Climate Investment Funds

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CLIMATE INVESTMENT FUNDS: LESSONS LEARNED FROM PRIVATE SECTOR INTERVENTIONS THROUGH MDB INTERMEDIARIES

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In Collaboration with the African Development Bank, Asian Development Bank, Inter-American Development Bank, International Finance Corporation, and European Bank for Reconstruction and Development

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Acronyms

AMDEE	Asociación Mexicana de Energía Eólica the Mexican Wind Energy Association
CTF	Clean Technology Fund
CIF	Climate Investment Funds
EBRD	European Bank for Reconstruction and Development
FIP	Forest Investment Program
IADB	InterAmerican Development Bank
IFC	International Finance Corporation
IP	CIF Investment Plans
LDC	Least Developed Countries
MDB	Multilateral Development Bank
MIDSEFF	Mid-sized Sustainable Energy Financing Facility
MW	Megawatts
PPCR	Pilot Program for Climate Resilience
PPP	Public-Private Initiative or Partnership
SCF	Strategic Climate Fund
SREP	Program for Scaling up Renewable Energy for Low Income Countries
TFC	CTF Trust Fund Committee
TURSEFF	Turkey Sustainable Energy Finance Facility

1 Introduction

Overview of the study

The Climate Investment Funds (CIF) support developing countries as they move toward climate-resilient development that minimizes the output of greenhouse gases. Set up to demonstrate how innovative strategies and scaled-up financing can initiate transformational change in policies, institutions, and markets, CIF embeds climate-smart action in development and poverty reduction plans. Within this context, the CIFs employ an approach meant to address a country's needs through both public sector and private sector interventions.

Private sector programs and projects are meant to contribute to overall market transformation by using CIF funds to address barriers preventing investments, be they risk (real or perceived) or cost barriers. Private sector investments benefit from concessional funds provided by CIFs, but these operations also bring to the mix of CIF investments, additional financing, leverage and technical expertise that would not be generated simply through a public sector focus. Private sector engagement is crucial to addressing climate change going forward due to the immense amounts of finance required for mitigation and adaptation actions. These needs are simply too large to come from public balance sheets. In order to transform climate-related investment trends, sustainable business models are needed in the climate space. Such sustainable private sector activities will also be a source of innovation, technical expertise, and improved livelihoods. Engaging the private sector in the endeavor to transform markets towards low-carbon and climate-resilient development is, and will continue to be, a necessary component in achieving climate-related objectives.[1]

Three years into the life of the CIF, the multilateral development banks (MDBs) who have been developing private sector programs have learned a number of lessons specific to the CIF structure and operational modality; these lessons could help to improve the effectiveness of the CIF and provide insights for the development of future climate change programs or facilities. Private sector projects under CIF are financed in two main ways: (i) through public-private initiatives or partnerships (PPPs) and other initiatives in which the public sector engages the private sector via the public sector arms of MDBs; or (ii) directly through the private sector arms of the MDBs. While both approaches are complimentary and interdependent, there are some fundamental distinctions between the two. This document is the first of a series of two notes on lessons learned from private sector engagement and focuses on interventions financed through the private sector arms of the MDBs. A second note will highlight lessons drawn from experience in targeting the private sector through public sector operations of the MDBs.

In addition to documenting lessons learned, the paper also attempts to identify opportunities for better tapping the potential for private sector engagement in the market transformation process. The lessons outlined are presented from the perspective of the MDBs, as implementing entities for the CIFs, and are primarily informed by experience to date in preparing and/or implementing projects that receive financing through the Clean Technology Fund (CTF), Forest Investment Program (FIP), Pilot Program for Climate Resilience (PPCR) and Program for Scaling up Renewable Energy for Low Income Countries (SREP). Insights are also derived from broader experience in planning and deploying funding for various climate-related investments and advisory services with the private sector.

Private sector approach to market transformation

Successful market transformation requires coordinated interventions at the policy level as well as incentives to catalyze public and private sector players to implement and finance climate-related projects and programs. This

[1] "Engaging the Private Sector" is a phrase often used with different meaning in the context of climate finance. Broadly speaking any activity where private sector is (i) developing climate projects, (ii) providing capital to climate projects, or (iii) providing capital to climate funds are within the scope of what is meant by "engaging the private sector".

implies actions by both public and private sector actors. Market transformation can be achieved in the most efficient and effective manner when governments and private sector address market barriers in a complementary and synergistic way.

As noted, governments have a crucial role to play in creating a policy environment that can incentivize private companies and investors to mobilize capital and entrepreneurship for climate-relevant actions. The effectiveness of policy making in support of climate change responses depends on a range of factors – from addressing political constraints to ensuring government agencies work together and present a coherent set of policy-driven incentives to investors. It may be necessary, for example, for governments to create new bodies or assign new authorities or funding. Governments can also support sector development through (i) early stage research and development of new climate friendly technologies; (ii) PPP arrangements (e.g., as a revenue source for private companies developing and managing key infrastructure activities for the government through concessions or independent power producer arrangements); (iii) funding limited and targeted demonstration projects in order to prove the viability of a renewable resource or demonstration of a technology in local conditions; and (iv) providing information on market and environmental trends to aid good decision making.

