Climate Law and Governance Working Paper Series

MOVING BEYOND BY INCENTIVIZING GREEN INVESTMENTS IN EBRD'S COUNTRIES OF OPERATION

By: **Angela Delfino**

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Contact Information

Centre for International Sustainable Development Law (CISDL)

McGill University Faculty of Law, Chancellor Day Hall, 3644 Peel Street
Montreal, Quebec H3A 1W9, Canada
tel +1 818-685-9931 fax +1 514-398-4659
www.cisdl.org

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Angela Delfino**
European Bank for Reconstruction and Development (EBRD)

Abstract

Using the European Bank for Reconstruction and Development (EBRD) as an example, this Working Paper considers: (i) the promotion of low-carbon technologies and investments, including in renewable energy; and, (ii) law and governance measures that can signal changes in the global marketplace. The paper describes how, within its mandate, the EBRD has taken initiatives on energy efficiency and climate change, and types of financing used in EBRD operations. The paper concludes with a note on the importance of such bottom-up approaches in climate change financing.

Keywords

Sustainable energy investments, promotion of low-carbon technologies, renewable energy, energy efficiency, implementation of the Paris Agreement, bottom-up approaches

** Angela Delfino works as Senior Counsel in the Office of the General Counsel of the European Bank for Reconstruction and Development in London. The paper was delivered during the Climate Law and Governance Collaborative Workshop on Incentivising Sustainable Energy Investment held during the Inaugural Climate Law and Governance Day 2015 in Paris on 4 December 2015.

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INTRODUCTION

Each organisation has its own dynamic and its own developmental logic. Each organisation has its own set of policies, systems and practices as a platform from which to move forward. Generally, this results in incremental rather than sudden or radical change. The European Bank for Reconstruction and Development (EBRD), a multilateral development bank, has the mandate to foster transition to open market oriented countries in South-eastern Europe, Central Europe and Baltic States, Eastern Europe and the Caucasus, Central Asia, Southern and Eastern Mediterranean, Russia and Turkey. As part of this mandate it invests in environmentally sound and sustainable development projects, mainly in the private sector, including sustainable energy projects.

Using the operations of the EBRD as a case study in the areas of sustainable energy and climate finance, this paper focuses on two issues: *(i) the promotion of low-carbon technologies and investments, including in renewable energy; and, (ii) law and governance measures that can signal changes in the global marketplace.*

The first section of the paper describes EBRD's mandate and certain EBRD's initiatives on energy efficiency and climate change; the second addresses types of financing instruments and associated engagement in EBRD operations; the third illustrates application in the Republic of Kazakhstan to incentivize sustainable energy investments. The fourth section concludes on the importance of bottom-up approaches in climate change financing.

1. EBRD'S HISTORY IN INCENTIVISING SUSTAINABLE ENERGY INVESTMENTS

The EBRD was established 25 years ago in 1991. EBRD has 67 shareholders, 65 countries and 2 international organisations. EBRD has a triple-A rating from all three main rating agencies (Standard & Poor's, Moody's, and Fitch Group), a capital base of 30 billion euros, and a cumulative business volume of 106 billion euros[1].

As foreseen in Article 1 of the *Agreement Establishing the European Bank for Reconstruction and Development*, EBRD's mandate is to "*foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed*

[1] EBRD, *About the EBRD, We invest in changing lives* p. 1 (2016).

to and applying the principles of multiparty democracy, pluralism and market economics." Although EBRD's emphasis has been on the private sector as the main driver for change, it also finances projects in the public sector.

To fulfil on a long-term basis its purpose of fostering transition, the Bank assists its recipient member countries to implement structural and sectoral economic reforms, including demonopolization, decentralization and privatization[2]. Across the full range of its operations EBRD promotes environmentally sound and sustainable development[3], including a commitment to sustainable energy.

