GCF insight #14
Project financing

March 2020

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25th Meeting of the Board

GCF insight #14

GCF insight seeks to understand what's working - and what's not working – in Green Climate Fund (GCF) project development. The surveys and reports spotlight the most topical GCF issues. This 14th edition explores stakeholder experiences and challenges with project financing and discusses the implications for the GCF.

Spotlight on climate project financing

According to GCF insight #13, 'Top 5 climate finance knowledge gaps', there is a distinct lack of knowledge surrounding project financing and financial instruments, and only a limited awareness of financial systems. However, effective use of GCF finance, and that of other funds, is key to driving transformational change towards climate-resilient and low-emission development.

Accredited entities have the significant role of designing and submitting climate projects and programmes. These projects must address existing financial barriers; demonstrate the least concessionality needed; catalyse private and public-sector investments; and demonstrate financial viability in the long term. However, in order to be effective in this role, the project developers require not only a deep understanding of financial markets and a sophisticated financial literacy, but they also need a solid understanding of climate project financing and the various mechanisms necessary to leverage private sector participation.

Why is project financing proving such a challenge?

To answer this question, this 14th *GCF insight* report turns to stakeholders to share their key challenges in designing climate projects for the GCF and other funds.

Here's what we found:

1: Respondents are generally familiar with banking and finance language and most of them have experience with grant financing. Other financial instruments have been less used.

2: There is a distinct lack of understanding of key notions, such as incrementality and concessionality, and how to incorporate these concepts into project proposals.

3: Determination of co-financing and matching available finance with climate project proposals is very challenging. Project proponents struggle to match government priorities with potential projects that could be bankable from their perspective.

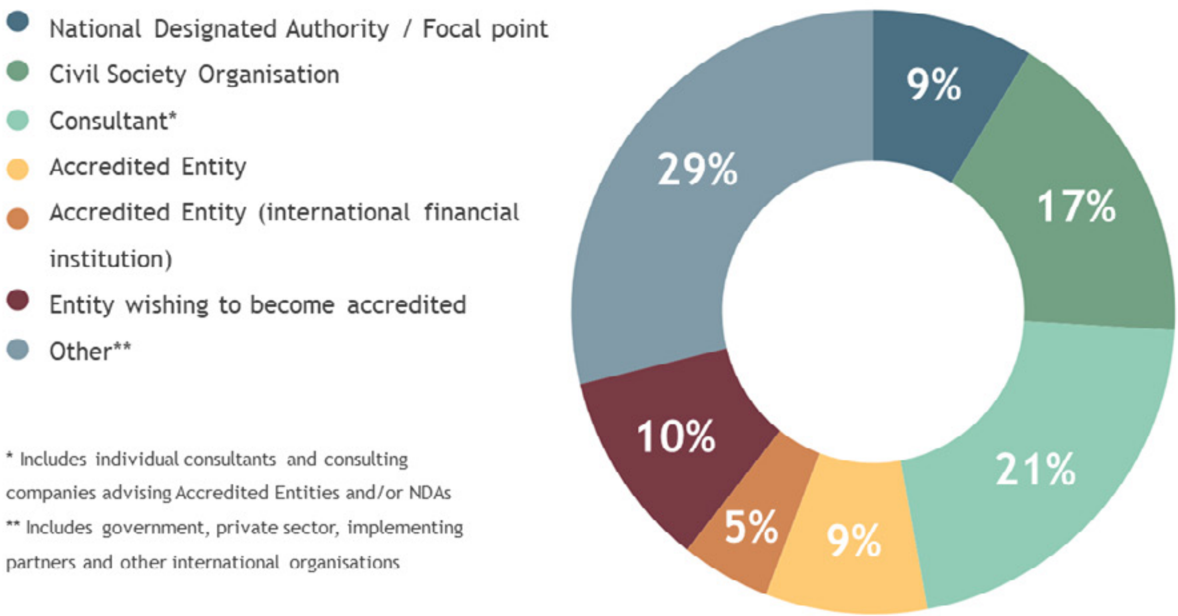
Methodology

The study was carried out between January and February 2020 and it has been produced using a mix of primary data collection (a quiz and interviews) and literature reviews.

Test Your Knowledge quiz: E Co. conducted an online quiz to challenge stakeholders to test their knowledge on basic concepts of climate project financing. There were 104 respondents. Responses were anonymous and results were aggregated to capture an overall picture of climate finance knowledge. A similar version of the quiz was used in Indonesia during face-to-face training on GCF proposal development that E Co. conducted on behalf of GGGI Indonesia. There were 50 participants from private sector, local government and civil society stakeholders.