Supported by groundwork from the public sector, and in response to the market landscape, the private sector itself can develop markets for climate goods and services. However, there are a number of risk, cost and capacity barriers that private companies and investors face (especially early movers) which prevent them from investing in climate friendly projects, and which cannot be addressed through government intervention alone. Typically, first movers into a market experience higher risks and costs than later entrants because of a lack of track record or proven performance history of a technology in a given environment, or higher than normal perception of market, regulatory, or technology risk. First movers are also for instance faced with learning the procedures of how to implement their project or market their product within a new country, market or policy environment. The risk profile of first time projects affects the decisions of both investors and lenders as well as developers or technology adopters. When the costs and risks outweigh the expected returns, projects do not happen and market development does not occur.

Box 1: Investing in First Movers as a Means of Catalyzing the Wind Market in Mexico

The Isthmus of Tehuantepec in the State of Oaxaca, Mexico, has one of the best wind resources in the world, with an estimated potential of 8,000 MW, but by 2008 only 88 MW had been installed through two public projects supported by the World Bank.

In November 2008, a new Renewable Energy Law was passed establishing a more effective regulatory framework and greater incentives for developers. Despite the new law and a favorable tariff structure, private sector projects were still not coming to fruition, largely due to significant additional costs and risks associated with being "first movers", and a financial crisis which dried up access to capital.

Using funds from the CTF, the government of Mexico, along with the International Finance Corporation (IFC) and the Inter-American Development Bank (IDB) took a strategic approach to catalyzing and fast tracking Mexico's private "self-supply" wind development following the financial crisis of 2008 and the withdrawal of commercial lenders from the market. The approach entailed supporting the first 2-3 developers to help establish a track record of performance and prove these projects could be profitable. It also included support to technical and financial learning in the sector, included important components to reduce environmental and social risk and focused on a strong demonstration effect,

The Eurus Project in Mexico

The first project, a 67.5MW wind farm developed by EDF Energies Nouvelles was unable to secure commercial financing and the financing package was closed with IFC, IDB, and the US Export-Import Bank. The second project, a 250MW wind farm developed by Acciona Energia, was able to attract commercial financing but still needed the support of MDBs to complete its financing package. For both projects, the CTF funds were structured in a subordinated position to fill the gap between senior lenders' risk perceptions and what sponsors needed to receive an acceptable return. A third large, 396MW wind farm is now being constructed by Macquarie under Mexico's selfsupply framework; however, this time it will be fully financed by commercial sources.

The CTF funds demonstrated that private wind projects under Mexico's self supply framework could take on more debt than was previously thought and helped to catalyze and fast track wind development even during a financial crisis. Today, the State of Oaxaca benefits from around 500 MW of installed wind capacity including projects under the private selfsupply framework and IPPs. A further 700 MW is expected to be commissioned by December 2011 and another ten projects totaling about 2000 MW is expected to come on line in later years. In all, since the financing of the two CTF-funded projects, about 20 more projects have closed financing or begun construction under the self-supply framework (AMDEE)

The risk versus reward imbalance for early investors and market entrants can most efficiently be addressed by intermediaries that can respond to market changes in real time, and have the ability to: (i) identify and aggregate a pool of strategic initial investments and, (ii) offer incentives on a case-by-case basis, including advisory support (which can reduce the cost of entering a new market), respecting the principle of least concessionality.[2] In the CIFs the MDBs play this intermediary role; however, it is possible for this role to be played by other institutions, including private financial institutions or global developers/manufacturers, which have the capacity to aggregate multiple projects in a strategic way to address a market barrier.[3] To be effective, though, intermediaries must

[2] Concessional financing means non-market based pricing for the terms of an investment. Under the principle of least concessionality, the subsidy embedded in the concessional financing package should be no greater than necessary (the minimum needed) to induce the intended investment.

[3] For example, a global developer or manufacturer could address cost barriers by implementing several projects globally that push the market towards economics of scale for certain technologies.

have the ability and willingness to adhere to the procedures, safeguards and reporting requirements of contributor country funds such as the CIF. Box 1 and 2 provide examples of two approaches to market development through direct private sector interventions.

The design and governance of the CIF have been an improvement over previous climate financing facilities that could be accessed by MDBs for private sector projects primarily because of the inclusion of specialized processes to deal with the private sector. In the three years since the CIF became operational, there have been a number of private sector programs developed as part of government Country Investment Plans, and several projects have begun implementation. What follows is a summary of key emerging lessons derived from knowledge drawn from the design of the Fund, implementation of private sector programs/projects, and MDBs experience to date with the CIF. The lessons presented are broadly divided into two types: (i) *strategic* – offering insights into how best to achieve transformational change through climate-related private investments, and (ii) *operational* – giving suggestions for ongoing CIF work and the design of related climate financing efforts. Inevitably, there are both strategic and operational implications of all lessons presented. Each of the ten lessons offered begins with a background section which is followed by a summary of CIF experience and, for some, suggestions regarding improvements and alternatives applicable to CIF operations and other climate financing facilities.

Box 2: CTF-led Market Transformation of Private Sector Clean Energy Finance in Turkey

The EBRD's Sustainable Energy Financing Facility in Turkey aims to make a transformational impact in areas critical to addressing climate change mitigation in the country. By boosting the private sector investments in energy efficiency and renewables, they will support the transition to a clean energy model. This will reduce green house gas emissions by decreasing the consumption of fossil fuels. And at the same time, this will foster further economic growth at a rapid pace. The CTF-financed TURSEFF focuses on funding smaller scale energy efficiency and renewable investments by small and medium-sized enterprises (SMEs), as well as households.

