Comments on "Business Model Framework, Private Sector Facility" (GCF/B.04/07)

By Friends of the Earth U.S. and Institute for Policy Studies

Governance structure

A separate governance structure for the Private Sector Facility (PSF) would be counter to the intent of the GCF's Governing Instrument, put into serious question the mandate of the Fund to be country-driven, and upset the delicate compromise embodied by representation on the board. This would be doubly so were the establishment of the PSF to be outsourced to another institution. Private investment experts can be well-placed to provide technical advice, but they must not be placed in decision-making positions. The PSF paper seems to suggest that it is not possible to glean insights from the private sector without endowing them with decision-making authority (e.g. "private sector representation *would be standard* in order to ensure best practice [risk management] commensurate with finance industry standards" - emphasis added), which is wholly mistaken. Therefore:

Option 1 – a PSF with its own governance structure, whose establishment is even possibly outsourced – should be rejected in the strongest possible terms. Option 2 – *PSF as a business unit that is fully integrated within the Fund's governance and management structure* – is clearly preferable. However, we would suggest that this be modified to clarify that the PSF need not be a separate business unit but could, initially at least, be established as a sub-unit of the mitigation unit, within the structures identified as Chapter III, options 1 or 2 of document GCF/B.04/08 (*Structure and Organization*). Adequate provision should be taken, alongside this, to ensure that the Fund as a whole maintains a balance of adaptation and mitigation efforts.

Option 1 also contemplates the PSF having "specific policies and procedures that differ from those of the rest of the Fund." However, international best practice social, environmental, and fiduciary standards should be uniform, clear and binding on all GCF activities, including PSF activities.

The option of an independent governance structure, and the relative emphasis on the advantages of Option 1, is emblematic of how the PSF paper veers toward envisioning the PSF as a relatively large, independent financial institution dependent upon Wall Street, the City of London, and International Finance Corporation (IFC) expertise, and geared toward serving financial sector clients.[1] But the GCF is a fund (not a bank) with a climate and development mandate. Ordinary people in developing countries are the Fund's clients. Community; micro, small and medium-sized enterprises; and national representatives -- not the financial sector -- should be the focus of its funding efforts. The staffing of the PSF should clearly reflect this. In-house expertise in large-scale finance and economics is important, but this should be balanced with experience and expertise in development, micro and small enterprises, the informal economy, resilience, gender-responsiveness, etc.

Outsourcing

The establishment of the PSF should not be outsourced, and the suggestion that the IFC might take the lead in establishing the PSF is particularly worrying. The IFC's record reveals limited success with effective development outcomes, and limited experience with lower income countries and mirco, small and medium enterprises – all of which are the most subject to credit scarcity and high borrowing costs, but traditionally the least served by the IFC. In 2012 less than 29% of investment went towards the poorest countries (i.e. IDA countries).[2] Of the IFC's already limited investment in low and lower-middle income countries from 2006 to 2011, only 2.4% went to small and medium enterprises.[3] Further, the World Bank Group's own Independent Evaluation Group (IEG) found that of the IFC projects it examined, only "13% of projects had objectives with an explicit focus on poor people." The IEG also found that, "the majority of [IFC] investment projects generated satisfactory economic returns but did not provide evidence of identifiable opportunities for the poor to participate, contribute to, or benefit from the economic activities that projects directly or indirectly support."[4]Additionally, the PSF paper provides partial justification for outsourcing the PSF's establishment because of the need for speed. While speed is important, quality and legitimacy are fundamental, and both would be seriously undermined were the establishment of the PSF to be outsourced.

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[1]See, for example, GCF/B.04/07, p. 10, para 35(a) – *It may prove difficult to attract experienced professionals with this background [i.e. 'successful investment in the private sector'] unless the PSF can provide competitive compensation packages to bring the best people, experience and practice together*.

[2]http://www1.ifc.org/wps/wcm/connect/CORP_EXT_Content/IFC_External_Corporate_Site/Annual+Report/2011+Printed+Report/Global_Results/.

[3]Eurodad, *Cashing in on climate change: Assessing whether private funds can be leveraged through the Green Climate Fund and other channels to help the poorest countries respond to climate challenge*s, April 2012, at http://eurodad.org/wp-content/uploads/2012/04/CF_report_web.pdf.

[4] Independent Evaluation Group of the World Bank Group, *Assessing IFC's poverty focus and results,* 2011, at http://ieg.worldbankgroup.org/content/ieg/en/home/features/poverty.html.

