



WORKING PAPER



Leveraging private sector finance for climate compatible development: Lessons from CDKN

By Charlotte Ellis and Kamleshan Pillay



October 2017

About this Working Paper

Accelerating the shift to climate compatible development is CDKN's business, and improving the lives of the most climate-affected people is our mission. A multi-year, GBP 130 million programme funded by the British and Dutch governments and many others, CDKN works to support climate compatible development in Asia, Africa, Latin America and the Caribbean. Our programme provides technical assistance to governments as well as research-into-action projects that fill gaps in our understanding of climate change impacts and solutions. A further, crucial part of CDKN's programme is knowledge management and policy engagement, an effort to which this Working Paper contributes.

We assess information on the collective performance of governments, as well as non-state actors, in tackling climate change. We convene online discussions and in-person events to assess how climate actions are serving the most climate-affected people and how climate action could be more ambitious and effective. Find more CDKN thought leadership, including news of our latest events, on www.cdkn.org or follow us on twitter @cdknetwork.

This paper is based on private sector related lessons from projects that have been funded by CDKN, across Africa, Asia and Latin America. Our purpose is to facilitate the exchange of experiences on climate compatible development, to accelerate the transition towards a low-carbon, climate-resilient global society.

What is climate compatible development?

Climate compatible development is defined as "a 'development first' approach that minimises the harm caused by climate impacts while maximising the many human development opportunities presented by a low-emissions, more resilient, future".¹ In other words, development, climate adaptation and climate mitigation should go hand in hand, and one should not undermine the others.

About the authors

Charlotte Ellis and Kamlesh Pillay have been working on the CDKN learning project to provide lessons from CDKN's portfolio, to assist developing country policy-makers who wish to leverage private sector climate finance. Ms Ellis, who has a master's degree in Applied Development Economics from the University of Cape Town, has a project management role with CDKN, and has a keen interest in sustainable development. Mr Pillay, seconded from SouthSouthNorth, is a climate finance specialist.

Acknowledgements

The authors would like to thank the CDKN project managers of the respective projects. Special thanks to Andy Jones for his input and contribution to this paper. Thanks also go to colleagues who have taken the time to contribute to and review the paper, including Suzanne Carter, Susannah Fitzherbert-Brockholes, Margaret Kamau, Lisa McNamara, Liliana Ramos, Areej Riaz and Simbisai Zhanje.

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Abbreviations

ARC	African Risk Capacity
CDKN	Climate and Development Knowledge Network
CFAS	Climate Finance Advisory Service
CSO	civil society organisation
DFI	development finance institution
DGO	diesel generator operator
GCF	Green Climate Fund
IEA	International Energy Agency
IFC	International Finance Corporation
IPP	independent power producers
KEPSA	Kenya Private Sector Alliance
MSME	micro, small and medium-sized enterprise
NAMA	Nationally Appropriate Mitigation Action(s)
NDC	nationally determined contribution
NGO	non-governmental organisation
PPP	public-private partnership
REO	renewable energy operator
TARA	Society for Technology and Action for Rural Advancement (India)
UNFCCC	United Nations Framework Convention on Climate Change
XCF	Extreme Climate Facility (ARC)

Key lessons learned

1. Private sector engagement requires a country-based and context-specific approach.
2. Public policy is a fundamental tool for influencing how the private sector views climate finance.
3. The business case for private sector involvement is specific to an individual project's characteristics, and its sector dynamics.
4. Aligning language and interests with the private sector will help gain their buy-in.
5. Leveraging private sector finance requires involving private sector actors in the design phase.
6. Pilot projects help demonstrate the business case for private sector investment.
7. Risk-sharing measures, such as insurance and guarantees, can reduce financial risks and facilitate private sector participation.
8. Innovative financial instruments can facilitate private sector investment in climate compatible development projects.
9. Using existing micro, small and medium-sized enterprises (MSMEs) and financial institutions presents a further opportunity to bring in private sector finance.

Introduction

Developments in the international climate negotiations and the climate finance landscape, in particular the signing of the Paris Agreement and operationalisation of the Green Climate Fund (GCF), have opened up opportunities for enhanced private sector action on climate change. The Paris Agreement demonstrates a common global acknowledgement that urgent climate action is needed, and there is broad consensus among the signatories that translating the agreement into action will require significant finance from the private sector.

The Paris Agreement sets out the goal of limiting mean temperature increases to less than 1.5°C, a target far from being reached. It has generated much needed momentum and has provided a framework for country commitments to low-carbon development pathways. It also sets out a target of US\$100 bn per year of climate finance by 2020, which is expected to be mobilised by developed countries and channelled through the GCF. According to the International Energy Agency (IEA), to limit temperature increase to 2°C, cumulative investment of US\$53 trillion will be needed by 2035. This represents, between US\$780 bn and US\$2.3 trillion annually by 2020 and 2035, respectively, in low-carbon infrastructure investment.² Public sector balance sheets are only able to cover a small proportion of this. All stakeholders must therefore seek ways to facilitate private sector finance in climate projects.

Risk and opportunity for the private sector

The economic transition required to implement the Paris Agreement also presents a unique opportunity for private finance. An International Finance Corporation (IFC) report indicates that the agreement has opened up nearly US\$23 trillion in opportunities for climate-smart investments in emerging markets leading up to 2030.³ However, for these opportunities to materialise, national governments will be required to understand and create the policies and enabling environment that will help to provide a clear path for private sector action. Currently, and to a large degree, the commercial interests of private financial institutions and the nature of climate projects do not align.

Climate change is already having significant impacts on the bottom line and private sector actors are increasingly reflecting on the cost of inaction and what this means for business as usual. In many instances, businesses are seeing the economic benefits of shifting towards energy efficient and greener means of operating – responding to these impacts by changing the way they operate, irrespective of the political expectation or motivation to do so.

