CLIMATE INVESTMENT FUNDS

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Agenda Item 3

THE CLEAN TECHNOLOGY FUND AND DEVELOPMENT POLICY OPERATIONS

PROPOSED DECISION

The CTF and SCF Trust Fund Committees reviewed document CTF-SCF/TFC.9/11. *The Clean Technology Fund and Development Policy Operations*, and welcomes the information provided by the MDBs on their use of development policy operations. The Committees stress the importance of ensuring that results can be measured and monitored if development policy operations are to be funded by the CIF. The Committees agree to keep this under review as specific projects or programs making use of this instrument are submitted to a Trust Fund Committee or Sub-Committee for funding approval.

I. INTRODUCTION

1. This brief note[1] explores the suitability of using Clean Technology Fund (CTF) and potentially other CIF funds for development policy lending. The paper begins with a brief description development policy operations (DPOs) used by Multilateral Development Banks (MDBs).[2] It then explores the advantages and disadvantages of investment lending and DPOs for advancing the objectives of the CTF. While the current focus on this note is only on CTF, it is anticipated that this discussion will be expanded in the future to cover other CIF windows as well. For expositional ease, a Question & Answer format is used to investigate the suitability and scope for policy operations as a tool for catalyzing cleaner growth.

Development Policy Operations in the World Bank

2. First introduced in 2004, development policy operations in the World Bank provide support for a program of policy and institutional actions in a country or sub-national entities, in particular with regard to poverty reduction and promotion of growth. The Operational Policy statement on development policy operations (OP 8.60) clarifies how a results orientation should be pursued. As part of preparation of the operation, the OP advises that, "The Program Document sets out the country's program being supported and the specific results expected from the resource transfer. The program design includes measurable indicators for monitoring progress during implementation and evaluating outcomes on completion." During supervision and completion, "The borrower implements the development policy operation, monitors progress during implementation, and evaluates results on completion. Bank staff assess and monitor the adequacy of the arrangements by which the borrower will carry out these responsibilities, with due regard to the country's capacity. In addition, Bank staff review implementation progress during supervision to verify fulfillment of program conditions and compliance with legal covenants, and to validate monitoring and evaluation findings. Supervision includes a focus on development impact, assessing the changes in outputs and outcomes resulting from the operation."

3. While funds are not earmarked towards specific investments, development policy operations require efforts by both borrowers and the Bank to measure results, provide legal evidence of the completion of the prior actions, and monitor progress during program implementation to improve outcomes.

4. DPOs have supported country-owned reforms aimed at achieving specific development results in a broad range of countries with different needs—from middle-income countries to fragile states emerging from conflict. DPOs have been provided in the form of grants, credits, or loans, and have supported borrowers in designing and implementing their medium-term

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[1] This note has been prepared by Charles Cormier (SASDC), Richard Damania (AFTCSN), Habiba Gitay, Philippe Ambrosi (Climate Policy and Finance Department), Manuela Francisco (OPCS), and Muthukumara Mani (SASDC). The team thanks Gevorg Sargsyan (World Bank), Mafalda Duarte (AfDB), Claudio Alatorre Frenk (IDB), and David Mccauley (ADB) for their very useful comments and suggestions.

[2] These are budget support operations usually linked to support policy and institutional actions undertaken by countries. They are called Development Policy Loans (DPLs) or Development Policy Operations (DPOs) in the World Bank, Policy-Based Loans (PBLs) or Programmatic Policy-Based Loans in IDB, Program Based Operations (PBOs) in AfDB and Policy-Based Loans (PBLs) in ADB.

development programs or have provided emergency financing to meet crises or exogenous shocks. Their increasingly programmatic nature has allowed the Bank to stay aligned with country processes and respond more flexibly to changing country circumstances and government priorities, which has been essential to strengthen ownership of reforms supported by the Bank. They have especially provided financing and policy advice in areas where country authorities required expertise and technical knowledge.

