Financing the Local Climate Transition Through Local Climate Funds

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CITIES CLIMATE FINANCE LEADERSHIP ALLIANCE

FMDV
Supporting local authorities to access funding

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ABOUT THE CITIES CLIMATE FINANCE LEADERSHIP ALLIANCE

The Cities Climate Finance Leadership Alliance (the Alliance) is a coalition of leaders committed to deploying finance for city level climate action at scale by 2030. It is the only multi-level and multi-stakeholder coalition aimed at closing the investment gap for urban subnational climate projects and infrastructure worldwide. Climate Policy Initiative (CPI) serves as Secretariat for the Alliance. Funding for the Alliance's activities is jointly made available through two German government ministries: The Federal Ministry for Economic Cooperation and Development (BMZ) and the Federal Ministry for the Environment, Nature Conservation, and Nuclear Safety (BMU).

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INTRODUCTION

The fundamental challenge for small and medium-sized cities seeking to broaden the finance available for their climate projects and investment needs is prioritizing their projects and fulfilling the conditions of investors. These conditions request cities to formulate projects that are financially and technically sustainable, that integrate ESG criteria, that need a sufficient initial level of capital, and that are aligned with investors' risk level tolerance.

Cities require professional capability and sufficient creditworthiness to secure investors' confidence to mobilize their capital. However, many local governments, especially small and intermediary cities, both in developed and developing countries, do not have the professional skills to leverage external capital on their own, severely constricting their capacity to finance investments. Larger cities, mainly in developed economies such as Paris, London, and New York, seek ways to diversify their capital investment resources using off-balance sheet instruments.

To respond to these challenges, some local governments have developed or used existing territorial investment funds as **local climate funds**. These funds allow local governments to externalize mobilization and management of additional capital. They also allow them to pool both the resources and the green investment portfolios needed to contribute toward cities' climate transition. The local climate funds can serve as an efficient instrument to operationalize the local government's climate strategy (climate action plans, climate and green budgeting).

With their capacity to catalyze private capital and blended finance, and investment in small and medium size projects, these local climate funds investment vehicles have the potential to address the gap in green investment in developing and emerging markets.

This factsheet aims to explore the typologies of these instruments and their legal, technical, and financial prerequisites that need to be put in place.

This factsheet is intended to help local government leaders and their technical and financial partners have a better understanding of the complex structural components of setting up local climate funds, including identifying attractive financial models and the different ways to support financing the local climate transition.

WHAT ARE LOCAL CLIMATE FUNDS?

Although local climate funds are diverse in status, objectives, governing and financing structures and operating modalities, they share a core **mission to use limited public funds to leverage additional private resources, with the goal of supporting local governments to finance the climate transition at a local level.**

Local climate funds are defined by the following shared attributes:

- They are owned, controlled, or supported by local governments
- They execute a public, development-oriented mandate
- They are off balance sheet special[1] purpose investment vehicles
- They act as financial intermediaries to catalyze and aggregate public and private financing

A. TARGETS

Local climate funds generally use a set of financial tools to finance projects, programs, or entities with environmental benefits and – in most cases – social and economic benefits as well. Depending on local priorities and financing needs, local climate funds typically support investment in:

- **Projects in targeted sectors:** energy efficiency, transport, water & sanitation, public lighting, waste management, nature-based solutions, green infrastructure retrofit, etc.

OR

- **Specific environmental entities operating within the territory with various profiles:** sectorial public utilities, public agencies, and private companies such as project company (special purpose company), or small and medium enterprises and start-ups.

1 Off-balance sheet commitments are assets or liabilities that are not recorded on a local government's balance sheet. They can be managed by Special Purpose Vehicles (SPVs) which are subsidiaries created by parent bodies (private or public entities) enjoying their own legal status. This model allows to isolate off-balance sheet commitments from the local governments' constraints, in terms of creditworthiness and financial risk. For instance, SPVs' obligations remain secure even if the creditworthiness of parent entity (local governments) deteriorates or faces bankruptcy. These separate entities also allow flexibility in terms of management that are free from the constraints of municipal management, for by making it easier to recruit financial experts.

