



The Southern Africa  
Climate Finance Partnership

# DESIGNING CLIMATE FINANCE SOLUTIONS IN A SHIFTING INVESTMENT LANDSCAPE

A toolbox for innovative practitioners

Week 3: Enabling conditions for  
climate finance

# **Week 2: Enabling climate finance through policy development and appropriate financial structures**

## **Learning Objectives**

- Enabling policies to enhance climate finance mobilization: An overview of enabling policy frameworks and strategies that can be implemented by public sector actors to increase climate finance mobilization efforts. Focus will be placed on policies, institutions and frameworks that can be implemented to reduce greenwashing and other irregular practices related to climate finance.
- Climate Finance Structuring within Project Development: This part will introduce financial structuring techniques to ensure that project concepts are considerate of investment criteria that make projects bankable and attractive to investors and donors beyond grant and loan financing support. The topic will also focus on blended finance approaches, private-public partnerships, and climate markets.

# Methods of Financing Capex

- Traditional Financing or Balance Sheet Financing
- Project Financing or Off-balance Sheet Financing



# Traditional vs. Project Financing

- Traditional financing: financing of capital spend is undertaken through retained earnings and profits and long-term debt issued by lenders. The lenders will evaluate the lenders' entire portfolio to understand their ability to service their debt.
- Project financing: Raising of funds to finance an economically separable capital investment project in which the providers of funds look primarily at the cash flows generated from the project to understand a.) how debt will be serviced and (b.) and the possible returns generated. Investments mostly structured in SPVs.

# Project Appraisal Process

- Promotor Evaluation
- Contractual Framework
- Commercial Assessment
- Financing Feasibility Assessment

## Project Cycle Stages

- Development
  - Construction
  - Operational
  - Termination/Closure
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# Characteristics of Project Financing

- a) Complex contractual arrangements
- b) Limited or non-recourse financing
- c) Risk management strategies and techniques
- d) Changing perceptions, new innovations



# Financing Choices

- a) Portfolio Theory
- b) Options Theory
- c) Equity vs. Debt
- d) Type of Debt
- e) Sequencing



# Financing Choice: Portfolio Theory

- Combined cash flow variance (of project and sponsor) with joint financing increases with:
  - Relative size of the project.
  - Project risk.
  - Positive Cash flow correlation between sponsor and project.
- Firm value decreases due to cost of financial distress which increases with combined variance.
- Project finance is preferred when joint financing (corporate finance) results in increased combined variance.
- Corporate finance is preferred when it results in lower combined variance due to diversification (co-insurance).