The EBRD approved TURSEFF on 6 May 2010 for a total of US$ 200 million, including US$ 40 million which became available from CTF. Since the programme's launch, its funding has been extended by US$ 40 million, including a further US$ 6.75 million from the CTF funding. In total this is expected to generate up to US$ 385 million of investment. JBIC is also co-financing US$ 20 million to one of the banks, further increasing the volume. Apart from concessional co-finance and technical assistance of a total of US$ 50 million from the CTF, another US$ 7 million has been raised from the European Commission. The private banks involved are Akbank, Denizbank, Garantibank, Vakifbank, and Izbank. Following a slow start, during which the facility financed considerable technical assistance to the banks to allow them to build up their business, and develop a strong project pipeline, they are now rapidly rolling out loans to the private sector.

Building up on their beneficial relationship with the EBRD, Turkish banks asked for further funding. This led to significantly larger facility which is not benefitting from CTF support. This facility is known as the Mid-size Sustainable Energy Financing Facility, or MidSEFF, and has started to address the mid-size renewable energy market, as well as covering larger industrial energy efficiency and waste-to-energy investments.

A Turbine is being installed at EBRD/IFC/EIB-financed Rotor windfarm, Turkey

On 14 December 2010, the EBRD approved the MIDSEFF project for a total of up to US$ 536 million (EUR 400 million). This facility is reinforced by a close collaboration with the EIB, which has contributed US$ 402 million, and JBIC, which has contributed US$ 120 million. An extension of US$ 402 million has also been approved by the EBRD Board. The total volume of MIDSEFF has now reached US$ 1.46 billion. This rapid increase reflects the excess demand by the banks and the renewable energy sector in Turkey, and the ability of the private sector to respond quickly to changing market dynamics.

The contribution of the CTF was crucial to unlocking this potential. It provided the EBRD with the means to engage local private banks in this new area of business. Their rapid response, coupled with their willingness to scale up the business, demonstrates the private sector's ability to quickly rise to the occasion, and provide finance to sustainable energy, where a business case can be made. The initial CTF stimulus of US$ 50 million in Turkey is now expected to lead to over US$ 1.8 billion in investment in clean, sustainable, and efficient energy production and use.

2 Strategic Lessons

Lesson #1: MDB private sector climate financing has generated an attractive degree of leveraging

Background. Given the significant financial needs to address the global climate challenge, an important CIF criterion for selection of investments is the ability to use CIF funding to leverage additional capabilities and financing in support of programs and projects, particularly from the private sector.

CIF experience. According to CIF data, as of August 2011, of US$4.35 billion in endorsed CTF financing allocated to 14 country investment plans, US$1.5 billion, or 34%, is for direct private sector projects and programs (Annex I). Within this, 16 CTF private sector programs have been approved in 9 countries, amounting to US$505 million in CIF support, which is projected to leverage a further US$4.7 billion of investments from MDBs, bilateral agencies, other development partners and the private sector. This means that every dollar of CTF funding should catalyze about $9 of MDB and private financing. The leverage figures indicate that CTF direct private sector interventions are an efficient way to leverage private capital in support of climate-related goals. This becomes even more attractive when the probable copycat effect in the market is considered, whereby a successful demonstration project can catalyze investment in further similar projects as risks are effectively lowered.

Lesson #2: Least concessionality is an important principle for avoiding market distortions, and is workable in practice with close coordination among MDBs

Background. The use of public funds for private sector initiatives has traditionally been a controversial and sensitive debate. To ensure appropriate application of public funds in private sector initiatives, the CIFs have facilitated an agreement among MDBs on the key principles for deploying concessional finance. The "principle of least concessionality" reflects the idea that the subsidy included in concessional financing should be no greater than necessary to induce the intended investment. This approach helps to accelerate transformation of nascent markets and reduces the potential for market distortions. It also maximizes the leverage of the resources available. Determining the minimum level of subsidy requires an evaluation of the individual market and the barriers inhibiting investment. In some cases, it may be feasible to use competitive bidding to elicit market information, such as when rival firms are invited to bid for projects on the basis of the least subsidy required. Where competitive bidding is not feasible, commercial negotiations are required, informed by relevant market benchmarks. To support effective market transformation, the level of subsidy provided to successive investments in the same market is usually reduced progressively to facilitate the transition to financing on full commercial terms.

The barriers inhibiting private investment vary by project, sector and market. Even within the same market, differences between potential investors in matters such as their risk appetite, capital structure and technology or expertise offered can result in differences in the required form and level of concessionality. When this is the case, the goal of minimizing concessionality may require that packages be designed on a project-by-project basis. Otherwise, deploying an identical package to all players in the market could result in over-subsidizing some and providing others with inadequate incentives to invest.

CIF experience. While there have been exceptions to the application of this principle in the early period of CTF programming (notably the CTF Turkey financial intermediary programs, where CTF pricing in the market was benchmarked against the public sector CTF program), MDBs have generally worked to achieve least concessionality by negotiating the subsidy amounts within the overall structuring and pricing on a case-by-case basis with each client. This has proven both feasible and effective in allowing MDBs to reduce the subsidy amounts offered on CTF pricing as a market develops and based on client/project profiles. For example, in the

Mexican wind market, the first CTF loan was priced at a flat interest rate, the second project was priced at Libor plus the same flat interest rate, and the third project did not need a subsidy at all. For least concessionality to prevail, it is essential that all implementing agencies abide by the same principles for the deployment of funds, especially within a single market, to avoid market distortion. The dynamics and principles behind the requirement of least concessionality are also relevant for public sector operations, because low-priced public sector loans can lead to market distortion – especially when these pass through to private markets.