Financial intermediaries

The PSF paper pre-supposes a heavy reliance by the PSF on financial intermediaries, even recommending that during the first phase, the PSF "would be initially established as a specialized, agile business unit, working entirely through accredited partner financial institutions." The paper fails to first examine the many risks and limitations this poses; for example, if the PSF were to direct its resources to the several intermediaries named, it would simply replicate the financing patterns typical of multilateral development banks and bilateral finance agencies – namely, financing biased towards multinational corporations and the largest emerging markets. The paper's emphasis on financial intermediaries also ignores the considerable work that would be required to ensure adequate PSF oversight and supervision, as shown by the experience of other development finance institutions.[5]

A reliance on financial intermediaries would bring tremendous challenges in ensuring alignment with developing country priorities and serious limitations in implementation of social, environmental, fiduciary, transparency, and accountability standards. Indeed, the independent recourse mechanism of the IFC – the Compliance Advisor-Ombudsman (CAO) – recently conducted a damning audit of the IFC's financial market lending.[6] The CAO found that the IFC conducts "no assessment of whether the [environmental and social] requirements are successful in doing no harm," and that, "The result of this lack of systematic measurement tools is that IFC knows very little about potential environmental or social impacts of its [financial market] lending." The CAO found that "the proportion of cases of non-improved performance was around 60 per cent at the subclient [i.e. sub-project] level, which is where IFC seeks to really have an impact." Further, the CAO pointed out that most financial intermediaries do not have a development mandate, so they often cannot justify any additional measures to ensure a positive development outcome — and the IFC does not provide them with the "business case" for doing so. Financial intermediaries often do not have the capacity, knowledge or willingness to assess and monitor the development, social and environmental impacts of sub-projects, or to take corrective measures. There are also huge transparency issues; the greater the use of financial intermediaries, the more difficult it will be for the GCF to confront the proclivity of the financial sector to desire less disclosure, less liability and less accountability for the environmental and social outcomes of their transactions. Further, the private financing arms of many multilateral development banks, including the IFC, rely on financial intermediaries based in tax havens. Offshore tax havens have led to the loss of billions of dollars from developing countries through tax evasion and avoidance.[7]

Performance metrics and leverage ratios

The PSF paper states that the "Board faces a choice between a defined climate impact… and capital leverage performance metrics and broadly defined development impact metrics to measure and assess the performance of the PSF." It makes multiple assumptions and assertions about leverage and the ability to calculate leverage ratios, particularly with regards to performance indicators, financial instruments, and modalities. However, the determination of leverage ratios is controversial, complicated, and far from resolved, in contrast to what the paper implies.[8] Leverage ratios tend to inflate claims as to how much finance has been moved, including by double counting public funds that are already earmarked and failing to differentiate between public and private money in leverage calculations. Financial and institutional/operational additionality (i.e. would the investment have happened anyway, and is the resulting investment better aligned with the aims of the GCF?) is a counter-factual that is difficult to measure and statistically manipulable, with small variations in assumed future exchange rates, technology costs or interest rates yielding vastly different figures.

Indeed, measuring leverage is often a poor performance indicator because it is far from obvious that more leverage leads to better outcomes, either in terms of carbon mitigation or development effectiveness. Projects with high leverage ratios tend to show greater discrepancy between what the public institution intends and what the projects actually accomplish, and generally mean that the influence of the public institution is significantly diluted.[9] Research looking at 232 Clean Development Mechanism (CDM) projects and 370 Global Environment Facility projects failed to find a correlation between leverage ratios and mitigation efficiency (described in the PSF paper as "dollars and carbon"). In the case of the CDM, researchers even found evidence of a paradox in which projects with lower leverage ratios achieved better results than those with higher leverage ratios.[10]

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[5]Friends of the Earth U.S., Pan African Climate Justice Alliance, Pro-poor climate finance: Is there a role for private finance in the Green Climate Fund? April 2013, at http://libcloud.s3.amazonaws.com/93/7b/5/2931/5-13_Pro-poor_Clim_Fin_-_Role_4_Priv_Fin_in_GCF.pdf.

[6]CAO (2012) CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries. Office of the Compliance Advisor-Ombudsman, World Bank Group.

[7] J Henry (2012) The Price of Offshore Revisited, http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf.

[8]BOND (2013), "Critical issues for channeling climate finance via private sector actors," http://tinyurl.com/kpj7frf.

[9]Bretton Woods Project (2012) " *Leveraging " Private Sector Finance: How Does It Work and What Are the Risks?* London. http://www.brettonwoodsproject.org/art-570165.

