ENERGY
CATALYST

Investment guide: Special instruments

Introduction

Investors, development partners, and governments are increasingly adopting innovative models to facilitate business investment, aiming to overcome the inefficiencies associated with traditional financing, including high risks and low return on investment in development. This guide highlights several special financing instruments that are used in the energy sector, their features, benefits, and risks.

Special instruments overview

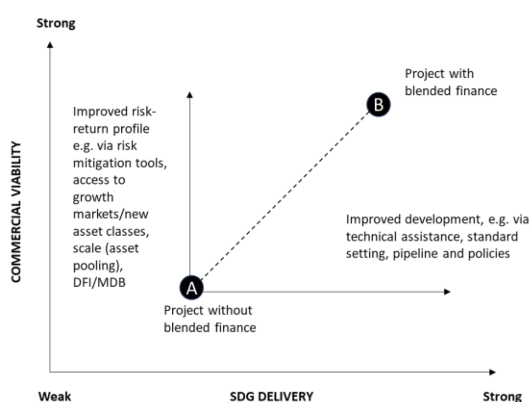
The attainment of social and developmental objectives such as 100% energy access by 2030 (as per SDG7), is a monumental challenge due to multiple factors such as high upfront costs, considerable risk due to technical and political issues, low returns, etc. As such, development partners and governments have devised new innovative models to crowd in private sector investment amplify progress by de-risking projects and ensuring outcomes are achieved.

Examples of special finance instruments

Blended finance

It is an innovative finance concept that refers to the strategic use of public and private capital, often with philanthropic or development finance components, to mobilize investment for sustainable development projects.

Figure 1: Blended finance as a tool for development



As illustrated, blended finance can enhance the commercial viability of SDG-related investments.

Examples of blended finance instruments

1. *Technical assistance grants* – refers to support aimed at crowding in private investment by strengthening the viability of projects by addressing knowledge gaps through capacity building. It is useful for early-stage organisations that require support in defining operational structures, business models, product development, and other support leading to operational viability.

2. *Catalytic first-loss capital* – refers to an arrangement where the development partner underwrites the initial risk of potential loss by providing capital to function as a buffer for more risk-averse private investors.
3. *Risk underwriting* – refers to insurance policies and guarantees that preserve capital for private lenders by providing a formal assurance that in case a pre-determined undesirable event occurs, the guarantor (development partner) will assume responsibility e.g., make repayments on behalf of the guaranteed (the business).
4. *Subordinated debt* – refers to a form of debt that ranks below other debt in terms of repayment priority. By providing subordinated debt, development partners ensure that there is buffer capital to absorb potential losses, thus minimising risk for private investors.
5. *Concessional funding* – refers to a form of debt that is provided by development partners at a lower-than-market interest rate, longer repayment periods, or flexible repayment terms as compared to commercial lenders. Concessional funding enhances the viability of projects by reducing risk, hence crowding in private investment.

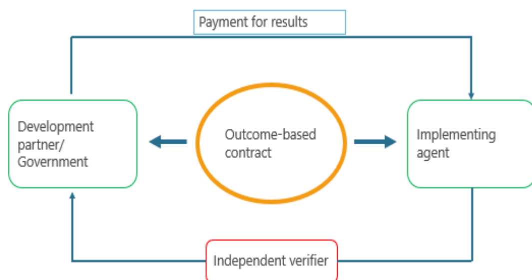
Impact finance/Outcome-based finance

Refers to an innovative field of finance that combines social and environmental outcomes with financial returns. Impact finance represents a shift in the way capital is deployed by aligning traditionally divergent objectives to enhance the participation of the private sector in social and environmental development. It does this by linking the disbursement of funds to the achievement of specified and independently verifiable social, environmental, or developmental outcomes. In the energy sector, outcome-based payment programs are useful in financing high upfront project development costs and de-risking outcomes. These instruments have been applied in clean cooking projects and off-grid energy across Sub-Saharan Africa and South Asia.

Examples of impact finance instruments

1. *Impact bonds* – these are a type of impact finance that uses private funding from investors to undertake a high-impact social or environmental project with specific, measurable outcomes. The investor is repaid by the government or development partner after the attainment of the specified outcomes. This model is quickly gaining momentum to facilitate the attainment of sustainable development goals (SDG)-aligned projects which typically have low financial returns.
2. *Social impact bonds* – also referred to as a social outcomes contract (SOCs), these are impact bonds where the government is the outcome payer for a social welfare project e.g., in health, affordable housing, energy access, etc.
3. *Development impact bonds* – typically refers to an impact bond where the external donor or development partner underwrites the social welfare project.

Figure 2: Outcome-based payment activities



Climate finance

It refers to the national, regional, or transnational financial flows or mechanisms drawn from both public and private sectors that are aimed at addressing climate change challenges through adaptation or mitigation efforts.

