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ENGAGING THE PRIVATE SECTOR IN GEF ACTIVITIES

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1. This paper responds to the Council's request for a review of modalities to facilitate private sector involvement in GEF-financed activities and is consistent with provisions in the Operational Strategy to leverage additional financing.[1] The GEF will benefit from a better understanding of how the private sector operates and what opportunities exist for engaging businesses to address global environmental challenges.

2. The discussion divides the private sector's relationship to GEF's programmatic goals into three parts. First, it reviews the key position occupied by the private sector, such as its role in transferring technology and maintaining project achievements in the long-term. Next, the special challenges that GEF must address in forming private sector partnerships is detailed. The third and central section describes the various ways GEF can engage private sector partners as well as how these modalities conform to GEF criteria. The discussion includes opportunities to make greater use of modalities that have been used previously, as well as potential new ones.[2] An annex defining financing modalities concludes the paper.

IMPORTANCE OF THE PRIVATE SECTOR

Global Environmental Impact

3. Recent growth of the global economy and ongoing privatization have enormously increased the influence of private sector activities on the global environment. Investments in the energy sector in developing countries, for example, are now estimated to be $100 billion annually, much of it privately financed. The trend toward privatization of state-owned electric utilities means that decisions about the carbon intensity of power plants will be made on the basis of narrower economic criteria with both positive and negative environmental consequences.[3] Business also affects, and is in turn influenced

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[1] This paper responds to the Council request made at the October 1998 Council meeting that the "Secretariat prepare a paper for Council review on the private sector and the GEF. The paper should address modalities to facilitate private sector involvement in GEF-financed activities, including partnerships with the private sector to promote the transfer of technology."

[2] This paper incorporates information and perspectives from several previous reviews. Two papers on private sector issues were prepared for the Council: *Strategy for Engaging the Private Sector* in April 1996 and *Engaging the Private Sector* in October 1995. The Overall Performance Study had several pertinent conclusions: (i) GEF has been able to mobilize a small but growing level of financing for projects, but comparatively little by mainstream private financial institutions; (ii) GEF assistance can be provided to address commercial risks without subsidizing private profits through measures such as low interest loans, contingent payment features and partial guarantees; (iii) GEF is urged to engage private financiers to mobilize additional resources from banks, insurance companies and pension funds. Other sources of useful insights include, *Lessons Learned from the GEF Pilot Phase* (April 1998) and *Study of GEF Project Lessons* **-** *A Summary Report* (January 1998). There is a need to operationalize the suggestions from these studies both at a project level and programmatically.

[3] In developing countries, privatization of utilities has typically resulted in the reduction or elimination of subsidies and significant improvements in system efficiency, reduced pollution and improved service. In the industrialized countries, it has resulted in a sharp reduction in expenditures on conservation programs

by, biodiversity concerns in many ways including policies on the use of lands and natural resources critical for habitat; rights to plants with potential application as medicinal drugs; and preservation and regulation of genetic resources for agriculture.[4] Engaging the private sector in the promotion of global environmental objectives is essential.

Resources

4. Many GEF projects involve private sector enterprises as important sources of co-financing and as executing agents.[5] One important reason for seeking to further engage the private sector is to obtain additional project resources consistent with the GEF's strategic focus on leverage. Ultimately, to be successful, GEF must help create conditions that promote private sector investment in projects that benefit the global environmental without requiring external resources.

5. Over the past decade, net private sector flows to developing countries have grown rapidly to more than $250 billion in 1997, while development assistance declined to about $50 billion.[6] While private flows sharply declined in the past year in many countries due to uncertainties created by the Asia economic crisis, the basic trend is likely to continue. Private investments are therefore an increasingly important source of financing for development.

6. In many cases, the barrier to private sector investment is perceived risk rather than a clearly identifiable higher cost; thus it may be sufficient and indeed more appropriate in some cases to provide a guarantee or some other alternative to a grant. This approach, discussed below, offers the potential to significantly expand the effective value of GEF resources while avoiding potentially sensitive transfers of resources to large private enterprises.