Private investment across renewable energy, energy efficiency and land use sectors, including forestry, in 2014 was estimated at US\$337 bn – with renewable energy investment being the highest (US\$243 bn).⁴ Total private investment in 2014 represented 72% of global climate finance, with public finance making up the remainder. Project developers are the most prominent private investors (US\$98 bn), followed by corporate actors (US\$58 bn) and commercial financial institutions (US\$46 bn). However, to close the finance gap, significantly more finance will be required to flow from the private sector. The fundamental challenge is that the private sector is more likely to invest in mitigation than adaptation projects, as these typically have short-term quantifiable benefits attached to them. This is a big issue for unlocking private climate finance for much needed adaptation interventions in many developing countries, as the lack of simple revenue streams, and therefore returns, make these investments riskier.

The use of innovative financial instruments and mechanisms can help address the risks associated with financing climate projects, and help leverage private finance for mitigation and adaptation. These include instruments that are favoured by the private sector – for example, the use of green bonds and guarantees. This has opened the door for private sector investment by creating options to present investment opportunities in an attractive risk–return package.

Remaining barriers need to be addressed

Leveraging private sector finance requires an appreciation of the numerous challenges associated with financing many climate-related activities. According to Berliner et al. (2013),⁵ there are seven classes of barriers that may deter private investment, namely: externalities and public goods; imperfections in financial markets; new and unproven technologies; information gaps; economies of scale; political economic frameworks; and regulatory risks.

In the developing country context, the political and economic framework – including factors such as political instability, country risk and instability of legal framework – could potentially pose significant barriers to investment in climate change activities.

Other risks to private sector investment in climate projects include currency risks, project and technology risks, and credit risks. Additional factors, such as the lack of investment-ready, low-emission, climate-resilient projects, as well as the low price of carbon and resultant uncertainty in carbon markets also pose additional constraints to private sector investment. As outlined in *Mainstreaming climate compatible*

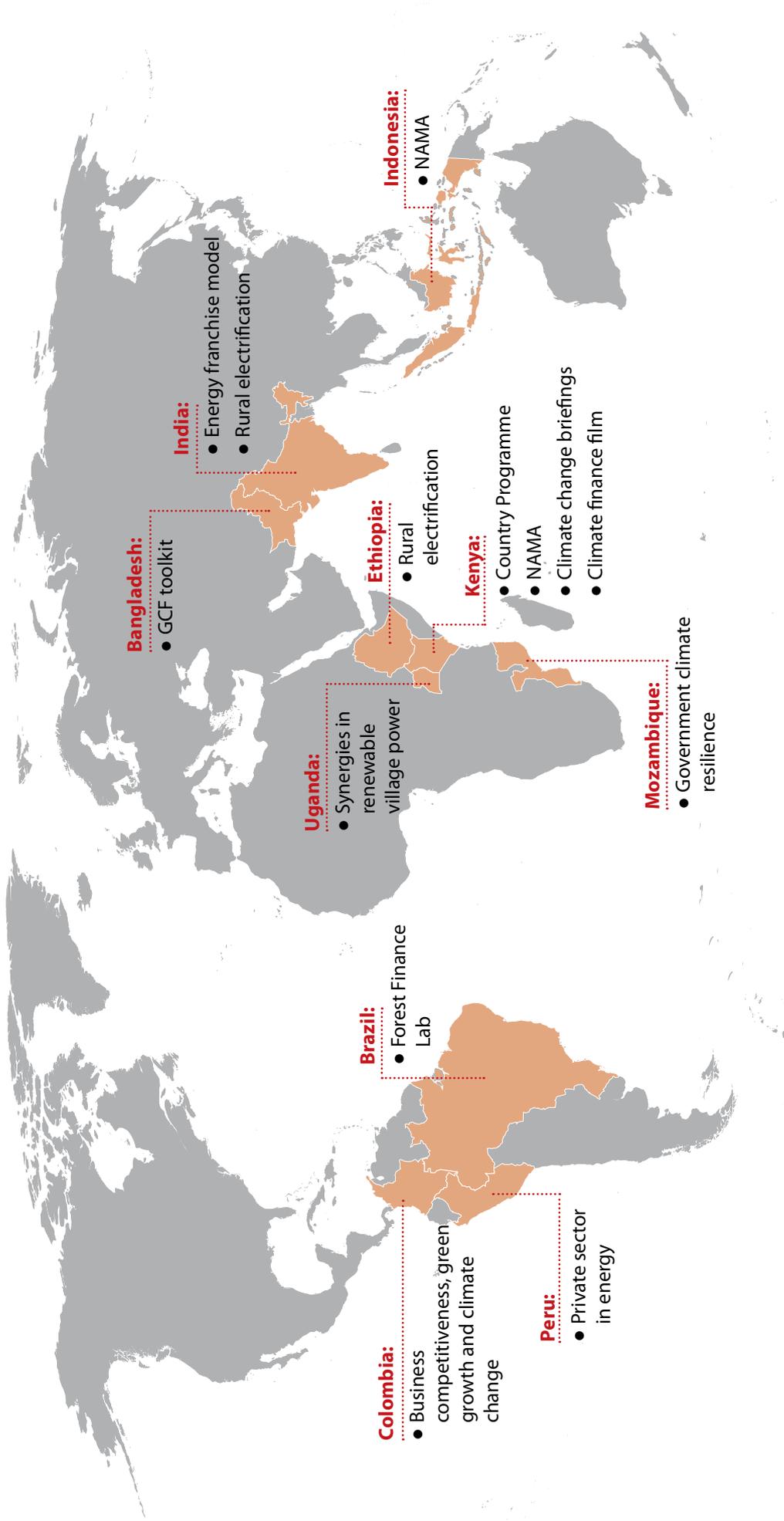
Box 1. CDKN's global climate finance programme

CDKN has supported a process of building climate finance readiness in seven countries: Bangladesh, Colombia, Ethiopia, Indonesia, Pakistan, Peru and Rwanda. In addition, a number of CDKN projects have, to a certain extent, influenced the design and operationalisation of the Global Climate Fund (GCF), including the 'Climate Finance Advisory Service' (CFAS) project, which has continued to support selected members and advisers of the GCF Board, the Adaptation Fund and the Standing Committee on Finance of the United Nations Framework Convention on Climate Change (UNFCCC).

