CLIMATE INVESTMENT FUNDS

CTF/TFC.9/7
April 13, 2012

Meeting of the CTF Trust Fund Committee
Washington, D.C.
May 3, 2012

Agenda Item 7

PROPOSAL FOR IMPROVEMENT MEASURES OF THE CTF PRIVATE SECTOR OPERATIONS

"Based on the document *Lessons Learned through Private Sector Interventions through MDB Intermediaries (*document CTF-SCF/TFC.7/Inf.4)"

Proposed decision by the CTF Trust Fund Committee

The Trust Fund Committee reviewed and approves the proposed revisions to the documents *Financing Products, Terms, and Review Procedures for Private Sector Operations* and *CTF Private Sector Operational Guidelines*.

I. INTRODUCTION

1. During its November 2011 meeting, the joint meeting of the CTF and SCF Trust Fund Committees reviewed the document, *Lessons Learned through Private Sector Interventions through MDB Intermediaries (*document CTF-SCF/TFC.7/Inf.4), and requested the MDB Committee in collaboration with the CIF Administrative Unit to prepare a revised version with recommendations for improvement measures of the private sector operations in the CTF.

2. Based on the document CTF-SCF/TFC.7/Inf.4, the MDB Committee and the CIF Administrative Unit have produced a matrix with recommendations for improvements and have introduced revisions to two CTF documents, *Financing Products, Terms, and Review Procedures for Private Sector Operations*, (document CTF/TFC.5/9), and *CTF Private Sector Operational Guideline*, in line with the above recommendations.

3. This paper provides:

a) Matrix with recommendations for improvements in private sector operations of the CTF (Annex I)

b) Revised document, *Financing Products, Terms, and Review Procedures for Private Sector Operations*, (document CTF/TFC.5/9) (Annex II),

c) Revised document *CTF Private Sector Operational Guideline*. (Annex III)

d) *Climate Investment Funds: Lessons Learned through Private Sector Interventions through MDB Intermediaries* (Annex IV)

Annex I

Changes to Relevant CTF Design Documents based on the document, *Lessons Learned through Private Sector Interventions through MDB Intermediaries* - November 2011

Lesson	Suggested Revision from the paper	Document impacted	Changes
Lesson # 3: Maintaining flexibility for MDBs to structure financing outflows and other transaction terms is essential	• Recognition that flexibility is needed and terms set at approval may not meet client/market needs during implementation. Allowing for flexible terms after CTF approval	CTF Financing Products, Terms and Review Procedures for Private Sector Operations (March 2010)	***Pricing/Subordination*** New heading and new paragraphs 44 and 45, pages 13 and 14 *Procedures for amending financial terms of approved CTF Programs* 44. As markets change over time, the parameters approved by the Trust Fund Committee may prove difficult to implement, particularly in cases where the floor pricing is close to commercial pricing already available in the market, or where the financing gap requires subordinated or mezzanine finance. In this case and in accordance with paragraph 19 of this document, MDBs will indicate to the Trust Fund Committee in the CTF project or program proposal the range of financing terms maximum concessionality, as well as information about fees, seniority (absolute and relative to MDB financing), security, tenor, and grace period) for CTF funds that would be offered to clients, along with a justification for why such terms are required. 45. If an MDB believes that the floor pricing or other terms approved by the Trust Fund

	• Allowing local currency lending		Committee are not flexible enough to meet the needs of a project or the market at the time, the MDB may propose revisions to those terms in the form of an [amendment of the CTF proposal] which outlines the justification for the changes requested. Such amendment shall be circulated to the Trust Fund Committee, on a confidential basis, on a two week no-objection basis. [see para 32]
			Local Currency New paragraph 21, Page 8 *21. Local Currency Lending*: In some cases, projects supported by CTF funds require local currency lending. When MDBs swap CTF funds into local currency, costs are incurred and one party in the transaction bears the ongoing foreign exchange risk (or swap breakage costs, if applicable) during the life of the project. When costs for swaps are factored in, the effectiveness of the CTF concessional funding may be reduced and the impact these funds can have is further limited (particularly when the spread between the floor price and market is already narrow). This can be particularly problematic in least developed countries because swap markets often do not exist, or they are not sufficiently liquid for long tenors. Private companies do not have the capacity to manage foreign exchange rate risks in their balance sheets. As part of the additionality that CTF funds can provide, CTF funds [can

			be/should be] used and deployed in local currency for projects that require this kind of funding. If such flexibility is anticipated within a program, the MDB will indicate the need for local currency lending at the time it presents the CTF project or program proposal, including the relevant prevailing costs that may be incurred to deploy local currency swaps with CTF funds in that countryas well as assessment of the risk incurred. Swapping costs will be calculated into the overall allocation request at the time of the CTF program submission. If approved as part of the overall financing terms within the program, the MDB will have the ability to swap CTF funds into local currency, and the CTF allocation to that project will bear the foreign exchange risk (or swap breakage costs, if applicable) embedded in the financing portion of the CTF. Where applicable, as each sub-project within the program is approved by the MDB through its process, swapping costs will be calculated at financial close, and deducted from the overall allocation approved for the CTF program. <u>New Footnote #6 (in para 21, page 8)</u> Swapping costs and risks vary over time, and costs estimates presented at the time of the proposal will be indicative
Lesson # 8: Results measurement indicators need to be	Results indicators need to be set at the time of approval of the CTF program (implication is that future evolution of	CTF Private Sector Operational	<u>Amendment to paragraph 18, page 7</u> 18. In line with the Investment Criteria,

established from the outset of Fund design	Results framework cannot retroactively be applied to already approved programs)	Guidelines (Dec. 2011, revised)	proposals must include performance indicators **from the Results Measurement Framework relevant for the CTF at the time of Program submission for approvals by the CTF Trust Fund Committee,** for each Project, Program and the sub-projects within each Program, along with a timeline for such indicators. New footnote #3 to paragraph 18, page 7 The CTF Results Framework may evolve over time, but MDB private sector programs will be required to comply with the results frameworks in effect at the time of the MDB Program Approval. New footnote #4 to paragraph 22 Page 9 The CTF Results Framework may evolve over time, but MDB private sector programs will be required to comply with the results frameworks in effect at the time of the MDB Program Approval.
		CTF Financing Products, Terms and Review Procedures for Private Sector Operations (March 2010)	Amendment to paragraph 48, page 14 48. Supervision and reporting will be conducted in accordance with paragraph 23 of the CTF Private sector Operational Guidelines, which were approved on January 12, 2009, and **revised on December 15, 2011**. Measurement criteria for each project will conform to the requirements determined under the Results Measurement Framework as approved by the CTF Trust Fund Committee **existing at the**

			time the project was approved. In addition, any MDB using CTF funds in a subordinated position to their own funds must report to the Trust Fund Committee on an annual basis, i) how the additional risk assumed by the CTF investments is delivering additional impact, and ii) the MDB's preparedness to invest on similar terms to the CTF investments in similar future projects.
Lesson #9: Special monitoring and evaluation provisions are warranted for private sector operations	This lesson was confusing likely because of multiple MDBs editing the text. But the essence of both parts of the discussion under this lesson has to do with the inability of MDBs working with private sector to disclose certain client's operational and financial information	CTF Financing Products, Terms and Review Procedures for Private Sector Operations (March 2010)	N/A Proposed language in paragraph 48 – see above.
Clarify information to be provided on private sector investment criteria	To ensure accountability under the programmatic approach used for private sector projects and agreed by the Trust Fund Committee, and also to ensure that useful data is available to the Members of the Trust Fund Committee to allow them to exercise their role with respect to private sector projects, MDBs will report to the Trust Fund Committee, at the financial closing of each project (when details of the project are available), on how each project meets the 10 CTF investment criteria.	CTF Financing Products, Terms and Review Procedures for Private Sector Operations (March 2010) – As new Annex B: Information to be provided in private sector proposals submitted for	New Annex B, pages 19, 20, 21 - See attached here after.

		approval for CTF funding	

New Annex B

To ensure accountability under the programmatic approach used for private sector projects and agreed by the Trust Fund Committee, and also to ensure that useful data is available to the Members of the Trust Fund Committee to allow them to exercise their role with respect to private sector projects, MDBs will report to the Trust Fund Committee, at the financial closing of each project (when details of the project are available), on how each project meets the 10 CTF investment criteria.	**See below - Information to be provided under each criterion.**
1. Potential GHG Emissions Savings: as outlined in paragraphs 9 – 11 of the CTF Investment Criteria for Public Sector Operations.	A calculation of expected GHG impact will be provided. Acknowledging the current discrepancy in method across MDB, the CIF Administrative Unit will propose to the Trust Fund Committee a robust methodology to assess the carbon footprint of investments financed, based on best practices around the world.
2. Cost-Effectiveness: as outlined in paragraph 11 of the Investment Criteria for Public Sector Operations and when relevant paragraph 12 of the CTF Investment Criteria for Public Sector Operations.	A calculation of the cost effectiveness will be provided.
3. Demonstration Potential at Scale: as outlined in paragraphs 13 - 17 of the CTF Investment Criteria for Public Sector Operations.	A description of the demonstration potential at scale will be provided including a qualitative discussion of how the particular project is expected to help influence the market, reduce barriers and/or demonstrate success for others.
4. Development Impact: as outlined in paragraphs 18 – 21 of the CTF Investment Criteria for Public Sector Operations.	A description of the development impact expected to be achieved by the project will be provided without specific numeric matrices.
5. Implementation Potential: the extent to which the current	A discussion of the implementation potential for the project

regulatory environment supports, or does not impede, the development of the private sector, and where barriers exist, explain how these will be addressed. Projects and Programs will also adhere to paragraph 25 of the CTF Investment Criteria for Public Sector Operations.	will be provided and the extent to which the current regulatory environment supports the development of the private sector. Please note this is likely to always be "high" for subprojects that have just completed financial closing with an MDB.
6. Additional Costs and Risk Premium: CTF financing will provide a grant element tailored to cover the identifiable additional cost of an investment and/or to address identified perceptions of risk and other nonfinancial barriers. Projects and Programs will also adhere to paragraphs 28 and 29 of the CTF Investment Criteria for Public Sector Operations.	MDBs will provide the rationale for the need for the CTF investment in its given amount and structure. Such rationale will include a discussion of how the structure addresses, and is expected to reduce, market barriers. Subsidy amounts offered to individual clients would not be disclosed publically as it would undermine the ability of MDBs to negotiate minimal concessionality in future transactions. MDBs will however present to the CTF Trust Fund Committee justifications of the range of concessionality (subsidy element) that could be negotiated with the clients.
7. Financial Sustainability: the likelihood of long-term financial sustainability of a particular Project or Program once the CTF funds are no longer available/have been used. Projects and Programs should not be approved if they are likely to be dependent on a continuous flow of CTF funds. Particular emphasis should be on a Project's or Program's ability to perform profitably under prevailing and projected market conditions. The CTF subsidy element of the investment should be transparent and provided for limited scope, in terms of project finance component and time. The Project or Program should at a minimum have the potential to achieve a substantial reduction in the need for subsidies in similar future projects beyond the initial few projects	MDBs will describe the project's expected role in moving the market towards sustainability. This would include a description of the project's role in the overall programmatic approach to market transformation, the impact of the project sponsor in influencing other market players, and a description of the design of the investment projects coupled with the Advisory Service program to address the capacity building and knowledge sharing intended to achieve a substantial reduction in the need for similar subsidies in future projects.