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and long term research and development of new technologies as well as increased generation from facilities that are less expensive, but dirtier.

[4] See the recent report of the World Business Council for Sustainable Development and the IUCN-World Conservation Union, *Business and Biodiversity: A Guide for the Private Sector (1997).*

[5] As reviewed in the Overall Performance Study (projects through 1997), private sector financing has or will take place in forty five GEF projects in both the Pilot Phase and GEF 1. Of the twenty two underway or nearly underway, ten were in the ozone depletion focal area, ten in climate change, and two projects involve both climate change and biodiversity. At the time there were no reported instances of international waters projects leveraging private investment. Total private investment in these twenty two projects is $1.12 billion, but more than half of this ($754 million) is accounted for by the Philippines geothermal project. While there have been many relevant projects in the GEF pipeline, there has been insufficient experience from which to draw significant conclusions regarding the special challenges to private sector involvement in GEF work.

[6] Foreign direct investment has so far been concentrated in a relatively small number of countries and regions while largely bypassing others, including most of Africa. However, the distribution of private investment is more equitable when viewed relative to the size of economies, i.e., most FDI has gone to the largest developing country economies while smaller but still significant amounts are reaching many other countries. See generally World Bank, *Private Capital Flows to Developing Countries: the Road to Financial Integration* (1997).

Technology Transfer

7. Another important benefit from increasing private sector participation in GEF activities is the opportunity for technology transfer. Much existing environmental technology has been developed and is owned by private companies. Joint ventures and other forms of foreign direct investment have become significant sources for transferring state-of-the-art technology along with the supporting skills and training to adapt technology to local needs and circumstances.

8. In recent years, many technologies of great environmental benefit have been transferred to developing countries through private-private or public-private transactions. For example, the efficiency of refrigerators, air conditioners, and other energy-intensive appliances made in China has steadily and substantially improved in recent years as these products have been redesigned with technology primarily obtained through joint ventures with firms from industrialized nations. In negotiations with automobile companies, China has also been able to condition entry to its market upon both local manufacture and training, with the associated transfer of considerable technological knowledge. Similarly, a benefit of opening electricity markets in many developing countries has been the transfer of cleaner technologies for power generation, often accompanied by some commitment to local manufacture.

Sustainability of Global Environmental Benefits

9. Even when development assistance or other public resources are available for projects with global environmental benefits, project replication and sustainability often depend on creating conditions for similar investments by private actors. Thus, the target audience for many environmental projects is frequently the private sector, whether or not it is initially viewed as an important focus. This is particularly true in those countries that have moved most rapidly to sell state enterprises and privatize their economies. Thus, the transfer of assets from publicly owned utilities is making privately owned firms much more independent as decision makers on technology and the structure of energy markets.

SPECIAL CHALLENGES

10. Experience in GEF projects and discussions with a range of private companies, financial institutions, business associations, and selected NGOs reveal that efforts to engage the private sector more effectively in GEF activities are steadily increasing but still face several challenges. The main obstacles appear to be that the private sector is largely unaware of the GEF and the steps necessary to achieve tangible returns through partnerships with the GEF are vague and not readily understood.

Private Sector Experience with GEF

11. According to the Overall Performance Study, the private sector has had little opportunity to directly execute GEF projects. Their role has mostly been limited to providing procured equipment and services or, in some cases, to acting in an advisory capacity. In some cases there are concerns that providing GEF resources to private companies would distort the market or inflate profits rather than compensate for incremental costs.

12. Despite the frequently expressed desire by focal points and other government officials to involve the private sector directly, there appears to have been only limited progress toward this end. The range and number of successful private sector experiences with the GEF can however be increased by sharing information and creating new opportunities. To do this, successful experiences for specific projects such as those of Argentina and Hungary will be shared with other private sector entities and focal points through the GEF Country Dialogue Workshops. Additional opportunities will be created for the private sector by carefully selecting and applying modalities that match the way the private sector operates with GEF requirements.