EBRD's countries of operations include 30 countries in South-eastern Europe, Central Europe and Baltic States, Eastern Europe and the Caucasus, Central Asia, Southern and Eastern Mediterranean, Russia and Turkey. The Czech Republic is the only member to have 'graduated' and no longer receives investment from EBRD.

The EBRD region has traditionally been characterised by: (i) a legacy of widespread environmental neglect, natural asset mismanagement and severe levels of water stress; (ii) high carbon intensity due to heavy reliance on fossil fuels and high energy intensity due to wasteful practices, distorted energy pricing and absence of effective regulation and standards; and (iii) general market failure to internalise and monetise the cost of environmental damage. In recent years, EBRD countries of operation have taken important steps to reduce environmental degradation, with noticeable results including improved air quality, the phase-out of ozone-depleting substances, increased use of renewable energy sources and better water management. Nonetheless, the EBRD region still lags behind; its average carbon intensity is almost 5 times higher than the EU-28 average, and the level of energy intensity is 4 times higher[4].

In 2006, EBRD unveiled its **Sustainable Energy Initiative (SEI)**. This focused on energy efficiency and climate change projects (including renewable energy and adaptation projects) with the aim of scaling up sustainable energy investments in EBRD's countries of operation, improving the business environment for sustainable investments and removing key barriers to market development. The initiative was mainstreamed across the full range of EBRD's financial instruments and sectors including the agribusiness, manufacturing and service sector. In 2013, the SEI was enhanced by the **Sustainable Resource Initiative (SRI).** The SRI continued to finance energy efficiency, renewable energy, and adaptation projects through the SEI and, in addition, focusses on water and materials efficiency, *e.g.* through the promotion of

[2] *Agreement Establishing the European Bank for Reconstruction and Development*, Article 2.1.
[3] *Agreement Establishing the European Bank for Reconstruction and Development*, Article 2.1(vii).
[4] EBRD, *Green Economy Transition* p. 4 (2016). Available at: www.ebrd.com/what-we-do/get.html

recycling and the reuse of waste streams. Both initiatives were grounded in the view that environmentally sustainable energy is good business, not an add-on.

EBRD environmental financing over the past 10 years since the launch of SEI has surpassed 18 billion euros for more than 1,000 projects. Climate resilience financing amounted to 612 million euros, and SRI water and materials efficiency related financing about 1 billion euros[5]. A recent review showed that, in terms of transition impact and financial return, the SEI and SRI were the best performing of EBRD's major initiatives.

Over 15 countries have also benefitted from EBRD's policy dialogue activities in the sustainable energy area, namely by strengthening their investment frameworks for renewable energy, developing specific laws and regulations governing energy efficiency in buildings as well as promoting the adoption of specific measures to enable more private sector participation in buildings energy efficiency through Energy Service Companies and Energy Performance Contracting.

In 2015, EBRD launched the new **Green Economy Transition (GET)** approach. EBRD defines a Green Economy as "*a market economy in which public and private investments are made with a specific concern to minimise the impact of economic activity on the environment and where market failures are addressed through improved policy and legal frameworks aiming at accounting systematically for the inherent value of services provided by nature, at managing related risks and at catalysing innovation*.[6]"

The GET approach is to deliver increased green financing both by expanding EBRD activity in areas in which it already has experience; broadening the environmental dimension of investments supported by EBRD (this includes additional elements of environmental compliance or remediation); engaging new areas and flexible financing channels. Examples of the latter include pollution prevention projects, green logistics, water efficiency in the power sector and irrigation, and green cities. The GET aims to increase the EBRD's green financing from an average of 24 per cent of EBRD annual business investment over the previous ten years to 40 per cent by 2020.

EBRD will increase operations in existing activities to meet up demand for investment in areas such as: renewable energy development in the power and industrial sector; energy efficiency and renewable energy finance for municipal district heating, public transport, water and wastewater and solid waste management networks; energy and resource efficiency across sectors, including residential and

[5] *Ibid* p.2
[6] *Green Economy Transition Approach* BDS15-196 (Final), 1 October 2015, p. 25

commercial buildings; infrastructure finance, including energy transmission networks and railways; and solar energy.