supported by CTF.	
8. Effective Utilization of Concessional Finance: adherence to the principals for using concessional funds as outlined in Annex B of CTF Financing Products, Terms and Review Procedures for Private Sector Operations. CTF funds should only be used by the MDB if it is unlikely that the project would go forward as contemplated without CTF resources (additionally).	MDBs will discuss the likelihood of the project being done without CTF support citing, when possible, examples of the market conditions necessary to entice similar projects to be done in other regions and/or the lack of such projects in the absence of CTF type support. In addition, the MDBs will explain how the financial conditions offered by the CTF allowed leveraging other resources.
9. Mitigation of Market Distortions: the extent to which the project/program avoids market distortions. Program and Project proposals must discuss how they would seek to minimize or avoid distorting markets, displacing private sector investment or reducing market competitiveness particularly when it is proposed to use funds as grants. Similarly, it will be important to ensure CTF funds are complementary to carbon finance, and it will be necessary to demonstrate that the CTF intervention would not be supporting projects that could otherwise be financed by the Clean Development Mechanism alone.	A discussion of how the project avoids market distortions will be provided.
10. Risks: the risks inherent in the project and how these will be mitigated/ addressed. The risks of the Project or Program (including implementation, financial, social and environmental, market transformation, etc.) must be discussed in light of why the project is expected to be successful. Each MDB will adhere to its own social and environmental safeguard policies.	MDBs will outline the market risks faced by the project and how they are being addressed; however, project specific risks which could negatively impact the project's success or reputation if publically disclosed would not be included.
When presenting programs to the Trust Fund Committee, MDBs will provide as much information as possible at the program level, including information on likely project features	Within the program proposal, MDBs will provide the rationale for if and when they would need to subordinate a CTF investment compared to an MDB investment.

(sectors, instruments, expected range of concessionality etc.) Trust Fund Committee Members understand that this information represents an indicative expectation and that MDBs should not be bound by this information when negotiating instruments and conditions with potential clients. In case of subordination of CTF loans relative to the MDB loans, the MDBs will provide sufficient rationale, analysis and quantification of the risks associated with the subordinated CTF funds, including an explanation of what risks, assumptions and caveats have been taken into account in that quantification, and what the process will be for assessing and mitigating those risks. Even if CTF funds are expected to be ranked pari passu, if the proposal requests flexibility to adjust the terms where appropriate (without the need for further approval from the Trust Fund Committee), the same level of justification as when subordination is the most likely option should be provided.	MDBs will provide rationale, analysis and the expected risks of any CTF investment which is subordinated IFC. While quantification of such risks would be difficult and arbitrary given the level of uncertainty: i. surrounding the likelihood of subordinating a CTF loan to an MDB loan; ii. the amount of any such subordination at the program level; and iii. the details of the project sponsor and remaining project structure, MDBs will articulate the elements of risk that would/could impact the risk of the subordinated investment as well as its potential for impacting the CTF investment negatively.
Recognizing that each deal is different, the Trust Fund Committee members may request an oral briefing (either bilaterally or by teleconference) to allow for more detailed discussions and for immediate questions to be raised. This should prevent a lengthy process of detailed comments to which formal responses are required.	MDBs will make themselves available to any Trust Fund Committee member that wishes an oral briefing prior to the close of the approval period of a program proposal. Equally, if an MDB believes a consultation is needed to clarify questions, the MDB may request an informal meeting with Trust Fund Committee members by telephone or VC within the two week circulation period.

Annex II
Revised document, *Financing Products, Terms, and Review Procedures for Private Sector Operations*

CTF/TFC.5/9
(Revised)
March 3, 2010

Meeting of the CTF Trust Fund Committee
Manila, Philippines
March 15, 2010

FINANCING PRODUCTS, TERMS, AND REVIEW PROCEDURES FOR PRIVATE SECTOR OPERATIONS

Proposed Trust Fund Committee Decision

The Trust Fund Committee reviewed document CTF/TFC.5/9, *Financing Products, Terms and Review Procedures for Private Sector Operations*, and approves the financing products that may be deployed by the MDBs in private sector operations funded by the CTF, the expected terms and principles for such financing, the procedures for the deployment of such resources, and the proposed supervision and reporting.

The Trust Fund Committee agrees that the use of these products and procedures should be kept under review on the basis of actual experience, and requests the CIF Administrative Unit, in collaboration with the MDB Committee, to prepare a report for consideration by the Trust Fund Committee at its first meeting in 2012 with a view to allowing consideration of any changes that would serve to enhance the effectiveness of the CTF.

Introduction

1. The Trust Fund Committee is being requested to approve the attached document "CTF Financing Products, Terms and Review Procedures for Private Sector Operations". This document was drafted jointly by the MDBs to provide guidance in the use of CTF funds in private sector investments complements the "CTF Financing Products, Terms and Review Procedures for Public Sector Operations" which were approved on May 28, 2009.

2. This paper establishes: i) the financing products for which the multilateral development banks (MDBs) may deploy CTF resources in private sector operations; ii) the expected terms and principles for such financing; iii) the procedures to ensure standard of care within the MDBs with respect to the deployment of such resources; iv) the procedures for handling investments including problem investments with respect to the deployment of such resources; and, v) the supervision and reporting procedures for such investments. It is proposed that this document be kept under review by the Trust Fund Committee on the basis of actual experience in its application.

3. CTF funds are expected to target three types of private sector players: i) project sponsors (eg. developers of clean technologies or large companies implementing new technologies); ii) investors in climate mitigating projects (banks, pension and equity funds, insurance companies, etc.); and iii) financial intermediaries developing new lines of credit for climate change investments (banks, leasing companies, ESCOs, etc).

Barriers addressed through private sector interventions

4. In the private sector, decisions to undertake new investments are based on the risk-return expected from the investment[1]. If the risks are expected to be high, the return on that investment must also be commensurately high if the private sector is to engage in the project. As a result, CTF's direct private sector investments seek to address the risk-return imbalance which occurs in many early market projects and which prevents the scale-up and proliferation of such projects. In all cases the objective of CTF funds is to reduce the barriers for early market entrants such that additional investors, developers and financial intermediaries will subsequently enter the market without additional CTF support. This is typically achieved by i) mitigating risks for several early entrants until a track record can be established which would reduce the risk for later entrants, and/or ii) off-setting the incremental costs faced by early entrants (which reduce the return on such projects), but which will not be borne by later entrants. In all cases CTF funds are used to encourage investors to undertake projects they otherwise would not or to fast-track the scale-up of such projects.

5. *High cost of early entrants*: Early entrants often face higher costs than later entrants into the market. Such costs include those resulting from being the first companies to negotiate

[1] Note that every investor, developer or financial institutions will perceive different levels of risk for the same project based on their own knowledge and experience of a market or sector.

contracts and establish procedural "precedents" within the sector (eg. knowing which government and other institutions have authority for which part of the development process – often the "rules of the game" and roles of each authority body are established or clarified as the first projects move through the process). High costs are also the result of more expensive technology inputs that are not yet manufactured at scale and higher debt service costs because investors perceive more risk in projects without a track record. It is envisioned that concessionally priced CTF funds would be used in such cases to off-set some of these costs and encourage developers to enter the market. With scale up of the market, later entrants are expected to face lower technology costs due to production at scale. Cost barriers are typically addressed through lower interest rate loans.

6. *Risk:* It is important to note that although CTF funds may be used in higher risk investment structures MDBs would not use CTF funds to support investments where there are upfront expected losses in a specific transaction, as doing the latter would lead to market distortions (by supporting unsustainable markets). In sectors where the teams managing CTF funds believe that the real market risks are lower than the market perceives them to be, the teams managing CTF funds would seek to use CTF funds as a risk mitigant to encourage private companies and the MDB's own operations to undertake investments they otherwise would not. Typically risk is addressed through guarantees, first loss instruments, subordinated debt or equity.

Examples of private sector barriers:

a. Many financial institutions (FI) hesitate to develop energy efficiency or renewable energy financing lines when there is a cost in terms of learning curve and new procedures with no track record on revenue potential and loss performance for such loans. Using CTF funds to absorb the losses that FIs fear would exceed their other typical business lines can give these institutions the comfort needed to undertake the new investment while a track record is being established.

b. Perceived risk also inhibits investors to finance renewable energy projects in markets where the sector is not yet developed and there is no track record. Generally, if an investor is to assume high risks, the return on those investments must be adequate to compensate for such risks. Many times, however, the expected returns on early entrant renewable energy projects are not high enough to compensate for the lack of track record that exists (in part because of the higher costs that early entrants have to absorb that later entrants don't), even though those same returns may be enough to compensate later entrants for the lower risks that they will later assume (because of a by then established track record). To address the barriers to early entrants, CTF funds could be used to either cushion the risks (through subordination, guarantees or equity gap coverage), off-set the upfront costs (through lower pricing on investments), or both (concessionally priced subordinated instruments or guarantees), as the case requires.

c. In yet another example, renewable energy developers may hesitate to invest in certain markets if they perceive the credit profile of contract off takers or the structure of a contract to be weak. In such cases, CTF funds could be used to credit enhance, through guarantees, the off taker or contract off take agreement, and enable the investment to happen. Here again, the establishment of a track record would encourage new players into the market as the perceived risk decreases.