Box 3: IDB & IFC working together in Mexico and Colombia

In both of the CTF countries beginning implementation in Latin America and the Caribbean, there has been a strong positive cooperation between the IFC and the Private Sector department of the IDB. In the Mexico Renewable Energy Program, both MDBs worked together to identify and develop wind investments. They channeled CTF funds into the first two projects in an alternating manner with both institutions co-investing alongside CTF. This collaboration maximized the MDB leveraging on each transaction as well as the demonstration impact of both projects which entered the Mexican market around the same time. Similarly, the IFC and IDB are investing together in the Colombia Sustainable Energy Finance Program, focused on energy efficiency and clean production finance. Like in Mexico, both banks will invest together in each project, but only one MDB will channel CTF resources in order to reduce administrative costs, and streamline the investment process. This cooperation is expected to lead to mutual learning between MDBs, offering a combination of bank strengths to the local financial institutions.

Alternate approaches. To mitigate the risk that MDBs use contributor country funds to compete with each other and oversubsidize clients, there could be a requirement that MDBs working in the same country / region formally agree on the principles for the deployment of CIF funds within the market (see Box 3 for an example of such coordination). Alternatively, where MDBs compete in the same markets, the investment plans could specify that CTF allocations for the private sector are segregated by sectors (e.g., wind, solar, biomass, waste to energy) or sub-sectors to reduce the chance of introducing distortions. This would not eliminate the possibility of some healthy competition for deal flow, but it could eliminate competition for the application of CTF funds.

Lesson #3: Maintaining flexibility for MDBs to structure financing outflows and other transaction terms is essential

Background. The CIFs are designed to give MDBs the ability to structure financing packages to private sector clients in a flexible manner to target and address specific barriers inhibiting investment. Barriers preventing investment tend to center on risks (perceived and real) and costs. Program proposals submitted to the CTF Trust Fund Committee for the private sector are programmatic in nature, and outline the parameters of the terms that can be offered to any project, including which instruments are eligible to be used (e.g., debt, subordinated debt, guarantees/risk sharing facilities), the floor price of such instruments proposed, and expected tenors needed. This allows MDBs to engage clients in a more efficient manner once program envelopes are approved and gives them the flexibility to structure concessional funds to be responsive to market demands so they can increase the catalytic impact of these funds in private sector projects. Underlying these parameters are the principles of concessional finance, as outlined in the *Clean Technology Fund Financing Products, Terms and Review Procedures for Private Sector Operations* endorsed by the CTF Trust Fund Committee (TFC) in March 2010.

CIF experience. In the context of global climate financing experience over the last 20 years, the CIFs have, and continue to, provide the most hands-on and in-depth experience on engaging the private sector through multi-donor climate financing facilities or funds. The MDBs and the CIF TFC members have developed specific principles for deploying concessional funds to private sector and have designed processes within the CIF mechanism to improve the overall flexibility of the CIF to meet the needs of private sector. This has allowed greater alignment of project cycles and has allowed the private sector arms of the MDBs to be more responsive to clients; projects are developing – in most cases without delay. Applying the "principle of minimum concessionality" has also balanced, on the one hand, the needs of contributors to avoid over-subsidizing, with the

desire, on the other hand, to be responsive, efficient and flexible with products that meet the needs of private sector clients.

While improvement of the CIF mechanism to engage and fund climate relevant private investment has been considerable and noteworthy, there remain some areas where instructive lessons for the future can be drawn. These are primarily linked to limitations agreed by the CIF governing bodies, either due to the nature of contribution to the CIF[4], evolving political realities, or shifting market conditions. While many may be unavoidable, they are illustrated here to raise awareness:

- ***Pricing***: Each program submitted by a private sector arm of an MDB is required to submit a floor price for the instruments proposed. Justification of floor pricing is provided in the proposals submitted to the TFC, and often different country and market circumstances warrant a different margin for concessional lending. While the pricing parameters utilized by MDBs to date have been sufficient in most middle income countries, the need for greater pricing flexibility to catalyze investments is higher in least developed countries (LDCs). In some cases, sensitivity by the TFC to the minimum pricing offered to private sector projects has resulted in an increase in the floor price deemed to be allowable in the market, which in turn has limited the subsidy incentive that can be offered by MDBs to potential private sector partners. This may have the effect of reducing the scope for impact, particularly if floor pricing is close to commercial pricing already available in the market.

- ***Subordination***: The use of subordination in structuring an investment package can be useful to strengthen a project's equity profile and encourage additional commercial lenders to provide senior debt financing. In many cases, pricing concessionality alone is not enough to catalyze private sector investment, and subordination is also required. In such cases, program proposals outline how CIF funds will be used in a subordinated position to other lenders and especially MDB financing and guarantees to reduce the risk profile of such investments and the possibility that those funds will not be repaid. Limits on the amount of funds within a program that can be subordinated has proved challenging, especially in circumstances where (i) the cap does not cover the entire need of one project, which results in not being able to deploy any CTF funds in a subordinated position; or (ii) the cap prevents scale of a particular approach across many players, such as deploying risk sharing/guarantees across multiple financial institutions in the same market. Subordination is a tool that addresses a combination of risk and cost barriers in the same project, and limiting it can greatly affect the ability to meet client needs or incentivize companies to undertake projects they would not otherwise consider under a business as usual scenario.

