.

- In terms of bilateral development partners, it is estimated that projects and programmes valuing around \$1.4 billion are currently supported by bilateral agencies in Kenya. The AFD has the largest programme in Kenya (with projects valuing more than \$400m) with the Danish International Development Agency, the Swedish

International Development Cooperation Agency, DFID and KfW being other key development partners supporting climate change activities.

- Multilateral development partners have climate change relevant activities with a value of \$0.9 billion, with the World Bank and the African Development Bank being easily the most important partners.
- In terms of climate funds, the Scaling-Up Renewable Energy Programme has an investment plan of \$85 million in Kenya⁵, of which around \$25 million has been disbursed to date; while the Special Climate Change Fund, the Global Environment Facility Trust Fund and the Forest Carbon Partnership Facility Readiness Fund have all disbursed resources to Kenyan projects. In total around \$300 million worth of resources have been disbursed from climate funds to projects in Kenya.
- Of the total \$2.3 billion invested in Kenya by development agencies, roughly \$920 million is in the energy sector and \$670 million in water and sanitation. Forestry, agriculture and coastal areas account for most of the rest.
- The amount of funds devoted to mitigation and adaptation is roughly equal, with adaptation accounting for slightly more, as is appropriate for the Kenyan situation.

However, it is generally recognised that this architecture is complex and may have difficulty in effectively and efficiently channelling the increased flows of public climate finance anticipated in pursuit of the Copenhagen Accord’s \$100 billion target. As the World Bank’s World Development Report⁶ notes:

“There is a risk of [a] proliferation ... of special-purpose climate funds. Fragmentation of this sort threatens to reduce the overall effectiveness of climate finance, because as transaction costs increase, recipient country ownership lags, and alignment with country development objectives becomes more difficult. Each new source of finance, whether for development or climate change, carries with it a set of costs. These include transaction costs (which rise in aggregate as the number of funding sources increases), inefficient allocation (particularly if funds are narrowly defined) and limitations on scaling-up.”

These concerns are borne out in Kenya. Although Kenya has been relatively successful at attracting international public support, this has come at the cost of fragmentation. There are at least 15 different agencies supporting climate change activities and programmes in Kenya, each carrying their own administrative costs and with different rules and processes concerning both the extent, and means, of engagement with the Government of Kenya. There is little evidence of the pooling of resources. Although the Climate Change Coordination Group provides a forum for harmonisation, it is informal and not legally binding.

The problems created by this fragmentation have led to at least two initiatives of significance to Kenya: at the global level, the likely emergence of the Green Climate Fund (GCF), which may facilitate consolidation of the existing array of climate funds, and, at the national level, a greater interest in the role of national climate funds to manage the flows of international public climate finance within countries.

The Green Climate Fund intends ‘to evolve over time and become the main global fund for climate change finance’⁷. It was launched at the 17th Conference of the Parties (COP 17) in Durban in 2011 with the intention of making a significant and ambitious contribution to combatting, and adapting to, climate change. It is plausible that, over time, this will supersede the existing proliferation of different funds; indeed, the Climate Investment Funds contain an explicit sunset clause linked to the establishment of the GCF. A further key feature of the GCF is a commitment to provide balanced funding between

adaptation and mitigation, which would imply a different allocation to that currently achieved globally (as shown in Figure A1).

National funding entities (or national climate funds) are also emerging as a way to provide coordination on climate finance at the country level and strengthen country ‘ownership’. The aim of such funds is to provide a centralised pool of resources that can be allocated to individual projects and programmes according to a common, nationally-relevant set of priorities and criteria. Bangladesh, Brazil and Indonesia are among the countries that have developed a national funding entity. By allowing funding decisions to be made at a national level, it is expected that climate change financing will be better placed to address or respond to developing country concerns or priorities (such as formulated in the Kenya Climate Change Action Plan). By reducing the multiplicity of different procedures and processes associated with acquiring funding from different sources, they can also reduce transaction costs.

There is an important link between these two initiatives. The Governing Instrument for the Green Climate Fund states that “*The Board will consider additional modalities that further enhance direct access, including through funding entities [emphasis added] with a view to enhancing country ownership of projects and programmes*”⁸. The GCF is also committed to pursue country-driven approaches and promote and strengthen engagement at the country level through involving relevant institutions and stakeholders.

The Kenya National Climate Fund section (section B) provides more detail about how Kenya might respond to these initiatives in a way so as to maximise the opportunities for financing the KCCAP.