7. *Combined Risk and Cost barriers*: The structuring of CTF funds will in principle follow the same principles of risk-return as private funds, i.e., subordinated debt or equity will get commensurately higher returns compared with senior loans in the same transaction. At times, however, CTF funds will need to address a combination of risk and cost barriers in the same transaction. This becomes a challenge in terms of risk/reward because a subordinated loan which addresses risk for an investor may still need to off-set the high costs of being an early market entrant for the developer (in this example it is important to ensure the risk-return balance is sufficient to entice both parties – the investor and the developer - if the project is to take place). In such cases MDBs may need to price their subordinated instruments at concessional interest rates in order to address both barriers; otherwise, if the subordinated debt were priced at a market interest rate[2] the investment would be decreasing the risk barrier for the investor while increasing the cost barrier for the developer by adding higher debt service costs to the project. MDBs will always seek to price the CTF funded instruments on the least concessional terms possible.

Principles for using CTF funds in private sector investments

8. CTF funds used in private sector investments will adhere to the principals outlined in paragraph 3 of the Clean Technology Fund Financing Products, Terms and Review Procedures for Public Sector Operations, dated April 28, 2009 and approved on May 28, 2009.

9. Because each country, sector and project faces a unique set of barriers, CTF financing will not be uniformly offered to all private sector companies. As a result, the following principles for use of CTF funds in private sector investments have been designed to guide the MDBs in structuring private sector investments.

10. *Minimum concessionality*: The pricing and terms of the CTF funds offered to private sector clients will be tailored to address the barriers identified for each case. MDBs will seek to provide the minimum concessionality needed to catalyze projects and programs within a sector. In order to honor this principle, CTF funds will be structured on a case-by-case basis to address the specific barriers identified in each project/program. The amount and terms of CTF funding offered to an individual client will be determined between the MDB and the client on the basis of efficient and effective use of CTF and MDB resources. While an attempt will be made to quantify the additional costs faced by early entrants and compare that with the subsidy element implicit in the financing terms being offered, country, industry and individual company dynamics will impact the amount of concessionality a company will accept in order to undertake a project. Very often three different companies in the same industry will require three different levels of concessionality to implement a given technology. For example, if catalyzing market uptake of waste/heat recovery technologies in a sector were dependent on having the three market leaders implement the equipment, then

[2] It must be noted that in many cases there is no "real" market interest rate because financiers are not providing subordinated debt at any price. In such cases, the MDBs will approximate a market interest rate by adding a "risk premium" to the interest rate being charged on senior debt.

the MDB would need to offer each company the minimum amount of concessionality required to have that company undertake the investment. If all companies were offered the same concessionality the MDB may over-subsidize some while not providing enough concessionality to engage key companies that are necessary to achieve the program or projects' objectives. Finding the right amount of concessionality[3] is largely a matter of client needs, market conditions and negotiation, and is dependent on information not flowing between the companies or being available in the market. MDB's will always seek the minimum concessionality necessary to enable projects to happen and will justify the amount of concessionality requested in each CTF proposal.

11. *Avoiding distortion and crowding out:* CTF financing will target the CTF related benefits of the projects and will be proportional to the incremental costs of their achievement. CTF funds will not be priced or structured to displace commercial financing or set unsustainable expectations in a market. CTF funds will be used to "crowd in" the private sector by enabling projects and investments to happen that otherwise would not by catalyzing those investments with their concessionality.

12. *Leverage*: CTF funds will seek to catalyze and maximize the amount of MDB and other bilateral financing as well as commercial financing available for its projects and programs. A key feature of the CTF will be its ability to unlock both MDB and other private sector financing for clean technology investments and catalyze ongoing sustainable investments in these sectors beyond the initial CTF investments.

13. *Financial Sustainability*: CTF programs will be developed to maximize the probability of long-term financial sustainability once the CTF funds are no longer available/have been used. Projects and programs should not be approved if they are likely to be dependent on a continuous flow of CTF funds. After taking into account the CTF financing, particular emphasis should be on a project's or program's ability to perform profitably under prevailing and projected market conditions. The project or program should at a minimum have the potential to achieve a substantial reduction in the need for subsidies in similar future projects beyond the initial few projects supported by CTF.

14. *Absence of Foreseeable Losses*: In all cases, the use of CTF funds will be applied prudently in the project's financial structure, such that the CTF component of the financing is not be expected to experience a foreseeable loss.

Financing Products and Terms

15. *Financing Products*: Unlike public sector CTF loans, which are given to governments that in turn structure their investments into projects and programs, CTF investments which go directly into private sector programs or projects through MDBs must give the MDBs the flexibility to structure the project in such a way that the CTF funds can clearly address and

[3] Concessionality (or subsidy element) would be measured as the difference between the (real or hypothetical) market interest rate and the actual interest rate charged on an instrument, times the amount of financing, over the term of the transaction. For example, if a subordinated instrument and senior instrument had the same amount ($30m), tenor (15 years), and interest rate (8%), but the market rate for the subordinated instrument was 12%, the subsidy would be equal to $1.23m.

overcome the barriers that prevent transformation. For purposes of clarity, CTF funds will not always be subordinated to other lenders or to MDBs. While the MDBs have tried to anticipate the barriers that exist globally, and the types of instruments needed to address them, markets change, barriers change, and the need for financing changes over time. It is therefore essential that MDBs have the flexibility to develop new financial instruments not envisioned in this document if the need arises to achieve the objectives of the CTF. In all cases, the MDB would be responsible for explaining why it believes it can structure and implement the financial instruments proposed in the CTF proposal. See Annex A for some examples of CTF private sector instruments that may be utilized by the MDBs.

16. *CTF subordination to MDB investments*: As noted earlier, subordinated loans or guarantees are sometimes (but not always) needed to mitigate project risks so that an appropriate risk-return balance can be achieved to catalyze investors to finance climate mitigation projects. Over the years the MDBs have built a significant track record of investments in emerging markets. This experience and market knowledge reduces the risks that MDBs assume in their projects and improves the expected risk-reward balance for such projects. As a result, the MDBs will often undertake projects in emerging markets that other private investors, who lack such knowledge and experience, will not. However, some projects the CTF Trust Fund committee is considering for approval would require the MDBs to go beyond their "business as usual" to finance projects in sectors where there is less track record, and where the returns are less certain. As financial institutions themselves, the MDBs are unable to take risks that are not covered by an appropriate return without threatening their own credit rating and negatively impacting their ability to conduct their regular business operations. CTF funds may therefore be used to enable the MDBs to undertake projects they otherwise would not be able to consider without such funds. CTF funding that is subordinated to an MDB investment mitigates the risk for the MDB and enables it to broaden the scope and scale of the CTF relevant, transformational investments that it can undertake.

17. Climate finance is not necessarily different from any other new market being developed by the MDBs. Typically, the MDBs have expanded into other new markets when there has been a willing party to mitigate the higher risk portion of investments while the MDB is establishing its own track record in the new sector. This has been the case in the expansion into health and education investments where health and education associations (groups that know and understand the risks of their client base best) assume the first losses while the MDBs remain in more senior positions, until confidence can be established in the underlying portfolio's performance. Guarantees from strong sponsors is another way of achieving the risk coverage needed to venture into new and untested markets. Unfortunately, in climate finance, the risks are much less tested than in other sectors, and to date only donor groups have been willing to provide the risk coverage needed to allow the MDBs to venture into this new product area.

18. Risk mitigation is the primary reason CTF financing may need to be subordinated to an MDB investment; however, not all CTF projects address risk barriers and therefore not all CTF investments would be subordinated to MDB transactions. The transactions most likely to require subordination are first loss and guarantee products for financial institutions (where a lack of track record would not allow the MDB to take on the first loss component

themselves[4]), and some direct renewable energy and energy efficiency investments where perceived risk perception is a barrier[5]. CTF financing is not expected to be subordinated to MDB investments when the only barrier being addressed is cost. While the MDBs may not be able to provide the terms necessary to offset such costs from their own account, in such transactions, CTF funds would rank pari passu with the MDB financing. In transactions where the MDBs have become comfortable with the risks of a project while the market has not, and cost is a barrier, both the MDB and CTF could be structured in a subordinated position to other lenders; here, the pricing and repayment terms for the CTF component could be different than the MDB investment but the seniority and security would be pari passu with the MDB. When MDBs seek CTF funds for investments that are subordinated to the MDB's own investment, MDBs will justify the need for such structures in the CTF proposal being submitted for Trust Fund Committee approval. Subordination of CTF funds to MDB funds must be clearly noted in the summary terms section of each CTF proposal.

19. *Pricing and terms*: MDBs will indicate to the Trust Fund Committee in the CTF proposal the range of financing terms for CTF funds that would be offered to clients, including a range for price, tenor, subordination and security, along with a justification for why such terms are required. When CTF proposals are for programs that include heterogeneous investments (eg. for differing technologies or different types of recipients – eg. solar developers and a solar manufacturer) establishing a range of terms may be more difficult. In such cases, the MDB will seek to outline to the Trust Fund Committee in the CTF proposal the possible uses of CTF funds and will in all cases establish a floor price for any CTF investment. (see also paragraph 2~~8~~9 below on amendments to CTF proposals). The MDB will inform the Trust Fund Committee on the final terms once they have been determined and agreed.

20. *Grants for Advisory Services / Technical Assistance:* In addition to investments, CTF funds may be used for technical assistance / advisory services to address non-financial barriers that prevent market transformation. If such funds are anticipated within a program, the MDB will indicate so in the CTF proposal, including the amount required, the barriers being addressed and how the CTF funds will be used (eg. for publications, workshops, institutional capacity building, etc.). Advisory services/technical assistance is often required to ensure adequate market capacity, market knowledge, information sharing and a comprehensive approach to transformation. The use of CTF funds for such work must be justified according to its key contribution to the achievement of the transformation objective in the private sector and to the lack of alternative sources of finance.