- ***Local currency lending***. As currently designed, MDBs are unable to provide CIF funds in local currencies or to take foreign exchange risk on sub-project cash flows. As a result, CIF funds are on-lent to projects in either Dollars or Euros, and projects take, or hedge, the foreign exchange rate risk themselves, which results in additional costs for clients. In middle income countries, where hedge markets exist, companies will swap their hard currency CIF loans for local currency loans, with the cost of such swaps directly reducing the subsidy element of the CIF investment. When costs for swaps are factored in, the effectiveness of the CIF concessional funding is reduced, and the impact these funds can have is further limited (particularly when the spread between the floor price and market is already narrow). In LDCs this problem is exacerbated because swap markets often do not exist, and private companies do not have the capacity to manage foreign exchange rate risks on their balance sheets. This has proven to be an extremely challenging constraint to CIF private sector investments in LDCs, affecting the effectiveness of any CIF funding in these countries when projects need local currency.

Alternate approaches. While the CIF processes and procedures have indeed been "transformational" in the context of the ability of global multi-contributor climate financing facilities to catalyze private sector climate

[4] Specifically the need to repay loan contributions.

investment, each of the above lessons given is in some way linked to operational rules agreed by the CIF governing bodies, many of which did not exist in previous facilities. These constraints can at times seem counter-productive, and in practice may limit the ability to fully support private sector development – especially in the hardest markets where the potential catalytic impact of CIF funding is extremely high. While the CIF process allows MDBs to structure outgoing CIF funds in a flexible manner, further provisions should be considered to ensure that the nature of CIF contributions do not inhibit the MDBs from deploying appropriate structures and subsidy levels at the project level, especially in LDCs. This could potentially be achieved through ring fencing contributions for certain types of activities, and ensuring that riskier private sector interventions, including those in LDCs, have sufficiently flexible funding support to enable those activities to maximize their impact (though always applying the principle of minimum concessionality. Another step that should be considered is to ensure a streamlined methodology for changing the financing parameters for outgoing funds when market environments change, so as not to adversely affect the ability to meet client needs or deploy funds.

Lesson #4: Fund design should explicitly allocate resources to private sector interventions

*Background***.** CIF is designed to engender and respond to country ownership of the climate change programs and projects it finances. In order to facilitate coordinated national market transformation to low-carbon and climate-resilient development, recipient country governments are meant to lead and coordinate the analysis that informs the CIF Investment Plans (IPs) as well as drafting the plans. These determine the nature and amount of funds to be requested from the CIF as well as the specific activities that will be funded and the implementing agencies and MDB partners that implement such activities.

*CIF experience***.** Strong country ownership promotes good coordination among projects under an IP and improves commitment to its objectives. However, recipient country CIF focal points responsible for the design of the IPs almost always work for public agencies, and they are most familiar with public interests, institutions, programs, competencies and persons. Governments also have a greater ability to control publicly managed initiatives and thus may have a higher comfort level with such investments. Private sector instruments, investment structures and associated needs for financing or incentives are often less familiar to government officials, and therefore they may be assessed as a less effective or a riskier use of funds. This arrangement can lead to an incentive structure for the programming of international climate financing that discourages investment in projects and programs that engage the private sector directly through MDBs. In addition, a viewpoint has often been expressed that CIF fund allocation is a sort of 'zero sum game', whereby use of funds for private sector projects amounts to a loss by the public sector. When that perspective is prevalent, countries may be less enthusiastic to complete the administrative requirements of the CIFs just to 'give away' funds to private sector. In some instances this has contributed to limited or no allocation within IPs being given to private sector initiatives, despite the necessary and complementary role such initiatives play in transforming markets.

As noted, nearly one-third of total endorsed CTF programming to date has been directed to private sector initiatives. CTF recipients are by and large middle income developing countries, with private sectors that are typically more advanced than those of less developed countries and small island states. In addition, with its focus on maximizing greenhouse gas emission reductions, especially through investments in the energy and transport sectors, there is an easily understandable case for promoting private investment in large low-carbon infrastructure projects. However, the significant allocation of CIF funds to direct private sector initiatives is also seen to have been largely influenced by the strong public statements made by the CTF TFC about the need for a private sector component in CTF IPs. During development of the CTF IPs, some recipient governments initially noted to their MDB partners that they did not understand how private sector projects could contribute to their climate response goals, but they eventually took a stance to support such initiatives because of the TFC expectations.

In contrast to the CTF, the SCF trust fund committees have been far less vocal about their expectations for private sector investment, and the results have been quite different. Even when there has been a clear need and ability for

the private sector to support transformational objectives in SCF pilot countries, recipient governments have been less willing to allocate resources to such initiatives, especially grant funding. In some pilot countries, it has even occurred that governments were initially supportive of private sector programs within their IPs but changed their minds when they learned that they could take their CIF allocation in the form of grants only. In these instances, private sector programs were withdrawn from consideration in IPs because governments preferred to use grants to support public programs. In at least two FIP pilot countries, governments have been open about not accepting even highly concessional loans for public projects because they did not want to add to their debt burdens. In these cases, grant funds were allocated to public sector government-led programs, and loan funds were allocated to private sector programs.[5] These experiences show that without expectations regarding the promotion of private sector engagement being built into the Fund's structure, there are inherent biases against attention being paid to opportunities for engaging the private sector in addressing low-carbon and climate-resilient development.