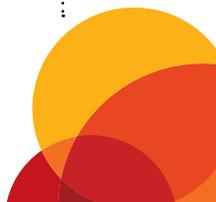
In another project, work with Both ENDS and a consortium of five Southern civil society organisations facilitated enhanced knowledge of those participating organisations in international climate finance issues and contributed to increased engagement by GCF negotiators on the role and opportunities for direct local access to the GCF. CDKN has also worked with Dalberg to prepare advisory documents on the role and needs of micro, small and medium-sized enterprises (MSMEs) and National Climate Funds in the climate finance landscape. In addition, in 2014, CDKN and the Adaptation Fund launched a joint website at climatefinanceready.org.

Figure 1 (facing page) details the country-specific support that CDKN has provided for mobilising climate finance.

Figure 1. Map of CDKN's country-based projects that were analysed for this paper



NAMA: Nationally Appropriate Mitigation Action



development,⁶ resourcing climate compatible development will require strong public sector leadership to address some of these constraints and barriers to private investment.

Despite the potential existence of the barriers discussed above, the appropriate use of policy measures and financial instruments can help reduce costs and investment risks, thereby attracting the private sector. Moreover, the finance gap and the evolution of the climate finance instruments landscape present an opportunity for private sector actors willing to understand the market. It is hoped that, as project pipelines increase under nationally determined contributions (NDCs), risks are reduced and development finance institutions (DFIs) enable rather than crowd out private entities, there will be an ever greater role and opportunity for the private sector.

Learning from across the globe

This paper aims to provide a synopsis of some of the lessons that relate to harnessing private sector involvement in climate compatible development that have emerged from CDKN projects across Africa, Asia and Latin America (as represented in the map on page 5). By sharing these lessons with developing country governments, project developers, development finance institutions and private finance institutions, we aim to demonstrate ways of enabling the private sector and ensure that private sector perspectives are better understood and incorporated into financing climate compatible development.

Engaging the private sector in climate projects: Lessons from CDKN's project portfolio

1. Private sector engagement requires a country-based and context-specific approach

In addition to understanding the individual characteristics at the project level, it is important to ensure good understanding of the national context and policies that make any private sector investment possible. The case of Indonesia's Renewable Energy Nationally Appropriate Mitigation Actions (NAMA), the development of which was supported by CDKN, is an example of policy reforms that support private sector investment in independent power producers (IPPs).⁷ By initiating a number of policy reforms, the Government of Indonesia was able to promote the participation of the private sector in two key ways:

- First through a grid compensation mechanism that assures income stability to producers when instabilities in the grid made it impossible to absorb their production. This approach not only reduces economic risk to potential investors, but also assists in reducing operational costs, particularly where continuity in operations is imperative.
- Second, IPPs were offered a choice of financial instruments, including direct public loans, credit lines and partial risk guarantees for banks, and mezzanine debt for developers. Offering a wider range of financial instruments allows for a greater variety of investment risks to be addressed; this has the potential to increase investor participation and diversity.

Understanding the local and global private sector landscape is crucial to understanding which instruments address local barriers and are better suited to creating the necessary incentives for private sector investment.

Owing to the disparities in the level of maturity of the private sector market in different countries, and the differences in private sector priority investment areas, it is imperative to understand the country context to determine the most relevant approach. This is a clear message that emerged from CDKN's Kenya Country Programme, in which CDKN supported a number of private sector interventions (Box 2). CDKN's experience of engaging with the private sector in Kenya highlighted several key lessons, including the need to identify where there is real demand for entrepreneurial companies to address market failures. Businesses in Kenya only engaged in activities where they had existing knowledge and commercial opportunity. Again, this emphasises the difficulty involved in trying to leverage private sector finance for climate compatible development activities, more especially the challenge of getting the private sector to invest in adaptation and climate-resilience projects.

CDKN's experience of working in Kenya provided a good basis for understanding the private sector landscape and appetite in Kenya. It also emphasised the importance of ensuring that there are

Box 2. Kenya's private sector begins to step up to climate action

- **Development of Kenya's geothermal NAMA proposal:** CDKN supported the development of Kenya's NAMA proposal and prospectus, which encompasses the Government of Kenya's efforts to mobilise private investment and support to improve the business case for private sector investment in geothermal power.⁸
- **Kenya's geothermal development drilling risk finance innovation:** CDKN supported a project to establish a private sector network to support a geological risk mitigation and development drilling risk insurance facility in Kenya. This network of key stakeholders, including domestic insurers and brokers, provided the platform on which to increase institutional knowledge about geothermal development risk and the use of innovative financing techniques to develop geothermal projects.⁹
- **Communicating climate compatible development to the Kenyan private sector.** Kenya Private Sector Alliance (KEPSA) Climate Change Briefings: CDKN supported a project to inform the Kenyan private sector about climate compatible development. The project also helped to develop KEPSA as a platform for engagement between the Government of Kenya and the private sector on issues relating to climate change. In addition, the project reviewed existing tools used by the private sector and developed a set of sector briefs which outline the potential impact of climate change on businesses in various sectors.¹⁰

mechanisms to evaluate, promote and enable multi-stakeholder coordination in understanding priorities, as well as the importance of identifying entry points for mutually beneficial engagement.

2. Public policy is a fundamental tool for influencing how the private sector views climate finance

Public policy plays an important role in shaping private sector investment in climate projects. Used effectively, private resources can successfully leverage large-scale private sector investment. It is important to promote the inclusion of private sector actors, not least providers of finance, in developing country programmes and decision-making processes from the outset.