21. *Local Currency Lending*: In some cases, projects supported by~~with~~ CTF funds require local currency lending. When MDBs swap CTF funds into local currency, costs are incurred and one party in the transaction bears the ongoing ~~FX~~foreign exchange risk (or swap breakage costs, if applicable) during the life of the project. When costs for swaps are factored in, the effectiveness of the CTF concessional funding may be ~~is~~ reduced and the impact these funds can have is further limited (particularly when the spread between the floor price and market

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[4] Note that the MDBs that have developed a track record of projects which use GEF funds in a first loss position to promote energy efficiency lending through financial institutions, are now beginning to consider sharing some of the first loss risk in similar transactions. Such a "shift in MDB risk appetite" is a demonstration of how establishing a track record can change behavior and lead to sustainability.
[5] These instruments would still be subject to paragraph 12 regarding no foreseeable losses.

is already narrow). This can be particularly problematic in least developed countries because swap markets often do not exist, or they are not sufficiently liquid for long tenors. ~~and~~ ~~p~~Private companies do not have the capacity to manage foreign exchange rate risks ~~i~~on their balance sheets. As part of the additionality that CTF funds can provide, CTF funds [can be/should be] used and deployed in local currency for projects that require this kind of funding. If such flexibility is anticipated within a program, the MDB will indicate the need for local currency lending at the time it presents the CTF project or program proposal, including the relevant prevailing costs that may be incurred to deploy local currency swaps with CTF funds in that country[6] as well as assessment of the risk incurred. Swapping costs will be calculated into the overall allocation request at the time of the CTF program submission. If approved as part of the overall financing terms within the program, the MDB will have the ability to swap CTF funds into local currency, and the CTF allocation to that project will bear the foreign exchange~~FX~~ risk (or swap breakage costs, if applicable) embedded in the financing portion of the CTF. Where applicable, a~~A~~s each sub-project within the program is approved by the MDB through its process, swapping costs will be calculated at ~~the time the terms of the financing are finalized~~financial close, and deducted from the overall allocation approved for the CTF program.

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Guidelines for structuring and implementing CTF investments:

~~21.~~22. Private sector CTF investments will be made in accordance with the investment criteria established in paragraphs 11 and 12 of the CTF Private Sector Operational Guidelines, which were approved on January 12, 2009.

~~22.~~23. Unless otherwise approved by the Trust Fund Committee in the CTF proposal, CTF funds will be allocated by the Trustee to the MDB, and be repayable to the Trustee, in United States Dollars. However, MDBs may denominate individual financing provided by them to the beneficiaries according to their own policies and procedures, subject to the MDB assuming any exchange rate risk[7].

~~23.~~24. The MDB will, for purposes of each financing, conclude either a separate agreement with the beneficiary of CTF funds, or a single agreement with separate tranches for the CTF and MDB investments.

~~24.~~25. The design and implementation of activities financed with CTF resources will ensure that appropriate environmental and social safeguards arrangements are carried out in accordance with each MDB's policies and procedures.

~~25.~~26. Agreements between MDBs and beneficiaries will incorporate provisions for default interest (in addition to regular interest) in the case of a default scenario[8]. The CTF

[6] ~~Note: s~~Swapping costs and risks ~~may~~ vary over time, and costs estimates presented at the time of the proposal will be indicative.

[7] It should be noted that not allowing CTF funds to be on-lent in local currencies reduces the flexibility of the funds and increases the costs and complexity of the project, as currency risk must be hedged. It should further be noted that most of the MDBs are prevented by their guidelines to incur such exchange rate risk.

[8] Most MDBs charge a standard rate of 2% for default interest.

investment will apply the same rate of default interest that the MDB applies for its own investment in the same project.

~~26.~~27. The MDBs will follow their own operational procedures regarding notification of the national government of a proposed financing before Board consideration.

~~27.~~28. Except as otherwise justified and approved in the CTF proposal, where CTF concessional rate loan products are pari passu to a senior MDB loan:

(a) In determining whether any guarantee or security for the CTF loan will be obtained, the MDB will adopt the same approach as the one used for the MDB's own loan;

(b) In respect of negative pledge covenants, the CTF loan will have the benefit of any negative pledge covenant;

(c) In respect of suspension, cancellation and acceleration of CTF loans, the CTF loan agreements will provide for suspension and cancellation provisions and acceleration events like those included in relation to the MDB’s own loan unless to do so would negatively impact the objectives to be achieved by the CTF funds, as outlined in the CTF proposal.

~~28.~~29. Where the CTF funds are to be made available for subordinated debt instruments, regardless of their concessionality and relative status compared to the MDB loan:

(a) Senior creditors would not expect a subordinated lender to be able to force acceleration of the project debt where the borrower remains current on the senior creditors’ debt;

(b) Senior creditors would expect subordinated lenders to take a subordinated security, if such loan is to be secured; and

(c) Subordinated CTF loans would rank behind senior lenders in any share of recovery proceeds.

~~29.~~30. Similarly, where the MDB proposal relates to a joint MDB and CTF equity investment, with the exception of provisions for return on investment, the MDB will obtain the same terms for the CTF equity investment, and proposed exit provisions, as the MDB’s own equity investment, unless to do so would negatively impact the objectives to be achieved by the CTF funds, as outlined in the CTF proposal.

~~30.~~31. Where the MDB proposal relates to a grant component, the grant would not generally be reimbursable except where misused. Potential misuse of the grant components will be assessed under the Results Measurement Framework as approved by the CTF Trust Fund Committee.

Role of the CTF Trust Fund Committee in approving private sector financing terms

~~31.~~32. The CTF Trust Fund Committee is responsible for approving the range of terms of outgoing CTF financing as outlined at the time of submission of the CTF proposal by the MDB. Such proposal will include a range of terms expected to be offered on the CTF funds as outlined above, recognizing that program proposals may only be able to identify the types of structures contemplated for the various interventions. The final terms will be notified to the Trust Fund Committee once these have been agreed. If during the implementation of a project, it becomes clear that the terms of the CTF funds should fall outside of the approved terms, the MDB would be required to circulate, on a two week no-objection basis, an amendment to the CTF proposal which outlines the new terms being requested and the justification for the change.

Safeguards for using CTF funds within the MDBs

~~32.~~33. The CTF Trust Fund Committee decided to channel CTF funds through the MDBs to achieve a number of benefits, including: i) the opportunity to leverage and scale-up MDB funding; ii) increasing efficiency and reducing costs by utilizing the MDB's established infrastructure, policies and procedures, and iii) tapping into the MDB's well established network and project development ability. However, MDB management of CTF funds, which are coupled with their own funds, results in a number of perceived and potential conflicts of interest. The MDBs take the responsibility of managing third party funds seriously and have each developed safeguards to manage such conflicts of interest.

Financing Procedures and Conditions

CTF Approval procedures:

~~33.~~34. Private sector projects and programs are expected to be approved following the procedures outlined in paragraphs 9 and 10 of the "CTF Private Sector Operational Guidelines" which was approved on January 12, 2009, and revised on December 15, 2011. Proposals will be submitted using the template provided in Annex A titled "CTF Private Sector Proposal Template" and will follow the timeline outlined in Annex B titled "Proposed Private Sector Cycle of Activities" both of the same document.

Disbursement procedures for private sector CTF investments from the CTF:

~~34.~~35. MDBs that deal with the private sector undertake certain reputational, and at times financial exposure during project financing. MDBs would, for example, lose credibility with their private sector clients (as well as co-lenders) if a CTF investment were not funded upon request due to insufficient cash in the CTF accounts. Therefore, the MDBs may incorporate into their CTF proposals, a specific request for the TFC to approve that the Trustee provide an unconditional letter of commitment which would ring fence available cash for the proposed projects included in the proposal (subject to prior clearance by the TFC/Trustee that such available cash existed). While an actual cash transfer from the Trustee on behalf of the CTF to the MDB for each such project would only take place after approval by the MDB's Board approval of the project (per Annex B of the CTF Private Sector Operational Guidelines), the unconditional letter of commitment would allow the MDB, the client and co-lenders to enter into negotiations with the comfort that funds would be available at the time of disbursement.

Procedures for suspension, cancellation and acceleration of outgoing CTF investments:

~~35.~~36. The MDB will determine, in accordance with its policies and procedures, whether to (i) suspend, cancel or accelerate any CTF investment, (ii) declare an event of default, terminate, or exit from, any CTF investment, (iii) grant any waiver, or agree to an amendment, to any CTF investment terms, including a waiver or amendment that may result in not taking action under (i) and (ii) above, and (iv) enforce any security or guarantee provided for any CTF investment, or (v) pursue other remedies available to the MDB. When CTF loans rank pari passu with MDB investments, and the MDB pursues any of the above remedies with respect to its own investment, it will pursue the same remedy with respect to the CTF investment (unless otherwise agreed with the Trust Fund Committee).

~~36.~~37. Similarly, and irrespective of the ranking of the loans, if both the CTF investment and MDB co-financing have not been fully disbursed, suspension or cancellation of disbursement of one would normally result in suspension or cancellation of disbursement of the other unless to do so would negatively impact the objectives to be achieved by the CTF funds, as outlined in the CTF proposal.

~~37.~~38. The MDB will be responsible for returning to the Trustee all interest/returns, including default interest, fees and principal payments on the CTF investments received by it from a borrower/investee. Processing the payment of those interest/returns, including default interest, fees and principal payments plus the MDB investment income will be made in accordance with the Financial Procedures Agreement entered into between the Trustee and the MDB. In any event, any payment defaults or negative returns which are not recovered in respect of or arising under a CTF investment will be borne by the CTF, without recourse to the MDB's own assets, unless such loss is incurred as a result of the MDB's gross negligence or willful misconduct.

~~38.~~39. There will not be any sharing of payment proceeds received by the MDB under the CTF investment and MDB co-financing or any other MDB investments.

Procedures for handling problem investments:

~~39.~~40. If there is a payment default by an MDB client, under a CTF investment that continues for 30 calendar days or more, the MDB will promptly report such default to the Trustee, so that the Trustee may promptly report to the Trust Fund Committee. MDBs will consult with the Trust Fund Committee on any anticipated sales which would result in a negative return to the CTF once such losses can reasonably be anticipated[9] .

[9] It must be noted that exit prices are negotiated and the final sales price in a transaction may only be known shortly in advance of the transaction closing. In any event, the MBDs will make all reasonable efforts to notify the Trust Fund Committee of anticipated losses through the Trustee as soon as losses are anticipated.

~~40.~~41. Once a course of action has been determined by the MDB, but in any event within 90 calendar days following a default, the MDB will (a) inform the Trust Fund Committee of its proposed course of action (confidentially)[10], and (b) consult with the contributors on the proposal. The MDB may set a deadline for receiving comments from the contributors. After the consultation with the contributors, the MDB will determine if and what (further) action shall be taken. The MDBs and contributors may agree at any time to have the CTF investment assigned or novated to one or more contributor(s), or a third party agency[11]. If as a result of any action proposed to be taken, the MDB is expected to incur any cost, the MDB will seek approval from the Trust Fund Committee (or such other body as the Trustee Fund Committee may designate)[12] for allocation of the Trust Fund funds to cover such costs. The MDB will then take appropriate action in accordance with its own policies and procedures, but only to the extent that the costs related to the CTF component of the transaction for such actions are borne by the Trust Fund and resources have been allocated to the MDB to fully cover such costs.