In terms of new activity, there will be a particular focus on developing EBRD adaptation financing activity and supporting the accelerated deployment of new and innovative technologies. These could include climate resilience in power and transport infrastructure, water efficiency and the development of bioenergy. The aim is also to broaden EBRD environmental scope to promote the sustainability of natural resources use, prevent pollution and protect ecosystems. That would involve increasing water supply, improving the resilience of groundwater and surface water resources**,** sustainable agriculture projects and work on rehabilitating contaminated sites**.**

The GET aims to commit a total of 18 billion euros, with annual green financing reaching over 4 billion euros by 2020. EBRD expects to mobilise 60 billion euros for a total project value up to 78 billion euros. Given EBRD's business model, it is expected that between half and two-thirds of that financing will be in the private sector.

The GET further aims to deepen the policy dialogue and partnerships needed to drive the growth of the green economy.

2. FINANCING INSTRUMENTS

This section examines three types of instruments used by EBRD to finance sustainable energy operations. These are: investments, technical assistance and policy dialogue.

EBRD's **investment instruments** include *inter alia*: (i) direct financing in the form of private, non-sovereign and sovereign guaranteed loans, direct equity, equity funds and credit lines in the context of individual green projects; (ii) carbon finance or other market based systems that provide additional revenues for projects; and (iii) co-financing with the private financial sector, public sources, and other international financial institutions.

Donors provide critical support for EBRD projects that mitigate or build resilience to the effects of climate change and other environmental threats. Donor funds are generally used for concessional (including grant) co-financing, policy dialogue and technical assistance. EBRD works with bilateral donors, including the European Union, and multilateral climate finance partners, such as the Climate Investment Funds, the Global Environment Facility and the Green Climate Fund.

Concessional financing (including grant co-financing) provides appropriate incentives and addresses affordability constraints of projects. Addressing specific market failures and providing suitable incentives to diminish risk and support the uptake of new technologies are key objectives of donor-funded concessional finance. The combination of concessional finance and EBRD investment funding has proved to be a successful approach when market barriers are high. The availability of concessional finance helps EBRD address pricing and credit risk barriers; reward energy, resource and CO_2 savings in the absence of right pricing of CO_2; water and waste; make technologies with high (upfront) costs affordable; address equity and capital gaps; and cover the first loss to address first-mover risk in the absence of a sound borrower track record in the sector.

In keeping with its mandate, EBRD engages in **policy dialogue** to promote and assist with reform. This is of equal importance as its investments in projects. Drawing on its institutional knowledge, investment experience and local presence, EBRD engages in policy reform dialogue with public authorities in its countries of operation. It also promotes dialogue between the public and private sectors to help identify policy and institutional challenges to private sector led sustainable and inclusive growth.

EBRD's engagement is guided by a combination of two approaches. First, identification through country strategies and country diagnostics of the main obstacles to private sector development, and how these might be addressed through specific investments. It encourages reform, contributes to the development of new or amended legislative and regulatory frameworks, and supports implementation. Discussions with a Government during the country strategy development facilitate a common understanding of priorities and actions required. Self-evidently Government buy-in is essential if reforms are to be successful.

Secondly, consultations with clients and other private sector stakeholders on what they perceive to be the key obstacles to business development and growth. EBRD uses its convening power to bring together the public and private sector to promote discussion and knowledge transfer.

Throughout, EBRD gathers evidence and information from projects in its portfolio on what works and what type of policy interventions may trigger policy reforms. There are periodic reviews of needs and progress during implementation. Successful investment projects may demonstrate best practice and results achievable in terms of growth, investment and jobs. They can provide a model which can be followed by others.