Box 1: Shandong Green Development Fund (ADB 2019)

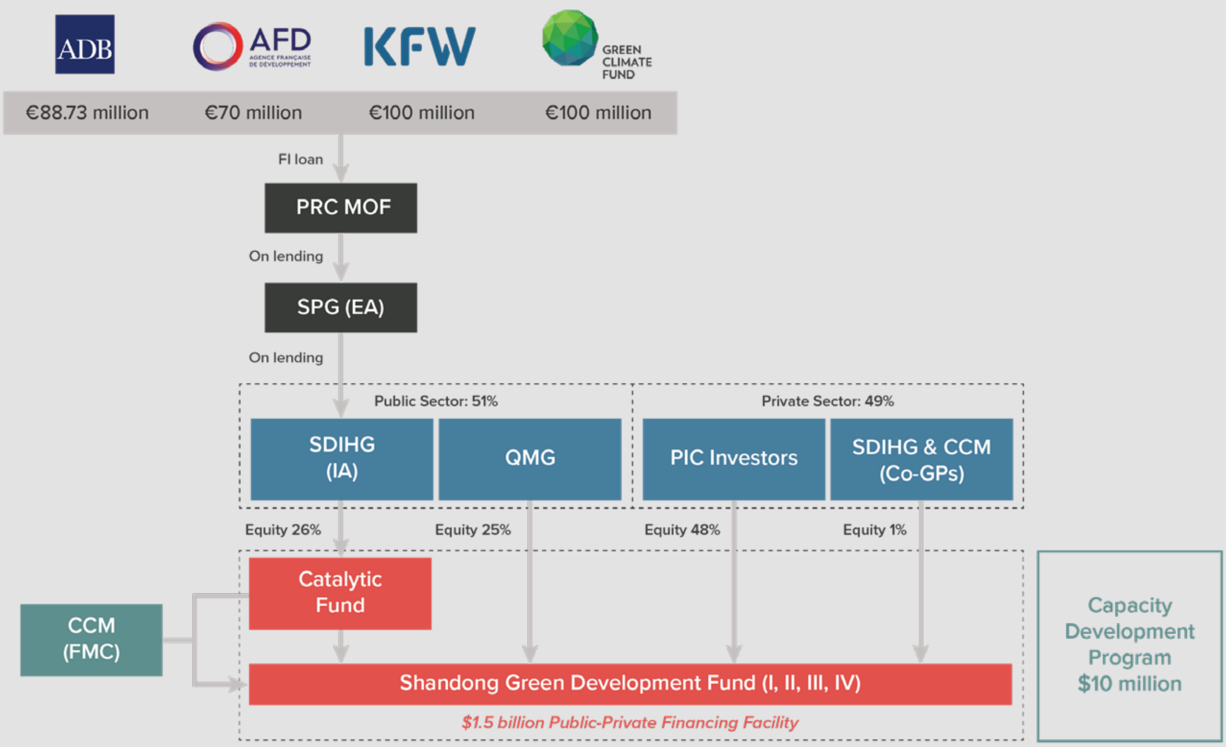
The Shandong Green Development Fund (SGDF) consists of a 1.5 billion USD public–private financing facility targeting higher-risk climate-resilient infrastructure projects, green and high technology manufacturing businesses, and investment, in municipal and sectoral sub-funds in the Shandong Province (Lindfield et al. 2021). The financing plan to fund USD 1.5 billion relies on public funding (over USD 800 million), including catalytic funds from IFIs (about USD 500 million). The private, institutional, and commercial (PIC) funds invest as limited partners (about USD 650 million).

This results in a public–private fund with an overall ownership structure as follows:

- 33%: Catalytic funds (Asian Development Bank [ADB], Agence Française de Développement [AFD], KfW and the Green Climate Fund [GEF])
- 25%: Shandong Provincial Government and local governments (Public)
- 41%: PIC investors
- 1%: SGDF Fund Management Company as general partner

Figure 1 illustrates how funds are channeled to the SGDF through the chosen capital structure.

Figure 1. Shandong Green Development Fund structure



B. CAPITAL STRUCTURE BASED ON BLENDED FINANCE

Local climate funds are usually capitalized with a combination of resources to allow for large infusions of seed capital and long-term financing. The typical capital structure is the following:

- **Public resources:** One or more local government(s) might provide an initial tranche of capital for the creation of the fund. This is normally considered to be a start-up phase capital and should not represent the majority of the capital used to leverage additional resources to be blended. More public resources for the start-up phase may be drawn from additional local, regional, metropolitan, or national public authorities.
- **"Catalytic" and concessional resources:** Development finance institutions (DFIs), donors, and philanthropies may provide concessional finance, guarantees or grant resources to help mitigate the risks for private investors, provide technical assistance, or concessional loans to blend with private capital.
- **Private resources** might be sourced from various types of investors and raised by different mechanisms, but mainly private capital will be mobilized through bond issuance, capital fundraising from private investors and/or syndicated loans.