~~41.~~42. However, prior consultation with the Trust Fund Committee will not have been needed (i) for any actions commenced by the MDB and (ii) for allocation of resources for any costs incurred in connection with those actions, where the MDB commenced its actions (reasonably and in good faith) either (a) prior to any consultation referred to in paragraph 39 above or (b) during or after any such consultation where the MDB considers that swift action is required, in each case, to protect, defend or secure the CTF investment. In such cases the MDBs will inform the Trust Fund Committee prior to taking such actions on a confidential basis as knowledge of such information by the counterparty could undermine the effectiveness of the MDB's actions. The Trust Fund Committee (or such other body as the Trustee Fund Committee may designate) will allocate the resources to reimburse the MDB for any such costs, upon submission of a request by the MDB showing the cost items/expense list and the particular amounts incurred and the action taken to protect, defend or secure the CTF investment.

Procedures for handling recovery proceeds:

43. The MDBs are responsible for returning to the CTF via the Trustee all proceeds recovered from defaulted investments as will be reflected in the Financial Procedures Agreement.

Procedures for amending approved private sector financing terms

44. As markets change over time, the parameters approved by the Trust Fund Committee may prove difficult to implement, particularly in cases where the floor pricing is close to commercial pricing already available in the market, or where the financing gap requires subordinated or mezzanine finance. In this case and ~~I~~in accordance with paragraph 19 of this

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[10] Bearing in mind the potential effects any disclosure of the proposed actions may have on (i) the bargaining positions of the borrower and the lenders, and (ii) the liability of the MDB to other banks in a syndicate, any information provided by an MDB regarding possible actions will be kept confidential by the Trustee, the Trust Fund Committee and any relevant contributors.

[11] To the extent the agreement cannot be freely assigned by the MDB, the MDB may include in the CTF investment agreement a clause giving the MDB the right to make such assignment.

[12] Per the CTF Sunset clause, paragraphs 53-55 of the CTF Governance Framework document.

document, MDBs will indicate to the Trust Fund Committee in the CTF project or program proposal the range of financing terms maximum concessionality, as well as information about fees, seniority (absolute and relative to MDB financing), security, tenor, and grace period) for CTF funds that would be offered to clients, ~~including a range for price, tenor, subordination and security~~, along with a justification for why such terms are required. ~~However, as markets change over time, the parameters approved by the Trust Fund Committee may prove difficult to implement, particularly in cases where the floor pricing is close to commercial pricing already available in the market, or where the financing gap requires subordinated or mezzanine finance.~~

45. If an MDB believes that the ~~pricing~~ floor pricing or other terms approved by the Trust Fund Committee are not flexible enough to meet the needs of a project or the market at the time, the MDB may propose revisions to those terms in the form of an [amendment of the CTF proposal] which outlines the justification for the changes requested. Such amendment shall be circulated to the Trust Fund Committee, on a confidential basis, on a two week no-objection basis. [see para 32]

~~42.~~

Project Administration Fees

~~43.~~46. Implementation and supervision costs will be determined according to the guidelines outlined in paragraphs 19-22 of the CTF Private Sector Operational Guidelines, approved on January 12, 2009, and will be submitted as part of each CTF proposal.

~~44.~~47. Eligible implementation and supervision costs will be determined in accordance with the policies and procedures of the respective MDBs.

Supervision and Reporting

~~45.~~48. Supervision and reporting will be conducted in accordance with paragraph 23 of the CTF Private sector Operational Guidelines, which were approved on January 12, 2009, and revised on December 15, 2011. Measurement criteria for each project will conform to the requirements determined under the Results Measurement Framework as approved by the CTF Trust Fund Committee existing at the time the project was approved. In addition, any MDB using CTF funds in a subordinated position to their own funds must report to the Trust Fund Committee on an annual basis, i) how the additional risk assumed by the CTF investments is delivering additional impact, and ii) the MDB's preparedness to invest on similar terms to the CTF investments in similar future projects.

~~46.~~49. In accordance with the Financial Procedures Agreement executed between each MDB and the Trustee, each MDB will provide the Trustee with certain confidential financial information on the projects within its portfolio. The confidential information will include (i) financial information on each project that is required to facilitate the financial management of the CTF account and is provided on a quarterly basis and (ii) final terms of each project (financial instrument (loan, guarantee, etc), interest rate, tenor, and security/ranking (secured/unsecured, senior/subordinated, etc)) to be provided within 30 days following the project's financial closing. In order to maintain the confidentiality of the information, the

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Trustee may provide project-specific information relating to the CTF private sector projects only with the prior approval of the relevant MDB concerned, such prior consent to be consistent with the MDB's policy on disclosure of information.

Annex A

Examples of Private Sector Financing Instruments
(not comprehensive)

Concessional interest rate loans and loans with performance incentives

1. Concessional interest rate loans are used to off-set the high costs of early market entrants as described earlier.

2. Credit lines and loans with incentive characteristics such as performance bonuses or interest rate reductions provide clients with the incentives to achieve certain milestones or targets established at the onset of the program. These loans are used to fast track the rate of implementation of a program or to direct funding to a sector that otherwise wouldn't get funded. These instruments are most effective with local banks that are comfortable with the risk of a new initiative but that need to incentive either for their clients or loan officers to "kick-start" a new line of business (such as clean energy lending). In this financial structure the donor's funds are coupled with, and leverage, MDB funds to provide the client with one aggregate loan. The bonus or interest rate reduction is deducted from the donor's portion of the loan.

3. *Relevance for climate change*: Concessional interest rate loans can be valuable as a means of encouraging large renewable energy developers to enter new sectors that have high early entrant costs.

4. Loans with incentive features can be used to encourage local banks to develop lending programs for small sized renewable energy and energy efficiency projects; working through local banks is particularly appealing for small sized investments given the scale required to have a climate change impact (in this structure scale is achieved through a local bank's network and client relationships).

Subordinated Debt and Mezzanine Finance (to senior debtors which may, or may not include an MDB)

5. Subordinated debt and mezzanine financing, refers to loans that in case of payment defaults or bankruptcy have a lower repayment priority compared to other company or project loans. Subordinated debt strengthens a company/project's equity profile and enables/encourages commercial lenders to provide senior debt financing. Donor funds that are used as subordinated loans effectively leverage senior financing. While this type of debt has some equity characteristics, it is normally repaid on a regular schedule.

6. *Relevance for climate change*: Subordinated debt has high potential for impact. In addition to subordinated loans for large scale renewable energy projects, subordinated debt is being tested with financial institutions who on-lend donor funds along with their own and MDB financing to small renewable projects. The donor funds in such cases are used to fill the 'equity gap' that exists for many small sponsors. In cases where high capital costs and risk perception barriers are being addressed through the use of subordinated debt, concessional rates could also be a structural feature of the product in cost barriers are also trying to be addressed.

Guarantees and Insurance

7. Guarantees and insurance products enhance the credit worthiness of a transaction because the guarantor agrees it will cover some, or all, of any defaulted payment or repayment per an original contract; guarantees are sought when payment or repayment flows are risky. Guarantees allow MDBs to use their strong credit rating to provide comfort to decision makers that cash flows will take place. This can influence banks and other financiers to provide funding for low carbon technologies (by extending tenors, a project's financial viability becomes more attractive to a sponsor and enables them to make the investment). In general guarantees can be used to cover any of the risks the market will not bare, including credit risk, technology risks, or changes to the project's regulatory environment. Donor funds would be used to provide guarantees for climate change initiatives when no party is willing to pay for such guarantee.

8. *Relevance to climate change*: Guarantees can be applied in different ways to support the development of the renewable energy sector, for example, by enhancing the expected revenue stream from a Power Purchase Agreement, by increasing access to bank finance, or by extending loan tenors and improving the financial viability of a project.

Risk Sharing

9. Risk Sharing is a way of "sharing" the risk of a portfolio of sub-projects with a local bank or financial institution. While the bank funds the sub-project loans from its own account, MDBs guarantee a portion of the repayments from borrowers if a sub-project defaults. A risk-sharing product gives a bank comfort that their risks are mitigated during the period when they are learning a new line of business and a performance track record is being established for the underlying loans. In this structure, donors play a critical role by covering the losses from the first few defaults (if any) which occur in a portfolio of projects (first loss). To date the experience with risk sharing structures has been positive both in terms of low to no losses and the amount of funding leveraged from financial institutions.

10. *Relevance for Climate Change*: Risk-sharing is an effective way to engage a financial intermediary to lend for sectors such as energy efficiency and small scale renewable energy.

Equity

11. Equity is a capital investment in a company or project that is not repaid on a fixed schedule. Equity provides unlimited revenue potential if the project is successful, but risks losing part or all of the investment if the project is not successful. Within the CTF context, equity could be needed to support projects that have viable business plans but where sponsors either do not have the financial wherewithal to implement the project alone (senior debtors require varying levels of equity investments depending on the level of risk perceived in a project or market), or because project developers themselves do not want to take the risks to enter a new market. While subordinated debt has some of the risk profile of equity, it is primarily a structure that mitigates risk for senior debtors; equity on the other hand, shares, or encourages developers to undertake risks they otherwise would not.

Relevance for climate change: Equity could be used to fast-track development of a renewable energy sector in a country where regulatory changes have just taken place or are anticipated to take place. There is a long development stage for most renewable energy projects and the CTF may wish to fast-track project implementation to achieve its ultimate goal of offsetting GHG emissions. If developers are uncertain about a government's commitment to regulatory change, these developers may hesitate to begin the development stage of projects. If however, an MDB, through its relationship with a government and because of that government's engagement in a CTF program, believes that the regulatory environment will become or remain supportive to the relevant technology, it may wish to use equity as a means to encourage project development sooner than would otherwise happen. The equity in this case would be used to share in the development costs of the project (thereby reducing risks for the developer) but would also share in the upside of the project. For purposes of clarity, it is noted that with many early entrant projects, high costs are also a barrier. As a result, to address the cost barrier, the equity returns may be different (or not) for the project sponsor and the CTF investment. In all cases, the MDB would seek to obtain the least concessional/most advantageous terms for any CTF investment.