Alternate approaches. As discussed above, when funding for both public and private sector projects come from the same "country allocation", there can be a perception that allocating funds (grants or concessional) to a private sector program reduces the resources available for public sector projects. This gives recipient countries an incentive to favor public sector projects. Private sector investment may be 'anticipated', or 'expected' by TFCs, but if they do not make it 'required' in IPs, there is no guarantee that countries will even consider allocating funding to direct private sector support let alone decide to do so. If contributing countries wish to see support for the private sector, this intent must be made clear. Recipient country governments would have greater incentives to develop both public and private sector interventions if: (i) CIF funds were divided into separate public and private sector allocations, (ii) CIF governing bodies or rules included specific requirements for the allocation of resources to private sector investments, or (iii) there were a completely separate fund for the private sector. In any case, recipient governments must still be able to draw funds from each allocation according to their needs within the limits of available resources.

Lesson #5: Recipient countries need guidance on differing public and private sector processes and mechanisms

Background. As noted, government CIF focal agencies have a strong orientation toward public sector investments, even though many national climate change strategies give attention to the role of the private sector in achieving adaptation and mitigation objectives. Moreover, the public sector sides of MDBs typically have the strongest relationships and most frequent contact with government agencies that design IPs. Recipient country governments and their public sector MDB partners tend to understand the policies and procedures for public sector projects and programs well, but they are less familiar with conceptualizing how best to mobilize private sector resources. Moreover, the public sector sides of MDBs often are misinformed as to the CIF terms of finance for the private sector, and as primary point of contact they may unintentionally misinform governments. For example, some recipient country governments have received the erroneous message that CIF funding can only pass through the public sector and then to private recipients – not directly to private entities.

CIF experience. Governments have typically been advised on CIF policies and procedures for public sector projects early in the programming process given their ongoing relationship with the public sector arms of the MDBs - well before being advised that different polices exist for private sector operations. Due to their contrast from public operations, these different parameters have been difficult for some government CIF teams to understand, especially when there have been changes in recipient country staffing or responsibilities. In part due to lack of familiarity, compounded by misconceptions, private sector opportunities have often been treated as an afterthought – especially for the SCF targeted programs. As noted, governments also lack a consistent and clear

[5] This reflects a clear misperception on the part of recipient governments, since CIF funds directed toward private sector initiatives and channeled through MDBs do not contribute to sovereign debt burdens (i.e., there is no guarantee by or borrowing obligation incurred by the government).

message from SCF trust fund committees on contributing country preferences for strong private sector participation in IPs. This has sometimes created an awkward dynamic, given that private sector arms of MDBs may appear self-serving when advising governments on CIF positions regarding private sector operations.

Alternative approaches. It would be helpful if the CIF Administrative Unit, in consultation with the MDBs, were to have a stronger role in presenting the guidelines for private and public sector investments. As a neutral party, the Administrative Unit would be able to convey relevant information without advocating a particular type of investment or MDB. It would be helpful if it could prepare a concise (1-2 page) document which it would distribute to recipient countries on how governments should proceed in both public and private sector operations, including what is looked for in investment plans. Another helpful intervention could be participating by videoconference or even in person during important missions and orientation meetings.

Lesson #6: Country focus generates national and local benefits but not complementary regional or global actions

Background. The CIFs are country-focused and rely on country-level strategic planning and decision making to determine the activities to be supported. While there are two regional programs under the PPCR, these programs too have been designed largely as an aggregation of individual country plans with some synergies among the countries.

CIF experience. As CIF is currently designed, there is little scope to do regional or global private sector projects, especially fund structures (or fund of funds), which have the potential to unlock significant amounts of capital.[6] While country projects and programs can be directly linked to national climate change plans and actions to help catalyze sector development and scaling up, regional and global programs – especially funds - can help unlock the flow of capital at scale to fund growth of targeted sectors, consistent with national plans. Fund investors typically prefer regional and global programs, which help to address their scale and risk diversification goals. This is especially relevant in the case of small countries, for example in the SREP, where very limited and nascent markets mean risk and deal flow is too small for a country fund, creating too much concentration of risk.

Alternate approaches. Should additional financing become available, or should there be an opportunity to reprogram existing funds, regional and global set asides for a limited number of private sector interventions could increase CIF's impact. Explicit provisions perhaps could also be made whereby, for instance, country allocations could be incorporated into a new regional fund (for public and/or private investments), thereby decreasing overall fund risk and attracting investors but still assuring that there will be an agreed degree of country-level investment.

2 Operational Lessons

Lesson #7: Approval processes and criteria need to be efficient, clear and aligned with private sector operations

Background. MDB operational staff who work with private sector clients seek objective, timely and clear approval processes. Despite the financing incentives offered, private sector clients often do not have the luxury or patience to undergo drawn out approval processes, especially when the underlying climate projects are already more challenging than their normal course of business. The risk of having CIF funding disapproved, and the costs

[6] The CIFs do have some regional programs; however, the regions supported by the CIFs and the countries within those regions were determined by an expert committee and do not necessarily coincide with the demand for regional diversity that investors in a fund structure would have.

associated with the time and procedures necessary to acquire such funding are always weighed against the potential return expected to be achieved by the funding. When approval criteria or processes are unclear, private companies are unlikely to invest their time to try to obtain such funding. MDB private sector staff are cognizant of these constraints in managing private sector client's expectations. One negative experience can often deter a staff member from engaging again in a similar process and could discourage other MDB staff from undertaking similar projects. In some cases, CIF concessionality is insufficiently meaningful to defray its approval processes and criteria, and it can therefore be difficult for MDB focal points charged with designing programs or projects drawing upon CIF funding to interest and engage private sector participants. While some investment staff still consider the process of achieving CTF program approval somewhat laborious, reducing their appetite to develop CIF programs, this is more related to early experiences of evolving investment criteria and uncertainly about what was needed to obtain approval. MDB staff have been quite satisfied with the CIF processes and procedures for private sector operations once they were established. The development of efficient, objective and timely approval processes are, therefore, crucial to ensuring ongoing private sector uptake and engagement in CIF IPs.