As part of the Business Partnerships Programme, CDKN supported a project in India looking at franchising approaches and financial models to convert diesel generator operators (DGOs) to renewable energy operators (REOs) thereby improving energy access in rural communities.¹¹ This project highlighted the opportunity for the use of a risk guarantee system as a financial mechanism to reduce investment risks and allow DGOs to access credit on better terms from financial institutions. The project looked at franchising approaches to provide increased energy access in rural India using decentralised renewable energy based mini-grid projects, with the aim of scaling the conversion of DGOs to decentralised REOs. The objective of this project was therefore to establish pilot projects to showcase the viability of conversion of DGOs to REOs and to provide evidence of the enabling conditions for scaling the intervention.

A key lesson from this project was the importance of government's role in providing subsidies to incentivise the conversion of DGOs to REOs, and to demonstrate that these are viable and scalable solutions. This was especially important during the initial phases of conversion, because the REOs typically want to own the asset in four to five years, while renewable energy projects usually have seven- to eight-year payback periods. One of the financial models included a subsidy component, which was helpful in ensuring the protection of the DGOs' earnings and profits, thereby making the prospect of converting to renewable technology more tenable. Subsidies and grants were therefore essential in making conversion models financially feasible thereby enabling buy-in of the new renewable energy technology.

The project also found that in India, government dialogue was key to addressing policy ambiguity and providing clear plans around rural electrification.¹² Demonstrating the viability and scalability, and hence the stability, of these investments could potentially incentivise local entrepreneurs to self-finance their renewable energy plants in the absence of subsidies. Therefore, government support is important to incentivise private sector participation in climate projects in two ways: first in providing subsidies that reduce the investment costs to the private sector actor, and second in supporting the implementation of pilot projects that can demonstrate the viability of private sector investments. The same can be said

of other developing countries where the private sector is often relatively small and faces significant investment risks, in which case the role of the government is even more important.

Policy reform in Bangladesh presents a useful example. In 2011, Bangladesh implemented a comprehensive green banking framework, mandating that 10% of loans and grants issued by banks (private and public) and financial institutions be channelled towards green investment and sustainable development. This decision by the Bangladesh central bank represents a good example of how a government high-level mandate and changes in public policy can contribute to creating the enabling environment for private sector participants. It also demonstrates how changes in public policy that respond to issues specific to the context can help to address barriers and create entry points for private sector participation in climate projects and activities. In 2016, CDKN supported a project in Bangladesh to explore the question of how the private sector can best engage with larger funds such as the GCF. As a result, a toolkit was produced, *How can Bangladesh's private sector engage with the Green Climate fund?*¹³ which provides basic facts about the GCF and information on how to access it, and explores possible avenues through which private sector entities in Bangladesh could go about accessing funding from the GCF, and engage with the GCF through the Private Sector Facility and readiness support.

3. The business case for private sector involvement is specific to an individual project's characteristics, and its sector dynamics

Project characteristics, for example its duration, size, risks and revenue-generation potential, as well as the finance needed, will influence whether or not the private sector is able to participate. According to Berliner (2013),¹⁴ individual mitigation and adaptation projects have different features and barriers, depending on the sector or region in which they take place. Similarly, the design and selection of finance instruments depend on the characteristics of the project, including the project lifetime, the transaction volume and the economic or development sector in which the investment is meant to take place.¹⁵ Therefore, identifying project-level characteristics and barriers to investment in adaptation and mitigation allows identification of appropriate financial instruments that are favourable to the private sector.

In 2012, CDKN supported a project in the south-western Amazon, the 'Forest Finance Lab',¹⁶ which aimed to create a finance framework and cash-flow template for innovative financing mechanisms. The project used professional facilitation to bridge the supply and demand sides of forest-related finance. The specific focus of the project included research and analysis to support decision-making in REDD+¹⁷ as well as the development of innovative finance mechanisms and solutions through effective and creative engagement of different stakeholders (local governments, non-governmental organisations [NGOs], investors, forest communities and local farmers) within the state of Acre in the Brazilian Amazon.

Traditionally, forestry protection has been funded through national budgets earmarked for conservation or through REDD+ initiatives with very little interest from the private sector. Stakeholders from the private sector (local farmers and investors) suggested that their participation in forest protection initiatives such as REDD+ was limited by insufficient returns on investment. Initially, REDD+ revenue streams were expected from the trading of REDD+ credits on the carbon markets.¹⁸ However, the lack of binding climate policies and targets has meant a lack of demand for these credits, and a lower REDD+ credit price. Should demand-side policies¹⁹ be implemented effectively, it is likely that private sector investment in REDD+ would increase.

Multi-stakeholder engagement, as was the case within the Forest Finance Lab, could be further developed by the integration of other forest users into the forest financing design. The 'landscape approach', sometimes referred to as 'integrated landscape management', is an evolving framework that seeks to address emissions arising from multiple land uses in a holistic manner,²⁰ thereby reducing potential trade-offs and realising inherent synergies. In the context of REDD+, the landscape approach acknowledges that deforestation occurs across multi-functional landscapes, in which functions can include supporting indigenous communities' and farmers' use of natural resources. Taking a landscape approach involves a wide variety of stakeholders and encourages cross-sectoral perspectives to deliver on equity goals, co-benefits of forest conservation and restoration, and multilevel governance of natural resources.

The landscape approach avoids dependence on international donors. These projects may possess attributes which can be easily commodified and thereby increase the revenue-generation capacity of the project as a whole (e.g. sustainable agriculture, agroforestry and sustainable value chains). Consequently, these projects may be particularly well positioned to gain support from private investors.

4. Aligning language and interests with the private sector will help gain their buy-in

To facilitate private sector investment in climate action, there is a need to bridge the public and private sector language and identify common interests on which to capitalise. CDKN has supported various messages to broker the engagement of business in the climate agenda, and part of this has sought to find the appropriate language and means of communication in a discussion that has been dominated by both science and public policy.

