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ISSUES AND OPTIONS FOR ENGAGING THE PRIVATE SECTOR

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INTRODUCTION

1. This paper provides a number of issues and options associated with efforts to engage the private sector in GEF activities and seeks comments and suggestions from Council Members, NGOs, and other interested parties. Comments are requested by July 15, 2003 as an input to the development of a more detailed strategy planned for presentation at the November Council meeting.

2. The ideas and proposals presented build on several previous papers and reviews of GEF efforts to engage the private sector[1] as well as the results of the interim report of the Monitoring and Evaluation Unit also prepared for this Council meeting. See Review of GEF Engagement with the Private Sector: Interim Report, GEF/C.21/Inf.8. The M&E review is a key input to the preparation of a planned private sector strategy and is not expected to be completed until July 15, 2003.

3. Two broad themes are central to the ideas presented in this paper and distinguish it from previous reviews of the topic prepared for the Council. One is the importance of recognizing the diversity of actors that constitute the private sector, with a correspondingly wide range of circumstances. The GEF approach must evolve to meet this variety of needs. (See pars. 8-10.) The second theme is the need for coordinated action addressing both private and public sector issues. In working with the private sector, GEF involvement should foster commercially viable activities that generate global environmental benefits. In working with the public sector, GEF involvement should support policies and institutions necessary to enable private sector investments. The GEF strategy needs to address both fronts in a targeted and coordinated manner.

ROLE OF THE PRIVATE SECTOR

4. As summarized in the M&E Review, the importance of engaging the private sector in GEF activities has been described numerous times in papers and discussions before the Council and in both Overall Performance Studies, as well as in conclusions of the WSSD and other international forums. In brief, private sector entities are essential partners for achieving global environmental benefits. The private sector will in many instances be the primary source of technology, finance, and ultimately sustainability for projects seeking to promote renewable energy, ecological services, and other environmentally beneficial activities.

5. In recent years, some of the most optimistic expectations concerning the role of privatization and foreign direct investment in developing countries have undergone some revision. Privatization of energy, water and other basic services, while still widely viewed as promising in many cases, is now seen as far more complex and with many potential pitfalls than perceived only a few years ago. Private lending to emerging markets, particularly in lower income countries, has declined markedly, although the flow of resources for asset acquisition has

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[1] Some of the issues and options related to engaging the private sector were outlined in earlier papers. See, e.g., C.13/Inf5; C.12/Inf5; C.7/12; and C.6/Inf.4.

been less volatile. GEF projects have not been immune from these trends, as several IFC funds and other projects based on optimistic assumptions about market opportunities have had to be substantially revised or terminated.[2] As noted in the M&E review, GEF projects may now have to give greater consideration to addressing the wider range of market risks that impede investment in developing countries, perhaps through more proactive partnerships with other sources of risk mitigation prepared to address non-environmental risks.

6. At the same time, new types of incentives for environmentally beneficial products and services have also increased for a variety of reasons including pressure on international firms to demonstrate social responsibility; increasing corporate interest in environmental accounting; the growth in consumer interest in certified "green products" (e.g., shade grown coffee and hardwoods from sustainably managed forests); recognition that small scale, decentralized technologies – particularly for energy – can be economically competitive; and the emergence of markets for environmental certificates, particularly carbon offsets.

7. Another development relevant to engaging the private sector is the emergence of organizations and initiatives promoting a variety of strategies to enhance the environmental sustainability of business practices. These include corporate environmental rating services (particularly in connection with Socially Responsible Investments), reporting and disclosure policies, codes of conduct, and other incentives for identifying and implementing environmental practice substantially better than legally required. While the interest in such ideas has so far come primarily from companies and organizations based in the industrialized countries, they have considerable potential for developing countries. For example, in several developing countries including Indonesia pollution reporting and disclosure policies have been effective in mobilizing communities to successfully demand cleanup efforts.

8. The end result is that opportunities for engaging the private sector in GEF objectives continue and may even be growing in some areas, but identifying and implementing them successfully is now seen as more complex, and in some cases, higher risk, than had been thought only a few years ago. More specifically, key concerns include:

(a) The need to better clarify specific market opportunities that help to meet GEF objectives, criteria for support of specific technologies, products & services, as well as related standards, certificates, and labeling schemes.

(b) The need for more emphasis on market analysis covering all parts of the value chain, particularly with respect to demand-side barriers that impede the sale of environmentally beneficial products and services.

(c) Greater recognition of the investment climate, and the range of country specific risks as non-environmental factors that have often been critical for success.

[2] IFC has recently found it necessary to propose curtailing or restructuring specific funds such as Solar Development Group, Reef, and Terra Capital.

(d) Increasing inability of either the public or private sector alone to finance large projects in developing countries, as well as the need to share risks and to develop customized risk mitigation strategies.

