EUROPEAN UNION ENERGY INITIATIVE

Policy Brief

# Challenges and Opportunities for Blended Finance in European Energy Development Cooperation

Meeting global ambition to deliver sustainable development and avert climate change related disaster requires a transformation of all aspects of the economy. It is estimated that meeting the 17 Sustainable Development Goals (SDGs) will require annual investments of USD 1.4 trillion.[i] Around USD 16.5 trillion over the next 15 years will be needed to limit the temperature increase to 2°C by 2100.[ii]

The bulk of this investment will come from private investors hoping to make commercial returns. Yet, many of the technologies, projects and countries in which investment must take place are not currently regarded as proven investment opportunities. How can the gap be bridged? How can such investment opportunities be sufficiently de-risked for private investors to dedicate their funds to this transformation?

Blended finance involves the combination of relatively small quantities of public concessionary finance and larger quantities of public and private finance. Often, such blending aims to reduce risks for specific investments and thereby leverage investments from other actors. As such, it has become a key mechanism to drive investment in the projects needed for sustainable development in developing countries.[iii]

## KEY FINDINGS

- ODA and public climate finance alone will not be sufficient to tackle climate change and sustainable development; public money will catalyse private investments, rather than act alone. This means an increasing role for blended finance in international development.
- Blended finance involves the combination of relatively small quantities of public concessionary finance and larger quantities of public and private finance. Often, this aims to reduce risks for specific investments with sustainable development benefits, thereby leveraging investments from others.
- The current scale of blended finance is unknown; estimates range from USD 81.1 billion mobilised between 2012 and 2015, to USD 51.2 billion mobilised towards the SDGs in general.
- Estimates also vary in terms of public finance effectively raising private investments, with ratios oscillating between 0.38 and 3.6.
- The increasing use of blended finance presents some risks that will need to be monitored and mitigated to ensure that blended finance delivers concrete sustainable development outcomes.
- Blending mechanisms will have to be diligently evaluated and audited as experience grows.

This brief reviews two complementary spheres of international cooperation, in which blended finance is predominantly used. First, in international climate finance, following the developed country pledge to mobilise USD 100 billion per year in public and private finance - starting in 2020 - and the recently published "road map" to meet this goal.[iv] Second, in official development assistance (ODA), and the related blended finance facilities within the European Union (EU) that provide funding to projects supporting the delivery of the UN Sustainable Development Goals. **To date, the climate finance sphere has led the way on blended finance**, acknowledging the critical role private investments need to play in tackling climate change. This experience will prove useful as blending expands as a part of ODA.

Public concessionary finance includes:

- **Technical support** – Support provided that can either replace services that would otherwise have to be paid for, thereby increasing the development cost of projects, or ensure projects meet sustainability requirements and are therefore suitable for further support.
- **Grants and seed funding** – Early stage funding reduces development costs, at the most risky stage of project development.
- **Project equity** – Equity shares that are structured to accept more of the project risk, for example through the use of "first loss" share classes.[v]
- **Concessionary loans and loan guarantees** – Direct provision of loans or of loan guarantees lowers the cost of capital and improves project economics.

Ultimately, all these instruments share the same goal, namely to improve project viability. Each of these instruments allows for the transfer of risk towards public financiers to varying extents, thereby providing conditions that encourage and enable private investments.

## The rationale and challenges for blended finance

Blended finance has become common practice in international cooperation. The idea that donors will "mobilise" funds - as opposed to provide them directly themselves - has gained currency. For example, the commitment of developed countries in the Paris Agreement to mobilise USD 100 billion per year by 2020 for climate action in developing countries[vi] is an implicit commitment to blend finance. The main rationale for the rise in blended finance as a whole is the realisation that the major challenges facing humanity today inevitably call for a transformation of the economy, and this must mobilise public and private actors alike. ODA and public climate finance are not considered nearly sufficient to respond to sustainable development challenges alone.[vii] There is, therefore, a need for coordinated action from public and private finance to meet the scale of the challenge, striving to maximise the impact and effectiveness of public resources. In this respect the rise of blended finance reflects the understanding that the role of public finance is to shepherd private finance.