CIF experience. CIF has been successful in developing separate private sector processes and procedures that are relatively well aligned with private sector operations. Once an IP is endorsed, MDBs must submit specific sub-program and project proposals to the relevant TFC for approval. Private sector proposals are presented in a template which clearly describes the information required by the TFC and are submitted by circulation for a 2 week no-objection approval. These procedures have encouraged private sector MDB staff to develop programs and reach out to their clients.
Despite the 2-week no-objection approval process, actual approval time has varied between 4 and 6 weeks, with significant back and forth between TFC members and MDB staff being the norm. Further, this does not include time consumed internally at the MDB before the proposal can be submitted. Such delays can be attributed to many factors, including the need for clarifications on elements within the proposal, a learning curve for both the TFC members and MDB staff associated with new CIF procedures, differing expectations on structuring parameters requested in a proposal, and evolving requirements from the TFC on information required in private sector proposals (including results indicators and frameworks).

Alternate approaches. The no-objection approval procedures and template for private sector projects and programs are positive elements of the CIFs and are working successfully. However, delays could be significantly reduced if informal consultations between MDBs and TFC members could be introduced into the process. Such consultations would give MDBs the opportunity to clarify issues and understand TFC needs in an efficient manner versus current formal written procedures, which can sometimes exacerbate misunderstandings. If TFC members were required to request bilateral consultations with the MDB that submitted a proposal within a week of its submission, these discussions could then take place during the second week of the no-objection period, before the approval date. Such a procedure could efficiently improve response time and improve areas of the proposal needing greater clarity.

Lesson #8: Results measurement indicators need to be established from the outset of Fund design

Background. It is important for MDB staff and their private sector clients to know from the start of project or program design and negotiations how results will be measured and evaluated – including what they will be required to report upon. This allows the private sector client to weigh the benefits of the financial incentives provided through access to CIF resources against the additional costs associated with reporting requirements. MDBs also have experience with multi-donor programs which have overly complex reporting indicators (which effectively equate to investment criteria), and the consistent result has been to reduce the ability to deploy funds.

CIF experience. As the CIFs have evolved, the results measurement frameworks for each of the programs have slowly been developed. This created a level of uncertainty, especially with the early round of private sector

projects being negotiated, since MDBs had to anticipate the reporting criteria to be required by the TFC (for example, these did not typically include development and gender indicators in the first iterations). Knowing the reporting requirements up front is important, because changing the terms of a financing package midway through a negotiation process adversely affects MDB reputations. Reporting requirements are a sensitive negotiating point, and MDBs have experience with private sector clients (especially financial institutions) declining financing for projects/programs when even an MDB's own standard reporting criteria have been deemed to be too cumbersome.

Alternate approaches. In order to minimize the cost of reporting for private sector clients (especially financial institutions that seek systematic and cost efficient ways of gathering data), reporting criteria should be as simple and easy to gather as possible – closely aligned with the underlying project being financed and with processes as streamlined as possible. It is also important to establish the reporting requirements from the outset of fund design. If and when changes are necessary in the indicators and data tracking expectations, programs already approved should be grandfathered. For private sector clients, this is in fact essential, as legal agreements (which outline the client's reporting obligations) are signed with clients, and private sector clients are not likely to sign agreements with open ended and uncertain reporting requirements.

Lesson #9: Special monitoring and evaluation provisions are warranted for private sector operations

Background. Many private sector clients of the MDBs are privately held companies that are not traded on a stock exchange and therefore not subject to public disclosure of their financial statements. Disclosure of a company's detailed financial information, including the terms of financing received from an MDB, can send signals to a market and affect the competitiveness and bottom line of that company. MDBs, therefore, have strict disclosure policies regarding the information they will release on the financing terms of their investments in a company.

CIF experience. The CIFs adhere to each MDB's internal policies and procedures when it comes to disclosure of certain financial details on CIF investments. While elements such as interest rate, tenor, fees and amortization schedule are not disclosed to the public, private sector projects are required to disclose the amount of CIF funds invested into a project, and they report on all other criteria such as changes in greenhouse gas emissions and development impacts. To date, achievement of CIF objectives does not appear to have been negatively affected by project level MDB communication and disclosure policies.

Engagement of local financial institutions in climate finance is essential for establishing the sustainable growth of domestic climate friendly sectors, and domestic banks and other financial institutions are important partners in achieving CIF objectives. Reporting on financial institution subprojects is, however, more complex than direct MDB investments given that the MDBs do not communicate directly with subprojects and rely on intermediaries to gather and aggregate information. In addition, financial intermediaries are often the most sensitive to the additional costs and processes implied by the reporting requirements of funds such as CIF. MDBs have been working to find ways to address the legitimate needs for information disclosure while keeping the processes as simple as possible so as not to lock out essential financial sector interventions.

