LEVERAGING PRIVATE SECTOR INVESTMENTS IN ADAPTATION

The evolving role of climate finance in enabling a paradigm shift

Climate Markets
& Investment
Association

Mekong Delta, Vietnam

Leveraging Private Sector Investments in Adaptation:

The evolving role of climate finance in enabling a paradigm shift

Author

Mónica A. Altamirano, Ph.D

Delft, 1st July 2021

About the author

Mónica A. Altamirano, Ph.D., is a Specialist in Public-Private Partnerships and Systems Thinker. She is a specialist at Deltares and an advisor to Netherlands Ministry of Infrastructure and Water Management. Her work aims at making water security and adaptation financially feasible for developing countries. She is Chair of the Water and Natural Infrastructure Chapter of the World Association of PPP Units and Professionals (WAPPP), member of the World Economic Forum's Infrastructure 4.0 Initiative and the OECD-WWC-Netherlands Roundtable on Financing Water, and leading the NOW–Avina Foundation partnership.

Design and layout by Begoña Arellano Jaimerena

Editing by Deborah Sherwood

Please cite this work as follows: Altamirano, M. A. (2021). *Leveraging Private Sector Investments in Adaptation: The evolving role of climate finance in enabling a paradigm shift*.

This report can be downloaded from https://www.cmia.net/news/press-releases/mobilising-private-finance-for-adaptation-the-case-for-a-fair-transition-2/

The first phase of this research was financed by the Directorate-General for International Cooperation (DGIS) of the Netherlands Ministry of Foreign Affairs as part of the Dutch Climate Solutions programme (2014-2018). The Dutch Climate Solutions programme was implemented by a consortium comprising the following organizations: ECN, Deltares, DLO-Wageningen UR and Duisenberg School of Finance (until 1 October 2015).

Drought at corn field © Adobestock.com

FOREWORD

I first met Monica in Rotterdam at a C40 Adaptation Finance Academy where we were invited as technical experts to present on adaptation finance at city level. Monica and I got on like a house fire discussing climate finance, equity, and justice. We also discussed barriers for private sector adaptation projects at the Green Climate Fund (GCF) where I serve as Active Private Sector Observer. At the end of three days, our friendship was sealed, bonded in a determination to get more finance flowing into adaptation for climate change.

Thus, it's wonderful to welcome Monica's paper on leveraging private sector investments in adaptation. Given the inherent public good and common resources economic nature of most adaptation projects, it is likely to remain largely an activity under public sector responsibility. However, the private sector remains an untapped source of financing and expertise. The private sector can support governments facing constrained public budgets and rising costs of managing climate change to achieve resilience by leveraging the skills, innovation and financial resources of business and the financial sector.

Monica's research shows a public-private programmatic approach that enables the combination of multiple sectoral finance streams is required, along with non-traditional partnerships that bring the required expertise to effectively de-risk and significantly reduce transaction costs for investments at the watershed scale.

For the private sector, climate change does not only represent a risk, but also an important business opportunity. The IFC estimated that there would be a USD 23 trillion investment potential in climate-smart products and services between 2016 and 2030 (IFC, 2016). Climate finance is a crucial building block in blended finance strategies that can unlock opportunities and drive the shift towards a more regenerative economic model.

The need to intensify climate adaptation action and significantly increase the share of public and private financing for adaptation was the key message during the Climate Adaptation Summit, hosted by the Netherlands, in January 2021. Recently also the G7 nations recognized the fundamental importance of climate finance in addressing the climate crisis.

Climate finance can be a game changer. If we work together, we have a chance to leverage these investments towards green, resilient, and inclusive development that can remove existing systemic barriers to access for private sector and vulnerable communities alike. Only through consistent global-local and public-private cooperation can a truly transformational pipeline of investments that reach the last mile be achieved.

I am delighted to support Monica's work and launch this report together with the Kingdom of the Netherlands on leveraging private sector investments in adaptation.

Yours sincerely,

Margaret-Ann Splawn
Executive Director, Climate Markets & Investment Association
Active Private Sector Observer at Green Climate Fund

Dyke Oostzaan Tuindorp. Netherlands, 1960

EXECUTIVE SUMMARY

The UNEP Adaptation Gap Report 2020 found that despite an increase in available financing, enormous gaps remain in finance for developing countries and bringing adaptation projects to the stage where they bring real protection against climate impacts such as droughts, floods and sea-level rise. Global investment in adaptation has increased from USD 22 billion in 2015-16 to USD 30 billion in 2017-18. Nevertheless, to match the needs estimated between USD 140 and USD 300 billion per year by 2030, adaptation funding needs to increase five- to ten-fold to meet the needs in developing countries alone.

The private sector remains an untapped source of finance, expertise and ingenuity. Adaptation attracts only 5% of climate finance (USD 30 billion out of USD 608 billion), and of these, only 1,6% (USD 500 million) are private sector investments. This study assesses the current and potential roles of climate finance in unlocking private sector investments in adaptation.