Interviews: Experiences with accessing GCF funds. E Co. conducted three semi-structured interviews with stakeholders from Africa and the Caribbean region, from an international Accredited Entity, a financial entity currently pursuing GCF accreditation, and a non-accredited UN agency, supporting local actors to access GCF funds.

Quiz respondents (104 participants)



* Includes individual consultants and consulting companies advising Accredited Entities and/or NDAs

** Includes government, private sector, implementing partners and other international organisations

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Respondents are generally familiar with banking and finance language and most of them have experience with grant financing. Other financial instruments have been less used.

Of 104 quiz respondents from E Co.'s 'Test Your Knowledge' quiz, just over half described themselves as having some experience with climate finance (51%), while 26% had some project finance experience, but not as part of climate projects. 11% of respondents described themselves as having no project finance experience altogether.

The GCF uses four basic instruments at the various stages of the financing cycle: grants, concessional loans, guarantees and equity investments. As of February 2019, the GCF portfolio had allocated a large portion of funding (45%) to grants, followed by loans (41%), while other financial instruments such as equity and guarantees have been less used.

This study reflects a similar balance in terms of experience with different GCF financial instruments. Among respondents with climate finance experience, most of them (52 respondents) had experience with grants, followed by blended finance (25) and concessional loans (22).

Respondents had less experience with other instruments, such as equity investments and guarantees. Only 9 respondents claimed to have experience with senior loans and 6 with subordinated loans.

Overall, quiz participants responded correctly to most questions, with a mean score of 10/14. Only 9% of respondents scored 7 or lower. Most participants were able to correctly describe financial instruments - distinguishing between grants, concessional loans, equity, and guarantees. The differentiation between senior loans and subordinated loans was less well-known overall, with 28% answering incorrectly.

Questions on financial terminology, such as the definition of pay-back period and discount rates, appear to be more challenging, with 50% of respondents not being able to identify the Internal Rate of Return and 30% having failed to recognise the definition of Net Present Value.

***SENIOR LOANS VS SUBORDINATED LOANS**

Refers to the level of priority with which debt is repaid to lenders. Senior loans are repaid first, after which subordinated loans are repaid. Due to their high priority for repayment, senior loans are usually less risky than subordinated loans.

***INTERNAL RATE OF RETURN**

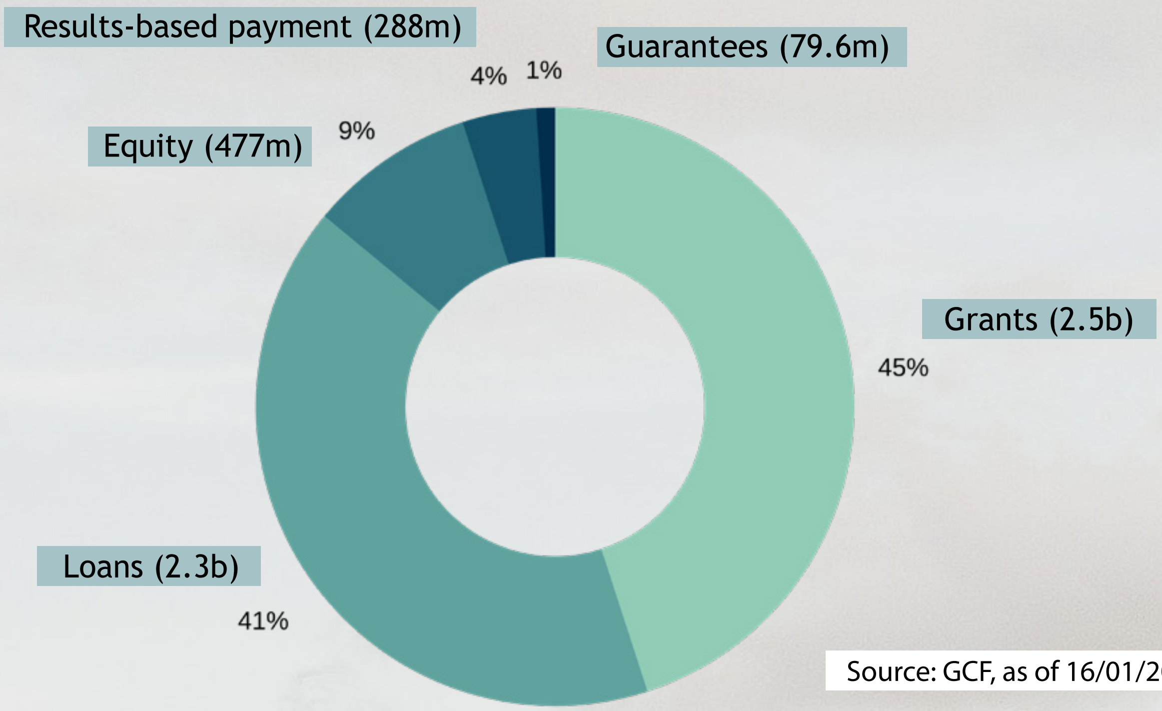
The interest rate when the Net Present Value of all cash flows equals zero. The IRR is often used to decide which projects to invest in based on expected profitability - where if the IRR is above a certain percentage (called the hurdle rate) then it indicates the project will be profitable enough to justify the investment.