5. DPOs also remain focused on results. They have been associated with positive results and outcomes in the delivery of social services in health and education, for example, and in public financial management. All Bank DPOs include a results framework that lays out the country goals, the objectives of the operation, and the expected results of the program supported by the Bank. Results frameworks have facilitated the evaluation of DPOs, but their quality has varied. Improvements are needed in defining the appropriate causality between the actions supported by the operation and their expected results, and selecting appropriate, measurable indicators.

6. World Bank Group's Independent Evaluation Group has rated 74 percent of recent development policy operations' outcomes satisfactory or better, and none unsatisfactory. DPOs have consistently been rated satisfactory in achievement of development outcomes during the past few years. For example, for DPOs that carry the poverty reduction support credit title, outcome ratings had increased steadily since FY2003—with 100 percent of them rated satisfactory in FY2006. Project performance was strong in FY2008, with 81 percent of all projects rated satisfactory and with DPOs receiving, on average, higher ratings than investment lending. In IDA countries, DPOs have also served as a useful platform for dialogue, harmonization, and alignment around the key policy and institutional reforms to achieve country goals.

Development Policy Operations in ADB

7. The role and design of policy-based lending at the Asian Development Bank (ADB) have been evolving to reflect the changing context and understanding of international development. Since its inception as balance of payments (BOP) support during the global oil crisis in 1978, ADB's policy for program lending has been adjusted a number of times. However, since the most recent amendment to the policy in 1999 following the Asian financial crisis, ADB has addressed the changing needs of policy-based lending primarily through flexible application of the existing policy.

8. Policy-based lending operations in ADB are referred to as program loans, and depending on client country needs, ADB provides three types of such loans. Standard program loans are provided in situations where the costs of policy adjustments are relatively small, program duration is short to medium term, and resources may be disbursed quickly in 1 to 3 tranches (or about 3 years). The program cluster approach (PCA) is applied when policy and institutional reforms are complex and require more time to implement (4-7 years), and it is akin to a series of smaller standard program loans provided in a sequence contingent on successful conclusion of the preceding program loan. The third type is special program loans, usually in the form of emergency lending actions that reduce the severity of a crisis and typically with a short-term time horizon, large size, and quick disbursement schedule (up to 3 years). A sector development

program is not a separate lending modality but rather a combination of an investment project and a policy-based program loan meant to facilitate an integrated and long-term engagement with client countries to meet a sector's needs and to enhance the effectiveness of policy and institutional reform.

9. Following a 1996 review, ADB introduced the comprehensive sector development program framework which combines investment loans with policy based loans to support both policy reform and investment requirements of a sector for its sustainable development. This led to a rapid expansion of program lending, which was also due to several crisis related loans ADB provided soon after the 1997 Asian financial crisis. These loans sought to mitigate the negative impact of large financial outflows from the region, with the average size of program loans increasing from $31 million during 1978-86 to $146.5 million during 2002-2009.

10. The expansion of policy based lending contributed to ADB's greater engagement in promoting broader developmental objectives in client countries in addition to traditional project financing. The transition to a greater emphasis on promoting a broader approach to development finance has been facilitated by periodic reviews and evaluations of program loans and ADB's keenness to incorporate the lessons learned in developing new program loan products, refining their design, improving their implementation and evaluation.

11. However, while the international trend has been to streamline conditionality over time, ADB averaged about 31 conditionalities in its program loans during 2000–2010 – well above the level of other MDBs in recent years. Therefore, under the 2010 streamlined business processes, ADB introduced a requirement to undertake a problem analysis as part of the summary sector assessment. The analysis assists client countries in identifying the most binding constraints to development and hence streamlining the conditionality attached to policy-based lending. Experience has also shown that country ownership of reforms and their implementation is strongest in sector development programs which link project investments to policy-based support, including technical assistance to refine and support the reform process.

Development Policy Operations in AfDB

12. For the African Development Bank (AfDB) Program-Based Operations (PBOs) are useful financing instruments in support of nationally owned policy and institutional reforms in African countries, while contributing to the availability of predictable medium term finance to support priority spending to meet African countries' medium and long term development goals.