3.1.2 Private sources of international climate finance

Private sources of international climate finance have, and will continue to play, an important role in resourcing climate-relevant projects and programmes. As shown in Figure A1, the best estimates suggest that around 60 per cent of international climate finance currently comes from the private sector, and the Copenhagen Accord commitments explicitly note that in pursuing the \$100 billion target private sources of finance will be used. As the Report of the Secretary-General’s High Level Advisory Group on Climate Change Financing notes: “*Enhanced private flows will be essential to economic transformation towards low-carbon growth*”⁹. They are particularly relevant for (and in practice focused on) mitigation.

Kenya has already proven itself to be a competitive location for international private sector investors looking for low-carbon investment opportunities in Africa. As part of the consultation exercise among international investors undertaken as part of the Finance subcomponent of the KCCAP, Kenya was described by some stakeholders as being “head and shoulders” above other locations in East Africa. Consistent with this, it is estimated that Kenya has attracted more than \$600 million of international private sector investment in renewable energy alone. However, much more will be needed in the future: power generation alone is expected to increase from the current 1,479 MW to over 21 GW by 2030, requiring up to \$45 billion, including \$18 billion to develop 5 GW of geothermal power.

Traditionally, carbon markets have been a key way of incentivising private sector investment by international investors in mitigation activities in developing countries. Carbon market activities are (predominantly) private sector projects where it can be demonstrated that the project results in a deviation from a business-as-usual level of emissions. The deviation in emissions can be crystallised as a ‘credit’ that can be sold to credit purchasers, mainly in developed countries. The revenue from the sale of these credits is intended to make a substantial contribution to the financial viability of the project. There are two broad categories of purchasers.

- Compliance purchasers: those who can use the credits to fulfil their legal obligations regarding emission reductions. These may either be sovereigns (countries) in relation to their obligations under the Kyoto Protocol or regulated entities under national or regional emission reduction schemes, predominantly the EU Emissions Trading Scheme (EU ETS). To date, the recognition of the emissions reductions achieved by projects, and the associated Certified Emission Reductions (CERs), have been managed by the Clean Development Mechanism (CDM). Prices for CERs are currently trading at historic lows of under €4 (less than \$5).
- Voluntary purchasers: those who purchase credits for reasons other than legal obligations, i.e. corporate social responsibility (CSR).

Although Kenya has been relatively successful in attracting carbon market projects to date, it will face important challenges if it is to keep up this performance. These include both price falls and changes in the rules on credit eligibility in the EU ETS. Section D provides more detail on opportunities for Kenya from international carbon markets provide a more detailed analysis of these issues and a list of recommended actions for Kenya to pursue in this more challenging external environment.

The challenges associated with the carbon market mean that other ways to scale up international private sector investment will need to be developed. One set of instruments that will be of particular importance are public finance mechanisms: financial instruments provided by the public sector, at below market rates, that help to support private sector investment. By helping to share risk between the public and private sector in this way, small amounts of public investment can leverage much higher levels of private sector investment, as much as three to 15 times according to some reports. As the Report of the Secretary-General’s High Level Advisory Group on Climate Change Financing states: *“careful and wise use of public funds in combination with private funds can generate truly transformational investments.”*¹⁰ The Kenya National Climate Fund described could be a key vehicle in providing these instruments.

More broadly, a suitable investment climate is crucial to encouraging international private sector investment. Arguably the most important determinant of the magnitude of international private sector flows will be Kenya’s policy and regulatory framework for low-carbon investment, in the context of its broader investment climate. There is a considerable body of work focussed on the key elements of what a so-called ‘investment grade policy’ for low-carbon (international) private sector investment might look like, centred around the ideas such as:

- Open dialogue;
- Transparent, long-term and predictable regulation;
- The use of price signals to support low-carbon options;
- The appropriate use of regulation and standards; and

- Public engagement with sources of private finance.

As explained in section E on the Investment Climate for Climate Investment, a key element of financing the Climate Change Action Plan will be to introduce reforms consistent with these ideas, so as to catalyse greater (international) private sector investment.

3.2 National sources of climate finance

National sources of climate finance will also play a key role in supporting Kenya's transition to a low-carbon, climate-resilient economy. Below we discuss the current state, and key areas of debate, in relation to these resources. As above, we distinguish between public and private sources.

