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Accelerating Private Sector Climate Finance in Africa

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Recommendations

- The development of a supportive and enabling regulatory and policy environment is crucial to attract private climate finance.
- Governments should develop NDC implementation plans and related engagement strategies for targeted investors.
- Governments and development finance institutions should provide credit enhancement mechanisms to the private sector.
- Capacity building, support and technical grant-based funding should be provided to borrowers to facilitate projects to the bankability stage, support impact reporting and identify SDG interlinkages.
- National governments should foster and galvanise funding for a bankable pipeline of infrastructure projects.
- Various actions are required to support private sector investment in adaptation, including blended finance, fiscal incentives and green bonds.

African perspectives
Global insights

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Executive summary

Considerable volumes of finance, from both the private and the public sector, are necessary to meet the anticipated mitigation and adaptation needs of Africa. In this policy briefing we highlight the importance of a supportive and enabling regulatory and policy environment in attracting enhanced private sector climate finance. While this is a priority relevant to private sector investment generally, it has particular resonance in relation to climate finance, where predictability, acceptable risk profiles and adequate financial returns are crucial for large-scale adaptation and mitigation investments. These can be supported by Nationally Determined Contribution (NDC) implementation plans and related engagement strategies for targeted investors. Increased access to credit enhancement mechanisms by providers of concessional finance will further accelerate private sector investment. Borrowers can make climate projects more attractive by brinzging their projects to the bankability stage, by identifying how their project will achieve the Sustainable Development Goals (SDGs), and through impact reporting. Capacity building, support and finance to borrowers to ready their projects in this way are imperative. We identify a number of measures that may help to bolster adaptation private finance, acknowledging that the nature of these projects will typically require some level of catalytic public finance support.

Introduction

In the lead-up to the UN Framework Convention on Climate Change's (UNFCCC) 26th Conference of the Parties (COP26), considerable attention is being paid to the need for scaled-up and enhanced climate finance, both public and private. The negotiation agenda has a dedicated section on enhancing private finance and establishing a taskforce on access to climate finance. Estimates suggest that Africa needs $7–15 billion annually in order to adapt to the impacts of climate change,[1] and that African NDCs will require approximately $3 trillion of investment by 2030 for their implementation.[2] At present, however, the region only receives about 3% of global financial flows.[3] High debt levels also plague a number of African countries – a situation that has been worsened by the COVID-19 pandemic. This means that most countries lack the necessary fiscal space to invest adequately in climate mitigation and adaptation.[4]

1 African Development Bank (AfDB), "Opening Speech by Dr Akinwumi Adesina, President, African Development Bank Group, at the Launch of Global Center for Adaptation – Africa", September 16, 2020.

2 AfDB, *Gap Analysis Report: African Nationally Determined Contributions (NDCs)* (Abidjan: AfDB, 2018).

3 AfDB, *Gap Analysis Report*.

4 International Monetary Fund, "What Financial Choices for Africa in the Face of Climate Change?: Remarks by Tao Zhang, Deputy Managing Director, IMF", July 1, 2021.

In the context of the failure by developed countries to meet their Paris Agreement climate finance targets to date,[5] and amid rocketing estimates of anticipated climate finance needs, national governments and development finance institutions (DFIs) are looking to the private sector to augment supply. For example, a recent report by the African Development Bank (AfDB) argues that 75% of the $3 trillion needed for NDC implementation should come from the private sector.[6] Surveys by the AfDB, however, suggest that relatively little private sector investment has been mobilised to date within African countries, with the degree of private sector investment in NDC implementation thought to be small.[7]

The COP26 presidency has also set its sights on the potential role of the private finance sector to 'unleash the trillions of private climate finance' needed to propel the globe to net-zero by 2050.[8] To this end, the COP26 presidency is championing the mainstreaming of climate considerations into private investment decision-making; improved corporate transparency around the risks and opportunities presented by climate change to their businesses; strengthened financial systems through the actions of central banks and regulators; and greater commitments by companies and lenders to align lending and investments with net zero.[9] These important actions will certainly spur the reform of the private sector to both be more climate resilient and contribute to a net-zero future. However, considered attention needs to be paid to the barriers to and enablers of climate finance in order to unlock the magnitude of finance that is required. In this policy briefing we explore how these barriers can be addressed to ensure enhanced private sector finance investment in Africa.

Barriers to finance

There are numerous barriers to increased private finance investment in Africa, including:

- political and/or regulatory risk, which arises as a result of insecure property rights regimes, fragile or unstable policy environments and/or legal systems, and volatile foreign exchange rates;[10]
- project risks, including capital expenditure and operational expenditure estimates, high up-front costs, revenue volitivity, and technology and resource risks;[11] and
- economic and financial risks, including fossil fuel subsidies that skew the relative cost

5 Organisation for Economic Co-operation and Development, *Climate Finance Provided and Mobilised by Developed Countries in 2013-18*, Report (Paris: OECD, 2020). According to this report, the target of $100 billion was not met between 2016 and 2018. It is estimated that the actual amounts were $58.6 billion in 2016; $71.2 billion in 2017; and $78.9 billion in 2018.

