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**PROPOSAL FOR AN APPROACH TO ENGAGE THE PRIVATE
SECTOR ON THE CLEAN TECHNOLOGY FUND**

Clean Technology Fund Proposal for an Approach to Engage the Private Sector

Summary

This note lays out a proposal for the Clean Technology Fund [for Climate Change] (CTF) to engage the private sector in pursuing its objectives. Private sector initiatives may well be relevant for other funds that are to be established, in parallel to the CTF, under the Climate Investment Fund (CIF). The approach outlined below may therefore also be applicable to private sector initiatives under such structures.

Objective: The CTF seeks to achieve large-scale transformation towards low-carbon and climate-sensitive market environments, for example, of an entire industry sector or sub-sector in a particular country or set of countries. CTF expects to achieve maximum impact by engaging in initiatives focused on a few select countries.

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 Emissions. Strategies for achieving transformational impact and a low carbon economy 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 regulatory environment, full engagement, and wide scale growth of the private sector will only occur if the regulatory environment is both attractive and stable within a country. At the same time experience has shown that private sector initiatives can successfully proceed and at times can even be a trend setter for subsequent regulatory change.

To achieve the CTF's objectives, MDBs will capitalize on their individual organizational strengths and experiences to develop strategies (at a country, sector or sub-sector level) which comprise: i) engagement with governments to design and implement regulatory frameworks that would encourage – rather than discourage - GHG reducing private and public initiatives, ii) providing private investors the financial and technical support needed to engage in wide scale GHG reducing behaviors and investments and iii) addressing non-financial barriers to market transformation such as information and knowledge gaps, consumer misperceptions, and fears and other behavioral challenges. It must be noted that advances in technologies and opportunities for high impact GHG reducing private sector initiatives will change over time, requiring an interactive and fluid approach to strategy development. Private sector initiatives may 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 becomes the foundation and basis for future regulatory change.

Engaging the Private Sector: The proposal below describes a framework for the CTF to engage the private sector and implement an effective public/private strategy, recognizing that CTF funding structures for engaging the private sector may have to be different than the structures applied for public sector proposal financing. Annex A outlines a further rationale for private sector participation in the CIF and the efforts to reduce Greenhouse Gas Emissions; Annex B provides examples of financial instruments that have been successful in doing so.

Private Sector Approach for CTF Proposals

Private Sector Proposals to the CTF:

1. ***Eligibility:*** All Multilateral Development Banks (MDBs) are eligible to submit proposals for Private Sector Programs¹. Private sector entities [and bilateral banks] will be able to access CTF funds through Programs managed by the MDBs.

2. ***Scope of private sector proposals:*** Private Sector Programs will leverage CTF funding to achieve transformational impact in a sector, sub-sector, and/or country². Proposals need to explain how the underlying projects and/or Envelopes contained in a Program will contribute towards this objective and address the specific elements of the transformation that would not be possible without support from the CTF³.

3. ***Approval Procedures:*** Proposals for a Private Sector Program may be submitted to the CTF Trust Fund Committee for consideration at any time throughout the year. The Trust Fund Committee will respond to all proposals with a formal approval, rejection or request for additional information within [XX calendar days] of the project's submission. MDB's may submit multiple proposals for Private Sector Programs simultaneously or sequentially and without limitation.

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

- (i) **Description of the Program's Strategy:** This section will describe the MDB's strategy for achieving transformational impact to a low carbon economy in a sector, sub-sector and/or country. It will discuss how the Program's "large-scale" projects and Envelopes fit within i) the MDB's transformation strategy, ii) already established country objectives and strategies, and iii) the existing regulatory environment, and if relevant, how regulatory issues are being addressed to ensure the Program's success. Programs must also describe how they leverage the MDB's currently ongoing activities and existing strengths.
- (ii) **Description of the Program:** Private Sector Programs proposed to the CTF should contain the following elements:
 - A description of the Program's pipeline, providing details about each of the projects in generic terms; for purposes of confidentiality, company

¹ 'Programs' may include any combination of individual large-scale projects and/or 'envelopes' of smaller thematically-linked projects.

² The donor group may need to consider establishing a common definition of "transformational impact"; alternatively, clarity on what exactly "transformational impact" means could be achieved through case-by-case discussions of individual proposals.