CDKN funded a project, 'Enhancing Private Sector Engagement in Energy Efficiency in Peru', focused on enhancing private sector engagement on energy efficiency in Peru. The objective of this project was to support climate compatible development in Peru through the identification and assessment of private sector energy efficiency opportunities, and building capacity to support energy efficiency, through skills transfer and upskilling in developing local carbon abatement plans. The project included work with local MSMEs, microfinance institutions and banks to identify and overcome the barriers to accessing finance, such as the ability to complete energy audits and project appraisals, and understanding the risks associated with energy efficiency investments. One of the key barriers to corporate investment in energy efficiency was found to be obtaining high-level buy-in and finance from management. This challenge was further exacerbated by the fact that many of the businesses do not capture the data necessary to prove the economic gains of being more energy efficient and therefore are not able to demonstrate the business case for energy efficiency investment. Another key barrier was the lack of skills to initiate public-private partnerships (PPPs), which emphasised the importance of engaging and partnering with organisations that will enable the public sector to work more closely with the private sector, such as NGOs and private sector alliance groups.²¹ A key lesson that emerged from this project was the need for and importance of financing options to facilitate the implementation of technological improvements.

5. Leveraging private sector finance requires involving private sector actors in the design phase of the project life cycle

The stage of the project cycle at which engagement between the private sector and the project proponent/sponsor, whether it be government or development bank, occurs is important. Engaging with the private sector during the initial phases of a project, and when the risks are likely to be the highest, can contribute towards a better understanding of the barriers and incentives by the private sector stakeholders and identify which financial instruments to use, recognising that some instruments are more appropriate than others, depending on the development stage of the project.

There is usually a disconnect between identifying financing needs and financing sources, and technical and financial proposals are often developed separately. As a result, private sector actors or investors can be approached in the latter phases of the project, particularly once the project has been conceptualised and specific finance is being sought. However, ensuring the involvement of private sector actors at the design and conceptualisation phase of the project increases the likelihood of private sector participation in later project phases. By involving private sector actors, for example potential investors, banks and insurers, during the conceptualisation or design phase, potential barriers to mobilising private capital can be more easily identified, which in turn can help to minimise additional costs associated with project development. It also supports the identification of financial instruments that are conducive to private sector engagement. Lastly, the early inclusion of the private sector supports enhanced cooperation, illustrating a move towards an inclusive, participatory decision-making process across stakeholders (see Boxes 3 and 4).

The Africa Water Facility in partnership with CDKN is currently supporting a climate resilience project in the Government of Mozambique to assess the feasibility of large-scale water infrastructure, specifically Mapai Dam to enhance climate resilience in the lower Limpopo River basin. As part of the project

Box 3. Public–private partnerships for competitiveness and climate compatible development – supporting green growth and the implementation of Colombia’s NDC

CDKN supported a project in Colombia, the ‘Business Competitiveness, Green Growth and Climate Change’²² project, which was carried out in close collaboration with the Colombian National Planning Department and the Colombia Competitiveness Privy Council. The aim of the project was to improve private sector understanding of the relationship between climate change and competitiveness, and to strengthen PPPs to bridge the gaps in public policy. In addition to this, the project aimed to develop an index (within the competitiveness national report produced by the council) that incorporates climate change to help businesses understand the importance of climate compatible investments.

While the private sector’s role is recognised as being critical to achieving green growth goals in Colombia, engaging the private sector in Colombia on this agenda has been difficult. One of the reasons for this was the disparity in the language of the private and public sectors; understanding what the private sector aims to achieve is critical. The project identified ‘competitiveness’ as part of that common language that can be used. It also contributed to private sector acknowledgment of climate change as a relevant factor for business operations. One of the ways in which this project achieved this was through including green growth and climate change indicators in the existing private sector council competitiveness report, and also by indicating how climate change, green growth and business competitiveness are related. This presents a starting point in terms of sending the right signals to the private sector on the importance of considering green growth and climate change as opportunities.

Another important lesson that emerged from this project is that the private sector is often already engaged in environmental and climate-related activities; however, information necessary to make the business case for investment is not readily available. At the same time, the private sector and/or businesses might be engaged in activities that are climate-related but do not label them as such. For example, businesses might have implemented cleaner or renewable technologies that are helpful from a cost-saving perspective and may not be labelling such an action as a climate mitigation action. Instead, they may simply be investing in activities that are beneficial to their business. This points to another challenge: for internal investment, climate-related decisions are not always well tracked or measured. In turn, this emphasises that bridging the language gap is reciprocal: businesses and private sector actors also need to learn the ‘climate’ language insofar as understanding how their activities relate to mitigation and/or adaptation.

The leadership of the company and ensuring engagement with the personnel in strategic positions of the company is also very important, as these have a major influence on the uptake and implementation of climate compatible actions and greener technologies within the company. Finally, it was found to be easier to get big business involved in climate-related investments than smaller business. The reason for this is that investments in greener technologies are often capital intensive and require the right enabling environment. In the case of Colombia, the post-conflict period and the ongoing tax reforms present an opportunity via carbon taxes and renewables incentives; however, these conditions have also created a complex environment for small business to make the necessary adjustments. This further emphasises the need for the public sector and government in particular to provide the necessary incentives and enabling environment via policy reforms and developments for the private sector to consider its role in green growth.

‘Building Climate Resilience in the Limpopo Basin’,²³ the feasibility of PPPs to finance water infrastructure will be evaluated. Recognising that built infrastructure alone will not result in resilience in the basin, an investment plan that focuses on no- and low-regret options for the basin is being developed. This project provides a good example of the importance of having a multi-pronged approach to financing and of identifying potential sources of funding during the early phase of project development, and including climate finance considerations early in the planning process.

To this end, a financing strategy will be developed that will include consideration of PPP feasibility, financial resource mobilisation and partnership arrangements for investment in and operation of the infrastructure. The financial structuring of the water infrastructure will be key to ensuring its commercial and economic viability and will allow the mobilisation of private and, potentially, public funds. This will require identifying the project components that will be suited to private finance, and significant engagement with different types of funding partners and investors to fund the multiple components, for example hydropower and irrigation.