In addition, the increased use of blended finance as part of ODA is also driven by the revision of the guidelines on how to account for loans in ODA from the OECD Development Assistance Committee (DAC). The new standard for reporting will take effect from 2018. The approach creates a "grant equivalent" value for loans by estimating the concessional value of the loan. In practice it is expected that the new reporting standard will render blended ODA finance more attractive to donors.[viii]

The increased use of blended finance comes with a number of challenges. First, to ensure the sustainability of blended finance it is important that blending mechanisms are effectively evaluated and audited, through the development of methodologies to measure their impact. A report from a coalition of NGOs recommended increasing ex post and ex ante project assessments as well as the development of a "climate effectiveness" metric that could be used to evaluate proposals.[ix] Perhaps of most significance is ensuring that projects are "additional", meaning that concessional finance is not provided to projects that could have been financed from private sector funds anyway. This **financial additionality** is one part of the picture; a further form of additionality is **developmental additionality** whereby the provision of concessional finance allows the project to be modified to achieve better developmental outcomes.[x] The development of transparent **methodologies and metrics** to assess additionality and to ensure that securing positive developmental outcomes is at the heart of decision making processes is a key requirement for a successful and effective blended finance sector.

Second, further, as governments make statements about and take on targets on mobilising funds - whether they be ODA or climate finance - it becomes pressing to address the challenge of **assessing how much funds can be said to have been leveraged**, or will actually be leveraged, through public assistance. To better reflect the trends in the use of blended finance in international cooperation, the revised guidelines proposed by the OECD DAC aim to improve accounting for the concessional element of loan finance in ODA, resulting in an increase of the extent to which loans can be counted for as ODA. This is bolstering an expansion in the sector, potentially leading to a corresponding reduction in other forms of ODA spending.[xi] This may be a source of inspiration for defining the rules under the Paris Agreement to account for climate finance provided to developing countries. There remains some uncertainty as to whether this shift will lead to better sustainable development outcomes. Evaluation has a key role to play to increase confidence that this expansion is warranted.

Finally, in addition to internal evaluation processes, some civil society organisations have conducted reviews of blended finance facilities. A recent review by EURODAD and Oxfam highlights a number of potential issues including the risk of non-concessional finance counting towards ODA, the potential diversion from other aid modalities, the risk of restrictions on how and where aid can be spent, and a risk of poor project ownership and accountability.[xii] In the shift to an increase in blended finance it may well be that **negative, unintended consequences** are encountered and that civil society organisations play a role in bringing these to light. Strengthening the role of civil society to engage with blended finance could be beneficial in the early detection and rectification of problems.

# On the current Status of Blended Finance

## The Scale of Blended Finance

Estimating the current scale of blended finance presents some challenges, since there are many institutions and funding mechanisms that are providing concessionary funding to sustainable investments. To develop estimates, much of the data is derived from analysis of annual reports or surveys of these institutions.

The OEDC DAC conducted a survey in 2016 evaluating the scale of private sector finance mobilised by official development finance interventions from guarantees, syndicated loans, shares in collective investment vehicles, direct investment in companies and credit lines. The results indicate that in the period 2012 to 2015, USD 81.1 billion was mobilised, mainly through guarantees. The survey contacted

80 funding institutions of which 30 responded that they used one or more of the aforementioned instruments.[xiii] The survey shows a considerable increase over previous years, rising to USD 26.8 billion in 2015, indicating increasingly good data – and increasing interest in blended finance. A summary of the data is shown in the figure below.

