

Additionality and Leveraging Private Finance

What is “additional” finance?

The Green Climate Fund is mandated to provide “additional” finance. But the meaning of “additional” has been the subject of rigorous debate, with questions raised about what it means and how it can be consistently measured.ⁱ Determining additionality is particularly important when public institutions deploy scarce financial resources in conjunction with private finance, or for private sector activities.

Additionality is frequently characterized by two components:ⁱⁱ

- Financial additionality — Would the investment have happened anyway? This is the most common way to determine additionality. Without financial additionality, instead of leveraging private finance, the public institution is simply subsidizing private financiers and companies, or competing with them.
- Operational and institutional additionality — Is the resulting investment better aligned with the aims of the public institution backing it? Have there been improvements in, for example, the environmental or social performance of the investment as a result of the public institution’s involvement?

A lack of financial additionality is common among development finance institutions (DFIs).¹ For example, an audit of projects supported by the Swedish DFI, Swedfund, found that 8 out of the 12 companies they interviewed stated that the investment would have gone ahead without public support.ⁱⁱⁱ


Operational additionality is often inadequately addressed by DFIs. An evaluation of International Finance Corporation (IFC) lending by the World Bank Group’s own Independent Evaluation Group found that “at least one form of operational or institutional additionality was identifiable in about one-third of the cases.”^{iv} A more recent report focusing on financial intermediaries concluded that around 30 percent of the projects did not show any improvements as a result of the IFC’s involvement and that the figure increased to 60 percent in the case of sub-projects.^v This casts doubt on the ability of the IFC, and potentially other DFIs, to improve the private investments it supports.

“Leveraging” private finance

Calculating leverage ratios — failure to differentiate between public and private money

When it comes to “leveraging” private finance, one would presume that a leverage ratio of 1:2 means that one unit of public investment leverages 2 units of private sector investment. However, that is often not the case. Many public financial institutions count both private and public finance in their leverage calculations, which leads to inflated leverage ratios.

¹ Development finance institutions are public institutions with a development mandate that often also provide finance to the private sector.



For instance, the World Bank's Clean Technology Fund (CTF) and the Global Environment Facility (GEF) calculate leverage ratios as the ratio between the finance they provide to the project and the total amount of funding provided by other financiers, without differentiating between public and private sources.^{vi} Thus, a project with a total cost of \$100 million that has a CTF contribution of \$10 million would have a leverage ratio of 1:9, regardless of whether the other \$90 million comes from public sources (such as other multilateral development banks and governments) or private sources.

The same project can also have different leverage ratios depending on which institution's methodology for leverage calculation is used. For example, the World Bank uses a different approach in its infrastructure projects and simply divides the total costs of the project by its contribution to the project.^{vii} Using the same example provided above, its leverage ratio would instead be 1:10. Here, also, the World Bank fails to differentiate between public and private finance.

Inflated claims of leverage

The actual potential to raise additional private climate finance is significantly less than what the leverage ratios of institutions like the CTF and IFC would suggest. The majority of the costs of projects supported by DFIs tend not to be shouldered by private financiers, even though this is not commonly reflected in leverage ratios. For example, private finance in private sector projects supported by the GEF and CTF averages 35.6 percent and 23.7 percent respectively (or, alternately, the public component is much larger — 64.4 percent and 76.3 percent, respectively).^x


Public funds often already earmarked

Public funds cannot be “leveraged” in the same way as private funds because they are usually earmarked for specific purposes or belong to specific budget lines. Governments tend to have detailed national budgets and money cannot be easily moved from one budget line to another; in other words, funds designated for climate adaptation, for example, would have “happened anyway.” This is likely the case of the \$770 million contributed by the Colombian government

Playing with math: Clean Technology Fund project in Colombia

Funding for a CTF project in Colombia was \$2,996 million, split among the following actors:^{viii} CTF (\$150 million), Colombian government (\$770 million), private sector (\$1,250 million), multilateral development banks (\$726 million), and other (\$100 million).

The CTF claims a leverage ratio of 1:19 for the project.^{ix} But by including the contribution of the Colombian government and the MDBs, the World Bank assigns a misleadingly outsized role to the leverage potential of the CTF money. The actual public to private finance leverage ratio, calculated using the CTF's methodology, at 1:8 is less than half of the CTF's claimed ratio.



to the CTF project. Similarly, MDBs contributed a total of \$726 million, but it is likely they would have spent part of that money on climate projects anyway.