One way of ensuring that the private sector is included in the early stages of the project development cycle is by establishing platforms that support or enable coordination between public and private sector actors. An example of such a platform is the Kenya Private Sector Alliance (KEPSA). These platforms can allow for a better

Box 4. CDKN building readiness of the private sector in Bangladesh for GCF accreditation

In 2016, CDKN commissioned a project to support the Government of Bangladesh in building its capacity and raising awareness on climate finance mechanisms, particularly to support access to international funds such as the GCF. This included exploring the business case for private sector engagement and investment in climate change activities in Bangladesh.²⁴

One of the key lessons that emerged from this project is the role that the national designated authorities have in supporting and facilitating private sector involvement in developing transformational climate change projects integrated into national country programmes. Linked to this, the project further highlighted securing buy-in for climate change related activities among senior executives and, where possible, establishing a designated climate change capability within business that can, among other things, support lobbying of government to provide the enabling environment for investment in climate change projects.

Another key lesson from this project – and one which is often overlooked – is the fact that, to effectively leverage the opportunities for private sector investment, there is a need to bridge the gap in the language and terminology used by the private sector and that used by the climate and development finance world. Making the case for businesses to invest in climate projects requires speaking their language – for example, framing the benefits in terms of revenue, or opportunities for market share.

understanding of private sector perspectives on business costs and risks, and help to identify ways in which national public sector climate change objectives can be aligned with business interests. Developing country governments need to create the incentives and platforms that promote private sector engagement and subsequent participation in financing climate compatible development projects and programmes. This requires a shift in how the public sector perceives the private sector, i.e. seeing the private sector more as an integral partner in addressing climate change and development challenges.

Recognising the critical role of businesses in addressing the challenge of reducing carbon emissions, creating green jobs and supporting climate compatible development, CDKN's Business Partnerships Programme aimed to increase donors' and the private sector's understanding of and interest in investing in business partnerships as vehicles for climate compatible development. The objective was to encourage and facilitate business-to-business partnerships that can support improved knowledge, skills and networks that in turn support the delivery of climate compatible benefits. The programme supported four pilot projects in Africa, Asia and Latin America (see Box 5).

Box 5. CDKN Business Partnerships Programme²⁵

- **Identifying Energy Efficiency Measures for Businesses in Peru.** Delivery of climate compatible development in Peru through the identification and enablement of energy efficiency measures for business, and the building of self-sustaining local implementation capacity. This is a partnership between the Carbon Trust, SENATI, Südesco Energy and Peru 2021, which aims to increase the supply and demand of energy efficiency services in Peru.
- **Testing Synergies in Distributed Renewable Village Power in Africa.** This is a partnership between Africa Power, Farm Africa and Sincronicity Power, which aims to deploy interconnected renewable power systems in off-grid rural communities in sub-Saharan Africa.
- **Franchising approaches to provide increased energy access in rural India using decentralised renewable energy based mini-grid projects.** This is a partnership between the Society for Technology and Action for Rural Advancement (TARA) and cKinetics, which aims to develop a franchising approach for conversion of diesel generator operators to decentralised renewable energy operators in rural India.
- **Geothermal Development Drilling Risk Finance Innovation.** This is a partnership between Parhelion, Kenbright NBC Insurance Brokers, E3G and GeothermEx, which aims to establish a private sector network to support a private sector geological risk mitigation and development drilling risk insurance facility in Kenya and Ethiopia.

There are opportunities for businesses to be involved in climate projects, and private sector can be seen more as an integral development partner if engaged early on. However, at the same time, private sector entities are unlikely to be willing to support the earlier phases of project development, including prefeasibility and feasibility analyses. Instead, they are more likely to invest in projects that have been proven to be viable through feasibility and due diligence studies, and financial and economic assessments, and proven to have an attractive return on investment. Making strategic use of public finance to provide grant-based support is helpful in aiding the development of pilot projects that can demonstrate the business case to the private sector and spur private investment.

6. Pilot projects help demonstrate the business case for private sector investment

Understanding project attributes such as duration and returns, and reducing the initial risks associated with demonstrating the long-term feasibility of untested and novel projects is an important aspect of leveraging private sector finance. The use of pilot projects can aid in demonstrating the business case and potential benefits of such project types, thereby overcoming the interest, knowledge and confidence gaps among investors. CDKN has identified complementary strategies for overcoming barriers to private sector investment, one of which links well with the idea of using pilot projects as a way to set the scene and environment for private sector investment and prove the concept and its viability. One of these strategies includes the use of public funds to support early entry projects that are scalable or have the potential to transform markets and pave the way for further private investment. The other strategy links to Lesson 4 (above), and outlines the importance of using innovative tools that will help catalyse private capital.

Currently, renewable energy micro-solutions are based on mini-grid sharing between users. In most cases, this model cannot function without financial support in the form of subsidies so that power can be delivered to the poorest communities. The CDKN-funded project 'Testing Synergies in Renewable Village Power in Africa'²⁶ implemented a pilot in Uganda to demonstrate the viability of remote off-grid community power in Africa without subsidisation. Specifically, the project aimed to demonstrate how further funds could be raised to operationalise an off-grid rural power company. This project was funded by CDKN to provide a pilot test of Africa Power's commercialisation model for distributed (off-grid) rural village power in Uganda.

The pilot project demonstrated that, by sufficiently scaling up the availability of working capital from development funds, a sustainable off-grid power service would be a viable solution in Uganda. Furthermore, discussions with impact, equity and commercial investors indicated their potential willingness to finance the project. This shows how piloting a project, particularly when newer technologies are being utilised, can help to alleviate some of the concerns private sector investors may have in investing in climate projects.