13. Each of the Implementing Agencies and executing agencies have unique and complementary opportunities for synergies and win-win collaboration with the private sector and the GEF. For instance, UNDP can create the enabling environment for successful private sector operation in recipient countries by focusing on supporting small to medium–sized enterprises. UNEP can build on its industry and energy clearinghouse function to fill information gaps. The World Bank and IFC can leverage their long experience of providing finance directly and indirectly to private sector projects. The comparative advantages of UNDP, UNEP, and the World Bank (including the IFC, its private sector affiliate), will depend on the nature of the services needed.

Awareness of GEF

14. The business community is generally unaware of GEF. Consistent with the evolving outreach strategy, a wide range of companies and business associations need basic information about the role of the GEF, its basic procedures, and how they can partner with the GEF to support projects of global environmental benefit. To increase awareness, GEF will support Implementing Agencies and GEF focal points to identify and develop private sector projects consistent with GEF's mission, primarily through the Country Dialogue Workshops.

Project Cycle, Timing and Predictability

15. According to Implementing Agency 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. The approval process may be hastened by simplifying the estimation of incremental costs (a topic separately addressed at this Council meeting), otherwise streamlining the project cycle, and communicating GEF procedures and requirements more effectively. The use of financial intermediaries, financial institutions, and private equity funds in appropriate projects also offers at least a partial solution.

Maintaining Commercial Confidentiality

16. Some GEF projects—particularly in the climate focal-area—relate to cutting-edge technology, business strategy, and regional or countrywide marketing plans. In such cases, businesses were fearful that procurement rules would require them to disclose valuable information without any assurance of a contract, according to World Bank-

sponsored interviews. To date, experience with GEF projects (and other non-GEF projects in the Implementing Agencies) suggests that this concern may be more a matter of perception than reality and at most an exceptional occurrence to be addressed as needs arise. Nonetheless, insofar as this view is widely shared, it is important to address it within the context of efforts to increase business awareness and understanding of GEF work.

MODALITIES

17. The GEF will work with the Implementing Agencies to further encourage a diverse range of projects with the private sector consistent with the modalities outlined below. Practical experience in a range of activities will better enable GEF to understand how the private sector operates, what special challenges it presents to the GEF, and what modifications to existing modalities may be necessary. New modalities may be required to address specific opportunities or challenges, following Council review and approval.

18. Initially, GEF's emphasis should be on building better awareness and understanding with the private sector. The key point is that, with focused outreach and communication, the various modalities offer a range of terms on which to steadily build understanding and experience. Four specific modalities have been identified to help increase the range and number of successful private sector experiences in the GEF.

- (a) The first is to continue to stimulate private sector involvement indirectly, through activities that *remove barriers* to the creation of, entry to, or transformation of markets that support global environmental objectives (e.g., markets for renewable energy or energy efficient equipment). Many of the projects GEF is currently supporting with the private sector use this modality.
- (b) The second is to pursue a range of *non-grant financing modalities*. GEF has on occasion involved commercial financial institutions and intermediaries through the IFC to create investment funds that enable fast pragmatic decision making within the policies of the GEF. Additional financing modalities have been identified in a joint study with the World Bank (and explained briefly in the annex) that extend and leverage GEF's resources through concessional and contingent finance, loans, and guarantees.
- (c) The third is to concentrate on the front end of investment (namely, *alternative bankable feasibility studies*), leaving the private sector to respond to the financial incentives that those studies reveal.
- (d) The fourth is to engage private entities in a longer term *partnership*, where information is continuously shared so that individual decisions can be made progressively and expeditiously.

19. Each of these modalities needs to be tailored to the operational principles of the GEF, thus ensuring that country-drivenness, incrementality, conformity with an operational program, and cost effectiveness are maintained in the process.

20. Projects developed and implemented by private enterprises must nonetheless be not only market-driven but also consistent with national plans and priorities and endorsed by

national focal points. To show incrementality, projects also must demonstrate that GEF resources are not substituting for development finance or private investment. Additional issues may arise with respect to the need to demonstrate cost-effectiveness and fit with operational programs.