C. VARIETY OF FINANCIAL SOLUTIONS OFFERED

The financing provided by a local climate fund needs to meet the funding requirements of their targeted investments, and each small and medium-sized project needs to be well-developed and contribute to the portfolio performance.

Local climate funds typically provide the following types of financing solutions:

- **Grants:** to demonstrate or support projects in pilot phases to prepare for scale-up, to de-risk the investment or to help the last mile preparation of a project.
- **Loans:** with various characteristics (senior, subordinate, concessional).
- **Equity:** through a special purpose vehicle (SPV), a project company or a company that provides a service that contributes to the low carbon local transition.
- **Credit enhancement & risk mitigation:** such as a first loss loan, insurance, or guarantees.

WHY SET UP A LOCAL CLIMATE FUND?

Even though there is not yet accurate mapping and it remains a niche market, there is an increasing number of cities around the world establishing or using local climate funds to finance sustainable and climate-friendly projects. These may include initiatives or companies within a city that face barriers to mobilizing capital for climate action and to developing strong portfolios of climate-friendly projects.

A. ADVANTAGES AND BENEFITS OF SETTING UP A LOCAL CLIMATE FUND

Despite different settings, priorities, focus areas, and operating modalities, the advantages and benefits of setting up a local climate fund are the following:

- **Using public funds efficiently**

Local climate funds leverage limited public funds to attract additional external investments to address financing gaps of climate projects. This approach allows public resources to be used efficiently through financing secured by repayment structures or revolving fund mechanisms, and for them to be scaled up by blending the public resources with finance from the private sector, DFIs and philanthropies, creating a multiplier effect.

- **Mobilizing private capital to meet demand**

Local climate funds can be effective in mobilizing private capital in several ways. They help reduce administrative and transactional costs associated with small, decentralized projects that are financially viable but too small to attract private financing on their own through economies of scale. In addition, through catalytic funds from DFIs, local climate funds can provide institutional backing for debt repayment that mitigates the risk of private investment in climate projects.

- **Generating and aggregating demand for financing**

To generate and aggregate demand for financing, local climate funds can provide technical assistance to support the development of bankable projects, which can in turn have two effects. First, it can help raise awareness of financing opportunities available for their target institutions (local governments, utilities, private companies) and increase the overall demand for climate finance.

Secondly, it can aggregate this demand for financing climate projects or initiatives by developing portfolios of bankable projects on a scale of investment attractive to DFI and private investors.

- **Supporting the local economy and job creation**

Because local climate funds are an incentive to generate local climate projects, to assist in mobilizing capital for those projects, and to support their scale-up, they can create substantial economic benefits at the local level, developing new sectors of the local economy and creating jobs and employment. Local climate funds also tend to function as "one-stop shops" for both investors and project leaders, making partnerships easier and thus spurring larger economic opportunities in the medium and long term.

- **Addressing knowledge gaps to reduce perceived risks**

Local climate transition projects usually introduce new concepts and technical solutions, which can be perceived as risky by investors. Local climate funds can help to incentivize investors to support climate-related innovations, lowering the perceived risks with first loss loans, grants, and guarantees, especially in the early stages of project development, and help demonstrate the viability of such innovation.

B. CONSIDERATIONS AND CHALLENGES TO BE ADDRESSED

Governments should also be mindful of potential challenges while seeking to establish a local climate fund. Amongst them, the following should be assessed in early stages:

- **Legislation:** Depending on the financial and operating modalities identified for the local climate fund and the associated legal requirements & framework applicable to it, particularly in regard to the ability of the local governments to provide seed capital to an investment vehicle, the legislation may need to be adapted. Legislative actions may need to be taken by, or promoted by, local governments seeking to establish a local climate fund.

Pertinent questions to ask are: *What current legislation applies to local climate funds? Does the existing legal environment allow for the establishment and operation of a local climate fund?*