In addition to supporting the implementation of pilot projects, national governments could also play a role in absorbing some of the costs associated with prefeasibility and feasibility assessments in the initial stages of projects. In May 2017, CDKN launched a film on climate finance, 'Switching on climate finance in Kenya', looking specifically at how the country is dealing with the challenge of generating more electricity and how it is looking at unlocking global climate finance to help access greener energy opportunities.²⁷ Countries such as Kenya are already investing national resources into climate compatible development. However, there is a need to draw on external sources of finance, including the private sector. This film highlights how the Government of Kenya's initial investment in geothermal project feasibility is a good example of using public resources at the start-up or prefeasibility phase of a project, to reduce the costs associated with the initial investment, and to provide the spark necessary to ignite further private funding for low-carbon and climate-resilient projects.

7. Risk-sharing measures, such as insurance and guarantees, can reduce financial risks and facilitate private sector participation

Risk-sharing mechanisms²⁸ associated with climate-related investments that present significant risks are a key tool to promote private sector involvement. In 2014, CDKN undertook a project to facilitate

the development of geothermal drilling risk insurance for Kenya and Ethiopia. In February 2017, CDKN published a Working Paper which shares insights on innovative risk finance solutions from this project.²⁹ The main objective of the project was to address the high risks associated with resource exploration and development/appraisal drilling which pose significant barriers to private sector financing. At this stage in geothermal site development, underwriting the associated risks can improve the prospects for private sector investment as the risk–return ratio of these projects is improved. In addition to creating a risk insurance product, the project also improved the technical skills and capability for geological risk mitigation instruments in the local insurance industry, as well as knowledge of opportunities for climate compatible development.³⁰

Insurance companies must possess the appropriate level of expertise and financial reserves to manage large-scale climate-related investments. In this case, re-insurance companies were a better choice than domestic insurance companies.³¹ Re-insurance was deemed to be the better option, given the lack of technical and financial knowledge, and capacity in Ethiopia and Kenya. Through this project, it was evident that the effectiveness of risk insurance mechanisms requires well-developed risk insurance markets, and local stakeholder awareness of renewable energy opportunities and risks.

In the short term, it is likely that these risks will continue to be managed by re-insurance companies, indirectly, until domestic financial actors have sufficient financial capacity. The use of international re-insurers may, however, reduce the degree of country ownership of a project. Nevertheless, local insurers have an appetite to provide geothermal resource risk instruments, and their involvement will be driven by policy incentives and access to information. This reinforces government’s role in influencing the direction of private finance through regulation, incentives and other policy measures, with the aim of minimising key barriers and constraints to private sector investment in climate-related projects. The government should also provide support through research collaboration or support funds.

8. Innovative financial instruments can facilitate private sector investment in climate compatible development projects

Careful consideration of the types of financial instruments that would incentivise private sector involvement is necessary. Innovative financial mechanisms such as risk insurance mechanisms and green bonds are already being used to finance climate projects. For example, a CDKN project on green bonds in Colombia is already looking at the possibility of financing green projects from the public and private sectors. Drawing on lessons from this project, CDKN published a guide that discusses key building blocks and enablers for a green bond market.³²

In 2015, CDKN supported the development of the African Risk Capacity’s Extreme Climate Facility (XCF).³³ The African Risk Capacity (ARC) is made up of two components: the more traditional risk-pooling approach, where premiums are pooled by member states to gain a specific amount of coverage against a particular hazard (e.g. drought); and the still to be finalised Extreme Climate Facility (XCF), which safeguards African governments from increasingly extreme climate impacts. ARC’s disaster financing strategy includes the transferring of risk to re-insurance markets while retaining a certain portion of premiums to guard against high-severity, low-probability weather events.

The XCF is a free product thanks to its financial structure in which catastrophe bonds are issued to gain finance through private investors, while the annual bond coupon payments are financed through donor support. XCF products will be offered exclusively to those countries participating in the ARC. Catastrophe bonds allow for the transfer of risk to financial markets, as opposed to re-insurance markets, demonstrating that different financial instruments can attract different financial actors. In the case of catastrophe bonds, attracting institutional investors from the financial market is significant as the financial market has 10 times the financial capacity of the re-insurance market. In this way, the private sector can play a role in adaptation financing – a role that has been limited to date due to low or lack of returns on investment. By using creative financing mechanisms, the XCF will help build resilience and thereby reduce the exposure to hazards, making the insurance product more sustainable.

Box 6. Green bonds – The Colombian strategy on climate financing

In 2016, CDKN undertook an assessment of Colombia's potential to develop a successful green bond market. Green bonds have been recognised globally as a financial instrument that can stimulate large capital flows from institutional investors for environmental projects. Colombia's interest in green bonds emerged from CDKN's work in developing its national climate finance strategy where, along with carbon markets, green bonds were identified as a potential key tool for mobilising climate finance in the country.

Colombia has an existing public and private sector committee on green bonds and saw its first green bond issuance in December 2016 from one of the country's largest commercial banks, Bancolombia. The interest of the assessment was in building a successful market, i.e. one that has depth, breadth, self-sustainability, longevity and impact. The assessment investigated the key building blocks of a market: the enabling environment, investors, issuers, standards and governance. It found various barriers to the growth of the market, but none of them were deemed to be significant. The most substantial barriers related to the functioning of the domestic bond and financial markets as a whole rather than barriers specifically to green bonds – for example, restrictions on the credit ratings investors can buy, slow and costly processes of issuance, and limited availability of instruments to mitigate currency risk for international investors.

Barriers related specifically to green bonds included the level of awareness of the green bonds themselves and the perceptions of significant additional administration and cost required to issue them; limited pipeline of sizeable green projects; uncertainty on alignment of international standards with national priorities; and capacity and readiness of local market players.

The assessment report outlines recommendations for market development and a roadmap for their implementation. Potential interventions were defined that could address all the barriers identified and that appear viable for Colombia on the basis of precedent of similar initiatives and institutional capability. These included central communication on green priorities and project objectives, a programme of awareness-raising with key market players, demonstration issuance and investment by government and development banks, technical assistance funds, guarantees to reduce risk, project aggregation facilities, and private sector pledges on green investment.