EBRD policy dialogue covers a range of areas, *inter alia*, the financial sector, local currency and capital market development, transport, municipal and environmental infrastructure, agribusiness and corporate

governance. In order to incentivise sustainable energy and support the effective development and implementation of projects, EBRD works with governments and key stakeholders to support strong institutional and regulatory framework namely on energy markets, energy tariff reforms, and carbon markets.

A key element in achieving the full potential of EBRD green investments is the provision of **technical assistance** to help build institutional and technical capacity, transfer knowledge and new skills to clients. Technical assistance facilitates project development and implementation. It can help reduce political, financial and technical risks, highlight new technical solutions, analyse market opportunities, training and skills requirements. Technical assistance may also include environmental and social impact assessments, and resource efficiency audits to identify and prioritise investments based on the financial return from input cost savings. Climate vulnerability assessments aim to support businesses and utilities most exposed to future climate change impacts to identify risks and integrate adaptation measures in investment programmes. For example, these assessments can include projections of water availability, sea-level rise or the increased occurrence of flooding and identify potential measures to mitigate the risks that a project faces.

A specific **Monitoring Reporting and Verification (MRV)** system has been developed, in line with internationally established practice, to assess the impact of EBRD's operations. The system's guidelines define the characteristics of green projects and project components and determine the data required for monitoring. Every EBRD investment is screened for its green potential by technical experts, at an early stage of the project cycle. Projects can be classified as not green, 100 per cent green, or partially green. For every fully or partially green project, an estimate is made of the energy savings, renewable energy production, greenhouse gas emission reductions, water savings and materials savings or waste reductions. This information is tracked in the EBRD's MRV database, integrated in knowledge management systems related to project cycle, and reported to the EBRD Board of Directors.

The EBRD is actively involved in working towards harmonised approaches for tracking green finance and reporting on green impact. To this end, the EBRD works closely together with other key stakeholders such as the OECD and the UNFCCC. Together with other multilateral development banks, EBRD has developed the *Common Principles for Climate Mitigation Finance Tracking*[7], the *Common Principles for Climate*

[7] Available at: http://www.worldbank.org/content/dam/Worldbank/document/Climate/common-principles-for-climate-mitigation-finance-tracking.pdf

Change Adaptation[8], a proposed approach to track climate finance[9], the *International Financial Institution Framework for a Harmonised Approach to Greenhouse Gas Accounting*[10] and joint approaches to greenhouse gases assessments in the sectors of transport, renewable energy and energy efficiency. Each year, the EBRD reports jointly with other multinational development banks on its climate finance activities.

3. APPLICATION IN THE REPUBLIC OF KAZAKHSTAN

"*If human history has taught us anything, it's that what we can understand, we can fix.*[11]"

EBRD's work in Kazakhstan presents a flagship example of the application of the above instruments to financing sustainable energy operations.

Kazakhstan remains among the world's most energy and carbon intensive economies, despite a sharp fall in carbon intensity since the 1990s[12]. Investment in new sustainable energy potential in Kazakhstan has traditionally been constrained by the ready availability and low price of fossil fuels. As set out in the *Strategic Development Plan of the Republic of Kazakhstan to 2020*, Kazakhstan seeks to reduce the amount of energy used per unit of GDP and further diversify its economy, which is heavily reliant on primary industries and commodity exports. Investments in renewable energy sources alone have the potential to reduce emissions by as much as 40 per cent[13].

Consistently with this strategic vision, Kazakhstan has become very active in green development by setting up a Green Economy Strategy, developing sustainable energy legislation including on tariffs, participating in international initiatives, and becoming eligible for co-financing from the Clean Technology Fund. Kazakhstan has also been a pioneer country in establishing a domestic emissions trading scheme.