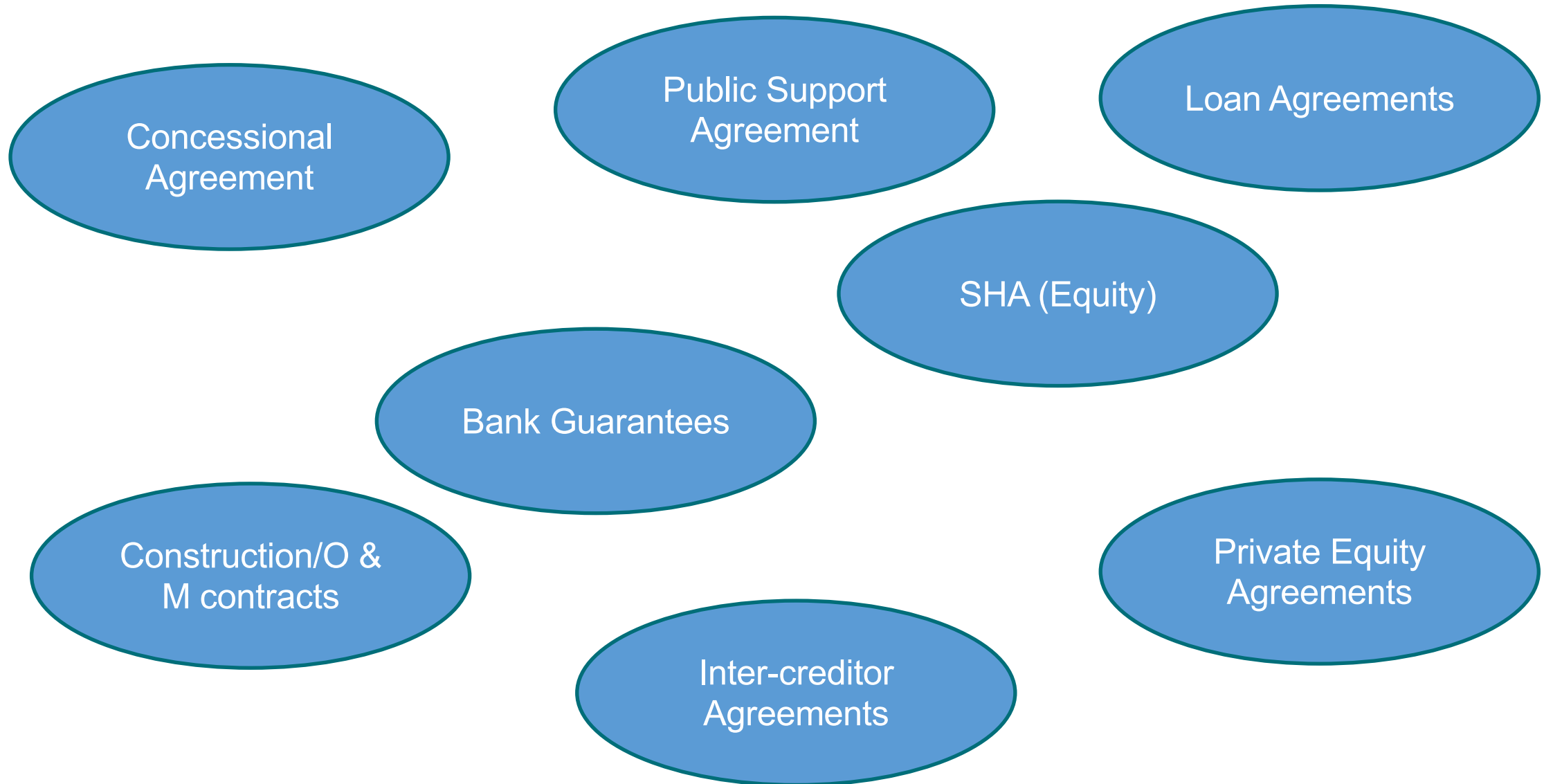
# Why is there a need for more sophisticated financial structures?

- There is simply an inadequate amount of budgetary assistance.
  - Financial sustainability has been prioritized; therefore, there is a need to look beyond grant financing.
  - Improvement of levels of service to users (expansion).
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# Optimization of the Financial Sources and Blended Finance

|                   | Percentage of Project Cost | Costs/Tenor                     |
|-------------------|----------------------------|---------------------------------|
| Grants            | 0 – 20%                    | Nil                             |
| Equity            | 15 – 30%                   | 14 – 20%                        |
| Sub-ordinate Debt | 0 – 20%                    | Maturity 7 – 15 years, 12 – 15% |
| Senior Debt       | 50 – 80%                   | Maturity 5 – 12 years, 11 – 13% |

# Landscape of Project Financing Structures



# Financing Choice: Type of Debt

- Bank Loans:
  - Cheaper to issue.
  - Tighter covenants and better monitoring.
  - Easier to restructure during distress.
  - Lower duration forces managers to disgorge cash early.
- Project Bonds:
  - Lower interest rates (given good credit rating).
  - Less covenants and more flexibility for future growth.
- Agency Loans:
  - Reduce expropriation risk.
  - Validate social aspects of the project.
- Insider debt:
  - Reduce information asymmetry for future capital providers.