[10]Brown, J., Buchner, B., Sierra, K. and Wagner, G., (2011). Leveraging climate finance: a survey of methodologies Climate Finance Effectiveness Background Paper #1 Environmental Defense Fund, Climate Policy Initiative, Brookings Institute, Overseas Development Institute, New York, Venice, Washington, DC, London.

Additionally, the paper's recommendation that PSF projects and programs only disclose development benefits while measuring carbon and leverage ratios seems to create a bias in favor of mitigation projects and against adaptation projects, which create harder-to-quantify development impacts. Further, the paper assumes that higher carbon abatement projects generate development benefits (i.e. "the metric of carbon emissions reductions and the proxy this presents for multiple co-benefits on the ground"). It should be noted that some projects with high carbon mitigation potential, such as the abatement of industrial carbon emissions and associated co-pollutants, indeed have high correlating co-benefits. However, other carbon mitigation projects, such as large hydroelectric projects or land-based mitigation projects, may involve resettlement, land grabbing, and loss of livelihoods, which can have adverse impacts.

Carbon markets

The PSF paper displays an enthusiasm for using "the global carbon market to drive private capital," which is far removed from the reality of a market where prices have collapsed, trading desks at major investment houses are shutting down, credit purchase agreements have been unilaterally torn up, and numerous CDM projects risk default.[11] Moreover, despite the PSF paper's assertions to the contrary, the CDM is widely viewed as a failure when it comes to sustainability, benefiting the poor, and reaching lower income countries. Over 75% of all projects in the CDM pipeline in 2012 were located in China, India, Brazil and Mexico.[12] According to the European Commission's *Study on the Integrity of the Clean Development Mechanism*, "the CDM governance process largely fails to ensure sustainable development and social equity," and "The CDM, while contributing to individual project level technology transfer, has been incapable of encouraging more widespread policy support for technology transfer, for example in energy systems. Technology transfer through the CDM often means import of foreign equipment which does not improve technological understanding and capacity to innovate in developing countries."[13]

Moreover, both the CDM and the GCF PSF are supposed to ensure additionality, without which, such projects would simply receive windfall profits. It is inconsistent for a CDM project to receive financing from both sources and still meet the additionality test. Finally, the emphasis on using scarce GCF funds to create floor prices and carbon market underwriting mechanisms – in effect, measures to bail out a failed policy instrument – raises the question as to whether it was appropriate to select as a co-author of the PSF paper the CEO of a carbon market investment firm that would stand to materially benefit from such mechanisms.

Missing: No objection procedure, National Designated Authorities, UNFCCC

The lack of mention of the no-objection procedure, which must be determined by the board before any GCF funds can be approved, in the PSF paper is puzzling, especially because it should form a crucial piece of country approval of any PSF activities. As noted in Paragraph 7 of the GCF decision "requests the Board to develop a transparent no-objection procedure to be conducted through national designated authorities …, in order to ensure consistency with national climate strategies and plans and a country driven approach and to provide for effective direct and indirect public and private sector financing by the Green Climate Fund. Further requests the Board to determine this procedure prior to approval of funding proposals by the Fund." Furthermore, the failure to even mention National Designated Authorities, potentially the most fundamental unit of the GCF and an essential driver of country ownership, in the discussion on the PSF institutional structure is also deeply troubling. Finally, the lack of any consideration as to how the PSF could be guided by or accountable to the UNFCCC is a significant omission in terms of ensuring that it meets its mandate.

In total, the PSF paper (GCF/B.04/07) does a poor job at examining the breadth of options available as to how the PSF might be structured, and fails to adequately consider key criteria set out in the Governing Instrument. It should not be accepted as the primary basis for Decisions taken by the Board, and we suggest that other alternatives be considered (such as those we have briefly sketched in the annex "A viable, fast-start alternative for the private sector facility").

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[11]FERN (2013), Carbon Desk Closures, http://www.fern.org/book/trading-carbon/carbon-desk-closures?page=1; China Daily (2013) "Buyers default on carbon credits," http://usa.chinadaily.com.cn/business/2012-02/09/content_14566956.htm; L Ran (2013) "CDM Projects face rising risk of default," *Caixin*, http://english.caixin.com/2013-02-28/100495555.html.

[12]UNEP – RISO Centre, *All CDM projects in the pipeline in Brazil + Mexico + India + China as a fraction of all projects,* at http://www.cdmpipeline.org/cdm-projects-region.htm#1. Accessed October 2012.