Whilst it appeared that most respondents understood the basics of project financing, building financial models and calculating potential profitability requires a whole other set of skills and expertise. In this regard, the study shed light on the different resources available to project developers for project preparation.[1] Some are able to benefit from in-house expertise in developing climate finance projects. For example, a financial institution working in Southern Africa demonstrated an in-depth knowledge of using green bonds, guarantees, and in financing infrastructure-related projects.

International Accredited Entities can rely on in-house units that focus on the financial and economic analysis of projects. However, they have, in some cases, struggled to integrate historical and projected models of climate change into their economic analysis. In some cases, concept note submission and the preparation of a pre-feasibility study has been identified as a useful process to get early feedback from the GCF on the potential modalities of support and its impact on the financial performance of investments.

[1] Based on interviews

FUNDING AMOUNT BY FINANCIAL INSTRUMENT (USD)



Source: GCF, as of 16/01/2020

> "The Fund needs to help people to understand the type of information [that should be] put into proposals so [that] they are bankable."

2

There is a distinct lack of understanding of key notions, such as incrementality and concessionality, and how to incorporate these concepts into project proposals.

To access GCF funding opportunities, project developers require not only a good knowledge of project financing, but also a good understanding of key concepts such as concessionality and incrementality for meeting the GCF's investment criteria.

The definition of incremental cost of climate change and its implications for project financing was considered particularly challenging for most of the quiz respondents. Among those with climate finance experience, in mitigation projects - only 39% recognised a standard definition of incremental costs, while in adaptation projects - only 39% were aware that there is no agreed definition of incremental cost.

Calculating the right level of concessionality has been considered a challenging aspect of proposal preparation. For example, when calculating the right level of concessionality for a GCF project, project developers from Indonesia identified two priority factors to be considered: 1) the level should be tailored to incremental costs or the risk premium to make investments viable, and 2) it should be the minimum amount necessary to make the project viable and help achieve GCF paradigm shift objective.

In practice, concessionality levels depend on various barriers to financing and they should be tailored to the specific context. An interviewee working in Small Island Developing States (SIDS) in the Caribbean region expressed that, while it is justified to see high levels of grant disbursements for SIDS, the GCF has also raised its expectations in regards to co-financing.

*INCREMENTAL COST FOR ADAPTATION

The GCF defines the "agreed incremental costs of a project are the difference in expenses incurred with respect to a baseline project to produce a new output or an equivalent output in a way that results in mitigation and/or adaptation impacts".

The GCF however recognises that defining the incremental cost for adaptation projects is complex, and the Fund still lacks a clear policy on how to approach adaptation costing. The Board has decided (GCF/B.19/34) that funding proposals must include an economic comparison between the proposed project/programme and the baseline, and it should identify which components and relative costs are directly related to climate change. In practice, "adaptation proposals should provide a qualitative description and estimate of the degree to which the proposed intervention is necessary as a result of climate change versus historically observed conditions".

Further reading:

GCF Review of the initial investment framework (2019)

GCF Incremental cost methodology: potential approaches for the GCF (2018)

WRI Commentary (2018): Deploying adaptation finance for maximum impact

Opinion: The Green Climate Fund's Proposed Approach to Costs: Not Fit for Adaptation

Climate Policy Initiative (2018) Understanding and increasing finance for climate adaptation in developing countries

Preparing GCF project proposals: *experiences from South East Asia*

During one of our climate finance training workshops, participants took a climate project financing quiz. The results helped us better gauge their level of experience with project financing. The study revealed that out of 50 participants, 65% had some experience with project financing, and only 20% with climate finance. In fact, the majority of respondents (65%) had experience working with grants.