13. Throughout the last decade, AfDB's use of PBOs has increased faster than the overall increase in the Bank's operations with total PBOs approvals from 1999-2009 amounting to UA 6.1 billion.

14. There have been a number of rigorous evaluations of the effects of policy-based/budget-support operations over the past five years and their results have been similar. The overall message is that such operations represent an important element in the toolkit of development partners to address critical issues of growth and poverty alleviation, which links directly to the critical issues of promoting low carbon and climate resilient development pathways. The

evaluations point to the difficulty in attributing outcomes to the operations and making the causal linkages and emphasized the need to deepen the quality and depth of macroeconomic assessments and determination of social, economic and environmental impacts; strengthen results frameworks; and improve approaches to multi-donor efforts.

15. As far as AfDB is concerned PBOs have demonstrated the following advantages which make them indispensable as financing instruments: (a) they strengthen country ownership since they are implemented through national systems in support of national development plans; (b) they enable comprehensive long-term planning and strengthen the national budget process as a central policy instrument at all stages; (c) they help to raise dialogue between development partners and the beneficiary country on key reforms; (d) they increase predictability of aid, especially with multi-year PBOs; (e) they contribute to state building; and (f) they allow development partners to harmonize procedures, improve aid coordination and effectiveness and help to reduce transaction costs.

16. In order to ensure attainment of results AfDB emphasizes monitoring and results measurement of PBO's. PBO operations are monitored from inception to completion in order to ensure smooth implementation and to track progress towards the achievement of development objectives.

17. Monitoring of PBOs is premised on the use of country performance assessments. In terms of results measurement projects need to clearly outline, in a results-based logical framework, the development objectives of the PBO, which will include the hierarchy of objectives, expected results, performance indicators and targeted time frame for achievement of results. PBO results are to be measured by reviewing: (a) national reporting, including annual performance and financial reports and assessment of the Performance Assessment Framework, where applicable; and (b) specific program documents, including performance indicators.

Development Policy Operations in IDB

18. IDB has supported efforts in the Latin American and the Caribbean region by adapting its instruments and developing capabilities to respond to the new demands from member countries. The *Policy-Based Loans (PBL*), were developed to reflect the evolution from macroeconomic adjustment programs to a new generation of reforms more focused on the functioning of the public sector and the efficiency of service delivery. The reforms supported by PBLs tend to address complex, medium term structural, social and institutional issues, where climate change became an eligible issue of PBL support in the last five years.

19. The Policy-Based Lending (PBL) instrument provides fungible resources to support an agreed program of policy reforms and/or institutional changes in a sector or sub-sector. PBLs assist a borrower to develop and implement its policy reforms and institutional changes to contribute to the achievement of sustainable growth, while addressing actual or anticipated development financing requirements that have domestic or external origins. The loan resources are disbursed based on compliance with agreed upon conditions, rather than in relation to specific expenditures; and the size of the loan is not necessarily related to the cost of the policy reforms/institutional changes supported by the PBL, but rather development financing

requirements. Assistance is given for the achievement of these commitments via non-reimbursable technical cooperation activities, as well as investment grants.

20. PBLs have become a very important instrument for the Bank in supporting sustainable, low-carbon and climate-resilient economic development in its borrowing member countries. PBLs are complementary to investment loans in that the implementation of policy reform and/or institutional change is a key factor to strengthen the economic and sector framework of a country, thereby supporting the creation of the necessary enabling conditions wherein both low-carbon and climate-resilient development can occur. Climate Change PBLs are used by IDB to assist in sector policy reforms and institutional changes required to ensure the development of robust regulatory frameworks that provide for necessary incentives to integrate climate change in national and sub-national development planning and to promote investments in low-carbon resilient activities.