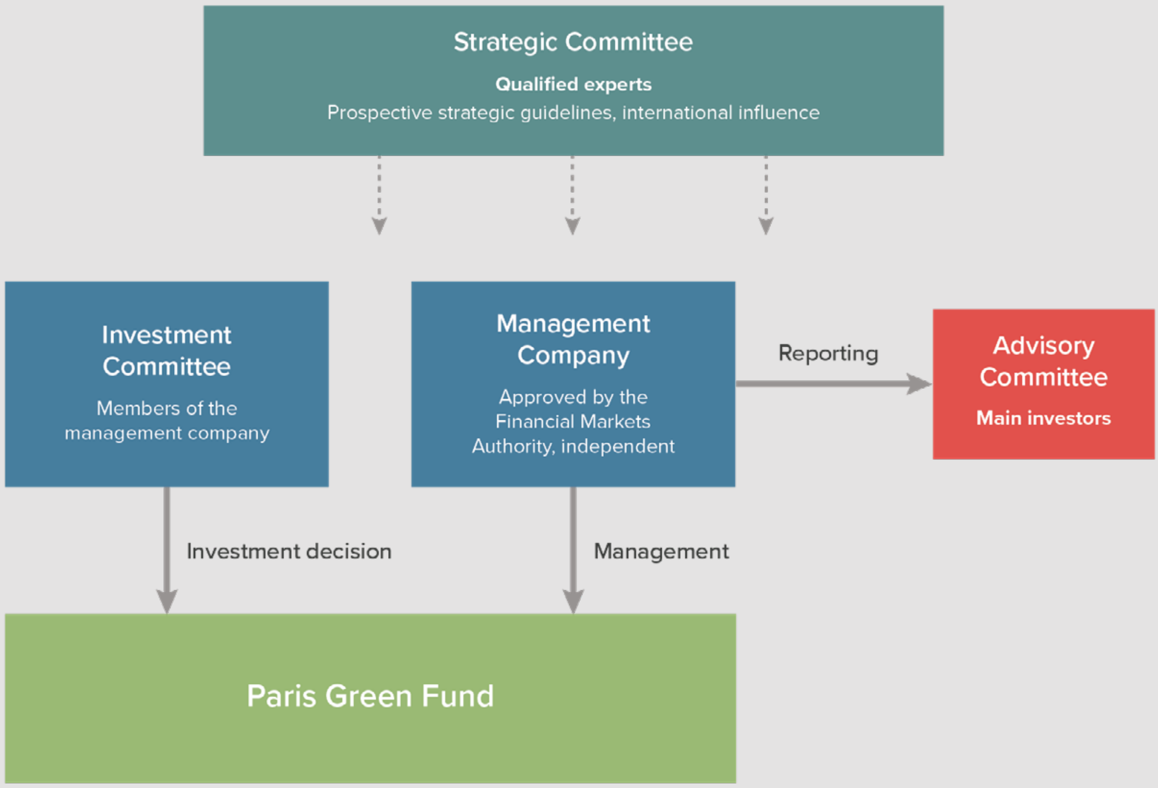
- **Governance:** The governance scheme of the local climate fund is an important aspect to consider during the creation process since it will determine the degree to which the local government(s) will be involved in the fund's operations and strategy, and the type of key local stakeholders that will be involved in the decision-making process. The great range of governance arrangements reflects the diversity of options available to local climate funds. Being capitalized by public funding and established by local governments, their boards should typically include public officials together with additional constituencies (such as operational partners, civil society representatives, research entities) to ensure transparent governance of the institution. In addition, a management team should be dedicated to the daily management and operations of the local climate fund. Usually, a professional asset manager company is recruited to act as the fund manager.

Pertinent questions to ask are: *What will be the governance scheme to oversee and monitor the development and operation of the local climate fund? What will be the* *local climate fund's board structure when operational? Does the governance scheme adequately represent key local stakeholders and decision-making bodies?*

Box 2: Example of the governing structure of the Paris Green Fund (FMDV 2019)

Figure 2 illustrates the Paris Green Fund's governance model, which is fully articulated within the Paris City's climate strategy: "Paris, a low-carbon city, 100% renewable energy in 2050", alongside green budgeting and green bond issuance.

Figure 2. Paris Green Fund structure (FMDV 2019)



- **Capitalization:** Local climate fund's initial capitalizations often rely on public funds which typically range from as little as USD 1 million to over 500 million. Depending on the modalities and objectives of the local climate fund, its capitalization can take different forms: some are continuously supported through a dedicated funding stream, others receive a one-time capitalization from the local government to attract additional resources (see capital structure for the origins of the resources).

Pertinent questions to ask are: *What are the arrangements for the initial capitalization of the local climate fund? Is this a one-off lump sum or a funding stream? How does the source and scale of the initial capital align with stakeholder objectives and market demand for the local climate fund's financing?*

- **Target market and clients:** The mandate, mission, and size of the local climate fund influence the type of projects, stakeholders, and financial markets that are targeted.