Barrier Removal

21. Institutional, economic and social obstacles are among the many barriers to the protection of biodiversity, mitigation of climate change, and protection of international waters. A strategic thrust of GEF programs has been to remove barriers to large-scale application, implementation, and dissemination of cost-effective approaches with global environmental benefits. By systematically removing barriers to market-oriented transactions, the foundation can be laid for increased public and private sector investments.[7]

22. To identify such barriers, the private sector could be more effectively engaged to address the difficulties they perceive to creating or entering particular markets. Such activities require the involvement of private actors most familiar with these problems for successful results.

23. The nature of barrier removal activities is highly diverse and varies with national circumstances and resources. Capacity building issues are common, such as the need for relevant standards and sufficient trained personnel to assure quality products. Information on locally available resources may not be sufficiently detailed to meet investor needs. The absence of rural credit systems is frequently an obstacle to the provision of commercial credit to cost-effective clean energy services. Sometimes technical assistance is necessary to support policy reforms that may include eliminating import duties and restructuring tariffs. Demonstrations may be needed to reduce local uncertainty about performance claims.

Conformity with GEF Criteria

24. Barrier removal has been a frequent basis for GEF projects, and such projects have shown that they can respond to Operational Strategy requirements. The recognition of barriers preventing use of cost-effective climate mitigation technologies is the basis for Operational Programs 5 and 6. Most often government ministries have been executing agencies, and projects appear to be country-driven and consistent with national development priorities. They further seek in different ways to support internationally agreed programs of action for sustainable development; transfer technology that is environmentally sound and adapted to suit local conditions; provide replicable models of wide application; strive to leverage other funds; and protect the global environment.

Non-Grant Financing Modalities

25. A potential role for non-grant financing is recognized in the GEF Instrument and Operational Strategy and has been incorporated to a limited extent in several GEF

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[7] See Operational Strategy, p. 6.

projects beginning in the pilot phase.[8] Non-grant modalities are most appropriate where projects are potentially economic but where there may be a lack of local experience, uncertain performance, regulatory uncertainties, or other such impediment. One particular form of contingent financing, alternative feasibility studies, is discussed later.

26. There is a wide range of non-grant financing modalities including contingent finance, concessional and contingent loans, and partial credit guarantees. These modalities increase the cost-effectiveness of GEF resources by reducing initial outlays, creating a potential for repayment, or allowing for a return on investment. A brief description of each of these approaches is provided in the Annex.

27. Contingent financing is conceptually attractive when there is substantial uncertainty about the existence and extent of incremental costs, characteristics not unusual in GEF projects. This is frequently true in short-term climate projects, which must show incremental costs below $10/metric ton C. Instead of committing to a grant which may subsequently prove to have been unnecessary, contingent financing recognizes the potential need for support but draws on GEF resources only when justified later, on the basis of actual rather than projected costs.

28. The International Finance Corporation, and to a lesser extent the World Bank, have accumulated experience in the use of these modalities. Contingent finance should be carefully focused on the tasks specific to GEF action to avoid underwriting other unrelated project or commercial risks. In an effort to better understand their application to GEF projects, the GEF together with the World Bank recently completed the first phase of a study *The Use of Non-Grant Mechanisms as an Incremental Cost – Financing Modality in GEF Sponsored World Bank Projects* (copies available on request from the Secretariat). Some of the lessons to be learned from these experiences include:

(a) Grant and non-grant mechanisms should be available as part of a menu of instruments to address specific barriers to project development;
(b) Effective and independently verifiable performance monitoring arrangements are essential to assure that GEF support is incremental; and
(c) Executing agencies must have strong capabilities for managing financial flows.

29. To avoid inducing project failure to "collect" a grant, contingent loans and contingent grants must be carefully structured to include risk sharing arrangements. Project sponsors should cover conventional commercial and other baseline costs while the GEF concentrates on incremental costs of achieving global environmental benefits.

Conformity with GEF Criteria

30. Contingent financing can reflect national priorities and be country-driven. It can also be very cost-effective relative to grants. However, it can also raise some GEF issues.