Familiarity with grant instruments, and perhaps low awareness of GCF co-financing requirements, prompted many project proponents to design GCF concept notes requesting grants - with a very low co-finance ratio, or none at all. In some cases, project proponents had difficulty in justifying selecting one financial instrument over another.

While key concepts of project financing were understood by most participants, the concept of incremental cost within climate finance was poorly understood. This indicates that, while many climate finance stakeholders have a working knowledge of financial instruments and project finance, they may not have a full understanding of how sources of climate finance can and should be used to leverage other investments. Additionally, they may not know how to justify requests for concessional finance and demonstrate the incremental value of that finance. This would be relevant for GCF funding proposals and for other climate funds.

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Determination of co-financing and matching available finance with climate project proposals is very challenging. Project proponents struggle to match government priorities with potential projects that could be bankable from their perspective.

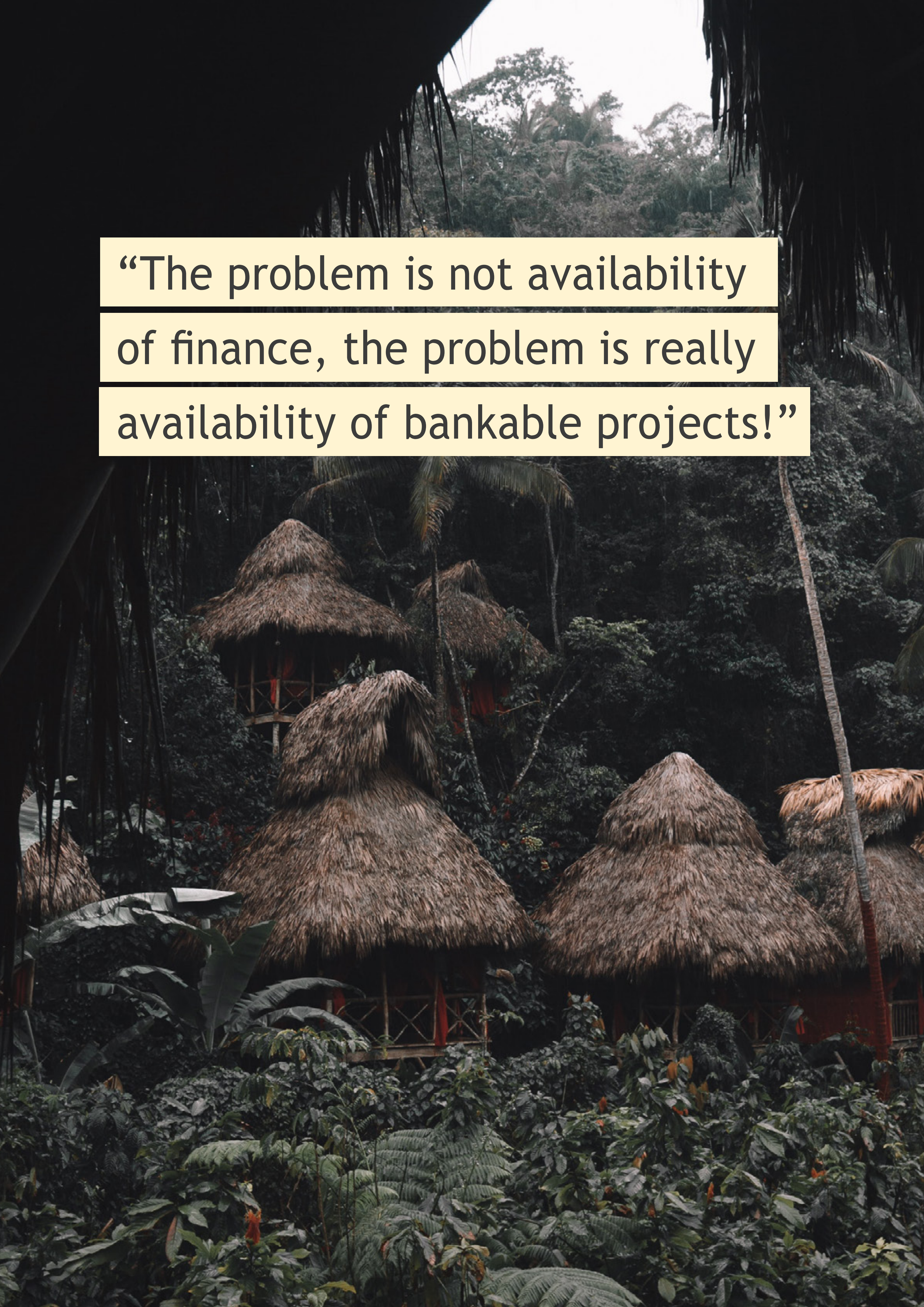
Obtaining co-financing was another challenging aspect of project financing, flagged by various stakeholders. The limited capacity of NDAs and environmental ministries was mentioned as a barrier to the identification and structuring of appropriate project co-financing. Experiences from Caribbean and Southern Africa highlighted that seeking government co-finance has been challenging due to the lack of awareness of GCF opportunities and requirements.

