Mitigation Action Facility

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Financial Mechanisms – Applications under the Mitigation Action Facility

Financial mechanisms represent an important topic for the Mitigation Action Facility as they are at the core of its funding. This lessons learnt factsheet provides an analysis of the financing mechanisms that have been proposed to the Mitigation Action Facility so far. It may also serve as an orientation for future applicants.

Why are financial mechanisms so important?

The Mitigation Action Facility was designed to finance the implementation of mitigation actions, building blocks for Nationally Determined Contributions (NDCs) under the Paris Agreement. Initially, the underlying assumption was that a sufficient number of "implementation-ready" projects were already out there, awaiting funding for their ambitious goals. A crucial evaluation criterion for projects is their transformational change potential. Both implementation readiness and transformational change potential heavily rely on the implementation of viable financing mechanisms.

The Mitigation Action Facility interprets implementation readiness and transformational change potential, which projects should exhibit, (see "General Information Document" and "Monitoring and Evaluation Framework") as the following: Implementation readiness signifies that a project is at an advanced stage of development, is feasible and ready for implementation. While a fully defined financial mechanism at the Project Outline stage is not expected, it should be detailed enough to ensure that it can be finalised during the Detailed Project Preparation (DPP) phase. Certain projects characteristically lack "implementation readiness" as requested by the Mitigation Action Facility, e.g.:

- Research activities
- Technological pilots. It is expected that the viability of a technology has been proven already. Ideally, the pilot should not only concern technical feasibility but also the business model as a basis for funding
- Project Outlines proposing the development of financial mechanisms and a business model only during the implementation of the project.

Transformational change potential is crucial for projects. The Mitigation Action Facility has developed a set of sub-criteria such as embeddedness in national/sector policies and wider mitigation actions, catalytic effect, scalability, replicability and sustainability. This requires projects to sustainably steer the flow of public and private funds towards greenhouse gas (GHG) mitigation actions. The political will and decisions taken towards GHG mitigation translates into laws and regulations, as well as into the reallocation of financial streams. In which areas or activities do such public and private funds (e.g., subsidies) flow? The financing mechanisms of a project should kick start this broader reversal of fund flows. Therefore, a financing mechanism is not a secondary feature; rather, it is at the very core of the project rationale.

Financial Mechanisms of Approved Projects

In many cases, the description of the proposed financing mechanisms received in previous Calls has required further development during DPP, and in some cases, adjustment during the Implementation Phase. Financial mechanisms can include the following approaches or tools:

1. Concessional loans and loan guarantees for financial intermediaries
2. Small-scale direct investment subsidies / grants to private sector investors
3. Grant funding of public infrastructure
4. Result-based financing for private sector.

The findings so far are:

- Most projects foresee a combination of at least two financing mechanisms targeting different levels of the financial system. Often, the combination involves (1) concessional loans for users/consumers by setting up a revolving fund and (2) grant funding elements either for the public sector or producers/ developers/ consumers or (3) loan guarantees for financial intermediaries.
- Some projects integrate results-based financing, albeit on a grant basis, which limits the scalability of the Mitigation Action Facility funding; however, this type of financing mostly supports changes of systems that aim to increase the projects' impact over time.
- The financial support mechanisms to be applied cover only a small part of the existing range of financing mechanisms (an overview of potential financial mechanisms is provided in the table below)
- Details regarding the financial support mechanisms are not fully defined at the Project Outline stage. The same applies to business models/cases that would serve as a basis for the selection of a suitable financial mechanism in climate finance. The table below provides an overview of the myriad of potential financial mechanisms for both the public and private sector that could be used in projects. The table illustrates that, especially with respect to public sector funding, there is a great diversity of options in addition to grant financing.

What type of detail is expected at the Project Outline stage?

Implementation readiness of the financial mechanism is closely linked to the:

- analysis/provision of business models for the typical investment(s);
- reasoning for the selection and description of a particular mechanism;
- institutional arrangements; and
- a reasonable phase-out concept.