(e) The critical role of access to market information, risk assessment and business planning know-how (often equally or more important than financing as a source of leverage for major investments).

(f) The need to assist governments in their efforts to level the playing field for solutions that help to meet GEF objectives.

9. Some private sectors players have vague and unrealistic expectations of the GEF; better communication is key for creating effective relationships

10. Some of these recent trends have already influenced GEF policies as well as projects recently approved or under development. For example, the climate change strategic priorities proposed in the Corporate Business Plan reflect some of this learning from experience, including the influence of power sector policies on investment in grid connected (and some off-grid) renewable energy projects. Proposed strategies for innovative financing and productive uses also reflect a private sector emphasis. This is indicative of the larger need for market enabling measures that facilitate conditions for private investment. Another proposed strategic priority based on learning from experience is the need for more innovative forms of financing that more effectively match project risk capital with local financial markets.[3]

RECOGNITION OF DIVERSITY OF THE PRIVATE SECTOR

11. The private sector is not a homogenous entity. As supported by the preliminary results of the GEF private sector review, the private sector actors involved in GEF operations are heterogeneous communities, varying in composition from sector to sector, market to market and country to country. The private sector spans a diversity of domestic and international players with different cultures, activities, needs, modalities, and incentives: farmers, small/medium size entrepreneurs, NGOs,[4] global corporations, domestic businesses, consultants, project developers, international and domestic financiers, service and technology providers, energy companies, traders and wholesalers, brokers of transactions, asset managers, and parastatal entities, etc.

12. Focusing on how the GEF can collaborate with these diverse players to advance global environmental objectives is of central importance in defining a successful private sector strategy. Consistent with their specific role in the market development process, each of these players can

[3] Two projects in the current work program (Mexico Renewable Energy and the Regional Geothermal project) reflect the potential for high leverage of GEF resources through investment in achieving policies and local financing more responsive to the needs of renewable energy technologies.

[4] NGOs have made significant contributions to private sector projects by supporting environmental enterprises for sustainable agriculture, renewable energy, etc., as well as through support of policies to promote such businesses.

offer different opportunities for collaboration and for contributing to the achievement of GEF goals.

13. The private sector strategy will also need to distinguish types of modalities appropriate for different barriers, risks and actors by focal area and market. For example, a large international company may require no financial assistance, but significant policy support, whereas a small local firm may require assistance with developing a business plan and obtaining credit.

14. The range of actors, needs, and interventions also implies the need for diverse outcomes as indicators of project success. In large investment projects, private co-finance may be critical, while projects aimed at small entrepreneurs might be measured by the demonstration of successful business models, non-GEF replication, and additional companies attracted to similar business activity. Projects aimed at expanding markets for energy efficiency products often measure growth in market demand relative to areas outside the program.[5]

ISSUES

15. While the situation faced by each private sector player will vary by project, there are some common issues facing the private sector as a whole when partnering with the GEF. The issues generally respond to the need to address the enabling environment or to create new leveraged funds, an *indirect* basis for engaging the private sector, and *direct* engagement of private sector entities through financing, partnerships, or other GEF supported activities.

Direct Engagement of Private Sector Entities

16. Criteria and procedures for accessing GEF resources. A longstanding concern of private companies who are directly engaged in GEF projects has been the perceived time, complexity, and lack of certainty associated with accessing GEF resources.[6] This is still a difficulty reported by project developers and other firms. The high transaction costs for relatively small projects is another facet of this problem, only partially addressed by the opportunity for medium-sized projects and delegated funds.

17. Private sector understanding of GEF requirements. Comprehension of the requirement for country endorsement, the importance of an appropriate Implementing Agency, and the other elements of the GEF project cycle is often lacking. Moreover, companies often do not know whom to contact as a GEF liaison, do not know the comparative advantages of the Implementing

[5] For further discussion of these issues in the context of the GEF climate change portfolio, see “Measuring Results from Climate Change Programs, Performance Indicators for GEF” (GEF Monitoring and Evaluation Working Paper 4, September 2000)

[6] “According to IA staff, one of the most significant challenges for direct execution of GEF projects by the private sector is accelerating the GEF approval process. Given the uncertainty, risk, and high opportunity cost inherent in GEF projects, private firms do not have sufficient incentive to wait up to two years for approval and endorsement.” “Joint Summary of the Chairs”, October 1998 GEF Council meeting, par. 15.

Agenies vis-a-vis one another for particular types of projects, or understand GEF-specific terms including incremental cost and global environmental benefit.

18. The limited private sector awareness and understanding of the GEF is a barrier to cooperation with some parts of the private sector, particularly large firms. This is gradually improving with time and outreach efforts as reflected in a steady increase in interest from business associations and individual firms interested in partnerships with the GEF. However, collaboration with the Implementing Agencies and local executing agencies remains critical to addressing this need. A further implication is that engaging the private sector will require more emphasis on relationship building and typically more upstream consultations than might be the norm for public sector projects.