21. All PBLs need to state the objective and expected results (outputs, intermediate outcomes and final impact) of the policy innovation or reform and/or institutional change program. The program design must include measurable indicators for monitoring progress during implementation and evaluating the effects of the operation on completion, including baseline data and clear targets. Frequently, policy reform agendas have complex causality and attribution issues in terms of the effect of the actions taken, given that PBLs aim to make non-marginal changes to the rules and incentive systems under which a sector operates, and that the overall impact of the reform generally depends on many factors outside of governmental control. Additionally, impact evaluation work is often challenged by the lack of counterfactual scenarios and control groups in policy reform/institutional change contexts. Bearing these issues in mind, the project teams are careful not to overstate the objectives of the PBLs as GHG or vulnerability reductions but rather identify clearly the intermediate outcome of generating enabling policy environment, i.e. inter-ministerial coordination for climate change investments, conducing to low-carbon and climate-resilient development.

II. SUITABILITY AND SCOPE FOR POLICY OPERATIONS FOR LOW CARBON DEVELOPMENT

Is a DPO more suitable for promoting low carbon development than an investment operation?

22. DPOs are one among a suite of instruments used by MDBs that include investment loans, program for results or guarantees. In the case of poorer developing countries, operations and projects can be offered on grant terms. When the binding constraint on achieving a low carbon transformation includes policy, regulatory or capacity issues, a DPO may be best suitable instrument for providing customized and targeted interventions for alleviating policy or institutional bottlenecks. DPOs can also help generate a policy where was non-existent before. If the constraint is purely a lack of access to technology or knowledge then a specific investment loan or TA could be more appropriate (Table 1 describes the difference between an investment loan and a DPO operation and on circumstances under which each instrument is appropriate).

23. DPOs could support:

a) Policies to eliminate subsidies to dirty fuels are common in many countries. These subsidies amount to a *de facto* reward for polluting and their removal can be an important first step to promote the development and diffusion of low carbon technologies. A DPO can be a useful instrument to catalyze the reforms needed to "level the playing field". At national or sub-national level, there would be both winners and losers from any such far reaching policy change and a DPO could provide the dialogue framework needed to garner support for the reforms;

b) Policy and institutional reform required to facilitate the deployment of new technologies, for instance through the use of preferential feed-in tariffs for Renewable Energy, Energy Efficiency standards and streamlined regulatory process, and to address policy and/or technical barriers to specific technologies which continually fail to meet expected penetration rates. The choice of prioritizing the technologies could be informed by the Marginal Abatement Cost Curves (MACs)[3];

c) Provide incentives towards research and/or the use of low-carbon technologies and practices from both public and private sectors;

d) Strengthen institutions for the design, implementation, monitoring and evaluation of climate change programs;

e) Assist in the identification and access to international climate funds; and

f) Coordination among institutions, ministries and donors.

Table 1: Investment Lending vs. Development Policy Operation

Investment Lending	Development Policy Operation
Finances activities that create physical and social infrastructure	Supports policy and institutional actions that are usually part of a broader government policy or program (e.g., public sector reform, financial sector, social policy)
Finances specific expenditures defined ex ante (positive list)	Quick-disbursing funds supporting overall development financing needs (normally negative list)
Disburses as costs are incurred	Disburses as actions are taken

[3] Forest sector reforms are also closely tied to climate change. On the mitigation side, policies could aim at managing logging so as to reduce carbon loss. Countries could also use DPO's to put in place institutional mechanisms to certify carbon credits from avoided deforestation. On the adaptation side, policies could support forest management, biodiversity protection, protection of wildlife and conservation areas and watershed protection.

Implementation: 5-10 years	Implementation: 1-3 years
Tends to be Appropriate When Focus On:	
Narrow (sub) sectoral scope	Economy-wide or sector-wide reform
Physical investment	Budget support
Sustained capacity-building with hands-on staff participation	Country committed to reform, e.g. good track record, and capacity to design, implement and monitor programs
Project fiduciary arrangements can offset country weaknesses	Overall fiduciary framework strong enough to ensure funds used for intended purposes

How can a DPO be used to catalyze transformational impacts to low carbon development and do so at scale?