Annex B

Information to be provided in private sector proposals submitted for approval for CTF funding

To ensure accountability under the programmatic approach used for private sector projects and agreed by the Trust Fund Committee, and also to ensure that useful data is available to the Members of the Trust Fund Committee to allow them to exercise their role with respect to private sector projects, MDBs will report to the Trust Fund Committee, at the financial closing of each project (when details of the project are available), on how each project meets the 10 CTF investment criteria.	**See below - Information to be provided under each criterion.**
1. Potential GHG Emissions Savings: as outlined in paragraphs 9 – 11 of the CTF Investment Criteria for Public Sector Operations.	A calculation of expected GHG impact (in terms of tons per CO2 per $ of CTF) will be provided. Acknowledging the current discrepancy in method across MDB, the CIF Administrative Unit will propose to the Trust Fund Committee a robust methodology to assess the carbon footprint of investments financed, based on best practices around the world.
2. Cost-Effectiveness: as outlined in paragraph 11 of the Investment Criteria for Public Sector Operations and when relevant paragraph 12 of the CTF Investment Criteria for Public Sector Operations.	A calculation of the cost effectiveness will be provided.
3. Demonstration Potential at Scale: as outlined in paragraphs 13 - 17 of the CTF Investment Criteria for Public Sector Operations.	A description of the demonstration potential at scale will be provided including a qualitative discussion of how the particular project is expected to help influence the market, reduce barriers and/or demonstrate success for others.
4. Development Impact: as outlined in paragraphs 18 – 21 of the CTF Investment Criteria for Public Sector Operations.	A description of the development impact expected to be achieved by the project will be provided without specific numeric matrices.
5. Implementation Potential: the extent to which the current regulatory environment supports, or does not impede, the development of the private sector, and where barriers exist, explain how these will be addressed. Projects and Programs will also adhere to paragraph 25 of the CTF Investment Criteria for Public Sector Operations.	A discussion of the implementation potential for the project will be provided and the extent to which the current regulatory environment supports the development of the private sector. Please note this is likely to always be "high" for subprojects that have just completed financial closing with an MDB.
6. Additional Costs and Risk Premium: CTF financing will provide a grant element tailored to cover the identifiable additional cost of an investment and/or to address identified perceptions of risk and other nonfinancial barriers. Projects and Programs will also adhere to paragraphs 28 and 29 of the CTF Investment Criteria for Public Sector Operations.	MDBs will provide the rationale for the need for the CTF investment in its given amount and structure. Such rationale will include a discussion of how the structure addresses, and is expected to reduce, market barriers. Subsidy amounts offered to individual clients would not be disclosed publically as it would undermine the ability of MDBs to negotiate minimal concessionality in future transactions. MDBs will however present to the CTF Trust Fund Committee justifications of the range of concessionality (subsidy element) that could be negotiated with the clients.

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7. Financial Sustainability: the likelihood of long-term financial sustainability of a particular Project or Program once the CTF funds are no longer available/have been used. Projects and Programs should not be approved if they are likely to be dependent on a continuous flow of CTF funds. Particular emphasis should be on a Project's or Program's ability to perform profitably under prevailing and projected market conditions. The CTF subsidy element of the investment should be transparent and provided for limited scope, in terms of project finance component and time. The Project or Program should at a minimum have the potential to achieve a substantial reduction in the need for subsidies in similar future projects beyond the initial few projects supported by CTF.	MDBs will describe the project's expected role in moving the market towards sustainability. This would include a description of the project's role in the overall programmatic approach to market transformation, the impact of the project sponsor in influencing other market players, and a description of the design of the investment projects coupled with the Advisory Service program to address the capacity building and knowledge sharing intended to achieve a substantial reduction in the need for similar subsidies in future projects.
8. Effective Utilization of Concessional Finance: adherence to the principals for using concessional funds as outlined in Annex B of CTF Financing Products, Terms and Review Procedures for Private Sector Operations. CTF funds should only be used by the MDB if it is unlikely that the project would go forward as contemplated without CTF resources (additionally).	MDBs will discuss the likelihood of the project being done without CTF support citing, when possible, examples of the market conditions necessary to entice similar projects to be done in other regions and/or the lack of such projects in the absence of CTF type support. In addition, the MDBs will explain how the financial conditions provided by the CTF allowed leveraged other resources.
9. Mitigation of Market Distortions: the extent to which the project/program avoids market distortions. Program and Project proposals must discuss how they would seek to minimize or avoid distorting markets, displacing private sector investment or reducing market competitiveness particularly when it is proposed to use funds as grants. Similarly, it will be important to ensure CTF funds are complementary to carbon finance, and it will be necessary to demonstrate that the CTF intervention would not be supporting projects that could otherwise be financed by the Clean Development Mechanism alone.	A discussion of how the project avoids market distortions will be provided.
10. Risks: the risks inherent in the project and how these will be mitigated/ addressed. The risks of the Project or Program (including implementation, financial, social and environmental, market transformation, etc.) must be discussed in light of why the project is expected to be successful. Each MDB will adhere to its own social and environmental safeguard policies.	MDBs will outline the market risks faced by the project and how they are being addressed; however, project specific risks which could negatively impact the project's success or reputation if publically disclosed would not be included.
When presenting programs to the Trust Fund Committee, MDBs will provide as much information as possible at the program level, including information on likely project features (sectors, instruments, expected range of concessionality etc.) Trust Fund Committee Members understand that this information represents an indicative expectation and that MDBs should not be bound by this information when negotiating instruments and conditions with potential clients. In case of subordination of CTF loans relative to the MDB loans, the MDBs will provide sufficient rationale, analysis and	Within the program proposal, MDBs will provide the rationale for if and when they would need to subordinate a CTF investment compared to an MDB investment. MDBs will provide rationale, analysis and the expected risks of any CTF investment which is subordinated IFC. While quantification of such risks would be difficult and arbitrary given the level of uncertainty: i. surrounding the likelihood of subordinating a CTF loan to an MDB loan; ii. the amount of any such subordination at the program

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quantification of the risks associated with the subordinated CTF funds, including an explanation of what risks, assumptions and caveats have been taken into account in that quantification, and what the process will be for assessing and mitigating those risks. Even if CTF funds are expected to be ranked pari passu, if the proposal requests flexibility to adjust the terms where appropriate (without the need for further approval from the Trust Fund Committee), the same level of justification as when subordination is the most likely option should be provided.	level; and iii. the details of the project sponsor and remaining project structure, MDBs will articulate the elements of risk that would/could impact the risk of the subordinated investment as well as its potential for impacting the CTF investment negatively.
Recognizing that each deal is different, the Trust Fund Committee members may request an oral briefing (either bilaterally or by teleconference) to allow for more detailed discussions and for immediate questions to be raised. This should prevent a lengthy process of detailed comments to which formal responses are required.	MDBs will make themselves available to any TFC member that wishes an oral briefing prior to the close of the approval period of a program proposal.

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Climate Investment Funds

Annex III
Revised document, *CTF Private Sector Operational Guidelines*

December 15, 2011
(Revised document)

CTF PRIVATE SECTOR OPERATIONAL GUIDELINES

The private sector operational guidelines are also applicable to sub-sovereigns and Public Private Partnerships.

Introduction

1. *Role of the Private Sector in an overall CTF strategy*: As the foundation of economic growth, the private sector has a significant role to play in the reduction of greenhouse gas (GHG) emissions. Strategies for achieving transformational outcomes and progress towards low carbon development will therefore need to include a combination of public and private initiatives. The relationship between public sector reform and private sector action is clear; while many private initiatives can be tested and operate in a less than optimal policy and regulatory environment, full engagement, and wide scale growth of the private sector will only occur if the policy and regulatory environment is both attractive and stable within a country. An appropriate business environment is particularly important for promotion of small and medium-sized enterprises that are critical to broad-based growth and technology adoption.

2. Experience has shown that private sector initiatives, especially those addressing market barriers that are not regulatory (see below), can successfully proceed and at times be a stimulus for subsequent regulatory change. At the same time, advances in technologies and opportunities for high impact GHG reducing private sector initiatives change over time, requiring an interactive and fluid approach to strategy development. Private sector initiatives can sometimes be tested in markets before regulatory issues are addressed or before official country strategies are developed. In these instances, the information obtained from undertaking such private sector initiatives not only contributes to but may also become the foundation and basis for future policy and regulatory change.

3. *Demonstration, replication, scale-up*: Private sector initiatives are used to address two primary market challenges: a) a dichotomy between perceived risks and real risks; and b) the disincentive for private investors created by the high costs associated with being a first mover in a new market. In both cases, private investors are discouraged from entering a new sector on their own.[1] CTF private sector initiatives will seek to achieve scale-up (a significant proliferation of the types of projects being supported - without a subsidy) by demonstrating, and creating a track record through a few initial investments. Once the private sector: i) understands the real market risks, and/or ii) the cost of the new technology decreases, and/or iii) the cost of carbon becomes internalised, replication is expected to occur without further subsidy, followed by a scale-up of investment and market transformation within the relevant country and/or sector.

4. *Engaging the Private Sector*: This document describes how the CTF will engage the private sector and implement an effective public/private strategy, recognizing that CTF funding arrangements for engaging the private sector will be different from the arrangements applied for public sector operations.

5. Recognizing that the CTF is to promote learning-by-doing, the structure and criteria for private sector projects and programs should be kept under review by the Trust Fund Committee, and the MDBs should prepare a report for the Committee, as appropriate, to allow for the

[1] Note, i) if the real risks (e.g., of technology failure) are as high as the market perceives, or ii) if the eventual costs of the projects (beyond those for the first movers) remain high, so as to make the projects financially unfeasible without public support, then these projects should not be undertaken. This would result in significant market distortions.

consideration of any changes to the operational policies resulting from lessons learned that would serve to enhance the effectiveness of private sector operations.

6. All private sector projects and programs will adhere to the principles outlined in paragraph 5 of the Investment Criteria for Public Sector Operations.

Private Sector Proposals

7. Private Sector projects and programs will support the initiatives outlined in paragraph 8 of the Investment Criteria for Public Sector Operations and will be based on an investment plan ("Investment Plan"). Private sector proposals will be submitted in the form of either individual large-scale projects ("Projects"), or program envelopes which aggregate several small and medium sized projects each utilizing less than $50 million of CTF funds and all having a shared focus and objective ("Programs"). Proposals will explain how the Projects and Programs are expected to contribute towards the objective of achieving transformational outcomes in a sector, sub-sector, country, sub-national region, sub-region, or region while demonstrating that these outcomes would not be possible without support from the CTF.