Alternate approaches. MDBs are working to develop simplified procedures to gather relevant information from financial intermediaries that would help others to better understand climate finance trends. For example, MDBs could track the sectors to which financing is ultimately deployed by financial intermediaries. MDBs are also working to develop methodologies to extrapolate information on development impacts in projects based on past experience.

Lesson #10: Approvals of IPs and Commitments of Funds by the TFC do not imply disbursements to private sector projects are imminent, and perceived "lags" can be explained.

Background. As outlined in the *Clean Technology Fund Financing Products, Terms and Review Procedures for Private Sector Operations*, the CIF project cycle entails (i) design of IPs through Joint Missions, (ii) submission of IPs to the relevant TFC and their endorsement, (iii) preparation of projects/programs by MDBs, and submission of these proposals for TFC approval. For private sector programs, MDBs submit programmatic country programs (not individual projects) to the TFC for approval. As noted in the section on Lesson #3 above, private sector programs submitted to the TFCs outline the general parameters of terms that can be offered to private sector clients, such as eligible instruments, the floor price of such instruments, and expected tenors. MDBs will engage in business development activities beginning with the design of the IPs, and through the submission of the private sector program to the TFC for approval. However, private sector arms of the MDBs are unable to sign term sheets with private sector clients prior to having certainty that funding is available and committed by the CTF trust fund. MDBs who work with the private sector may risk liability by clients if they have advanced negotiations on terms prior to knowing (i) that the funds have been approved and available, and (ii) the parameters of such funding (eg: instruments available, pricing floors) which are included in the submissions to the TFC. Since these parameters are only approved by the TFC when the private sector program is approved, MDBs cannot commit terms with clients until after TFC approval of the program is obtained.

CIF Experience. The transformational objectives of IPs often require investments that occur over a period of time or following initial policy work in a country. However, because the CIFs are a pilot program with limited funds, governments have had to secure allocations upfront in IPs for interventions anticipated to be implemented in the future. Private sector programs are submitted to the TFC only following a "readiness" test, which means that the MDBs feel there is sufficient pipeline to develop and deploy funds to projects, even though such projects are not yet secure because MDBs cannot confirm the exact structuring terms to be offered to the client. Once MDBs receive approval and endorsement of their private sector program envelope from the TFC, MDBs begin to negotiate terms and structure projects with clients identified during business development efforts. This means that project due diligence, structuring, negotiations and documentation commence only after TFC approval of the private sector envelope. The time between TFC program approval and the initiation of disbursement to a private sector project varies by project and sector. Generally, projects in the real sector take significantly longer to negotiate and structure than those with financial institutions, and often project finance deals can take more than a year to structure and reach closure with all parties. Only when projects are approved by the MDB Board, legal agreements have been signed, and all effectiveness conditions are met do CIF funds begin to be disbursed to a private sector client.

This sequence is a normal and agreed part of the CIF programming cycle. However, misperceptions have arisen due to the relatively quick progress that the CIFs have made endorsing ("committing") funds for IPs, and the more complex and time-consuming tasks associated with identifying and structuring private sector projects after TFC approval of private sector programmatic parameters.

Alternative Approaches. Given misperceptions regarding the CIF project cycle, it might be useful to produce a one-page summary of the funding flow and process – from conceptualization of an IP through approvals of private sector programs through to project level disbursement – to deconstruct the terminology and timing. This may help MDBs and the CIF Administrative Unit address concerns over the pace of disbursements, and it may allow for better communication on the process of getting funding to programs and projects.

ANNEX I: CIF Private Sector Portfolio Profile

Clean Technology Fund

The private sector share of the US$4.35 billion CTF funds allocated to the 13 investments plans corresponds to US$1.5 billion or 34%. The CTF portfolio of private sector investments is largely focused on renewable energy (66.3%) in the area of wind, solar, and geothermal, and energy efficiency (33.7%) for industrial, commercial and residential applications.

The CTF funding allocation for private sector by region has been demand driven and based on each country's ability to create a pipeline for private investments and an appropriate enabling environment – largely for renewable and energy efficiency. Currently, the CTF private sector portfolio is distributed as follows: 26% in Africa, 30% in Asia, 34% in Europe and Central Asia, and 10% in Latin America. It is worth noting that 2 of the 14 endorsed CTF investment plans – Ukraine and Kazakhstan – are entirely focused on private sector investments.

For CTF private sector projects, every $1 from the CTF is anticipated to leverage about $9 from private sector and MDB sources.

Strategic Climate Fund (SCF)

The US$ 2.0 billion Strategic Climate Fund (SCF)[7] provides climate-related financing to low-income countries through 3 program areas: the FIP, currently with US$609 million in funding available for eight pilot countries; the PPCR, with US$990 million in funds available for nine pilot countries and two regions; and the SREP, with US$356 million in funds available for six pilot countries.

The SCF remains at an early stage, and many investment programs are still under preparation. Under the FIP, two investment plans have been endorsed to date, with total funding of US$90 million. Of this, US$24.4 million or 27.1% is projected to be used for private sector interventions. Under the PPCR, 11 country programs have been endorsed, with total funding of US$684 million. Of this, US$63 million or 9.2% is allocated to private sector interventions. Under SREP, only one investment plan has been endorsed to date, with total funding of up to US$50 million. Any private sector component to be included will be defined in the second phase of the investment program.

[7] As of June 30, 2011