24. Low-carbon development faces two distinct challenges. First, there is limited experience, and second, efforts are constrained by funding that is not commensurate with the scale of the challenge. In most cases, it is a combination of instruments that is needed to sustain and build transitions at the desired scale. A DPO can be used to promote domestic policy reform and support regulatory and institutional capacity to expand low-carbon investment opportunities, to help to manage the risks and increase the returns for investors. Investment lending combined with technical assistance can provide the financial resources needed to accelerate investment in desired or riskier technologies, and build technical and implementation capacity and address crucial knowledge gaps. The synergistic and reinforcing impacts of the package of instruments can often induce greater change than the impact of any one instrument in isolation. It might also assist in the coordination among donors, and foster participation from the private sector.

25. Public finance for low-carbon development will necessarily be limited and should be used as a catalyst to leverage broader transformations wherever possible. A DPO is the appropriate instrument for catalyzing reforms when the constraint to low carbon development derives from institutional and policy deficiencies. However, if the constraint is technological, investment lending can support the desired transformation. Consider the example of promoting renewable energy use. The impact of an investment loan is limited to the number of projects that are financed by its credit. In contrast a DPO, for the same amount that supports a policy change mandating renewable energy as part of energy mix and can leverage investments across the entire country by:

a) By supporting policies that indirectly encourage the purchase of clean energy (examples: pollution reduction targets, carbon cap-and-trade);

b) By supporting policies that directly encourage the purchase of clean energy (examples: Renewable Portfolio Standards, Renewable Electricity Standards, and Energy Efficiency Standards); and

c) By mandating purchase of renewable energy by public sector (examples: buying and installing solar panels on rooftops; installing wind turbines on military bases)

The leverage factor thus of a policy change relative to the investment that is catalyzed can be significant.

Since DPOs provide budget support, where is the assurance that the funds provided by the operation are used for their intended purpose – promoting low carbon development?

26. As with any other policy outcomes, effective results are contingent upon the quality of project design. DPOs do not require that funding be commensurate to the cost of a policy change. It is recognized that the cost of policy change is often impossible to quantify. So is the time lag between the intervention and the expected results, given the nature of climate change interventions. Rather performance is to be measured in terms of indicators that capture the *desired results.* This encourages a shift in focus from inputs (financial needs, equipment, training programs) as indicators of performance to outputs – GHG reduction outcomes – as indicators of performance.

27. Further, one of the key characteristics and strengths of the climate change programs is the inter-institutional and inter-ministerial collaboration and coordination needed to achieve the commitments, which fosters dialogue within key stakeholders allowing synergies and a more effective use of resources. It is often the case that climate change dialogue is led by Ministries of Environment which weak both in terms of their capacity and convening power. Since, the DPO programs are led by the Ministry of Finance, their convening power often comes handy in fostering inter-ministerial collaboration between the ministries with mandates for climate change and for energy.

As policy change is an intangible output, how is it possible to credibly measure and monitor the success of a DPO?

28. A DPO is monitored at two levels. First, prior to disbursement there is verification that the prior actions are met, and if designed as a programmatic DPO, that triggers for the second or subsequent operations are met, when the subsequent operation is submitted for Board approval. This requires confirmation that the agreed policy or institutional changes have occurred,. At the end of the program a set of Results Indicators are used to assess the extent to which the ultimate policy goal has been achieved. As in any project, measuring success depends on the design of the indicators. Ideally indicators should be closely aligned to the final outcomes of the project – GHG reduction. Examples might include reductions in GHG emissions relative to a baseline, additional capacity in MW, reductions in measured levels of deforestation, adoption of energy efficiency targets or energy savings in MWh and so on. In the Energy Sector Development Policy Loan approved by the IBRD Board for Morocco in May 2007 for instance, a monitorable indicator was the attainment of power exchange capacity of 1400 MW with Europe and 1300

MW with Algeria by the end of the series, as a measure of the objective of opening the electricity market. Indicators recently employed in a PBL in El Salvador include a measurement of fiscal resilience and climate change considerations in sectoral plans.

29. Even when the objective involves long time frames it is possible to develop intermediate indicators that help the MDBs and the client country teams to measure progress towards meeting its longer term objectives. In the above example on Morocco, the end of series indicators are interim in nature, as the policies adopted within the DPO are expected to yield a larger power exchange capacity with neighboring states beyond the DPO timeframe.