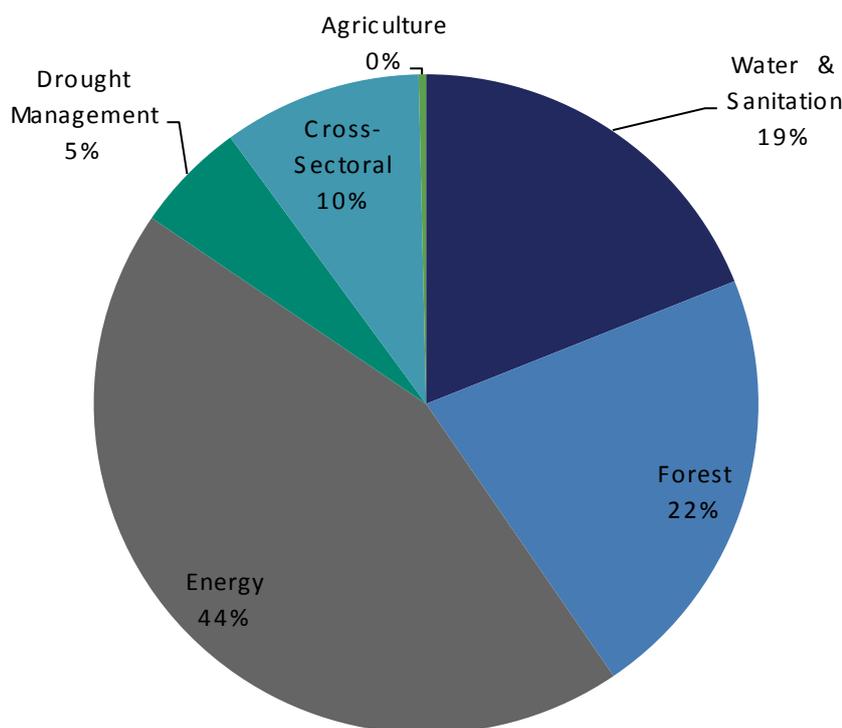
3.2.1 Public sources of domestic climate finance

The Kenyan government is currently implementing projects and programmes with climate change relevance to the value of KES 37 billion (~\$450 million). This is derived from some 30 to 35 ongoing projects and activities. As Figure A3 shows, the bulk of these resources, around 45 per cent, are in the energy sector, with forestry and land-use projects and water and sanitation activities accounting for a further 20 per cent of resources each. Consistent with this, the Ministry of Energy and Ministry of Environment and Mineral Resources are the two government agencies that account the majority of the government's spending on climate change-related activities.

Despite these funding levels, there has been relatively little attention given to climate change issues when formulating government strategies, nor efforts to monitor success. For instance, climate change did not feature in the 2008-2012 Medium Term Plan while Vision 2030 emphasises environmental management within its social pillar rather than within a specific environmental pillar. The monitoring of activity and financing levels on mitigation and adaptation is hampered by the lack of a specific climate change code or other reporting framework within the national accounts.

Given limited domestic resources, and other pressing development challenges, it is crucial that domestic public resources are spent as efficiently as possible, and with a view to exploit development co-benefits. As discussed below, and in the section on the Government of Kenya's absorptive capacity (section C), there are a variety of actions that can be taken to improve the efficiency with which Kenyan public resources allocated to climate change activities can be spent as efficiently as possible. These will also increase the efficiency with which any donor funds, whether through the National Climate Fund or otherwise, might be spent.

Figure A3: The bulk of the Government of Kenya resources devoted to climate change are allocated to the energy sector



Source: KIPPRA and ASI

3.2.2 Private sources of domestic finance

Kenya’s dynamic private sector can play a key role in helping the country realise its low-carbon, climate-resilient objectives, and it can build on the strong base already established. The Kenyan private sector is estimated to have invested close to \$150 million in renewable energy projects alone to date, a figure that rises to in excess of \$1.2 billion if the Kenya Electricity Generating Company and the Kenya Tea Development Authority parastatals are included. Much of this investment has been focused on geothermal activity, but relative to international investors the Kenyan private sector has also shown interest in other renewable technologies, especially small hydro and biomass.

The key factors determining the extent to which the Kenyan private sector can be brought in to help finance Kenya’s Climate Change Action Plan are the same as those for its international counterparts. It will require a supportive investment climate with clear and transparent regulation and well-designed policy incentives. Complementing this, the judicious use of public finance can help to leverage Kenyan private sector investment. This can build on the experience Kenya already has through such models as the Geothermal Development Corporation, a 100 per cent publicly-owned company which is absorbing the early stage drilling risks of geothermal power production.