Private sector engagement in adaptation is crucial, not only to close the implementation gaps of National Adaptation Plans (NAPs) and Nationally Determined Contributions (NDCs), but more importantly to ensure the long-term financial sustainability of adaptation investments. The study focuses on private sector participation in adaptation to tackle the diversity of challenges involved in developing investable adaptation projects. Multiple research methods were combined to carry out a dynamic and holistic analysis of a decade of international climate finance.

In order to draw cross-national lessons on how climate finance can be used to unlock private sector investments in adaptation, we analyzed global climate finance flows and the project portfolios and the evolution of three multilateral climate funds (MCFs) between 2010 and 2020: the Pilot Program for Climate Resilience (PPCR), which is part of the larger Climate Investment Funds (CIF); the Adaptation Fund (AF); and the Green Climate Fund (GCF). We validated our findings through interviews with experts from these funds as well as with international experts on climate finance and adaptation.

To generate further insights, including how to address the finance gap we analyzed many innovative projects and financing mechanisms of multilateral development banks (MDBs) and other impact investors.

An in-depth field research visit of the GCF, hosted by its Private Sector Facility (PSF) was also conducted. In total, three pioneering private sector adaptation projects from MCFs (totaling USD 194 million on investments), and four from MDBs located in Africa, Latin America and Asia are presented in this paper (totaling above USD 40 million in investments and financing facilities above USD 1 billion). Additionally, nine examples of public-private cooperation in flood protection financing programs in the UK, the Netherlands, Australia and Costa Rica are presented, along with an overview of innovative financing mechanisms for adaptation. Four of these nine programs are analyzed and presented in greater detail. The paper therefore presents insight into a) pioneering innovative financial structures and approaches, b) novel governance structures and implementation arrangements, and c) operational recommendations for key actors in the global climate finance architecture (donors, climate funds, private sector, banks and governments).

Combining multiple research methods (systems thinking, new institutional economics and case study research) at different scales, it offers a dynamic analysis of the past decade of climate finance. This timescale provides a unique opportunity to develop a holistic approach and framework for the evaluation and design of transformational climate finance interventions at the project, country and portfolio levels.

Concretely, we conclude that most private sector investment efforts in MCFs to date have worked with financial intermediaries and have focused on setting up financing facilities that improve access and reduce the cost of capital for adaptation strategies (especially in the agricultural sector). This research shows that although the increasingly complex and fragmented global climate finance landscape theoretically enhances the possibilities to provide funding complementarity, it often translates into prohibitive transaction costs and access barriers for private sector and vulnerable communities alike.

The most important systemic barriers, which go beyond the cost of capital, are yet to be tackled by programmatic approaches. These include:

- Transaction costs that stem from the scale (watershed and/or landscape) needed for effective adaptation investments.
- Transition risks that stem from the innovative nature of many of the adaptation technologies and or solutions required, for example Nature-based Solutions.

One programmatic example analyzed was pioneered by the PPCR at CIF. The program adopts a long-term blended finance strategy and combines country-level public sector-led interventions with targeted and well synchronized private sector instruments aimed directly at real economy private sector players, like companies whose operations affect and depend on a watershed.

The most important conclusions and recommendations of this report are:

First, MCFs, DFIs and donors need to intensify upstream coordination to remove systemic access barriers and reduce the transaction costs and cost of capital faced by local public and private actors. At the same time, they could play a catalytic role downstream by working with national and local governments and NGO's to strengthen local project preparation capacities and exploit the full potential of private sector participation. Cooperation in the design of application and evaluation procedures, as well as in the design of blended finance strategies, is urgently required.

Second, the full potential of private sector financing can be exploited by two main means. The first is to secure participation through innovative public procurement strategies, e.g. performance-based contracting (PBC) and Payment by Results (PbR) models. The second is to enable companies to invest collectively in the management of common resources by developing novel governance arrangements that fit local conditions while exploiting the economics of scale and scope, such as watershed-level collective contractual schemes and/or environmental markets.

All in all, this report provides a summary of the lessons learned over a decade of climate finance along with a holistic framework for the design of effective interventions. The most important conclusions of this research are:

- A public-private programmatic and blended finance approach that enables the combination of multiple (thematic and/or sectoral) finance streams is required;
- The development of novel governance structures for collective investments at watershed level in common pool resources and novel procurement strategies in the public and private sectors can accelerate the creation of new adaptation related markets; and
- There is a need for global and local partnerships that provide the necessary expertise and contribute to the reduction of transaction costs and transition-related risks.
- The next generation of investment vehicles and partnerships require closer collaboration between investors and problem solvers.

Evacuation of people from their homes during a flood in Watersnoodramp Zeeland, 1953