Briefing

Climate change

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Policy pointers

Country preparedness is needed to design better private sector initiatives. Providing clarity around which part of the private sector is being targeted (local, international, small or large) and precisely how it could invest, would provide reassurance to all parties, and potentially encourage more focused actions.

Institutions and financial instruments should be tailored to address specific private sector needs within a country. This may mean reducing policy barriers or it could mean more direct engagement.

International financial intermediaries should be mandated to work in coordination with governments, rather than alongside them, especially in 'developmental state' economies. This may mean tailoring leadership depending on the level of state involvement and the readiness of national financial intermediaries. Where state institutions are 'ready', funds may be channelled through national development banks.

Lead funding institutions should encourage development in priority areas even if commercial returns are unpredictable in the early stages.

What can the Green Climate Fund learn from SREP's role in engaging the private sector?

The UN climate talks in Copenhagen in 2009 demonstrated a commitment to increasing public and private sector investment in climate-related activities. However, the private sector needs encouragement to invest in novel and risky areas. As the UN's Green Climate Fund will use public funding to encourage such investment this briefing makes recommendations based on the experience of the Climate Investment Fund-funded Scaling up Renewable Energy Programme (SREP) already running in Nepal and Ethiopia. Early experiences show significant challenges: where potential private sector involvement is poorly defined, both public and private bodies hesitate to engage, causing serious delays in implementation. We also argue against a 'one size fits all' approach, and suggest that institutions and delivery methods are tailored to each country's specific needs.

The UN climate talks in Copenhagen in 2009 agreed to raise US$100 billion per year towards climate change, with a large proportion expected to come from private sources. However, as governments struggle to fulfil their funding promises, the private sector commitment around how much it will contribute, how this will be collected, spent and evaluated effectively, and how it will benefit all sections equally remains vague and undefined.[1]

The private sector is only just starting to respond to climate change; expected returns on investment are low, cost of capital is unaffordable and uncertainties such as political risks and state ownership systems provide barriers to engagement.

Various development assistance programmes are using public finance to remove the barriers to private sector investment in novel, risky areas. The UN's Green Climate Fund (GCF) will use public funds to leverage finance from private investors and offer dedicated support to nurture engagement. As the Climate Investment Fund (CIF) also uses dedicated public finance to leverage private finance in both adaptation and mitigation projects, this brief reflects on how its Scaling up Renewable Energy Programme (SREP) is engaging the private sector in Nepal and Ethiopia, and makes recommendations based on its early experiences.

How are CIFs catalysing private sector engagement?

CIFs channel US$6.5 billion worth of climate finance towards developing countries. A key part of the development strategy is to engage private sector institutions via public private partnerships, through direct financing via the Multilateral Development Banks (MDBs), or through technical assistance and capacity building.[2]

What is the role of SREP?

The SREP aims to demonstrate the viability of renewable energy and increase public access to energy, while also creating an enabling financial and regulatory environment for private investment. The private sector element of the SREP invests in two market segments: projects providing more power to national energy grids, and projects supporting increased access to energy in off-grid areas. SREP incorporates a range of financing methods that can be tailored to individual country needs and may be coupled with MDB loans to increase the volume of available finance. Financing products include:

Climate programmes are using public finance to remove barriers to private sector investment

- Grants to governments or private sector institutions or companies
- Concessional loans to commercial institutions or loans direct to private actors for investment
- Risk sharing or guarantees to commercial lending institutions
- Equity sharing agreements.

In Nepal and Ethiopia engagement will be with private commercial banks, which are supported with risk-sharing agreements (Ethiopia), or credit support, debt facilities, and foreign exchange risk support (Nepal). In both countries private banks also receive technical support to gauge better the risks of investment into renewable energy ventures.

Ethiopia's experience

SREP Ethiopia's private sector engagement comes through the Clean Energy Small and Medium Enterprise (SME) Capacity Building and Investment Facility, a US$4 million project to support greater energy access and develop the off-grid renewable market. In contrast, public sector components include a US$26 million project to expand a pre-existing geothermal power station, and another US$20 million project exploiting Ethiopia's vast wind power potential.

The programme has two distinct aspects. First, a technical assistance component that aims to skill up women-run SMEs and to remove barriers for suppliers of clean energy products such as home-based cook stoves, mini grids or solar-home systems. Funds will also support banks to develop their capacity for assessing the risks of investing in SMEs.