Examples of climate finance instruments

1. *Carbon finance* – this is a financing mechanism that allows entities to buy and sell carbon credits, which are market instruments created to incentivize the reduction or avoidance of greenhouse gas emissions. The carbon finance mechanism is significant to energy companies that reduce greenhouse gas emissions by providing alternative clean energy e.g., solar home systems, biofuels, electricity, etc. By registering a carbon project, energy companies can benefit from the sale of carbon credits, which improves the financial return on the project.
2. *Green bonds* – these are fixed-income instruments issued by governments or corporations to finance capital-intensive climate-related projects. The proceeds from green bonds are earmarked for investment in renewable energy, climate-resilient infrastructure, e-mobility, etc. Mid-stage and mature energy companies can tap into green bonds and can use impact bonds to scale their impact initiatives and attract capital from impact-focused investors.

Other special instruments

In addition to the previously described special instruments, businesses may encounter other alternative funding mechanisms when pursuing financing.

1. *Sale & leaseback*

In a sale and leaseback transaction, a business sells an asset to a third party and leases the asset back for a specific amount of time. Typically used on large, fixed assets such as land or facilities, this arrangement enables the business to realize a large cash payment whilst retaining access to the asset in return for smaller subsequent payments.

This model of financing can be useful to capitalise intensive energy projects where assets are held in the company's balance sheet.

However, consideration should be given to the implicit interest rate of the leaseback and ultimate cost of ownership over the lease and tax deductions available for depreciation or interest payment associated with lease agreements.

2. Off-balance sheet financing

Off-balance sheet financing is a tool used to separate specific assets and liabilities of a business from those that appear in the company balance sheet. This is done using a **special purpose vehicle** (SPV), a subsidiary company that is established to take ownership of the assets and liabilities that are unwanted on the books of the parent company. Securities (bonds/loans) are then issued by the SPV, backed by the assets, through a process known as **securitisation**.

This process is useful in that it separates these assets and liabilities from the holding company. The responsibility of paying the interest payments falls on the subsidiary and therefore protects the cashflows of the parent company.

3. Asset financing

Asset financing, also known as asset-based financing or asset-backed financing, is a type of funding arrangement where a company or individual secures a loan or credit facility by using specific assets as collateral. The assets can be tangible, such as machinery, equipment, inventory, real estate, or vehicles, or intangible, such as accounts receivable, patents, or intellectual property rights.

The lender provides funds to the borrower, and in return, the borrower pledges their valuable assets to serve as security for the loan. This reduces the risk for the lender, as they have a claim to the assets in case the borrower defaults on the loan. If the borrower fails to repay the loan as agreed, the lender can seize and sell the assets to recover their funds.

Asset financing can be a useful tool for businesses and individuals to obtain funding while leveraging their existing assets. However, it is crucial to carefully assess the terms and risks involved before entering such arrangements.

4. Invoice financing & factoring

Invoice financing, as either invoice factoring or invoice discounting, is the process of selling outstanding customer invoices to third parties. Businesses that extend credit to customers, or who have long payment terms, record sales as receivables until cash payment is made. These receivables can be sold to third parties at a discounted rate.

Invoiced factoring will transfer the collection of receivables to the third party; in invoice discounting the business itself retains responsibility for payment collection. Both types of invoice financing can be either **recourse**, where the business itself carries the risk of non-payment, or **without recourse**, where the third party carries non-repayment risk.

For businesses, invoice financing may provide a route to addressing the working capital need by realising cash from sales faster.

Hedging instruments (derivatives)

Hedging instruments are tools used to control the level of risk a business or investor is exposed to by providing downside protection on a specific external variable. This might include safeguarding against fluctuations in interest rates, exchange rates or commodity prices.

Tools including futures, forwards, options, and swaps involve contracts with third-party institutions that provide the business or investor with certainty about what rate will be applied when the returns on an investment are due.

Whilst hedging tools can help businesses better plan their cash flows, they can be sophisticated and expensive and may not be appropriate or accessible to earlier-stage businesses.

Conclusion

For businesses seeking financing, special investment instruments present an alternative to traditional term debt and equity funding. While these investment types may require additional effort to find investors, they can provide financing that aligns with businesses' unique needs, often balancing aspects of term debt and equity.

Further reading

Blended finance: A brief overview https://www.idfc.org/wp-content/uploads/2019/10/blended-finance-a-brief-overview-october-2019_final.pdf

Development impact bonds: https://corporatefinanceinstitute.com/resources/esg/development-impact-bond/

Off-balance sheet financing/ securitisation: Treasury Client Solutions: Securitisation (ifc.org)

Outcome based financing: GPRBA_Outcomes_Fund-Brochure-Final[19562].pdf

Results-based financing: https://www.oecd.org/dac/peer-reviews/Results-based-financing-key-take-aways-Final.pdf