During the project formulation phase, the identification of financial sources and responding to funding requirements was considered difficult by financial institutions attempting to match bankable potential projects with changing governmental priorities. A key barrier highlighted by interviewees was the lack of cooperation among climate focal points and financial institutions.

In Central and Latin America, where a stronger financing market is present, competition to obtain financing from sources, including development and commercial banks is high. In providing technical assistance for project preparation, one participant emphasised that government entities often lack awareness of the available financing opportunities. When more complex instruments are involved, for example, through private sector financing or Public Private Partnerships, these instruments are then designed by private investors such as commercial banks.

Other obstacles in obtaining co-finance include the lengthy processes for GCF disbursement and the related risks in changing commitments between project formulation and implementation. We also found that due to the volatile situations in certain countries, ensuring availability of co-financing from project submission to disbursement of funds proved a challenge.

“The problem is not availability of finance, the problem is really availability of bankable projects!”



Looking ahead

This study has identified the "need to help people understand the type of information to put into proposals so they are bankable." Here are some of the key takeaways:

Interviewees highlighted the need for ad-hoc capacity building (i.e. the availability of ongoing expert advice) and awareness-raising; there is a need to strengthen the capacity of governments to identify and prioritise projects that can mobilise private sector investments. The GCF's approach to invest in developing country capacity was considered a key entry point for raising awareness and for "helping countries become more strategic through mainstreaming priorities", for example, through readiness support. Regional integration and sharing of lessons learned from countries with similar priorities could be an approach to increase capacity on project financing and GCF financial instruments, as seen in Samoa's pathway for SIDS.

Closing the knowledge gap on climate project financing and financial instruments for government and Accredited Entities (working mainly with grants) is just one aspect of the capacity building needed. If the GCF aims to target riskier investments and mobilise more private capital, it should ensure that concessional funding is effectively used by financial institutions and private sector stakeholders too. The expectation from one financial institution interviewed is that the GCF will play a key role in de-risking investments, but the Fund's timelines and their complex accreditation requirements have inhibited their participation in the climate finance landscape so far.

One proposed approach is to use readiness funding to support pipeline creation for bankable projects, such as through Project Preparation Facility funds. This will raise both government and private sector awareness on opportunities for climate investments. It will ultimately change the current paradigm by de-risking the delivery of capital funding and scaling up private sector investment flows.

Moving forward, tailored capacity building will help close some of the knowledge gaps on climate project financing, but these efforts will only be catalytic if coupled with dialogue between financial institutions, climate focal points, private sector stakeholders and Accredited Entities.

"GCF has tough competition from other development banks and funds [...] and the private sector has even less awareness of the GCF.

Project preparation is really the problem and the GCF should get more involved in [generating] bankable projects."

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About this survey and report

This survey is an initiative of E Co., emerging from work we are doing to develop low-carbon, climate resilient projects. E Co.'s team of consultants designed and administered the survey and prepared this report. E Co. has conducted this research independently and is not affiliated with the GCF, the GCF Secretariat or donors. The views expressed in this report are those of the authors and do not represent those of the GCF. Nothing in the interviews or any information or material relating thereto shall be construed as implying any official endorsement of or responsibility on the part of the Green Climate Fund.

About E Co.

We specialise in designing low-carbon, climate-resilient projects and programmes. For over 20 years, we have been providing technical expertise to help our clients solve climate adaptation and mitigation challenges. We assess markets, develop strategies and formulate projects to provide long lasting solutions for vulnerable populations worldwide.

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