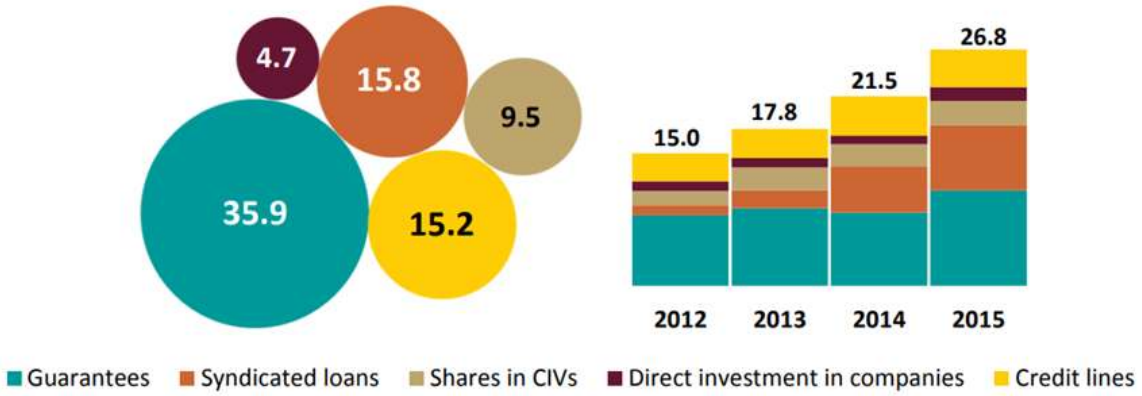


Figure 1 – Private finance mobilised in 2012-2015, USD billion
*Source: Benn et al., 2017*

A report from the Business & Sustainable Development Commission (BSDC) includes data from 187 blended finance deals that have mobilised USD 51.2 billion towards the SDGs. The report finds that the number of deals conducted each year is growing significantly and the quantity of finance mobilised grew at around 20 percent between 2012 and 2014.[xiv]

The European Commission tracks the activities of the EU regional blending facilities and the Global Energy Efficiency and Renewable Energy Fund (GEEREF). Since 2007, around USD 1 billion in EU grants have been issued to projects totalling USD 25 billion of total value. It is estimated that around 62 percent of these projects have “responding to climate change” as an objective.[xv]

It is clear from these sources both that blended finance is growing significantly and that the funds mobilised now account for many billions of dollars per year.

## Leveraging Private Funds

A key rationale for blended finance is that public funds can leverage private funds. It is therefore important to develop methodologies to evaluate this leverage effect. There are a number of examples of estimates for leverage from climate finance blending mechanisms. A summary of these studies is presented in box 1 below. The literature on historical performance of leverage demonstrates that there is very **significant variation in leverage estimates**. This may be partly due to the different sectors in which each institution operates but is likely to be even more dependent on the variety of calculation methodologies used.

### Lessons learned on leveraging private funds from climate finance blending

1. The OECD and Climate Policy Initiative estimated that USD 43.5 billion of bilateral and multilateral climate finance mobilised USD 16.7 billion of private sector finance in 2014.[xvi] A ratio of 0.38. This estimate was prepared only using estimates for co-financing that could be directly associated with public climate finance. The authors considered this approach as "best available evidence" for mobilisation.
2. A review of 9 years of data from the World Bank's International Finance Corporation (IFC) found that USD 72.1 billion of climate-related projects had been leveraged by USD 19.9 billion of IFC investments between 2005-2013. This indicates a ratio of 3.6.[xvii]
3. The Climate Investment Funds (CIF) review of leverage in their investments proposes three measures of leverage: Co-financing leverage, the ratio of CIF funding to total financing; private finance leverage is the ratio of CIF funding to total private finance in a project; and share of private finance relative to the entire CIF project. Every dollar of CIF funding is reported to leverage 1.6 dollars of private sector co funding (a ratio of 1.6).
   However, there was a great amount of variation between funds and sectors.[xviii]

## Blended Finance in the EU

Priorities for development across the EU are codified by the EU Consensus on Development. In 2017 a new consensus was adopted, establishing a set of principles to guide the approach of the EU and EU member states.[xix] The consensus specifically cites the use of blended finance as a tool to meet the objectives of the sustainable development goals and the EU's development priorities.

The EU has established 6 regional funds and 3 thematic initiatives that work across geographies in addition to two additional mechanisms that focus on accession and the EU neighbourhood countries. These facilities are listed in table 1 (below).

In September 2016 the European Commission proposed the European External Investment Plan (EEIP) to encourage investment in Africa and the European Neighbourhood to meet the SDGs. The Council adopted the regulation in September 2017. The EEIP aims to complement the current system of blending facilities to mobilise private sector finance in a coordinated manner. The plan establishes a new investment fund, the European Fund for Sustainable Development (EFSD). This fund will work with the Africa and EU Neighbourhood blending facilities to create a single point of contact for financial institutions and investors.[xx] [xxi] The EFSD will also offer guarantees to reduce risk for investors, provide technical assistance and promote dialogue to improve the investment climate in recipient countries. Civil society organisations have raised concerns that the presentation of the plan as a mechanism for controlling immigration is problematic, and have raised questions that safeguards to ensure sustainability are not adequate.[xxii]