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[8] Important precedents for the contingent financing approach exist in the IFC Hungary Energy Efficiency Co-Financing Program (HEECP), the IFC Small and Medium Enterprise Program (SME), and the World Bank Thailand Chiller Replacement Program.

The first issue is country-drivenness, an issue that has been raised with respect to several IFC funds presented as global projects. The rationale is to allow the flexibility to pursue promising investment opportunities wherever identified. In these projects, the existence of local investors willing to share defined risks (along with the focal point endorsement) is asserted to be, *per se*, sufficient evidence of country-drivenness. GEF will undertake a review of the investment funds and conformance with GEF criteria in the near future.

31. Another issue is the determination of incremental costs, which will not be precisely established until after project performance. As presented to Council, a typical project will incorporate a range of expected outcomes. Contingent financing (up to a declared maximum) would cover potential losses, but no funds would be required in the event a project is successful.

Alternative Bankable Feasibility Studies

32. Project developers cite many instances in which alternatives to conventional practice are available that provide global environmental benefits for comparable or even lower costs. However, costs and benefits frequently have not been established locally, and neither private investors nor host country governments may have the incentive or financial resources to explore the feasibility of alternatives.

33. A possible solution is to provide the resources necessary to explore an alternative course of action that meets GEF eligibility criteria, on the condition that the project sponsors agree to proceed with the environmentally superior option based on adequate evidence of feasibility. If successful, the output of the GEF project is a bankable study that project proponents could take to private sector financiers and other development agencies for funding. A conservative approach would divide the study costs between GEF and a private sector partners with some repayment to GEF (either partial or full) if the project goes ahead. Based on experiences elsewhere, notably the Organization of American States, $100 million in bankable studies over 30 years identified $4 billion in investments to protect the environment, from which $2 billion worth of projects were implemented.

34. Medium-Sized Grants could be applied to this approach. A clear definition of what constitutes a “Bankable Feasibility Study,” terms of reference, scope of work, and suitable models would have to be provided.

Conformity with GEF Criteria

35. In contrast with contingent financing, this modality would have clear initial costs. Such financing could be viewed as a specific form of barrier removal, where elimination of an identified information barrier (a detailed economic and engineering analysis) results in substantial private investment. This approach also has large potential for both replication and reduction in greenhouse gas emissions. The end result would be equivalent to a demonstration project but at a very low cost to the GEF. Cost-effectiveness and global environmental benefits would be conditional on projects going forward, a risk to be evaluated by the Implementing Agency.

Progressive Partnerships

36. Progressive partnerships with the private sector focused on global environmental issues could be a powerful catalyst for action. "Progressive Partnerships" mean direct collaboration between GEF and a company or business association to achieve an identified global environmental benefit, with sharing of risks and project costs. These projects also offer an opportunity to involve non-governmental organizations in creative, non-traditional roles.

37. An example from the GEF project portfolio is the Papua New Guinea Biosphere Reserve in the Ramu River Catchment Area, listed among the 200 most important eco-regions in the world by the World Wildlife Fund. The project, currently being prepared with PDF funding, aims to create a commercial-scale demonstration of innovative approaches to resource management based on a model partnership between The Nature Conservancy and a local private sector partner. Dissemination of lessons and best practices are integral to the project.

38. Another example in preparation for the GEF International Waters Portfolio is the PDF - B: Marine Electronic Highway. The project will support a marine navigation system to minimize accidents and protect environmentally sensitive areas in the Malacca Straits region between Indonesia, Malaysia, and Singapore. The project was originally identified by the three countries as part of a Pilot Phase GEF project for the East Asian Seas. With direction from the IFC, World Bank, and International Maritime Organization, follow-up is being provided by a Canadian entrepreneur with a venture capital partner. The concept has the potential to serve as a model for protecting the marine environment and incorporates a user pay financing mechanism for environmental protection and management.

39. Because of the site-specific, complex character of these projects, progressive partnerships (like other proposed strategic partnerships) may require additional time and resources to operationalize. Over the longer term, this modality may enable the GEF to leverage its limited resources and replicate results more cost effectively and in a shorter time.