Programming by MDBs

8. MDBs may submit private sector proposals consistent with the endorsed country or regional investment plans. However, in order to facilitate an early start-up of the CTF's operations, MDBs may, during the first six months of CTF operations, submit proposals to the Trust Fund Committee once a country has requested a joint mission and the MDBs have jointly assessed the potential for investments in the country to meet CTF criteria for significant GHG emissions reduction, demonstration potential at scale, development impact, and implementation potential. If the MDB's assessment confirms a potential fit with CTF investment criteria, and after consultations with the relevant CTF government focal point, submission of such project proposals may precede or be in parallel with the preparation of the investment plan. All proposals would need to demonstrate that they are consistent with the investment criteria established for private sector initiatives and the objectives of the CTF.

Timing, Form and Content of Private Sector Proposals

9. Timing and Form of Private Sector Proposals*:* Private sector Project or Program proposals in line with an endorsed country or sub-regional Investment Plan may be submitted to the Trust Fund Committee for consideration at any time throughout the year. Proposals will be submitted using the template outlined in Annex A, which includes the investment criteria and relevant country and Project/Program information. Annex B outlines the private sector cycle of activities for the CTF. When submitting a CTF proposal, each MDB will have to balance the level of detail required to present to the CTF Trust Fund Committee with the need to manage client expectations. Each MDB may choose when, within its own internal processes, it submits a proposal for CTF funding; however, in all cases, this must be prior to an MDB's final Board approval.

10. Content of Private Sector Proposals*:* Programs and Projects will be evaluated based on their merits as described in each proposal. Each proposal must include the following information:

a) *Description of the Project or Program*: Private sector proposals should contain the following elements:

i. For each Project: a description of the project in generic terms; for purposes of confidentiality, company names and details that would make the project identifiable by third parties are not to be included in the description. Final approvals of CTF financing for Projects will be subject to the internal approval processes of the implementing MDB. For previously approved projects further approvals will be required by the Trust Fund Committee only if the final project design results in i) GHG savings that are less than 85% of the original estimate; and/or ii) the changes require an increase in the CTF element of the Project's budget; and/or iii) the ratio of funding from MDB/other financing sources to CTF funding decreases more than 10% from the original leverage ratio. In such cases the Project will be resubmitted to the Trust Fund Committee for approval of CTF financing via circulation on a no-objection basis for a period of 10 working days prior to being submitted through the MDB's internal approval processes. Minor but material updates or changes to the Project's design will be provided by the MDB through annual reports but will not require further approval by the Trust Fund Committee (see Reporting below).

ii. For each Program: a profile of the types of sub-projects expected to be financed under the Program. For purposes of confidentiality, names, if known at the time of the Program's submission, and details that would make a sub-project identifiable by third parties are not to be included in the Program description. Sub-projects within a Program will not require additional CTF approval, unless agreed otherwise by the CTF at the time of original approval. Final approval of CTF financing for sub-projects will be subject to the internal approval processes of the implementing MDB. Minor but material updates or changes to the Project's design will be provided by the MDB through annual reports but will not require further approval by the Trust Fund Committee (see Reporting below).

iii. All proposals: a description of the elements that go beyond supporting a Project's or Program's financing needs, such as advisory services and knowledge management initiatives should be included. In keeping with MDB private sector practice a proposed Project or Program budget may include initiatives aimed at reducing information barriers or other non-financial barriers to market transformation. These activities may include capacity building for private sector entities, particularly small- and medium-sized enterprises, and knowledge products aimed at sharing information among private sector entities, public sector organisations and public-private sector entities, including financial intermediaries, as well as between and among the MDBs, and other relevant development partners.

b) *Strategy for achieving market transformation*: This section will describe how the Project or Program expects to achieve transformational action towards low carbon development in a sector, sub-sector, country, sub-national region, sub-region, or region. It will discuss how the proposal fits within: a) priority sectors for private sector investments identified in the Investment Plan b) already established country objectives and strategies, c) the existing policy and regulatory environment, and d) if relevant, how policy, regulatory and other institutional issues will be addressed to ensure the Project's or Program's success. Proposals must also describe how they leverage the MDB's ongoing activities and resources, and draw on areas of comparative advantage and organizational strength.

Investment Criteria

11. Private sector projects and programs will be measured against the criteria outlined below.

a) *Potential GHG Emissions Savings*: as outlined in paragraphs 8-10 of the Investment Criteria for Public Sector Operations;

b) *Cost-Effectiveness*: as outlined in paragraph 11 of the Investment Criteria for Public Sector Operations and when relevant paragraph 12 of the same document[2];

c) *Demonstration Potential at Scale*: as outlined in paragraphs 13-17 of the Investment Criteria for Public Sector Operations;

d) *Development Impact*: as outlined in paragraphs 18-21 of the Investment Criteria for Public Sector Operations;

e) *Implementation Potential*: the extent to which the current regulatory environment supports, or does not impede, the development of the private sector, and where barriers exist, explain how these will be addressed. Projects and Programs will also adhere to paragraph 24 of the Investment Criteria for Public Sector Operations;

f) *Additional Costs and Risk Premium*: CTF financing will provide a grant element tailored to cover the identifiable additional cost of an investment and/or to address identified perceptions of risk and other non-financial barriers. Projects and Programs will also adhere to paragraphs 28-29 of the Investment Criteria for Public Sector Operations.

12. In addition to the public sector criteria noted above, private sector projects will also be assessed against the following criteria:

[2] Note that when CTF funds are being used to address non-financial barriers (such as risk perception – something common in many energy efficiency programs) the intervention may not result in a reduction of the cost of the technology.

g) *Financial Sustainability*: the likelihood of long-term financial sustainability of a particular Project or Program once the CTF funds are no longer available/have been used. Projects and Programs should not be approved if they are likely to be dependent on a continuous flow of CTF funds. Particular emphasis should be on a Project's or Program's ability to perform profitably under prevailing and projected market conditions. The CTF subsidy element of the investment should be transparent and provided for limited scope, in terms of project finance component and time. The Project or Program should at a minimum have the potential to achieve a substantial reduction in the need for subsidies in similar future projects beyond the initial few projects supported by CTF.

h) *Effective Utilization of Concessional Finance*: adherence to the principles for using concessional funds as outlined in Annex C. CTF funds should only be used by the MDB if it is unlikely that the project would go forward as contemplated without CTF resources (additionality).

i) *Mitigation of Market Distortions*: the extent to which the project/program avoids market distortions. Program and Project proposals must discuss how they would seek to minimize or avoid distorting markets, displacing private sector investment or reducing market competitiveness particularly when it is proposed to use funds as grants. Similarly, it will be important to ensure CTF funds are complementary to carbon finance, and it will be necessary to demonstrate that the CTF intervention would not be supporting projects that could otherwise be financed by the Clean Development Mechanism alone.

j) *Risks*: the risks inherent in the project and how these will be mitigated/addressed. The risks of the Project or Program (including implementation, financial, social and environmental, market transformation, etc.) must be discussed in light of why the project is expected to be successful. Each MDB will adhere to its own social and environmental safeguard policies.

13. <u>Financial Instruments and Procedures</u>: Each proposal must describe, in broad terms, the financing instruments to be utilized, and justify the use of each instrument in light of the market barrier being addressed and need to avoid or limit market distortions. The Proposal will explain if and how subsidies are limited to specific components, and discuss why this approach would provide significant additionality, i.e., why such projects would not go forward as contemplated without use of CTF funds.

14. CTF financing will not be uniformly offered to all private sector companies. In order to honour the CTF's objective of using the least amount of subsidy necessary to enable a project to take place, CTF funds will be structured on a case-by-case basis. For Program proposals, the amount and terms of the CTF funding offered to an individual sub-project client will be determined between the MDB and the client on the basis of efficient and effective use of CTF resources. Country, industry and individual company dynamics will impact the amount of subsidy a company will accept to undertake a project. Very often it will be the case that three

different companies in the same industry will require three different levels of subsidy to implement a given technology. For example, if catalyzing market uptake of waste heat recovery technologies in a sector were dependant on having the three market leaders implement the equipment, then the MDB would need to offer each company the minimum amount of subsidy required to have that company undertake the investment. If all companies were offered the same subsidy the MDB would likely be over-subsidizing some while not engaging others necessary to achieve the Program or Projects' objectives. Finding the right amount of subsidy is largely a matter of negotiation and is dependant on information not flowing between the companies or being available in the market.

15. *Modalities for blending with MDB financing:* To achieve greater leverage, private sector Projects and Programs will seek to blend CTF financing with MDB financing in the most efficient and effective way possible. Financing proposals offered to end-clients may or may not initially differentiate between funds provided by the CTF and funds provided by the MDB's own account, as highlighting the CTF funds could lead to the private sector entity demanding more subsidy than it otherwise would accept to undertake a given project.

16. *Financial instruments:* MDBs may use or create financial instruments as appropriate to meet the needs of their private sector clients and achieve the goals of the Project or Program. Each MDB must explain in the proposal why it believes it can structure and implement the financial instruments proposed for each Project and Program. CTF resources may be combined with other instruments and mechanisms available in the market, such as GEF resources, other donor funds, and/or carbon credits. In the case of such resource pooling and to the extent available at the time of submission, underlying Project and Program proposals may need to explain the particular advantages of combining these tools in the specific circumstances. It will be important to share and build upon lessons learnt through deployment of various financial instruments, and identify opportunities for replication and scale-up as appropriate.

17. *Pricing and terms*: The pricing and terms of the CTF funds offered to private sector clients will be tailored to address the specific risk, market, and structural aspects of each Project and Program. MDBs will seek to ensure that the subsidized financing minimizes or avoids market distortions.

Results Measurements

18. In line with the Investment Criteria, proposals must include performance indicators from the Results Measurement Framework relevant for the CTF at the time of Program submission for approvals by the CTF Trust Fund Committee, for each Project, Program and the sub-projects within each Program, along with a timeline for such indicators[3].

Administrative and Project Management Costs

19. *Project specific budget allocation for implementation and supervision costs*: Private sector projects will vary in tenor and complexity resulting in the need for different supervision

[3] The CTF Results Framework may evolve over time, but MDB private sector programs will be required to comply with the results frameworks in effect at the time of the MDB Program Approval.

budgets for each project (e.g., a five-year investment will typically require less supervision budget than a 10-year investment). As a result, private sector projects will not receive a standard percentage budget allocation per project, but will submit a customized budget request to cover supervision costs over the life of the project along with each project/program submission for Trust Fund Committee approval. Extraordinary costs associated with complex restructurings or exists would require the submission of a request for additional budget to the Trust Fund Committee.

20. *Project and sub-project implementation includes*: sub-project due diligence; structuring, approval preparation and review; preparation and negotiation of legal agreements; and, board approvals; project and sub-project loan/grant disbursement management; oversight of, or management costs related to, sponsor capacity building or completing knowledge management products; and procurement and management of consultants.