Double counting

When multiple public actors are involved in a project, they may end up claiming to have leveraged each other's money, which leads to double counting. Co-financing of a project in collaboration with another DFI is quite common. For example, the GEF may contribute \$100 million, the IFC another \$200 million and the private sector a further \$300 million. Using the CTF methodology, the leverage ratio of the GEF is 1:5, while the leverage ratio of the IFC is 1:2. Moreover, the GEF could claim to have leveraged the IFC money, while the IFC could make a corresponding claim on GEF money. The leverage potential of each institution's money is thus further inflated.

Are high leverage ratios better?

Existing literature often suggests that high leverage ratios are better because that implies public funds are being invested more effectively.^{xi} However, this only holds true in a very limited number of cases and only if the additionality of the leveraged funds can be proven.

When a public institution claims a project has a high leverage ratio, this simply means that a very large share of the costs is coming from other sources, with that particular public institution's contribution only representing a small part. Using the example from Colombia above, the CTF's contribution to the project is a little over 5 percent of the total costs. It is possible that the CTF provided the first 5 percent of the funding and actively recruited new financiers for the remaining sum, but in all likelihood, most, if not all, of the remaining 95 percent of the funds required for the project were already available. A project with so much funding already raised is very likely to go ahead regardless of the CTF, either in its current form or with some minor modifications to account for the gap — yet the CTF claims to have mobilized 19 times its own contribution.

In addition, projects with high leverage ratios tend to show greater discrepancies between what public institutions intend to fund and what the projects actually accomplish; high leverage ratios generally mean that the influence of the DFI is significantly diluted. A survey of GEF projects with high leverage ratios found that, in reality, most of the total project funding went to activities the GEF would not normally fund.^{xii} Research looking at 232 Clean Development Mechanism (CDM) projects and 370 GEF projects failed to find a correlation between leverage ratios and mitigation efficiency. 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.^{xiii}

That said, there are a limited number of circumstances in which public institutions contributing small amounts of finance might be able to claim significant leverage ratios. For example, the signal a public institution sends to potential private investors by putting itself forward as the first investor to commit to a new venture may lead to truly additional private finance, but the project itself should also be operationally additional.



Recommendations for the Green Climate Fund

- Financial and operational/institutional additionality must be clearly demonstrated for any private investment or private sector projects under consideration for GCF support. This should occur during initial evaluation stages prior to any approval of GCF support.
- The GCF should refrain from using leverage ratios as criteria to guide funding decisions at least until:
 - » A common methodology is established to calculate leverage ratios, and its usage mandated.
 - » Leverage ratios only reflect private, not public, funds mobilized.
 - » Only private flows that are truly additional — both financially and operationally/institutionally — are counted.
 - » Public actors are not allowed to claim that they have raised each other's money. If different public institutions support the same project, leverage ratios should be calculated using the amount of private finance that is proportional to their contribution in order to avoid double counting.

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Endnotes

- i See: EC (2012) Climate Change Financing: the Concept of Additionality. European Commission, Directorate General for External Policies.
- ii Griffith, J. (2012) 'Leveraging' private sector finance: How does it work and what are the risks? Bretton Woods Project, April 2012. URL: <http://www.brettonwoodsproject.org/art-570165>
- iii Sjo, B. and Ulvang Flygare, S. (2008) Evaluation of Swedfund International An analysis of private sector development impacts, SADEV; and Swedish National Audit Office (2009) Swedfund International AB and its commission to society, Swedish National Audit Office.
- iv IEG (2008) Independent Evaluation of IFC's Development Results. 2008. IFC's Additionality in. Supporting Private Sector Development.
- v CAO (2012) CAO Audit of a Sample of IFC Investments in Third-Party Financial Intermediaries. Office of the Compliance Advisor-Ombudsman, World Bank Group.
- vi Brown, J., Buchner, B., Sierra, K. and Wagner, G., 2011a. 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.
- vii Brown, J., Buchner, B., Sierra, K. and Wagner, G., 2011a. 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.
- viii Brown, J., Buchner, B., Sierra, K. and Wagner, G., 2011a. 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.
- ix Please note that using the World Bank's approach to infrastructure investments would have resulted in a leverage ratio of 1:20.
- x Venugopal, S.; Srivastava, A., Polycarp, C. & Taylor, E. (2012) Public Financing Instruments to Leverage Private Capital for Climate-Relevant Investment: Focus on Multilateral Agencies. World Resources Institute, Washington, DC.
- xi Brown, J., Buchner, B., Sierra, K. and Wagner, G., 2011a. 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.
- xii Brown, J., Buchner, B., Sierra, K. and Wagner, G., 2011a. 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.
- xiii Stadelmann, M.; Castro, P. & Michaelowa, A. (2011) Mobilising private finance for low-carbon development. Tackling barriers to investments in developing countries and accounting of private flows. Climate strategies.