**Table 1:** EU Blending Facilities

| Responsibility | Type | Blending framework | Framework focus | Funding |
|---|---|---|---|---|
| EFSD Strategic Board | External Investment Plan | The European Fund for Sustainable Development (EFSD) | Africa and neighbourhood countries | 2017 - €3,350 million |
| Directorate-General for International Cooperation and Development (DG DEVCO) | Regional funds | Latin America Investment Facility (LAIF) | Latin America | 2009-2015 €270 million |
| | | Asia Investment Facility (AIF) | Asia | 2010-2015 €142 million |
| | | Investment Facility for Central Asia (IFCA) | Central Asia | 2010-2015 €145 million |
| | | Africa Investment Facility (AfIF) and EU-Africa Infrastructure Trust Fund (ITF)* | Africa | ITF €812 million, of which €647.7 million the European Development Fund (EDF), remaining from EU member States |
| | | Caribbean Investment Facility (CIF) | Caribbean | 2012-2015, €70.2 million |
| | | Investment Facility for the Pacific (IFP) | Pacific | 2014-2020, €20 million |
| | Thematic initiatives | Electrification Financing Initiative (ElectriFI) | Electricity networks | |
| | | Agriculture Financing Initiative (AgriFI) | Agriculture | |
| | | Climate Finance Initiative | Innovative climate finance | |
| Directorate-General for Neighbourhood and Enlargement Negotiations (DG NEAR) | European Neighbourhood Instrument (ENI) | Neighbourhood Investment Facility (NIF) | European neighbourhood countries | 2008 and 2014, 95 projects, €1.072 billion |
| | Western Balkans | Western Balkans Investment Framework (WBIF) | Western Balkans | 2009 €310 million |

All EU blending facilities were established since 2007 and are designed to combine grants from the EU with loans from other development finance institutions, and to pool these resources with other sources of public and private finance. EU funding is provided as a grant and then packaged as investment grants, interest rate subsidies, technical assistance or risk capital and other risk sharing instruments.[xxiii] Indicative allocation to the blending facilities are estimated to total € 2.2 billion from 2007-2017 and approximately € 5 billion between 2014 and 2020.[xxiv] The European Fund for Sustainable Development has been allocated an additional € 3.3 billion

## Conclusions and Recommendations for European Development Policy

To tackle the interrelated challenges of climate change and sustainable development requires global investment of many billions of euros. Participation of public and private sources of finance are needed to provide the necessary level of finance. Some of the investments needed are either already commercially viable or will achieve commercial viability in the coming years; they can therefore be expected to be made on a fully commercial basis. However, many potential investments offer substantial sustainable development benefits, but cannot be realised under commercial terms. There is a consensus in the EU institutions and Member States that **blended finance mechanisms have a role to play in promoting investments that would not otherwise be commercially viable**.

Blended finance has risen over the last decade to make up an increasingly significant part of the EU's development financing. The change in the OECD's guidelines on accounting for ODA promises to further increase the attractiveness for reallocating ODA towards blended finance. This additional money, coupled with snowballing returns from funds already invested in blended finance mechanisms, will entail a scale-up of blended finance over the coming decade.

The increasing use of blended finance presents some risks that will need to be monitored and mitigated to ensure that blending delivers concrete sustainable development outcomes. Specifically, blended finance practitioners will need to

1. demonstrate standards and methodologies to transparently gather data and honestly appraise the performance of the blending mechanisms;
2. ensure that the projects that receive investment would not have taken place anyway and are in line with sustainable development principles;
3. safeguard against developing countries being saddled with unsustainable debt;
4. ensure that the impacts achieved through blending mechanisms are comparable or better than alternative mechanisms; and
5. deliver on the promise that public money leverages a significant amount of private finance.

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## Imprint

**Published by**
European Union Energy Initiative
Partnership Dialogue Facility (EUEI PDF)

c/o Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH
P.O. Box 5180, 65726 Eschborn, Germany

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**Place and date of publication**
Brussels, October 2017

The **Partnership Dialogue Facility (EUEI PDF)** is an instrument of the EU Energy Initiative (EUEI). It currently receives contributions from the European Commission, Austria, Finland, Germany, Italy, the Netherlands and Sweden.