Business models for typical investments are important because they can determine if a project has a chance for economic success and sustainability. They can provide a foundation for the design and selection of a financial mechanism. The key question is how an appropriate or balanced incentive can be provided so that beneficiaries will take up the offer. At the same time, the incentive ought to be used efficiently without creating market distortions. Making a decision on the appropriate financing mechanism requires the proper identification of any financial/ economic determinants of a particular investment, e.g. the life span and the pay-back period under market conditions and the cost of alternatives. Therefore, a sound analysis of the business model is crucial to setting up financial mechanisms.

Financing Instruments of the Mitigation Action Facility

Public sector sourcing instruments	Public sector operational instruments	Private sector financing instruments
Environmental fiscal return	Grants	Equity
Loans	Purchase contracts for goods	First-loss (mezzanine, junior debt)
Bonds	Purchase contracts for services	Loans
Dedicated credit lines	Additional payments (e.g. premium price)	Bonds
Risk cover guarantees	Regulation (e.g. feed in tariff, quotas)	Risk cover guarantees
Grants	Public procurement guidelines	Project finance
	Tax credits, reductions/exemptions	Grants
	Variable or accelerated depreciations	
	Removing subsidies	
	Loan schemes	
	Guarantee schemes	

Source: Soren E. Lütken: Financial engineering of climate investment in developing countries, Anthem Press 2014

The design of an appropriate **financing mechanism** should be based on a business model and on a brief analysis of the specific financial market. Examples:

- The risk of investments for energy efficiency lies rather with the investor than with the financier (e.g. a bank). The risk for the financier (e.g a bank) only arises if the overall energy efficiency investment puts the economic/financial stability of the investor at risk. In this case, it would be more reasonable to cover the investor's risk, e.g. through an insurance scheme, in order to allow for the investment in technologies with uncertain results;
- A subsidised interest rate for certain investments could employ various possible instruments, such as straight interest subsidies or guarantee schemes. A tax exemption or a subsidy on specific tariffs is possible, as well.

It is important to justify the selection of the financing mechanisms on the basis of the business model and the respective market conditions. In addition, financing mechanisms should be selected in a way that will maximise the use of the grant element by generating high leverage rates.

Institutional arrangements of financing mechanisms are important in terms of national embeddedness, reach and accessibility. The responsible entity/entities shall apply fair, transparent and effective selection criteria for beneficiaries and/or intermediaries, as well as fiduciary operations, good governance and an efficient and transparent fund management. Transaction costs must be taken into account for efficiency and sustainability reasons. During Implementation Phase, all institutional arrangements shall be put in place for the successful implementation of the financial mechanism(s).

Phase-out concept: projects have a lifetime of up to 60 months (or an equivalent of 5.5 years). It must be clearly depicted how the sustainability, scaling up and replication of the financing mechanisms will be secured. At the end of the life span of the project, depending on the financial mechanism, there might be funds left (e.g. in a revolving fund). Therefore, the institution handling the funds should ensure that it will further serve its purpose and thereby upscale the results. There should also be an estimate of how much longer the funds will be available (e.g., in the case of a guarantee or first-loss fund), how the default risk will be estimated, and how much of the initial fund will be left at the end of the project. Ownership and oversight on the funds and their utilisation after the project should also be depicted. Risk will be estimated and how much of the initial fund will be left at the end of the project. Sustainability of the financial mechanism remains a key issue to reach the transformative effect expected by the Mitigation Action Facility.

Recommendations

A future task for all technical and advisory organisations involved in project preparation is to consider and integrate financing schemes right from the beginning of the project's development. It is also recommended that mitigation action readiness programmes integrate the financing sector from the very beginning of project preparation. Financing mechanisms shall be designed in such a way as to maximise the use of the Mitigation Action Facility's grant funds by creating a high leverage of funds, being based on realistic and sustainable business models and avoiding the creation of market distortions. Countries, advisory organisations, and project partners are encouraged to be innovative and creative in designing adequate financial mechanisms for projects.

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