19. Expanding the range of financial instruments and modalities. The GEF's ability to access different financial instruments and modalities is expanding in recent projects. However, the range of transactional diversity may in practice be limited by the modalities and priorities of existing partners. Within the World Bank Group, several units focus on partial risk guarantees and other risk management modalities and they are gradually becoming more involved in structuring tools for GEF projects – a positive development.[7] Neither UNDP nor UNEP have in-house capabilities for structuring financial instruments. Thus, there may be a role for other agencies and forms of collaboration to gain access to a broader range of risk mitigation instruments and modalities.

20. New partnerships. For encouraging investment and changes in business practices to promote the environment, collaboration with experienced partners in emerging markets can provide business advice, structured finance, risk management, and other knowledge. Choosing appropriate partners (within or outside the IAs) can help refine private sector approaches, identify additional partners for risk mitigation strategies and modalities, and leverage organizational structures which increase access to the private sector, without having to commit additional GEF resources.[8]

Indirect Engagement

21. Enabling Activities for countries with less developed markets. For some parts of the GEF portfolio, particularly energy efficiency, the strategic focus on quasi-commercial markets has limited the range of potentially eligible countries. Assuring opportunities for poorer countries may require different financial approaches consistent with the higher risk profile, where investors are provided risk mitigation for the risks that they are unwilling to shoulder.

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[7] The World Bank Group and regional development banks have extensive dialogs at the country level relevant to the banking sector, energy policy, and other key elements of the enabling environment. This is reflected in country assistance strategies and other country sector work. A key issue for the strategy may be to explore how GEF objectives can be more effectively integrated in these discussions.

[8] Finding partners prepared to address non-environmental risks generic to emerging markets is becoming increasingly important.

22. One way to foster greater private sector interest in poorer countries may be linked to the proposal for expanded capacity building efforts introduced in the Corporate Business Plan. If accepted, a more detailed capacity building approach is to be prepared for the fall Council meeting. Various forms of capacity building needs have been identified as important for the creation and evolution of sustainable investment climates for GEF projects. Existence of a stable and supportive policy environment that makes the country attractive for foreign and domestic investment is a basic building block. The lack of such an environment was brought up as an issue for some projects reviewed by the M&E private sector review and could be addressed through review of regulatory policies and other barriers. These types of capacity building activities can be even more important than financial approaches in some cases.

23. Capacity building should also extend to the private sector and intermediaries such as industry and business associations, as well as local banks, investment and trade promotion agencies. Needs identified include activities to enable access to critical market information, to improve business planning and risk assessment capacities, as well as provision of related due diligence tools. In many cases, the ability of banks and other local financial intermediaries to perform due diligence and make loans for environmental projects determines the viability of GEF projects. However, this knowledge and experience is often lacking or incomplete. In cases where supportive public policy conditions are not present at project design, associated capacity building by stakeholder groups during implementation can become a driver for policy reform. As a result, the long run sustainability of environmental benefits might be enhanced due to the role of the private sector as a change agent.

24. <u>New sources of revenue through green finance</u>. Recent developments in green finance can potentially provide new sources of revenue, as well as access to risk mitigation and project finance for GEF projects. In particular, carbon finance was identified as having immediate potential in many countries, and many project proponents interviewed by the private sector review were actively preparing for CDM eligible project activities. This development has the most implications for the climate change and biodiversity portfolios, and to a lesser extent, international waters. The GEF has not supported projects with carbon finance components (partly due to the concerns of parties who have not ratified the Kyoto Protocol) but is aware of the interest of some developing countries in using this potential source of revenue to demonstrate a means of achieving financial sustainability. There are other sources of green finance including premiums voluntarily paid by some consumers for renewable energy or other environmentally preferred products.

Project Design Issues

25. <u>Environmental objectives and financial risk mitigation</u>. The M&E private sector review found that the majority of projects examined, particularly the older projects in the portfolio, were lacking with respect to indicators of both market and environmental impact. Exploring how businesses can be provided incentives, not only for financial performance, but also for documenting the global environmental benefits which are generated, is important. Environmental impact criteria appear often to be only weakly tied to financial criteria and

performance. Production standards and certificates tied to defined benefits are being used in a few projects and are one possible solution.

26. Demonstration effect & replication risks. Replication of successful demonstration projects often rests on the financial resources of local entrepreneurs without adequate access to capital. For example, the M&E review found that for ecotourism projects, replication projects financed by local entrepreneurs tended to be smaller in size and scope such that the expected global environmental impact was much less. More attention needs to be given to the market assumptions associated with achieving effective replication in private sector projects.