³ This part of the proposal – which discusses the specific role of subsidized funds in achieving transformational impact – will have to be part of a proposal's overall strategy. Understanding, and discussing, the "additionality"-of a particular intervention, describing the "case without", is already part of many MDBs' regular project approval processes for private sector finance.

names and details that would make the project identifiable by third parties are not to be included in the project pipeline description. The project pipeline would consist of i) individual “large-scale” projects which each use more than [XX million] of CTF funds; and ii) Envelopes which aggregate several small and medium sized projects each utilizing less than [XX million] of CTF funds and in total not exceeding [XXX million], all having a shared focus and objective. Pipeline projects within a Program will require CTF approval only at the Program approval stage, unless agreed so otherwise. Final approvals for individual “large-scale” projects and Envelopes will be subject to the internal approval processes of the implementing MDB, which should be described in the proposal. Updates on changes to the Program’s pipeline will be provided by the MDB through semi-annual reports (see below). Such reports will describe substantive changes to the pipeline but will not be subject to additional approvals unless the changes require amendments to the Program’s budget.

- A description of how the Program pipeline will support the CTF objectives and the Program’s strategy.
- A description of the Program’s elements that go beyond supporting the financing needs of a project, such as advisory services and knowledge management initiatives and instruments.

- (iii) Justification of Financing Mechanisms: Each Program proposal must describe, in broad terms, the financing mechanisms to be available to its pipeline of “large-scale” projects and Envelopes, and justify the use of each mechanism in light of the impact, objectives, and need to limit market distortions. Specifically, the Program proposal will explain if and how subsidies are limited to specific project components, and discuss why this approach would provide significant additionality⁴, i.e. why such projects would not go forward as contemplated without subsidized funds.
- (iv) Performance Triggers: Program proposals must include performance triggers for each “large-scale” project and Envelope proposed, along with a timeline for such triggers. These triggers are milestones which indicate that a project may not be able to achieve the transformational impact initially expected. The Trust Fund Committee reserves the right to request that any “large-scale” project or Envelope that does not meet a performance trigger agreed to in the initial approval, be amended or replaced by a new “large-scale” project or envelope. If any Envelope is amended or replaced, all formal agreements entered into prior to the amendment or replacement (including mandate letters, commitments and disbursements), will be grandfathered.
- (v) Investment Criteria: The Program proposal will commit the submitting MDB to operate within investment criteria outlined below and explain, as necessary, how they will be applied specifically within the Program’s pipeline.

⁴ Further conversations may be required among the MDBs to ensure a similar approach to defining “additionality”.

- *Transformational Impact.* Underlying project investments must contribute to market transformation towards a low-carbon and climate resilient environment in developing countries (ie. a significant reduction in GHG emissions). This criteria needs to be applied by the MDB in the choice and scope of specific technologies, specific projects, sectors, and countries that are to be financed.
- *Avoidance of Market Distortions.* Program proposals must discuss how they would seek to minimize or avoid distorting markets, displacing private sector investment or reducing market competitiveness.
- *Effectiveness.* Underlying project investments will be expected to lead to significant GHG reductions in the medium term. The expected GHG reduction will then be compared against the amount of CTF funds invested to determine project efficiency. Units of measurement for impacts beyond GHG reduction may need to be defined within each Program proposal.
- *Financial Leverage.* CTF funds are expected to leverage other resources, specifically from the MDBs, other financial institutions, and the sponsor. All Program proposals will be required to consider the full range of financial mechanisms available in the market, including carbon finance. The MDB's decision to proceed with a particular underlying project should take into account the degree of leverage obtained, while also considering whether the specific project elements to which CTF resources are applied, are well defined. The use of CTF funds should only be authorized by the MDB if these elements are clearly delineated and if it is unlikely that the project would go forward as contemplated without these resources (additionality).
- *Risks.* Individual project investment decisions need to be taken in full awareness of a project's inherent risks, and considering possible risk mitigation strategies. The MDB will be required to discuss, in later reports, why it believed it had the ability to implement a particular project as described, and to achieve the results expected.
- *Financial Sustainability.* The investment decision will need to take into account the likelihood of long-term financial sustainability of a particular project once the subsidized funds are not available/have been used. Projects should not be approved if they are dependent on a continuous flow of subsidized funds. Particular emphasis should be on a project's ability to perform profitably under prevailing and projected market conditions. Investments constituting a subsidy must be clearly limited in scope, in terms of project finance component and time.