[13]http://ec.europa.eu/clima/policies/ets/linking/studies_en.htm

Annex: A viable, fast-start alternative for the Private Sector Facility (PSF)

The options presented in the PSF paper (GCF/B.04/07) primarily focus on attracting investment from international capital markets. As we have shown in detail elsewhere,[14] foreign direct investment would do little to meet the needs of micro, small and medium-sized enterprises (MSMEs), encourage investment in SIDS and LDCs, or be consistent with a country-driven approach, all three of which are mandated for the PSF by the GCF Governing Instrument.[15] Therefore, the Board should not limit itself to the options laid out in GCF/B.04/07. The PSF should not have its own business unit, at least initially, but should begin as a division embedded within the mitigation unit of the Fund (within the framework of options 1 or 2 in chapter III of paper GCF/B.04/08, *Structure and Organization*). We offer here a very brief overview of what the PSF could look like if it were to take seriously the targeting of local actors and a country-driven approach to investment, activities that are generally not the purview of international capital.

Capacity building and technical advisory role

The PSF should focus on capacity building and technical advice that is complementary to the activities funded through the mitigation and adaptation windows. As an example of how responsibilities may be divided yet remain coherent, the mitigation window may support policy measures aimed at improving building design codes, while the PSF might focus on helping the building (and building supply) sectors develop the capacity to implement these codes.

A good example: Getting started with direct financing through feed-in tariff support

The PSF's direct financing capacity should start with a focus on supporting the development, transfer and deployment of renewable energy – arguably, the area where the largest range of opportunities exists.[16] It should be built around a system of subsidized feed-in tariffs (FiTs).[17] FiTs have a track record of being able to serve the needs of SMEs and are already being successfully deployed in LDCs.[18] Focusing on financial support for FiTs would help to address the problem of scaling up (creating incentives to support the widening of renewables deployment, principally by SMEs). They are also results-based, since subsidies are only provided once the renewable energy is actually delivered.[19]

Under this proposal, the PSF would provide grant financing to a national implementing agency (e.g. energy or environment ministry) to support the cost of running a national FiT scheme. The implementing agency would then pay out this money to renewable electricity producers (public, municipal or private) for each unit of renewable electricity supplied to the grid, in order to reduce its cost to a level equivalent to that of the cheapest electricity derived from a fossil fuel source (e.g. coal). A significant acceleration in the deployment of renewables would, in turn, decrease the unit cost of the electricity they supply, with subsidies also decreasing over time. Such a system would also avoid the potential consequence that FiTs increase overall electricity costs (and thus harm access). By starting with a concrete problem, and a tried and tested modality based on grant financing, the PSF could build trust and confidence to undertake other support programmes. It is likely that these would mostly focus on mitigation, with adaptation remaining largely the preserve of public programmes. This should be taken into account when planning the overall balance of activities of the GCF.

Institutional structure and governance

A unit with the scope described above would have small staffing requirements. Its main role would be to offer support to national designated authorities and/or implementing entities in developing or enacting nationally appropriate mitigation actions, national adaptation programmes of action, and/ or other plans developed under their supervision. In the case of direct financing through subsidizing FiTs, grant payments would be managed through subsidy support for a nationally implemented scheme, limiting the institutional capacity needed by the PSF itself. Working with existing schemes, it could also hit the ground running.

As with other parts of the GCF's work, the PSF should be guided by political decisions and the implementation of work programmes at the UNFCCC, including those of the Standing Committee on Finance. Project and programme decisions should be taken in consultation with civil society groups, especially any potentially affected communities. Further, the rules, standards and safeguards governing the PSF should be the same as those operative across the whole GCF – there should be no special exemptions.

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[14] See Friends of the Earth U.S. (2013) "Pro-poor Climate Finance," http://tinyurl.com/l8ubso6, p.12; BOND (2013), "Critical issues for channeling climate finance via private sector actors," http://tinyurl.com/kpj7frf.

[15] Governing Instrument, paragraphs 41-44

[16] This corresponds to Option M5 of paper GCF/B.04/03 (p.6). We suggest that be amended from "low-carbon" to "renewable energy", and that "at scale" be removed. In discussing scale, the Board should avoid any ambiguity between aiming for a large volume of new installed electricity generating capacity, and the creation of large-scale projects. A feed-in tariff can achieve the former in a decentralized way without requiring the latter.

[17] See Banuri, T. and N. Hällström (2012) "A Global Programme to Tackle Energy Access and Climate Change." In *What Next III*, http://tinyurl.com/laqcenm.

[18] Nganga, J, M. Wohlert and M. Wood (2013), *Powering Africa Through Feed-in Tariffs*, http://tinyurl.com/lb47795.

[19] Banuri and Hällström, Op. Cit.