Pertinent questions to ask are: *What needs to be considered when defining the target for the local climate fund's financing? Who will benefit from the focus on the targeted sectors and how do they support the city's strategy?*

- **Financial products:** Financial products need to be decided during the creation process of the local climate fund, whether providing grants, loans, equity, credit enhancement, risk mitigation, or some combination of these.

Pertinent questions to ask are: *Which financial products will be offered? Who will partner to deliver these?*

- **Structuring a pipeline of projects:** One of the greatest challenges of local climate fund is to structure a pipeline of projects that are ready for investment, that corresponds to the general objectives of the local climate fund and to the investment prerequisites in terms of sustainability, duration, impacts, and profitability. Strong communication on the local climate fund objectives and criteria and a proactive consultation with the potential beneficiaries is needed.

Pertinent questions to ask are: *What kind of projects/initiatives is the local climate fund targeting in terms of sector, amounts, and impacts? What are the eligibility and investment criteria? How should the first pipeline of projects be selected?*

- **Duration of the local climate fund:** Again, different options can be considered. For example, it may be that the city defines a specific lifetime for the fund based on the capital raised, or they may seek financial self-sustainability for an ongoing indefinite period.

Pertinent questions to ask are: *What is the desired approach towards self-sustainability? How will this be incorporated into the design and operations of the local climate fund?*

- **Measuring impact:** Every new local climate fund should consider what metrics are to be used to measure its impact. Commonly used metrics will allow the local climate fund to benchmark its performance and identify areas for improvement. Performance metrics should also be used to communicate the mandate, mission, and impact of the local climate fund to stakeholders.

Pertinent questions to ask are: *How will the impact of the local climate fund be measured, by whom, and how often? How does impact measurement reflect the environmental, social, and economic objectives of the local climate fund and the local authority?*

The process for establishing a local climate fund may be divided into seven steps:

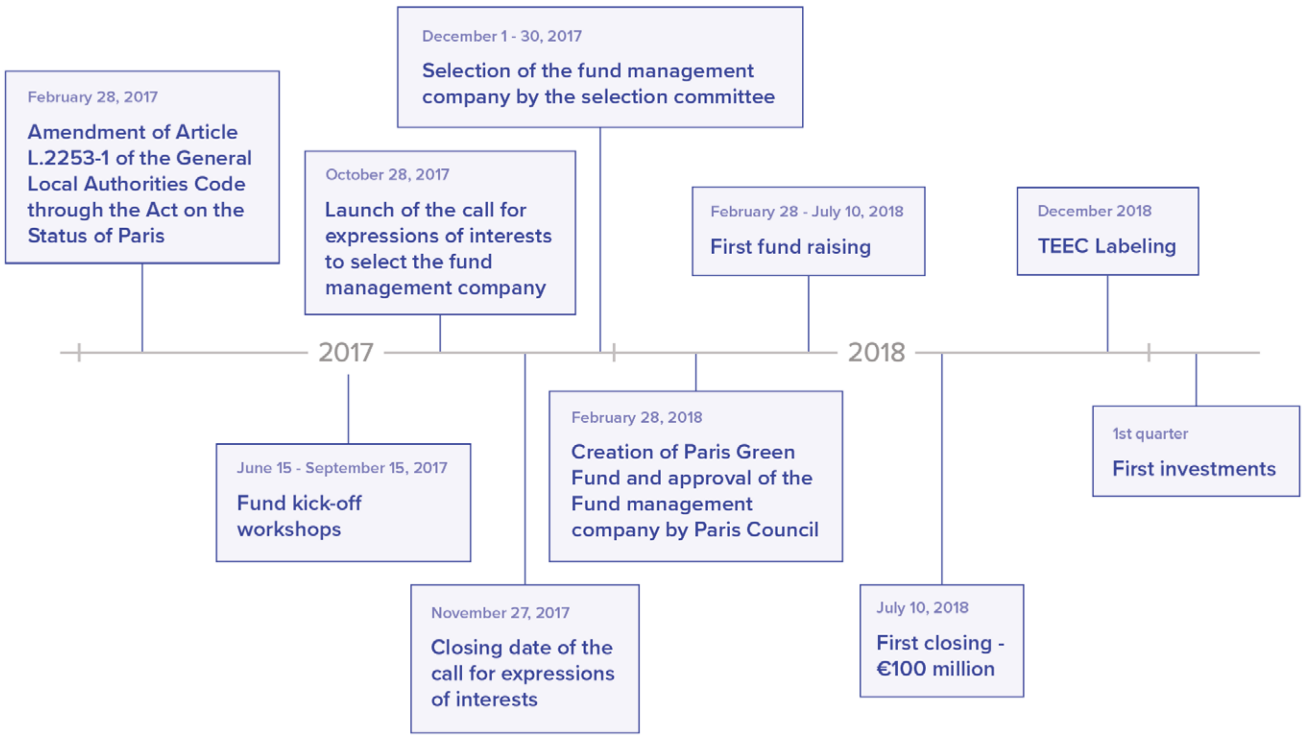
The setup of the local climate fund is to be led under the leadership and responsibility of the local government. These steps will have varying degrees of priority and will be implemented on a different schedule depending on the context.