[8] Available at: http://pubdocs.worldbank.org/en/222771436376720470/010-gcc-mdb-idfc-adaptation-common-principles.pdf
[9] Available at: http://www.eib.org/attachments/documents/mdb_tracking_climate_cofinance_en.pdf
[10] Available at: http://www.worldbank.org/content/dam/Worldbank/document/IFI_Framework_for_Harmonized_Approach%20to_Greenhouse_Gas_Accounting.pdf
[11] H.E. Mr. Karim Massimov, Prime Minister of Kazakhstan, Leaders Event at the COP 21 / CMP 11
[12] Friso de Jong, Janina Ketterer, Jan-Willem Van de Ven, "Kazakhstan's Developing ETS – An Example of Emerging Carbon Pricing Systems in the East" *IETA Greenhouse Gas Market* p. 53 (2013)
[13] *Ibid*. p. 53.

EBRD's country Strategy for Kazakhstan 2013 emphasises the promotion of low-carbon growth and energy efficiency, stating that EBRD will assist in "*implementing key aspects of the strategy through projects in energy, renewables, agriculture, water, waste management, transport, and other sectors.*[14]"

Between 2006 and 2015, EBRD invested more than 1 million euros of sustainable finance in Kazakhstan and has supported several initiatives such as the adoption of feed-in tariffs, green economy, renewable energy and energy efficiency legislation, the development of the Kazakh emissions trading scheme.

A typical renewable energy project[15], for instance, could benefit from co-financing from the Clean Technology Fund as well as feed-in tariffs for renewables introduced in 2014, in part as the result of dialogue between the government of Kazakhstan and the EBRD. Technical assistance could also be extended - for example for: project preparation including feasibility and environmental studies; development of the project as a domestic carbon project; development of a carbon credit monetisation strategy; support in monitoring, reporting and verification of emission reductions.

4. THE IMPORTANCE OF BOTTOM-UP APPROACHES IN CLIMATE CHANGE FINANCING

In 2013, Stewart et al. wrote that: "while the international UNFCCC negotiations will and should continue, attention and energy should focus on identifying and developing an array of discrete transnational regulatory agreements and programs. This strategy will involve not just national governments but also a wide range of highly important actors that are not parties to the UNFCCC, including sub-national governments, firms, [civil society organisations] and [international organisations]. These programs will aim to mobilize the incentives of governments, firms and consumers to undertake activities that have the effect but in many cases not the purpose of reducing [greenhouse gases]. They will be thematically sectoral and sometimes regional in scope and often include hybrid public/private governance arrangements.[16]"

Despite the recent progress made in the UNFCCC negotiations, the need for a coherent and coordinated bottom-up approach is more relevant than ever in order to translate international prescription into practice. The Multilateral Development Banks (MDB) are key actors in taking this forward.

[14] *Strategy for Kazakhstan*, BDS/KA/13-1(Rev 1), 5 December 2013, p. 9 (Confidential)
[15] For a snapshot of the Burnoye solar power plant see http://bit.ly/1MlbNjq
[16] Richard Stewart, Michael Oppenheimer and Bryce Rudyk "Building a More Effective Global Climate Regime Through a Bottom-Up Approach," 14 *Theoretical Inquiries L.* 273 (2013)

Even where domestic political demand for Government action on greenhouse gases reductions is weak, Governments acting as shareholders and members of MDB and climate funds have become very supportive of investments and policies to promote energy efficiency and cost savings, green technologies, substantial greenhouse gases reductions and other climate co-benefits. MDB have been incentivised to adopt policies and channel resources to reduce energy costs as part of their development mission, thereby creating bottom up demand for energy efficient goods and services and promoting more energy efficient patterns of growth.

MDB "may adopt policies and channel resources with the primary objective of reducing [greenhouse gases] for a number of reasons. First, professional elites within the [multilateral development banks] may favour action to combat climate change. Second, recipient countries, concerned about climate adaptation, might support them if they contribute to their adaptation objectives, or if they bring an increase in development aid, or promise to reduce costly energy imports. Third, (…) governments may support or acquiesce to such [organisations] initiatives because they potentially reduce the domestic burden of (…) nations to limit [greenhouse gases] emissions, correspondingly reduce demands from other states and environmental constituencies for mitigation[17]."