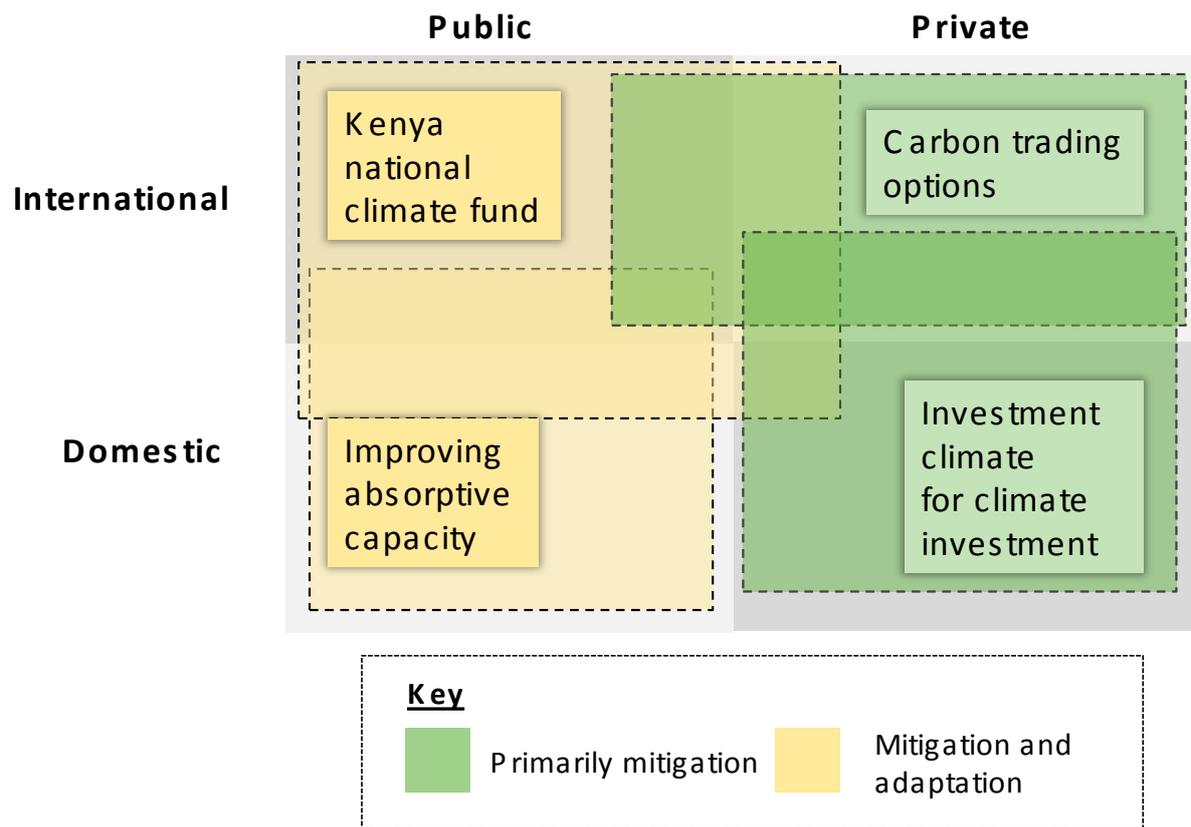
4. Financing the Climate Change Action Plan

This chapter provides an overview of the different elements of the strategy to enable the financing of the Kenyan Climate Change Action Plan and explains the methodology. It builds on the overall context provided in the previous chapter and shows how the key challenges can be overcome. Further details are provided in the four subsequent sections (B-E). The extensive research and analysis underpinning this analysis is also annexed to this report.

The methodology for developing the strategy has consisted on quantitative and qualitative desk research, complemented by extensive engagement with Kenyan and international experts. The strategy has been developed over a series of 9 months through a review of background literature, quantitative data analysis (for instance, on carbon market trends) and analysis of international precedents and experience. A crucial part of the work has been extensive engagement with Kenyan and international experts: over 70 experts have been engaged as part of this work. The relevant institutions consulted on are listed at the end of each section. In addition, the strategic insights and guidance provided by the Thematic Working Group (a body of Kenyan experts convened specially guide to this work) have been invaluable.

All aspects of climate finance are covered by the strategy. Earlier chapters in this section identified that climate finance sources can be helpfully divided into international and domestic, and, within this, public and private. The analysis and actions are intended to increase the scale and effectiveness of all four of these sources. This is displayed in Figure A4. It shows the different forms of climate finance – public and private, domestic and international – and how the recommendations cover all of these sources of climate finance. Each box represents a section and associated set of recommendations with the chart showing the extent to which they relate to public or private, domestic or international resources. For example, the absorptive capacity paper relates to domestic and international public resources. As such, the recommendations form a coherent package of actions intended to maximise the flows of climate finance into and within Kenya.