Colombia has high ambition and capability to optimise the use and impact of green finance to deliver its climate commitments as outlined in its NDC, which clearly considers adaptation, mitigation and means of implementation. As Colombia takes steps to develop its financial markets, green bonds can play a central role in generating issuance and liquidity to support this. By implementing the steps identified in this assessment, it can start to lay the groundwork for a future successful green bond market.

9. Using existing MSMEs and financial institutions presents a further opportunity to bring in private sector finance

It is essential for public sector actors to assess and define the scope of the local private sector, including small businesses and households, that could make a contribution to climate compatible development. In many developing countries, MSMEs form a major portion of the formal economy. Limiting the definition of potential private sector investors to large businesses misses the contribution of MSMEs and households in filling the climate finance gap. Clearly defining the private sector is important in identifying opportunities for investment. MSMEs represent a valuable opportunity to leverage private sector finance, provided that market barriers that could otherwise deter investors are adequately addressed. A CDKN project looking at increasing access to climate finance for small and medium-sized businesses, re-emphasised the importance of MSMEs in financing climate change activities, highlighting that MSMEs account for 90% of businesses in developing countries.³⁴

In addition to MSMEs, capitalising on other existing financial institutions, such as international finance institutions that have a track record in managing large capital reserves and that are operational in several developing countries, is important. Often, these institutions have the necessary track record and proven ability to meet the stringent requirements of multilateral funds such as the GCF, and could therefore be seen as potentially important partner institutions to unlock climate finance from such funds. By way of example, an assessment of Bangladeshi institutions carried out as part of a CDKN project to help build the readiness of the private sector for GCF accreditation, showed that the readiness of many of the commercial banks was greater than expected in terms of the fiduciary standards and environmental and social policies. Therefore, capitalising on these institutions, particularly in the developing countries where the domestic formal private sector may not be well established, could help to harness private sector investment.

Box 7. Exploring strategies to engage the MSME sector in financing climate compatible development

CDKN supported a project that looked at private sector engagement, sustainability and small grants for community-based adaptation actions. The aim of this project was to contribute to the development of governance frameworks for private sector engagement in climate finance. The research points to the need for developing countries to promote access to finance by helping the MSME sector overcome three key barriers – weak enabling environments, limited knowledge and awareness of financing, and inadequate financial products. The role of the GCF MSME Program in alleviating some of these barriers was underscored. However, this does not preclude the equally important role of national governments in addressing the key common barriers.

Key lessons that emerged from the project include:

- Developing countries need to explore alternative options that go beyond traditional forms of financing – such as alternative sources of collateral, asset-based lending, seed/venture capital and leasing – which could help to improve access to climate finance for MSMEs.
- There is a need to improve MSMEs' knowledge and awareness of potential opportunities when implementing climate finance – by providing technical assistance for MSMEs and investors, or matchmaking platforms that link investors with investees.
- Like the GCF MSME programme, governments themselves could earmark funds to help MSMEs reduce the risks of investing in climate compatible development, for example as part of national climate funds.³⁵

Conclusion

The scale of the climate finance gap and the need for trillions of dollars of low-carbon, climate-resilient investment implies that significant investments from the private sector will be critical. This requires that developing countries in particular are able to strategically leverage private sector investments in climate compatible development to achieve ambitious climate action in both mitigation and adaptation. Private sector contributions to the implementation of NDCs present a potential opportunity that will require more concerted effort on the part of the public sector to ensure the right platforms and processes are in place to facilitate cooperation and collaboration in the design of country projects and programmes. Furthermore, it is also necessary to ensure that engagement is capable of linking private sector priorities with national development plans and priorities.

This lesson learning brief has identified several insights for promoting private sector investment in climate change projects and for optimally engaging private sector actors, to maximise potential leveraging of private investment for critical climate projects.

Private sector engagement requires a good understanding of the sector for which the private sector investment is intended, recognising that some sectors, for example the energy sector, are more conducive to private sector investment because they provide prospects for return on investment. Engaging the private sector also requires finding a common language, for example competitiveness and cost reductions, to highlight the benefits of investing in climate projects.

The use of financial instruments to tackle mitigation and adaptation challenges has evolved significantly over recent years, and now includes instruments such as bonds and risk insurance mechanisms. Having a good understanding of the types of financial instruments that can facilitate private investment is important.

Lastly, having due consideration of the timing of engagement with the private sector is critical to an enhanced understanding of the barriers and constraints private sector actors face, how these barriers might be addressed and the potential extent of the private sector involvement. All this will require strong public sector leadership that supports policies and reforms that provide the enabling environment for private investments and the use of limited public finance to reduce risks, demonstrate the viability of projects and leverage private investment.

Other useful resources

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SouthSouthNorth supports the transition towards climate compatible economies and societies in developing countries. This is facilitated through collaborative and stakeholder-driven country processes, as well as local-level actions, that address climate change and promote equitable access to sustainable development.



Funded by:



Ministry of Foreign Affairs of the Netherlands

www.cdkn.org

[e: enquiries@cdkn.org](mailto:enquiries@cdkn.org)

t: +44 (0) 207 212 4111

This document is an output from a project funded by the UK Department for International Development (DFID) and the Netherlands Directorate-General for International Cooperation (DGIS) for the benefit of developing countries. However, the views expressed and information contained in it are not necessarily those of or endorsed by DFID or DGIS, who can accept no responsibility for such views or information or for any reliance placed on them. This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, the entities managing the delivery of CDKN do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. CDKN is led and administered by PricewaterhouseCoopers LLP. Management of the delivery of CDKN is undertaken by PricewaterhouseCoopers LLP, and an alliance of organisations including Fundación Futuro Latinoamericano, LEAD Pakistan, the Overseas Development Institute and SouthSouthNorth.