5. ***Use of CTF funds:*** Once approved, CTF resources can be used in the following ways.
- (i) ***Pricing and terms.*** The pricing and terms of the CIF funds offered to private sector clients will be tailored to address the specific risk, market, and structural aspects of each “large-scale” project and Envelope in the Program’s pipeline. MDBs will seek to ensure that pricing and terms of the subsidized financing do not distort the market.
 - (ii) ***Financial Instruments.*** MDBs may use or create financial instruments as appropriate to meet the needs of their private sector clients. Each MDB must explain in the Program proposal why it believes it can structure and implement the financial instruments proposed for each “large-scale” project and Envelope described in the Program proposal. Annex B describes some examples of financial instruments used to-date to encourage maximum impact in the goal of transformation. 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 proposals may need to explain the particular advantages of combining these tools in the specific project circumstances.
 - (iii) ***Country Eligibility:*** The donors have indicated that there will be a list of priority countries eligible for CTF support. A Program’s pipeline is expected to be substantially implemented within the list of priority countries; however, it is recognized that there may be high potential GHG reducing private sector projects which are best tested in markets that are outside of the priority countries, but where market conditions are more conducive to success and learning. A Program’s pipeline may contain up to [XX%] of such projects, with the requirement that once tested and determined to have high impact potential, such projects would be rolled out on scale within the priority countries.
 - (iv) ***Investments vs. Technical Assistance:*** At least XX% of a proposed Program’s budget should be used to finance private sector projects. Up to [XX%] of a proposed Program budget may be used for initiatives and projects aimed at reducing information barriers or other non-finance based barriers to market transformation toward allowing climate resilient and low-carbon growth.

6. ***Reporting to the Trust Fund Committee:*** MDBs will report on the progress of each Program semi-annually or more frequently if requested by the Trust Fund Committee. At each reporting date, an updated Program pipeline must be provided if the originally proposed pipeline list has been changed. To ensure consistency in reporting and evaluation, universal measurement criteria will be developed by the MDB Committee. The measurement criteria will be in line with already existing best practice. Semi-annual reports submitted by the MDBs should also include updates on the progress of “large-scale” projects and Envelopes, in particular vis-à-vis the application of the CTF investment criteria.

Annex A
Rationale for Private Sector Engagement in the
[Climate Investment Fund (CIF) / Clean Technology Fund (CTF)]

1. **Rising Greenhouse Gases (GHGs) present an urgent challenge to the well-being of all countries.** The Intergovernmental Panel on Climate Change (IPCC) makes clear that warming of the climate system is unequivocal and delays in reducing emissions significantly constrain opportunities to achieve lower stabilization levels and increase the risk of more severe climate related impacts. The impacts of GHGs are global and include, among others: increased frequency and severity of droughts, floods and storms, water stress, decline in agricultural productivity and food security, and further spread of water-related diseases, particularly in tropical areas. Stabilization of GHG concentrations within levels that would keep climate related impacts manageable, require limiting global GHG emissions.

2. **Financing GHG reductions: Focus on developing market-based solutions that would leverage the private sector.** Successful global action to tackle GHG reduction requires substantial financial and technology flows from developed to developing countries. The United Nations Framework Convention on Climate Change (UNFCCC) estimates that by 2030 financial flows to developing countries should be in the order of US\$100 billion annually to finance mitigation⁵ and somewhere between US\$28-67 billion for adaptation. Over 80 percent of these investment flows are expected from the private sector. Investment in private sector activities is necessary to test and fast-track the evolution of **financially sound business models** that can form the basis of market-based solutions for addressing GHG reduction. Dynamic growth in demand for energy in the power, transport, building and industrial sectors in developing countries over the next 10-15 years provides a finite window of opportunity to implement transformational investments that reduce emissions. Appropriate incentives need to be implemented now as investment decisions being made today will impact the environment for the next 40 to 50 years.