1. **Evaluation:** Scoping the demand and local need for climate finance. Identifying the issues created by the current legislative environment. Determining the feasibility of

creating and operating a local climate fund, its role within the local landscape, and the groups that can support its creation.

2. **Political leadership:** Ensuring strong political leadership, defining the governance modalities, the Board member composition, and its functions.
3. **Staffing:** Even if the management of the local climate fund is externalized to a fund manager, hiring of high-level expert staff (and consultants where necessary) will be needed to enable the city to support, control, monitor, and orient the engagement of the local climate fund.
4. **Operating modalities:** Introducing a business plan and the operating roadmap for the local climate fund. Determining the technical and financial products it will offer. Evaluating the capital needs (equity and debt) to commence and maintain operations.
5. **Fundraising:** Fundraising efforts to secure the initial capitalization and/or operating costs.
6. **Project scoping:** Identifying a first set of projects for financing, including project selection, quantification of financing needs (types and amounts), and identifying potential sources for external capital for the projects.
7. **Pre-launch activities:** Preparing for day one of the local climate fund and defining an action plan for the first years of operations.

Figure 3. Timeline of the creation of the Paris Green Fund (FMDV 2019)



THE SPECIFIC CASE OF LOCAL CLIMATE FUNDS IN INTERMEDIARY CITIES OR DEVELOPING CONTEXTS

While most of the experiences of local climate funds have been identified in developed and emerging markets and within big cities and territories (London, Paris, New York, Toronto, Melbourne, Shandong in China, and Tamil Nadul in India), some opportunities are being explored both in intermediary cities in Europe and in developing markets.

If the main challenges of these new contexts are the legal capacities and the size of the market of the potential pipeline of projects, cities in developing economies or in secondary cities could investigate alternative models when setting up a local climate fund, taking advantage of the experiences of cities sharing the same national legislation and/or currency. Aggregating cities to tap into economies of scale, for example, could present a solution to create a sizable market to attract private investors.

EXAMPLES OF LOCAL CLIMATE FUNDS

- Paris Green Fund: implemented by Demeter, Paris Green Fund focuses on SMEs that contribute to pre-defined local development targets.
- London Green Fund: a £120 million fund set up to invest in schemes that cut London's carbon emissions, managed by the European Investment Bank. It provides funding for three Urban Development Funds (UDFs) that invest directly in waste, energy efficiency, decentralized energy, and social housing projects. These are 'revolving' investment funds, where money invested in one project is repaid and then reinvested in other projects.
- Tamil Nadul pooled fund: state-level pooled funds set up by the Government of India in 2006. The resulting Pooled Finance Development Fund Scheme (PFDF), was intended to provide credit enhancement facilities to Urban Local Bodies (ULBs) based on their creditworthiness, enabling them to access market borrowings through these state-level pooled funds.
- Toronto Atmospheric Fund (TAF): a regional climate agency that invests in low-carbon solutions and accelerate the scaling up of retrofits across the Greater Toronto and Hamilton Area. TAF created an innovative, non-debt financing instrument called the Energy Savings Performance Agreement (ESPA) where energy savings are used to cover the retrofit capital costs.
- Sustainable Australia Fund: Sustainable Melbourne Fund is a commercially oriented, independently managed unit trust, originally known as the Sustainable Melbourne, established by Melbourne City Council in 2002 to progress sustainable development in greater Melbourne.
- New York City Green Banks: green banks are public, semi-public, or not-for-profit institutions that offer a variety of financial products focusing specifically on climate mitigation projects; as such, they act as catalyzers for investment in clean energy infrastructure.
- Shandong Green Development Fund: a pilot investment fund in China dedicated to the development of "green" infrastructures. Shandong has the highest energy consumption and is one of the most carbon-intensive provinces in China, driven by its high use of coal as an energy source for its large industrial base. This project catalyzes private finance by offering adequate returns thanks through the blending of public finance, concessional donor finance, and private finance.

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