As illustrated above EBRD works at a policy and project level. Although, unlike other MDB, EBRD does not finance development policy loans, budget and other programmatic lending at sovereign level, it has nevertheless consistently provided policy advice. Its key strength lies in financing projects in the private sector, but at the same time in promoting change and reform in the regulatory and business environment. Successful projects provide models, examples of good practice which catalyse and stimulate demand. They can be replicated in other countries and regions, thereby having a systemic impact. Regional projects, a feature of MDBs, accentuate the spread of innovation and best practice with impacts beyond national borders.

The private sector has proved adept in responding to new approaches where the positive economic and financial benefits have been demonstrated. EBRD support can also have a multiplier effect. For example, EBRD will make available to local banks lines of credit for green financing; on lending to the private sector. These facilities include dedicated technical assistance teams who help identify and assess green investment opportunities, training programmes and first loss risk covers. The demand for, and take up

[17] *Ibid.*

of, these credits demonstrate the increasing demand from the bottom up, from private sector entities that have come to appreciate the benefits of energy efficiency.

MDB coordinate closely on policies and programmes, sharing ideas and experience, developing common approaches. They collaborate, co-finance or jointly finance projects. Their operations are increasingly complemented by harmonised monitoring, reporting and verification elements and in line with emerging arrangements under the UNFCCC. This promotes assurances of mutual compliance and facilitates worldwide compliance assurance arrangements.

The net result has been to change the nature of the debate at local and country level; to demonstrate the real benefits to be obtained from change and reform. Below the international discourse and negotiations on climate change, the bottom up approach from EBRD and other multilateral organisations has catalysed action from the private sector as the primary drivers of growth and development. In the final analysis, EBRD cannot impose policies or force clients to borrow; that lending for green energy continues to grow demonstrates success.

CONCLUSION

MDB such as the EBRD have a major role to play in delivering sustainable development because of their potential to bring together private and public players to develop new low-carbon energy projects and to reduce the costs of capital for them[18] [19].

MDB work at a policy and project level within countries and regions. Monitoring, reporting and verification systems help assure mutual confidence and continued participation and create incentive on stakeholders and partner institutions.

Uncertainty and risks associated with investments and policy reform may be unavoidable and difficult to predict. While it is often impossible to mitigate such risks completely, understanding them and their potential implications is part of prudent management. MDB are well placed to take these into account by

[18] Zuckerman, J., Frejova, J., Granoff, I., and Nelson, D., 2016. "Investing at Least a Trillion Dollars a Year in Clean Energy" Contributing paper for *Seizing the Global Opportunity: Partnerships for Better Growth and a Better Climate*. New Climate Economy, London and Washington, DC. Available at: *http://newclimateeconomy.report/misc/working-papers*.

[19] At the same time development financial institutions, and multilateral development banks in particular, could direct more of their own investments toward low-carbon priorities. In Bhattacharya, Oppenheim and Stern, *Driving Sustainable through Better Infrastructure: Key Elements of a Transformation Programme* (2015), the authors estimate that multilateral development banks would need to increase their overall infrastructure lending five-fold over the next decade from the current USD30-40 billion a year to around USD200 billion a year, to meet overall infrastructure financing needs.

knowing how to engage with their shareholders, donors, clients and other stakeholders, adopting different approaches, outlining different scenarios and alternatives and by carrying regular monitoring.

There is of course much more to be done. The 2015 New Climate Economy Report[20] makes, among others, key recommendations which need to be harnessed to overcome barriers to low-carbon growth: raising resource efficiency standards, investment in clean energy and climate-smart infrastructure, and stimulating innovation. EBRD's policies to incentivise sustainable energy investments and the Green Economy Transition approach reflect these priorities. Its success to date demonstrates the development gains that can be made. There is a long road ahead but undoubtedly the one worth taking; that will make all the difference.

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