6 AfDB, "NDC Implementation in Africa Through Green Investments by Private Sector: A Scoping Study" (AfDB, Abidjan, 2021).

7 AfDB, "NDC Implementation in Africa".

8 See the climate finance priorities listed on the COP26 Presidency's website: https://ukcop26.org/cop26-goals/finance/.

9 COP26 Presidency, "Building a Private Finance System for Net Zero: Priorities for Private Finance for COP26", 2021.

10 AfDB, *Gap Analysis Report*.

11 AfDB, *Gap Analysis Report*.

benefit of low-carbon projects, weak creditworthiness of countries and cities,[12] high interest rates, inflation and a lack of hard currency.[13]

In addition to these general investment barriers, there are a number of climate-specific barriers related to private finance investment. For example, there is often poor understanding of the financial incentive to invest in adaptation projects.[14] Similarly, the cost-saving nature of adaptation projects is perceived to go against the motivation for revenue creation typical of private sector investment.[15] There is also little awareness of climate investment opportunities, particularly regarding adaptation opportunities.[16] In a recent review of private sector investment by the AfDB, it was highlighted that there is insufficient training in developing bankable green projects in the private sector; limited knowledge within the private sector of climate finance opportunities and access mechanisms; and inadequate capacity and qualifications in small and medium-sized enterprises to attract and access green finance from the private (and public) sector.[17]

Enabling actions

Regulatory environment, political will and NDCs

Private sector investment will benefit from greater clarity and stability in the regulatory and policy regime.[18] This could be achieved through reforms that address private sector concerns around currency convertibility and availability, the nationalisation and expropriation of assets, and defined national development plans. Equally, the development of climate-related legislation, such as regulations concerning energy audit requirements, as well as feed-in tariffs, will promote private sector investment in this sector.[19] An example of this is South Africa's Renewable Energy Independent Power Producer Procurement Programme, where the leadership and regulatory reforms provided by the national government attracted private sector investment of ZAR 208 billion ($1.5 billion) over an eight-year period.[20] Such reforms, of necessity, require considerable political will to facilitate a whole-of-government approach that supports private sector climate investment.

Similarly, investment in activities included in NDCs could be enhanced through the creation of NDC implementation plans that identify the most appropriate investor profiles

12 AfDB, *Gap Analysis Report*.
13 AfDB, "NDC Implementation in Africa".
14 UN Environment Programme, The Adaptation Gap Report 2017 (Nairobi: UNEP, 2017). See also AfDB, "NDC Implementation in Africa".
15 AfDB, "NDC Implementation in Africa".
16 AfDB, "NDC Implementation in Africa".
17 AfDB, "NDC Implementation in Africa".
18 AfDB, "NDC Implementation in Africa".
19 AfDB, "NDC Implementation in Africa".
20 South African Department of Energy, *Independent Power Producers Procurement Programme: An Overview* (Pretoria: DoE, March 2018).

for different actions, together with a related engagement strategy for targeted investors.[21] These instruments should identify overlaps and synergies between development and climate finance, which fiscal instruments could be used for various activities,[22] and domestic resources and/or blended financing approaches.[23]

Credit enhancement as part of a blended finance approach

Private sector climate finance can be further accelerated through the provision of concessional finance in the form of credit enhancement mechanisms. These mechanisms, at their core, seek to 'crowd in' or catalyse private sector finance. This has the effect of accelerating private sector funding by reducing some of the risks associated with infrastructure-based projects, such as performance and credit risks, currency risks and technology risks. Credit enhancement mechanisms can be provided by entities that provide concessional finance (DFIs, governments, and multilateral and regional agencies) in the form of guarantees, tenure extension mechanisms, lower-than-market pricing and subordinated loans.

Actions by borrowers to attract private climate finance

One of the key challenges highlighted by funders (public and private alike) is the dearth of 'bankable' climate change projects, ie, projects with a clear business case that can attract financial investment. Demonstrating the bankability of a project requires more than just a technical report, but extends to a financial model and an environmental, social and governance (ESG) impact report. It also looks to the experience of the development team and details of the investors, in the case of a private sector project or public–private partnership. Enhanced provision of 'technical grant-based funding' by donor governments, DFIs and national ministries of finance to develop projects from the feasibility to the bankability stage will help to unlock private sector investment.

Attracting impact investors will also help support enhanced investment in climate finance projects. Borrowers can do so by demonstrating they have the ability to submit impact reports, which are a fundamental requirement of this category of investors.[24] Similarly, borrowers may increase the attractiveness of projects by highlighting how the project helps support various SDGs. The SDGs are the filters used by private sector impact investors and the sustainable finance sector. The ESG impacts of the project frame the reporting requirements that private sector funders will insist upon. Identification of the relevant SDGs

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21 African Ministerial Conference on the Environment, Seventeenth session, "Policy Implications and Financing Opportunities for the implementation of Nationally Determined Contributions in Africa: Role of African Policy Makers", part V, Durban, November 11–15, 2019.

22 For example, by identifying projects that will be supported by concessional funding, which can be used to catalyse private sector funding on a blended finance basis.