What has been the uptake of Climate Change DPOs in MDBs?

30. In the World Bank, between 2004 and 2007, Climate Change related DPO lending amounted to USD 700 million in 3 countries. On the other hand, between 2008 and 2011, it amounted to USD 6.1 billion in 15 sector specific operations in 6 countries. Examples of sector-specific DPOs include: Indonesia (climate change), Peru (climate change/green growth/water sector), Mexico (low carbon growth), Turkey (energy efficiency) and Vietnam (climate change).

31. The IDB has approved a total of 7 PBLs in Climate change since 2007 in 7 countries (Mexico, Peru, Colombia, Panama, El Salvador, Guatemala and Trinidad and Tobago) for a total of USD 1.93 billion (as of Sept 2012). In addition it has approved a number of sectoral PBLs (in particular in the energy sector) that contribute to advance low-carbon development objectives. IDB's PBLs consist of a series of operations (2 or 3 phases) to be approved and developed progressively over a medium term period. The policy matrix of a PBL establishes obligations to fulfill as a condition of disbursement of the loan.

32. In AfDB, PBO's initial assessments demonstrate that PBO's can provide an incentive to establish a reform strategy and a forum for agreeing performance targets and criteria; can help sequence or pace of reform and can drive contracts for results in certain sectors, which is not normally the case when using other instruments like TA.

What would be the requirements for DPOs to be aligned to CTF Investment Criteria?

33. At the time of submission of a DPO to the CTF Trust Fund Committee for endorsement, project proponents should be expected to provide an assessment of eligibility to the CTF, including how the DPO meets the investment criteria, namely: (a) potential for GHG reduction potential; (b) cost-effectiveness/cost-benefit; (c) demonstration potential at scale; (d) development impact; (e) implementation potential; (f) additional costs and risk premium; and (g) innovation where relevant.

34. It is likely that the DPO series would include and thus monitor a sub-set of these criteria. For example if the project development objective is to address barriers directly related, for instance, to demonstration potential at scale, it could be measured through capacity additions, or potential GHG reductions. Some other criteria could be more qualitative and best be described as a narrative, including cost-effectiveness and additional costs and risk premiums, which require the comparison of several technologies, implementation potential, which could include

geographical areas beyond the scope of the investment project, and developmental impact. Implicit in the criteria are that baselines would be developed and some specified targets met.

III. Conclusions

35. Much of the information is drawn from how the MDBs design and implement Development Policy Operations. Results from the climate change policy operations suggests a good analytical basis (e.g. in Poland) and partnerships (e.g. in Vietnam) can make significant and positive contributions to the design and implementation. As a pilot, a DPO with support from CTF is proposed by the Government of India (Himachal Pradesh Green Growth Programmatic DPL). The pilot will be evaluated against the CTF criteria stated above (para 16.). There is a need to develop credible baselines and indicators that would allow measuring targets being included as part of the DPO outcomes.

36. Lessons learned from the MDBs could help contribute to the step-wise approach that CTF could take to include development policy operations as part of its suite of instruments.[4] Combining DPOs with technical assistance (analytical and capacity) could be additional considerations that would help bring about transformational change towards low-carbon development (see Box 1).

Box 1: Lessons Learned from Broader DPO Operations that have Implications for Climate Change DPOs

- Better integrate analytical work into country policy-making cycle →direct link to prior actions.
- Conditionality requires strong ownership and a thorough consultation process with stakeholders.
- Avoid process conditions. Focus only on critical policies/actions linked to expected outcomes/results. Process conditions have been heavy on Climate change DPLs.
- Major effort needed on quality of results frameworks →understand differences between policies and outcomes, aim for quantifiable outcomes with baselines and targets, and have a logical link of attribution between actions and outcomes.
- Need to retain flexibility, ownership and avoid bureaucracy in the context of Multi-Donor Budget Support Frameworks.

[4] MDBs had a CC DPO’s meeting in April and plan to have another one after the CIF Partnership Forum in Istanbul. These offer opportunities to further discuss potential use of CC DPOs under CTF.