Second, a financial component funds risk-sharing agreements with local banks to encourage lending, particularly for new manufacturing facilities. Inadequate coordination and information exchange around mandates and the rules of engagement with the private sector have delayed this latter component. Local financial banks are experiencing a 'liquidity squeeze' in the market because of interest rate changes brought about by regulatory changes, and in such circumstances the International Finance Corporation (IFC) cannot offer risk guarantees and other financial support. Also, in Ethiopia the private banks are not eligible to access direct credit from external agencies such as the IFC.

Nepal's experience

Nepal has focused on proven renewable technologies. A National Renewable Energy Programme provided the framework for the SREP, sharing the same steering committee. A US$20 million project to develop investment in Small Hydropower (SHP), boosting the grid capacity by 50MW,[3] aims to catalyse private sector development by demonstrating commercial viability of small hydropower projects (SHP), for example. Rather than provide direct subsidies, the programme will provide subsidised, long tenure loans to commercial banks, which will then on-lend to commercial hydropower developers. Loans are preferred to direct subsidies as they encourage financial services to adopt good practices for risk management and lending to future SHP projects.

Technical assistance and guarantees will be agreed with lending institutions, with the addition of foreign exchange risk support to banks to support market development. The initial public support of US$20 million to SHP is expected to leverage a ratio of up to 1:4 from private finance, although no firm commitments have yet been made.[4] The government's scepticism about using loans for subsidising the private sector and lack

Table 1. SREP focus areas in Ethiopia

Technology	USD
Public sector: Geothermal power plant	SREP Grant and loan: US$26 million. Total cost: US$231.2 million
Public sector: Wind farm and transmission line construction	SREP Grant and loan: US$26 million. Rest from GoE, MDBs and others. Total cost: US$250 million
Private sector: Improved cook stoves and solar lanterns (off grid)	US$400,000 for readiness US$1.6 million for advisory services only (Grant) US$2 million for financing facility from SREP Additional US$4 million expected from MDBs and others

of clarity on how private sector can contribute to climate resilient development are issues causing delays.

Barriers to engagement

Lack of clarity about who the private sector is and how they will engage. Private sector projects are developed without clarity about the bigger picture. Stakeholders remain unclear what exactly 'private sector' refers to, and what their role could be. Some stakeholders in Nepal, for example, trust that the private sector will be the driver of its own development, while others believe that the private sector is still unprepared to take the lead.

It is not clear whether the SREP will be targeting small or large local businesses or subsidising the international private sector engaged in technology transfer.

The MDBs and the Government of Nepal see SREP programmes as a way both to stimulate and to motivate the private sector, as once commercially viable projects are showing some success, the private sector should take the lead in the renewables market.

Other actors, particularly donors, see the private sector as recipients of support and technical knowledge that increases their capacity to invest in the renewables market. Private sector actors see the SREP as an opportunity to benefit from international technologies, providing opportunities to market and profit from new products. But not everyone thinks that businesses in Nepal are ready to take initiative in a nascent renewables industry.

In Ethiopia, some government stakeholders believe the private sector could engage in power generation and transmission but lacks the expertise, knowledge and finance to take leadership. As a result, most geothermal and wind programmes remain publicly owned. However, this is changing and the Ethiopian government is now making promising first steps towards open partnerships with the private sector (an agreement has been reached recently on a private sector led development of a very large geothermal field, the first of its kind in the country).

Some international actors see potential in leveraging finance from the private sector and identify a need to create an enabling environment with clearer rules and regulations. But it is not clear whether leveraging is defined as private sector co-financing or as additional grants and/or loans from international sources. Overall countries appear to be unprepared for developing private sector initiatives.

Table 2. SREP focus areas in Nepal

Technology	USD
Public sector: Mini- and micro-hydro and solar initiatives (off grid)	ADB – US$12 million Expected leverage – US$131 million
Public sector: Waste to energy-extended biogas	IBRD – US$8 million Expected leveraging – US$126 million
Private sector: Small hydropower (direct financing to commercial banks, capacity development)	US$20 million ADB – US$10 million IFC – US$10 million Expected to leverage US$93.4 million

The role of intermediaries in private sector engagement. The IFC plays a key role in creating a private sector enabling environment. The IFC ensures strong fiduciary standards in countries where public sector intermediaries are not yet ready. It is mandated to work directly with the country's private sector, often with limited engagement of government. In 'developmental' state economies such as Ethiopia, where the national Development Bank of Ethiopia plays a key role in nurturing the state as well as private companies, the IFC's approach has led to concerns. There is a mismatch between the IFC's approach and the government's regulations, which limit direct financial interactions between international agencies and local private banks to risk-sharing agreements.