3. **Public-Private synergies:** An integrated approach with public and private sector involvement should fast-track the development of long-term sustainable market solutions to reduce GHGs. Public sector financing can assist in creating the enabling environment for climate sensitive private sector development, securing private financing flows fast enough to make a difference in current investment decisions. At the same time, private sector action may well precede – rather than follow – changes in regulatory frameworks. Availability of subsidized funding for the financing of clearly delineated private sector expenditures that would replace or reduce carbon-intensive economic activity can set off important market trends and technology evolutions. The strategy for engaging the private sector through subsidized funds would be to encourage early adopters by partially buying down incremental investment costs or specific risks associated with clean energy technologies or sustainable management practices, with the assumption that such early adoption, if large enough in scale, would eventually lead, through

⁵ The costs and financing required are a function of the assumed level of greenhouse gas concentrations in the atmosphere, in this study 550 ppm. The IPCC and other recent studies indicate lower levels may be needed in which case costs will be higher.

falling technology costs and emerging best practice and standards, to long-term changes in industries as well as in their regulatory environments.

4. **Multilateral Development Banks (MDBs) as market catalysts.** MDBs are in a unique position to engage with the private sector in mobilize action that would address GHG reduction. In addition to sectoral and country expertise, MDBs have the ability to design innovative financial structures to meet private sector project finance needs and to support those projects with financing, technical assistance and knowledge sharing. MDBs also have strong client bases which include market leaders in the sectors and therefore the potential for maximum demonstration effect and market impact. Many private sector firms are hesitant to enter new markets or to engage in the early stages of product development and testing without the support of partner institutions like the MDBs who work with them to ensure project success. By leveraging their market position MDBs can therefore intervene in emerging markets to accelerate commercialization of proven emerging technologies and to test new ones. Building on their client networks of global industrial players, as well as their local presence on the ground across developing country markets, MDBs are positioned to play an honest broker role in addressing barriers to market development and mobilizing private sector investment.

5. **Preventing distortionary subsidies.** The availability of large sums of subsidized financing obviously poses significant risks of market distortion – irrespective of whether these funds would be channeled through MDBs or country governments. These risks are exacerbated here by the urgent need for markets to develop projects that would deliver low-carbon growth solutions in a long-term sustainable manner. Wrongly placed subsidized funds could exacerbate the climate challenge as subsidies may well increase the prices that firms can set for clean technologies or by preventing firms to take investment decision that would reduce the carbon intensity of their production as they wait for subsidies to become available later. At the same time, subsidies may end up only with the less successful market players as these would be more eager to apply for subsidies than firms whose products are winning over market share due to inherent product or firm advantages; having been placed with the “losers” the subsidies will not achieve their transformative goals and may in fact result in negative demonstration impacts. It is imperative that CIF/CTF financing mechanisms, both for engaging the public sector and for engaging the private sector, are designed to specifically address risks associated with market distortions.

6. **Project finance offers market discipline for the use of subsidized financing in the private sector context.** By integrating and linking subsidized funds into “regular” project finance activities, the CIF/CTF will introduce market discipline in the decisions about allocation, shape and size of the inherent subsidy elements injected into markets. “Riding alongside” otherwise commercially viable investments will allow the subsidized funding elements to be placed such that they achieve minimal market distortion and can focus on accelerating and spreading the application of particular (clean) technologies and/or sustainable management practices that would enhance transition towards climate-sensitive economic activity. Using the screening processes applied by project finance officers – as opposed to “application” approaches otherwise used when distributing for example technology-related subsidies – will ensure the allocation of subsidized financing to market players that are successful in their business and leaders in their sectors.

7. **Maximizing the use of CIF/CTF funds – the effect of reflows:** Subsidized finance used in the form of non-grant modalities generates principal and interest repayment reflows which can then be used to finance additional GHG reduction projects. Reflows extend both the duration of the fund and the size of the impact compared to when used in traditional grant investment forms.

8. **The benefits of competition.** Engaging several financial institutions in parallel in placing subsidized funding with private sector activities considered to have transformational potential will create beneficial competition. Such competition will benefit the private sector and donor objectives in that it ensures maximum creativity and innovation on the product offering side while keeping product pricing fair. It is also an important element in limiting possible distortionary market effects that could emerge from only one MDB being able to offer subsidized funding to specific industries or sectors. CIF/CTF funds will initially be available only to MDBs, in light of their development mandate and willingness to work with the CIF/CTF donor committee in testing and fully understanding allocation and reporting mechanisms. Eventually, it may be important to broaden the eligibility for proposal submission to private financial institutions active in the CIF/CTF countries.