Figure A4: The climate finance strategy covers all sources of climate finance



Source: Vivid Economics

Section B provides a recommended design for a Kenya National Climate Fund.

It is intended that this would become the primary vehicle for receiving and disbursing international climate finance. In doing so, it would aim to overcome the challenges of fragmentation associated with the current disbursement of international public climate finance in Kenya, and build an institution within Kenya with core climate finance expertise. This expertise, together with the adoption of robust governance arrangements, safeguards and a clear set of funding priorities (the KCCAP) should help strengthen Kenya's position as a credible and attractive destination for international public climate finance flows. The Fund could also become a vehicle for providing public finance that might leverage greater amounts of private finance from both Kenyan and overseas investors. The Government of Kenya could also commit public resources to this Fund.

Section C complements the National Climate Fund design paper by analysing the Government of Kenya's current ability to absorb, manage and disburse climate finance and how this may be improved.

The process by which the government manages funds from development agencies (as well as its own revenue) has a major bearing on the speed of funds disbursement to implementing agencies (e.g. line ministries or NGOs), and consequently on the effectiveness of project implementation. The section identifies that the absorption rate of climate finance, and development finance more broadly, is low. This is due to a range of factors, from budgeting and fund flow challenges on the part of the Treasury and line ministries, to the non-alignment of government and development partner fiscal policies and procedures, to the lack of prioritisation of climate change within the budget. It makes a series of recommendations to improve absorptive capacity, including continuing improvements to the government's PFM system, the creation of a climate change code in the budget, the standardisation of government and development agency fiscal practices, and improvements to the modalities of project implementation. All of these will have a direct bearing on the full design and establishment of the National Climate Fund.

Section D looks at how Kenya might maintain and strengthen its ability to access international carbon markets, as a way of stimulating private sector international investment.

As referenced above, and discussed in more detail in the second paper, external factors mean that Kenya's access to carbon finance will be limited in the short to medium term. This demands a strategic response: balancing the greater need for action resulting from the tough external environment against the fact that the external environment makes any action more risky. The paper makes a series of recommendations consisting of both institutional reforms, e.g. capacity building of the Designated National Authority and the creation of a modest unit tasked with promoting and marketing Kenyan carbon market activity, as well as broader policy reform options.

The final section, section E, addresses Kenya's 'investment climate for climate investment'.

This investment climate will be key to unlocking the resources of the private sector, both in Kenya and overseas, so as to move Kenya onto a low-carbon climate resilient growth trajectory. The paper identifies that, despite Kenya's strengths, there are a number of ways in which the investment climate is hindering private sector engagement. This includes a project development process that is long and complex, a policy environment that is either deficient (in the case of renewable energy) or non-existent (in the case of energy efficiency), a finance community that does not yet fully meet the needs of project developers and a lack of technical capacity among project developers and financial institutions. It identifies a series of targeted interventions to overcome these weaknesses including the creation of a one-stop shop for permits and licenses; establishing standardised Power Purchase Agreements for

renewable energy; improvements to the Feed-in Tariff regime; the development of a national energy efficiency policy and greater co-ordination of technical assistance programmes. The implementation of these interventions would be an important complement to the Kenya National Climate Fund and carbon trading platform.

¹ Government of Kenya, National Climate Change Response Strategy, (April 2010)

² UNFCCC, Draft decision -/CP.15 'Copenhagen Accord' (18th December 2009)

³ Each section then consists of a number of different chapters. It is intended that each section could be read as a standalone document if desired.

⁴ CPI, *The Landscape of Climate Finance* (2011). As the authors of this paper note, there are a number of reasons why this need not be interpreted as implying that the Copenhagen Accord target is close to being met including the fact that not all of the \$97 billion is likely to be 'new and additional' as well as disagreements as to how the \$100 billion target should be interpreted.

⁵ This, in turn, is expected to leverage around a further \$850 million of resources from the Government of Kenya, the AfDB and World Bank Group, development partners and private investors.

⁶ *World Development Report 2010: Development and Climate Change*, World Bank (2009)

⁷ *Governing instrument for the Green Climate Fund*, Green Climate Fund (2011)

⁸ *Governing Instrument for the Green Climate Fund*, Green Climate Fund (2011)

⁹ Report of Secretary General's High Level Advisory Group on Climate Change Financing (5th November 2010)

¹⁰ Report of Secretary General's High Level Advisory Group on Climate Change Financing (5th November 2010)