21. *Project and sub-project supervision includes*: monitoring and completion of reports, site visits, negotiation and implementation of waivers and restructurings; monitoring and evaluation of individual projects, including independent evaluation of completion/performance reports.

Reporting

22. MDBs will report on the progress of all Projects and Programs annually or more frequently if requested by the Trust Fund Committee. To ensure consistency in reporting and evaluation, universal measurement criteria will be developed by the MDB Committee[4]. The measurement criteria will be in line with already existing best practice.

[4] The CTF Results Framework may evolve over time, but MDB private sector programs will be required to comply with the results frameworks in effect at the time of the MDB Program Approval.

Annex A

CTF PRIVATE SECTOR PROPOSAL TEMPLATE

<table>
<tr><td>Name of Project or Program</td><td></td></tr>
<tr><td>CTF amount requested / Total Project Cost (US$):</td><td></td></tr>
<tr><td>Country targeted</td><td></td></tr>
<tr><td>Indicate if proposal is a Project or Program</td><td></td></tr>
<tr><td colspan="2">DETAILED DESCRIPTION OF PROJECT OR PROGRAM</td></tr>
<tr><td>Description of the Project or Program including:

➢ for each Proposal, a description of the country and sector targeted, as well as the technology supported, including an explanation for the technology choice.
➢ for each Project, a description of the project in generic terms; for purposes of confidentiality, company names and details that would make the project identifiable by third parties are not to be included in the description.
➢ for each Program, a profile of the sub-projects expected to be financed under the Program (sector, average size, geography, ranges of expected results, etc.) and the number of investments expected in portfolio.
➢ the financial instruments expected to be used including how the concessional finance portion will be applied (which components of the project, percent of overall financing, etc.).
➢ a description of the elements that go beyond the financing offered, such as advisory services and knowledge management initiatives and instruments.
➢ note the expected life of the Project or Program from date of approval (investment & supervision period).</td><td></td></tr>
<tr><td>Describe the Proposal’s strategy for achieving market transformation, including:

➢ explain how the Project or Program addresses the objective of transformation to a low carbon economy in terms of market transformation at a country and/or sector level.
➢ describe how the Proposal fits i) the identified role of the private sector as described in the Investment Plan; and ii) within a country’s existing regulatory environment and government policies; where it does not, explain how this will be addressed/mitigated.
➢ explain how the MDB will leverage its ongoing activities and existing strengths.</td><td></td></tr>
</table>

FIT WITH INVESTMENT CRITERIA	
i) Potential GHG Emissions Savings: ➢ Calculate the amount of CO_2-equivalent emissions savings expected to result during the life of the technology and/or service from the proposed Project or a range for the Program. Emissions reductions will be calculated by assessing the fuel savings attributable to the Project or Program for the country or region and technology specified multiplied by the CO_x intensity of the marginal technology. ➢ Note whether the technology is technically viable, commercially available and whether mitigation potential is high or low (per paragraphs 11-12 of this document).	
ii) Cost-Effectiveness: ➢ The expected GHG reduction during the life of the technology per CTF dollar invested. ➢ Note if a reduction in the cost of the technology is expected due to technological progress, learning curves or any other market occurrence.	
iii) Demonstration Potential at Scale: ➢ Note: i) the expected GHG emissions from the sector under a business as usual case; ii) the expected reduction of emissions resulting directly from the CTF financed intervention; and iii) potential emissions savings that would result if the CTF intervention were to be replicated throughout the targeted area or sectors.	
iv) Development Impact: ➢ Describe non-GHG related development impacts achieved through the Project or Program. A key objective of the CTF is to demonstrate the potential for low-carbon technologies to contribute to sustainable development and the achievement of the Millennium Development Goals. Proposals with co-benefits will be viewed favourably. Examples of development impacts include reduction in energy intensity of GDP or for the relevant sector; energy security in terms of avoided imports of fuels and diversification of energy supply; acceleration of access to affordable, modern energy or transport services for the poorest; and a reduction in air pollution.	
v) Implementation Potential: ➢ Note the extent to which the current regulatory environment supports, or does not impede, the development of the private sector; where barriers exist, explain how these will be addressed. Outline the range of resources mobilized by non-CTF funds, including the MDBs and the private sector – both domestic and international, including carbon finance, if appropriate.	

vi) Additional Costs & Risk Premium: ➢ Explain how CTF financing is being tailored to address the identifiable additional cost of an investment or to address risk perception and other non-financial barriers. Note whether CTF financing will complement other forms of donor or CDM finance.	
vii) Financial Sustainability ➢ Describe how sustainability will be achieved (i.e. why similar future projects would need significantly less or no concessional finance). Projects should not be approved if they are dependent on a continuous flow of CTF funds. The Project or Program should at a minimum have the potential to achieve a substantial reduction in the need for subsidies in future projects. ➢ Identify specific institutional factors that will be necessary to enhance the commercial viability of the technology/project, if any.	
viii) Effective Utilization of Concessional Finance ➢ Justify why the concessional finance is needed (why the projects would not go forward without concessional finance). ➢ Discuss why the structure suggested is most appropriate for achieving the Proposal's goals. ➢ Note the use of any other concessional or carbon related finance in the project and how CTF will add value.	
ix) Mitigation of Market Distortions ➢ Discuss how the Project or Program will seek to minimize or avoid distorting markets, displacing private sector investment, including carbon finance where it is supporting similar investments within a country and/or sector, or reducing competitiveness.	
x) Risks ➢ Discuss the risks inherent in the Project or Proposal and how these are being mitigated/addressed.	
xii) Performance Indicators ➢ List relevant "Performance Indicators" for the project.	

Annex B

PROPOSED PRIVATE SECTOR CYCLE OF ACTIVITIES

Steps/Actions Required	Responsible Party	Performance Standards
1. Preparation of Investment Plans, including identification of areas for private sector activity	Recipient country Government, MDBs and private sector	According to template approved by TFC
2. Prepare and submit proposals to TFC for approval	MDB	In the form of Annex A (proposal template)
3. TFC reviews proposals and approves	TFC	In the form of Annex A
4. Trustee commits amount of approved proposal	Trustee & MDB	As agreed with Trustee
5. Appraise, structure, and negotiate Projects and individual Program sub-projects	MDB	Based on CTF private sector investment criteria
6. Resubmission of any Proposal that differs substantially from Approval	MDB to TFC	Memorandum circulated on a no-objection basis
7. MDB management-level approval	MDB	According to MDB's operational policies and procedures
8. In accordance with each MDB's internal requirements a summary of project information which indicates at a minimum the company name and a brief project description will be circulated to the TFC when it is released to the public	MDB	No later than 30 days prior to MDB Board approval (for information purposes only)
9. MDB obtains board approval for Project, Program, or sub-project, as appropriate	MDB Board	According to MDB's operational policies and procedures
10. MDB submits cash transfer request to IBRD as Trustee	MDB and Trustee	As agreed with Trustee
11. MDB signs legal contracts with client	MDB and private sector	According to MDB's operational policies and procedures
12. Supervision and management of the portfolio projects	MDB	Consistent with MDB's operational policies and procedures
13. Annual Report submitted to the CIF Administrative Unit	MDB	Based on the Performance Indicators established at Proposal Approval

Annex C

Principles of Using Concessional Funding of the Clean Technology Fund

Fundamental Approach

1. *Avoiding distortion and crowding out:* Financial support through the CTF should be targeted at global benefits of the projects and proportional to incremental costs of their achievement. It should be structured in a way that maximizes incentives to improve environmental performance of the projects and their early implementation. It should not compete with the private financial sector, but instead should be structured so that it reinforces the activities of the private project sponsors and leverages private finance to uncharted territories of targeted projects. Where these principles are compromised by donor conditions, the MDB will seek to minimise the adverse impact of the financing structure.

2. *Guarding flexibility:* Different countries have different risk profiles and different barriers to the implementation of projects. Applying a uniform rate for concessionality risks may over subsidise some recipients, while being insufficient to prompt action with others. Ideally, requests for concessional elements should be accompanied by rigorous analysis of the reasons for the level chosen, and an assessment of the risks and benefits attached to it.

Calculation of subsidy base and subsidy intensity

3. *Significant portion of concessional financing (in particular grants) will be used for technical assistance and advisory services to project sponsors and local financial institutions, such as project preparation, training of project sponsors and financial institutions, and marketing of project opportunities to them. MDB experience shows that project-related technical assistance is the most effective and the least distortionary way of removing many institutional barriers to targeted projects, such as lack of know-how and excessive risk perception. Well-targeted technical assistance reduces the need for investment subsidies.*

4. *Subsidy* to project costs borne by project sponsors, in whatever form, will be calculated as CTF $ invested per tonne of CO_2e reduced against reasonably established baseline and boundaries. However, because of the diversity of private climate mitigation projects and clients, the MDB requires flexibility in determining certain parameters of this formula:

   a. *Level of concessionality (subsidy intensity)* will differ by project type, technology, sector and the country in order to account for specific market conditions and different incremental costs. A flat subsidy rate per tonne of CO_2e could result in insufficient cash flow to trigger some climate mitigation projects (e.g. energy efficiency in buildings or municipal infrastructure) and in excessive cash flow (windfall profits) for other projects (e.g., certain process improvements in industry, certain renewable energy sources).

   b. *Proxies for measured CO_2e emission reduction* will be applied in particular for small projects reached through financial intermediaries. Direct measurement of emission reduction may be feasible for large, stand-alone projects (e.g., rehabilitation of thermal power or heating plants). However for smaller projects a more practical and efficient approach would be to rely on conservative and robust technical proxies that would ensure proportionality with climate impact, but would be easier to monitor.

c. *Timing of disbursement*. The strongest incentive structure would be provided if performance premiums mimicked the cash flow of the carbon finance transactions and were disbursed upon delivery of verified emission reductions. However an accelerated schedule of disbursement (e.g., upon technical project milestones) can be applied for certain project and client types, where payments on delivery would not trigger the projects either because of high implicit discount rates applied by project sponsors or lack of up-front cash flow. Accelerated disbursement will be designed so as not to lose incentives for project's "climate performance".

Climate Investment Funds:

Lessons Learned from Private Sector Interventions through MDB Intermediaries

November 2011

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

Table of Contents

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.

[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".

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 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 "selfsupply" 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

[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.

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 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.

[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.

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.

[4] Specifically the need to repay loan contributions.

- ***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 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

[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).

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 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.

3 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 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.

[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.

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