Annex B

Moving markets through the use of Financial Mechanisms

1. **Experience in using financial mechanisms to encourage uptake of new technologies or business models.** International Financial Institutions, Bi-Lateral Agencies and Nongovernmental Organizations (NGOs) with a development mandate and motivated to address the climate change challenge have piloted and tested for some time a variety of financial mechanisms appropriate to engage the private sector in providing a substantial portion of the capital investment needed to affect the transition to low-carbon economies. This transition will require shifts in the way that private sector players operate and manage their business, and the financial mechanisms therefore address key decision points used by the private sector when allocating investments, specifically in relation to project, market and technology risks. This Annex describes examples of selected financial products suitable to engage the private sector in pursuing climate-sensitive investment strategies. While these products have been, or are in the process of being, tested, it is important to note that as new market barriers emerge new, or amended forms of these financial instruments will be created to effect change.

2. **Project Finance Instruments.** The financial mechanisms specifically designed to engage the private sector in addressing the climate change agenda use regular project finance instruments. Some core elements are listed below as they are important to understand the specific structures discussed later:

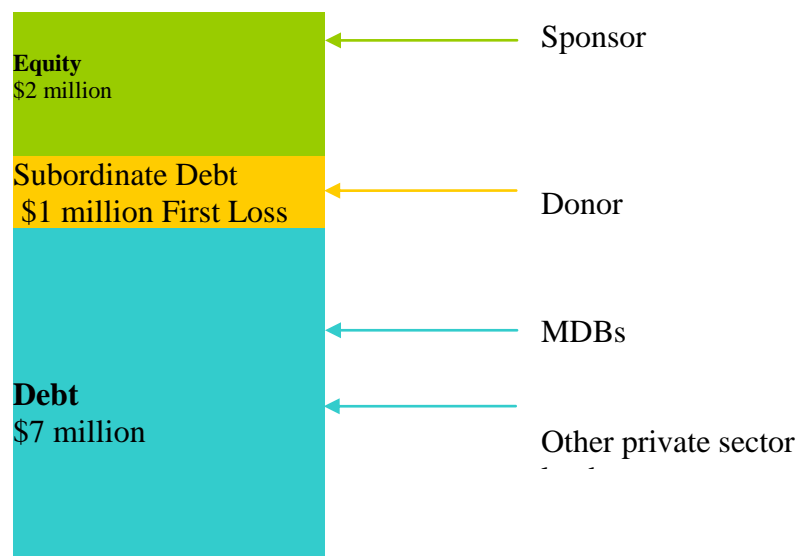
- **Equity:** Equity provides the investor with ownership rights and upside potential. Equity is generally used to support firms that have viable business plans to implement and test new technologies. In this structure donor funds can be used for investments that are too small or relatively unproven in the market to attract commercial funding without additional equity.
- **Subordinated Debt:** Subordinated debt refers to loans that have a lower repayment priority compared to other financiers of a company/project. From a local bank's perspective, subordinated debt strengthens a company/project's equity position and enables/encourages a local bank to provide senior debt financing. While this type of debt has some equity characteristics, it is repaid on a regular schedule, allowing the reflows from principal and interest to be on-lent to additional clients; donor funds deployed in this manner are therefore able to multiply the reach through multiple investments. Preferred equity shares can often be used for the same purpose depending on the needs of the project sponsor and regulatory environment.
- **Credit lines & loans with built in incentives:** Loans with incentive characteristics such as performance bonuses or interest rate step downs provide a client with an opportunity to earn a bonus (usually in the form of debt forgiveness) or reduced interest rate if they reach certain milestones or targets established at the onset of the program. This product is most effective with local banks that are comfortable with the risk of a new initiative but who want to use the incentive for clients or loan officers to "kick-start" a new business area (such as clean energy lending). For example, a portion of the bank's loan may be

forgiven if it makes loans to a specified number of clean energy sub-projects. In this financial structure, donor funds are coupled with, and leverage, Multilateral Development Banks (MDBs) 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.

- **Risk Sharing:** Risk Sharing is a way of “sharing” the risk of the underlying 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. 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). Donor support in such first loss facilities can be a powerful tool (requiring often less than 3% of the full loan facility) to incentivize banks to enter into lending sectors where they do not have full knowledge of the risk profile they face. 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.