Likewise, regulatory changes in Ethiopia's banking sector delayed the financial component of the Clean Energy SME programme. The Development Bank of Ethiopia recently required private banks to buy bonds using 27 per cent of their lendable capital, resulting in a loss of liquidity.[5,6] The IFC is now concerned about banks' liquidity and unwilling therefore to share significant risks. The mandate of the IFC to work outside government ministries and financial services means it is forced to compete directly with the Ethiopian state banks at a significant disadvantage, as it is unable to set the rules of the game.

The overarching control held by the Development Bank of Ethiopia and its relatively secure financial position gives it a significant advantage. In this context, it is worth asking if an institution with a mandate to work with the government, rather than alongside it, would be more appropriate.

Furthermore, although the IFC aims to nurture private sector engagement in novel and risky areas, the institution also seeks to achieve returns from investment, and the Ethiopian experience demonstrates its unwillingness to step into uncertain financial situations.

Barriers to the role of private sector. The Ethiopia government feels that the local private sector is not prepared to take leadership on renewable energy sector development. With a strongly state-led developmental strategy, it is understandable that there is interest in 'localisation', instead of harnessing the international private sector. International actors, however, believe that the private sector is held back by excessive regulation, which causes it to remain undeveloped.

In Nepal, there are also mixed attitudes towards the private sector. The government body for the distribution of renewable energy funding prefers direct subsidies to communities and is uncomfortable subsidising an undeveloped private sector using loans. Therefore, money for the private sector component of the SREP is not channelled through the government, but through the banks themselves using concessional loans. As the government decided not to take loans for the purpose of climate change, payback will not be administered within the central accounting system but will be the MDBs' direct responsibility.

Lessons for the Global Climate Fund

Clarity on role of the private sector. Investment is needed in country preparedness to better design private sector initiatives. There must be more clarity on what is expected from the private sector. There is no 'one-size-fits-all' solution, as different countries will have vastly different regulatory environments and levels of private sector development.

Clear guidance should be issued on the definition of 'leveraging' in each context. At present, it is unclear whether leveraging refers to public finance in partnership with private sources, grants backed by further MDB loans, or initial investments that leverage further finance from a variety of private sources. The distinction is crucial, as the private sector may be waiting for clarity before it is willing to make firm commitments, and urgent, as the private sector may move on to other opportunities.

Choice of leading institutions for implementation. The choice of an intermediary agency and their approach in engaging with the private sector should be adapted in each country to the policy environment, the preparedness of the private sector and the readiness of national financial intermediaries.

The IFC's lack of government engagement has caused concerns and delays. At the very least, the IFC should coordinate with national financing bodies which already engage the private sector. This would support the harmonisation of programmes and 'country-ownership'. Alternatively, the leadership of particular funding programmes could be tailored to take account of factors such as the level of public sector control over the private sector, or the level of maturity of in-country private sectors. In some cases it may mean channelling the funds through national development banks.

Tailoring programme modalities to different private sector needs. Consideration must be given to how funding can be tailored to the specific private sector involved, as renewable markets are at vastly different levels of preparedness. Where the private sector is at a low level of readiness, public finance can nurture private sector through regulatory change, direct subsidies or other concessional financing and technical assistance. It is also important that GCF programmes work closely with government-led financing institutions.

Where the private sector is more mature, there is more flexibility, including more direct engagement with local banks. Public sector co-financing may be more effective, as well as public-private partnerships. Where the private sector has some experience in renewable energy investments the focus may be on supporting riskier investments in small companies looking to be active in off-grid areas both by providing technical assistance and encouraging banks to lend to and develop this market segment.

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Clean Energy Nepal is an independent, non-profit organisation focusing on sustainable energy use.

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Notes

[1] Whitley, S. 2013. Five early lessons from donors' use of climate finance to mobilise the private sector, ODI [Online]. Available: http://www.odi.org.uk/opinion/7268-climate-finance-private-sector-donor-lessons 2013. / [2] CIF. 2014. https://www.climateinvestmentfunds.org/cif/node/8598 (Accessed 14/02/014) [Online]. / [3] GON. 2011. Government of Nepal: Climate Investment Funds: Scaling up Renewable Energy Program: Investment Plan for Nepal. CIF, p.18-24. / [4]Rai, N. et al. 2013. Climate Investment Funds: Scaling up Renewable Energy Programme (SREP) in Ethiopia – a status review. / [5] IFC. 2013. RE: Interviews with stakeholders, Ethiopia. / [6] IFC. 2014. IFC Responses to the comments from Trust Fund Committee members.