# Financing Choice: Equity vs. Debt

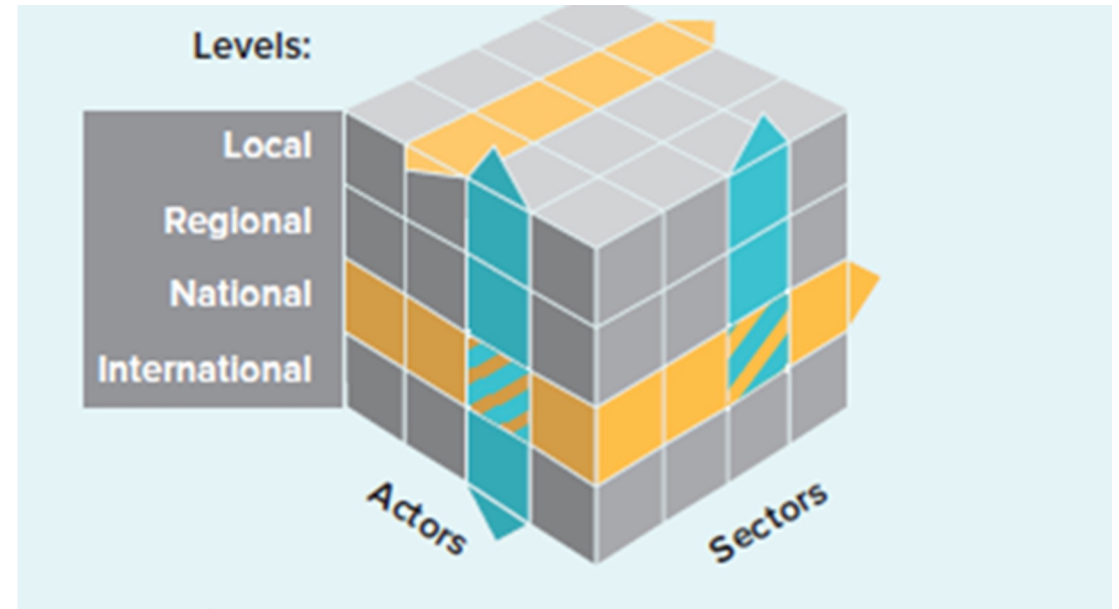
- Reasons for high debt:
  - Agency costs of equity (managerial discretion, expropriation, etc.) are high.
  - Agency costs of debt (debt overhang, risk shifting) are low due to less investment opportunities.
  - Debt provides a governance mechanism.

# Financing Choice: Sequencing

- Starting with equity: eliminate risk shifting, debt overhang and probability of distress (creditors' requirement).
- Add insider debt (Quasi equity) before debt: reduces cost of information asymmetry.
- Large chunks vs. incremental debt: lower overall transaction costs. May result in negative arbitrage.

# Climate Finance Diplomacy

- Climate diplomacy focuses specifically on national interests and international cooperation on climate issues to find common ground, and build trust and long-term relationships (Mabey et al., 2013).
- Climate diplomacy requires multi-level governance, which refers to the interactions between different levels of governments, non-state actors and sectors in governing climate issues.
- Climate governance related to climate finance would include non-state actors (stakeholders from the financial sector, such as commercial banks and institutional investors – pension funds, sovereign wealth funds and insurance funds), national climate funds, development finance institutions and guarantee facilities.



*Source: Jänicke (2013), Petrie et al. (2019)*

# Core Principles of Climate Diplomacy

- Know yourself: To negotiate successfully, a city needs to be able to understand climate finance and its impact on local government's interests. This includes understanding local government's political interests, as well as the economic, legal, policy and financial constraints that affect its negotiating position.
- Know the other: To be able to adjust its negotiating position, a city must understand the interests, motivations, constraints and capacities of the other actors. This will enable it to be adaptable in achieving its objectives and priorities, and to exert strategic influence on other stakeholders to attain positive outcomes.
- Capacity to influence: The ability to influence positions depends on the capability of cities to integrate their priorities into diplomatic processes. The starting point for having a clear influencing strategy is understanding

# Demand side policies

|                                                        |                                                                                                                          |
|--------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------|
| Economic Instruments - Taxes                           | Resource Production Tax<br>Resource Export Taxes<br>Taxes on fossil fuel capital                                         |
| Economic instruments - subsidies                       | Removal of fossil fuel producer subsidies                                                                                |
| Economic instruments - tradable allowances and credits | Cap-and-trade for production rights<br>Offsets for leaving assets in ground                                              |
| Regulatory Approaches                                  | Prohibiting development of certain resources or use of certain technologies<br>Limiting production or export (via quota) |
| Government provision of goods and                      | Restricted leasing of state-owned                                                                                        |

# Supply side policies

|                                                        |                                                                                                             |
|--------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|
| Economic Instruments - Taxes                           | Carbon or fuel use taxes<br>Border carbon price adjustments                                                 |
| Economic instruments - subsidies                       | Removal of fossil fuel consumer subsidies                                                                   |
| Economic instruments - tradable allowances and credits | Cap-and-trade for consumption rights                                                                        |
| Regulatory Approaches                                  | Coal Plant Emission Standards<br>Building Codes                                                             |
| Government provision of goods and services             | Infrastructure expansion (district heating / cooling; electric vehicle charging station; wind transmission) |

# Group exercise

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**Group Exercise:** Identify possible financial sources (public and private) that could be mobilized to finance the project? What enabling policies could be used to enhance climate finance mobilization for the project? Why?

Other Key Questions:

- a.) Are returns for the project significant to attract the private sector?
- b.) How can the project go beyond once-off grant financing?
- c.) How does the project deliver on other outcomes such as gender, social and economic upliftment.



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