Conformity with GEF Criteria

40. As in the case of other privately initiated projects, progressive partnerships may be subject to questions about country-drivenness. Incremental costs may be a negotiated outcome based largely on the GEF contribution necessary to bring about investments or other actions by private sector partners. Such projects may be very cost effective due to the potential for associated financing.

ANNEX

ALTERNATIVE FINANCING MECHANISMS

1. The use of alternative means to finance GEF projects (such as contingent grants, concessional and contingent loans, and partial credit guarantees) is a promising approach to engaging the private sector and furthering GEF's programmatic goals in all focal areas. These alternative mechanisms appear to be broadly consistent with GEF guidelines for support outlined in operational programs and related policy papers, most importantly the one on incremental costs. GEF has had some experience with non-grant mechanisms through the World Bank and IFC.

2. The most promising options appear to be partial loan guarantees and contingent and concessional loans. Loan guarantees and concessional loans can be tailored to specific project characteristics; monitoring and performance requirements for both instruments are similar. Contingent grants, which become loans if a project proves successful, may be useful particularly at early stages of project development requiring smaller, incremental funds.

CONTINGENT GRANTS/CONTINGENT PERFORMANCE GRANTS

3. A grant by definition does not have to be repaid by the grantee. The grant reduces net costs to the project or sponsor and brings the overall cost of the project closer to the costs of competing conventional projects. Grants of this nature have been used widely in World Bank projects and as a component to IFC-administered GEF funds.

Contingent Grant

4. Unlike a conventional grant, contingent grant is that a contingent grant is repaid to the GEF if the project is successfully financed. The project proponent views the grant as a short-term, unsecured loan that is included in total project costs. If the project is unsuccessful, the GEF funds paid out become a grant.

Performance Grant

5. This type of grant is provided on the basis of completion or satisfaction of certain milestones. A contingent grant and a performance grant could be combined so that a project sponsor receives funds upon completion of certain milestones (performance) and funds could be forgiven if the project is not successful (contingent).

CONTINGENT OR CONCESSIONAL LOAN

6. A contingent loan differs from a contingent grant in that a loan is treated as debt and therefore has a higher repayment priority than the converted grant. A grant is treated as project equity or an asset unless another arrangement is negotiated. A contingent loan is repaid on a similar schedule and with similar interest to other loans. Similar to the contingent grant, it could be forgiven if the project fails.

7. A concessional loan refers to GEF's ability to provide loans at below-market rates. The availability of the concessional loan could be contingent upon participation of other commercial lenders to achieve co-financing and leveraging of non-GEF funds. Contingent or concessional loans would likely supplement (and probably be subordinate to) other project debt.

PARTIAL CREDIT GUARANTEES

8. Partial credit guarantees are used to extend the maturity of commercial loans for projects and provide sponsors with improved cash flow during project life. They do not address risks that jeopardize cash flow, but rather provide an overall enhancement to the project's economics by covering general credit risk during a particular phase of the project. Partial guarantees have been used in the WB/IFC's Hungary Energy Efficient Cofinancing Program and can be tailored to project needs similar to existing World Bank guarantees.

INVESTMENT FUNDS

9. Investment funds are for-profit, private sector, environmental funds that receive grant and/or non-grant funding from GEF. The objective is to provide commercial or quasi-commercial financing to subprojects through a fund manager, with a possible financial return on capital. Investment funds leverage GEF financing to establish a larger pool of commercial capital to invest in eligible projects, utilizing debt or equity instruments as appropriate.

RESERVE FUNDS

10. The concept of a reserve fund is a method of leveraging GEF capital by allowing lending institutions access to a pool of reserves (or bank capital). For example, a GEF grant to a bank for $8 million could increase lending for renewable energy or energy efficiency to $100 million. Depending upon their capital adequacy ratios, these lenders can provide additional credit at some multiple of GEF support (U.S. commercial banks usually have ratios of 8 percent, which means for every $100 lent, they must maintain $8 in capital coverage).

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