23 African Ministerial Conference on the Environment, "Policy Implications and Financing".

24 Private sector financiers, particularly impact investors, often require that project impacts be reported. This entails a determination of the baseline of impacts the project is anticipated to achieve, and then monitoring, evaluating and reporting on the impact during the project's lifetime. These are normally contractually committed to as part of the funding process.

to which a project contributes informs the ESG impacts that can be achieved, which in turn will attract greater investment from impact investors and the sustainable finance sector. Governments can further facilitate this by ensuring that public institutions embed the SDGs within mandates and operational policies.

Investment grades

The use of traditional debt capital market instruments to raise private climate finance is challenging, because lenders cannot benchmark against acceptable investment ratings. In addition, many private sector funders are limited by investment mandates when investing in formal debt markets. As a result, private sector financiers take more of a 'project finance' approach to funding climate change projects than would be the case for traditional infrastructure investments. This means that financiers seek unusually high and more direct access to the underlying project assets for the purposes of security, and to the cashflows derived from such assets through contracted off-take agreements as the means of repaying the finance provided. An advantage of this approach is that it can lead to a portfolio of projects being funded on a programmatic basis, which allows for risk diversification. It is particularly attractive to long-term institutional investors with mandates to generate positive, measurable social and environmental impacts through their investments.

Finance for infrastructure

Long-term private sector institutional investors prefer infrastructure as an investable asset class, given its long-term nature. To date, governments across Africa have prioritised infrastructure development and, consequently, it is more likely to receive the necessary support for any related regulatory and policy reform. Infrastructure also lends itself to a project finance approach, as infrastructure projects generate identifiable cash flows to provide return on investment. Equally, as discussed above, it attracts credit enhancement mechanisms, which catalyse private sector finance on a blended finance basis (combining concessional and private sector funding).[25] To this end, national governments need to foster and galvanise funding that supports the development of a bankable pipeline of infrastructure projects in their countries, which can then attract private sector investment.

Private finance for adaptation

To date there have been low levels of private finance in adaptation projects, typically resulting in their being financed through grant or concessional public finance.[26] This is despite the fact that the private sector stands to benefit from adaptation investments. For

25 Blended finance is a structuring approach that allows organisations with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact, or a blend of both). The main investment barriers for private investors addressed by blended finance are high perceived and real risk, and poor returns for the risk relative to comparable investments. Blended finance creates investable opportunities in developing countries that lead to more development impact.

26 AfDB, *Gap Analysis Report*.

instance, the Global Commission on Adaptation estimated that a $1.8 trillion investment in early warning systems, climate-resilient infrastructure, improved dryland agriculture, global mangrove protection and resilient water resources could generate $7.1 trillion in benefits for both the public and private sectors.[27] Of late a particular focus has been on the potential of nature-based solutions (NBS), which have a wide range of co-benefits.[28] The most recent Adaptation Gap Report suggests that the following will help to support NBS (as well as adaptation) investments more generally:[29]

- expanding and consolidating currently limited and scattered evidence on the effectiveness (including avoided costs) of NBS and the linkage of impacts to financial flows;
- communicating this more effectively to investors;
- tracking finance investments more effectively;
- blending different sources of finance (eg, public and private finance); and
- ensuring a supportive regulatory and structural environment through regulatory frameworks and fiscal incentives.

Notwithstanding this, such projects will typically need anchor investments by public financers to crowd in other forms of investment. This means that governments will need to be intentional about fostering measures to attract co-finance for adaptation investments, for example through green bonds and tax incentives.

Conclusion

Considerable volumes of finance from both the private and the public sector will be necessary to meet Africa's anticipated mitigation and adaptation needs. In this policy briefing we highlighted the importance of a supportive and enabling regulatory and policy environment to unleash private climate finance investment. Such enhanced investment can be supported by NDC implementation plans and related engagement strategies for targeted investors. Increased access to credit enhancement mechanisms by providers of concessional finance will further accelerate private sector investment. Borrowers can make climate projects more attractive by bringing their projects to bankability stage, by identifying how their project will achieve the SDGs, and through impact reporting. Capacity building, support and finance to borrowers to ready their projects in this way is imperative. Lastly, we identified a number of measures that may help to bolster private finance for adaptation, acknowledging that the nature of these projects will typically require some level of catalytic public finance support.

27 Global Commission on Adaptation, *Adapt Now: A Global Call for Leadership on Climate Resilience* (Rotterdam: GCA, 2019).
28 GCA, *Adapt Now: A Global Call*.
29 UNEP, *Adaptation Gap Report 2020* (Nairobi: UNEP, 2020).

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Cover image

In recent years, natural disasters – not conflict – have been the main driver of displacement in Somalia, a war-torn nation in the Horn of Africa that ranks among the world's most vulnerable to climate change. Fierce and frequent droughts and floods have uprooted more than three million Somalis since 2016, according to UNHCR data that tracks internal displacement by cause. The phenomenon is emptying parts of Somalia's rural interior and spawning huge camps on the outskirts of cities, as urban populations swell with desperate migrants seeking a new start (Eduardo Soteras/AFP via Getty Images)

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