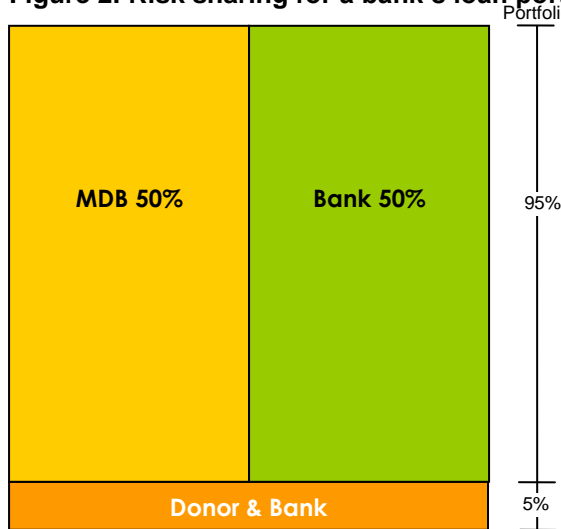
3. **Example A: Subordinated debt** provided to private sector investors to catalyze debt financing for renewable energy projects. In this example, MDBs and/or other private sector lenders require a 30% equity investment in order to provide debt financing for a project. Subsidized funds (donor funds) are used to supplement the equity structure of a project when sponsors have a viable clean energy project but do not have the ability to increase their equity stake. This type of structure can be used for individual projects and for bundled projects through a financial institution.

Figure 1: Subordinated debt for a \$10 million project



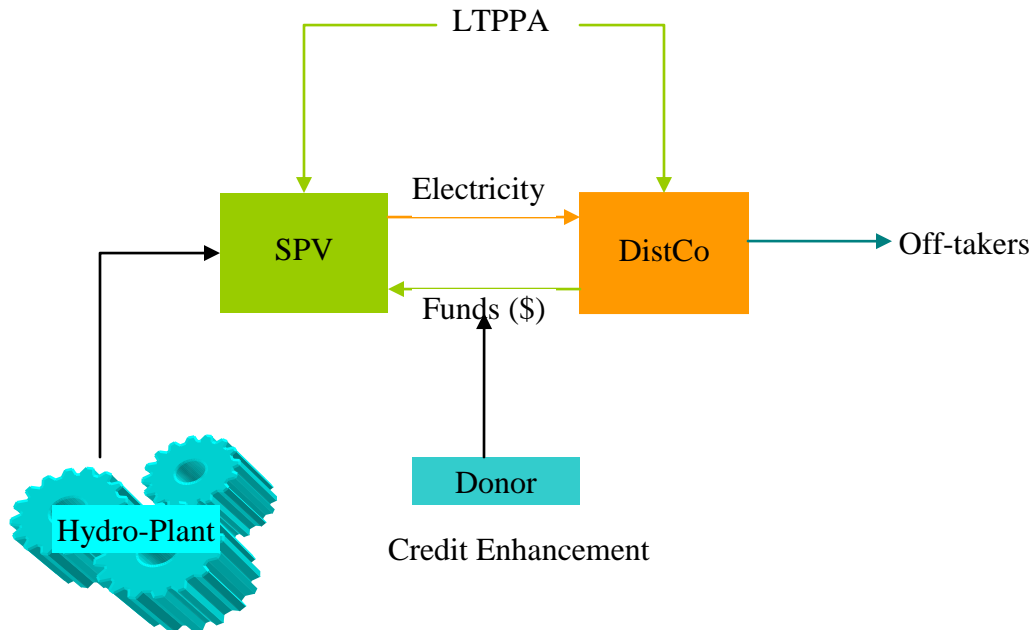
4. **Example B: A Risk-sharing Facility** to support a portfolio of loans from a commercial financial intermediary (banks and leasing companies). In this example the first 5% of losses on the portfolio would be shared equally between the bank and donor with the future losses being shared equally between the bank and MDB.

Figure 2: Risk sharing for a bank's loan portfolio



5. **Example C: Credit enhancement** to strengthen the credit-worthiness of a power generation project by ensuring long-term viability of utility off-take agreements related to the project's renewable energy (RE) portion (or co-generated steam). In this example, donor funds are used to guarantee payments from a distribution company to a hydro power special purpose vehicle (SPV). Without this level of comfort on their future revenue stream project sponsors may not develop RE projects

Figure 3: Credit Enhancement Facility for a Hydro Power Plant



Notes: LTPA: Long-term power purchase agreement; DistCo: Electric distribution company (utility); SPV: Special-purpose vehicle /project company.