27. Marketing and non-local costs. Addressing the full range of barriers to the creation of markets for environmental products and services sometimes raises issues concerning the boundaries between local costs and those related to exports and international marketing, e.g., for shade grown coffee beneficial for biodiversity. In such circumstances, the M&E review found that identifying support for non-local costs may be essential for project success.[9]

OPTIONS

28. In response to the issues described above, the following list of policy options is presented as potential directions for the GEF to consider in engaging the private sector. Each one may be considered on its own or combined with the other options presented. These options are consistent with the GEF's evolving strategic priorities and business plan.

29. Expanding the basis for outreach with the private sector. The benefit of outreach efforts is several-fold: to improve understanding of local needs, increase private sector awareness and understanding of the GEF, and to identify the most promising opportunities for intervention and modalities for GEF support.

30. Particularly within the climate change portfolio, past dialogues have been beneficial for lessons learned and strategic development of priorities for projects. The GEF, along with the German development bank KFW, recently facilitated an exploratory dialogue for renewable energy developers (from industrialized countries) and developing country utilities to test the potential for a large market for small-scale, distributed power generation. The dialog may be the basis for a more formal project. An earlier review of GEF sponsored photovoltaic projects with significant industry participation, sponsored by the Swiss government in September 2000, resulted in important conclusions about redefining GEF strategies, including the need to give greater emphasis to the link with income generation. A review of experience with wind energy projects is also under discussion with potential support from Denmark, with the aim of similar learning with respect to experience with wind energy technology. The STAP has also played an important role in identifying lessons from private sector experience, most recently in a March 2003 workshop on the GEF experience with projects to commercialize new energy technologies.

[9] In some circumstances partial GEF support might be appropriate, e.g., for a developing country labeling and promotional program.

31. Another example of a beneficial dialog with industry is the World Bank dialogue with CEOs of water companies to encourage more public private partnerships. This has resulted in the recent formation of a water guarantee fund, "GuarantCo", based on risk mitigation needs articulated by the water industry. Similarly, and in light of other ongoing dialogues between the public and private sectors, engaging in targeted communication can help further capacity building efforts as well as the strategic direction of the GEF portfolio. However, while dialogue may be appropriate for some types of industries and players, it may not be applicable for others.[10]

32. Risk-sharing and incentive creation for mobilizing capital for environmental markets. As noted above, the current perception of high risks in emerging markets will require a broad approach to risk mitigation in order to attract greater private sector interest to otherwise promising GEF projects. Making increased use of financial instruments and guarantees for risk mitigation purposes requires a structured finance skill set. Those are units in the World Bank Group (e.g., Private Sector Development) that specialize in providing the types of financial structures required can be utilized more effectively to enable the GEF to engage in a wider range of transactions.

33. Partnerships. Strategic partnerships are essential for leveraging skill sets and providing additional access to the private sector. Identifying partners to help mitigate risks for the different focal areas is also important. These partners can be internal or external to the IAs and their organizations. In addition, these partners can play a key role in creating a framework for encouraging a "business incubator" type approach. Next steps include identifying potential partners. For example, the World Resources Institute New Ventures Program already has a well established business incubator program in place that provides assistance to entrepreneurs in developing countries developing environmental businesses. Other partners to consider are regional banks and bilaterals, who may have the regional and sector expertise needed for a particular type of project. For example, EBRD is active in financing water and energy projects in Eastern Europe and has investment bankers with expertise in structuring such projects.

34. Capacity building. As already noted, the Corporate Business Plan proposal for expanded capacity building could create new opportunities for enabling markets consistent with private sector needs. The GEF could also provide business skills and knowledge through capacity building funds, as in the SME pilot program. One of the key lessons learned from this program is the importance of combining financial assistance with technical assistance for entrepreneurs. The M&E review supports continuing to provide such assistance on a larger scale in order to stimulate investment in environmental enterprises, consistent with the general concept of business incubation.

35. Country dialogue workshops. Another option is to make greater use of the country dialogue workshops to address private sector needs. One GEF strength is its role as a convener and facilitator. The country dialogue workshops have the potential to function as an intermediary

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[10] For example, for many large banks and insurance companies, their corporate foundations rather than their business units represent the company in environmental meetings, with little impact on day to day operations at the business unit level.

for engaging the private sector, by bringing together all the stakeholders together to discuss opportunities for GEF to support local needs. At the behest of a host country, an additional day at the end of a country dialogue workshop could be used for a private sector focused-dialogue.

36. New pilot modality for engaging additional private sector players. Given continued concerns about the time, complexity, and transactional diversity described above, consideration could be given to pilot quicker, simpler approaches with a range of financial instruments for private sector projects with substantial environmental benefits and high probability of success. Participation might be limited to firms who have contributed substantial resources and risk sharing. As noted above, the range of transactional diversity is currently limited by the modalities available and priorities of existing partners. Thus, further investigation into piloting other forms of collaboration to gain increased access to the full range of financial instruments and modalities, might be considered.