Adapting Blended Finance Approaches to Drive Net Zero Transition

'Blended finance' was first introduced into the global financial system vernacular as part of the 2015 Addis Ababa Action Agenda. It refers to the concept of using financial instruments such as concessional finance to attract capital for projects that contribute to sustainable development, while providing financial returns to investors.

The challenge is that blended finance has yet to scale. According to the UN, most blended finance currently goes to middle-income countries because of the size and ease of their transactions. Only a small portion goes to the least-developed countries (LDCs).

With estimates that USD$4-6 trillion per year will be required for a global transformation to a low-carbon economy in line with Paris Agreement objectives, there is a pressing need to flow finance to developing countries. How then can blended finance support this flow?

Thinking beyond the project

To open a flow of blended finance at scale, there is a need to go beyond projects to investing in businesses and markets.

A key challenge is that, currently, most blended finance focuses on funding projects rather than infrastructure businesses.

For governments, it makes sense to think about public-private partnerships from a project perspective because projects have clearly defined outputs and objectives. The construction industry also think of infrastructure in project terms, as this facilitates planning and budgeting for a specific job.

But investors don't think of infrastructure as projects. They think about infrastructure as assets or businesses. A project itself is not investable. The resulting infrastructure business which generates long term revenues is what the investor is interested in.

There are many examples of infrastructure businesses that institutional investors are attracted to including airports, marine ports and electricity utilities. This is not a recent phenomenon. Remember Monopoly? You'll find six infrastructure businesses represented among its 22 streets, four railroads and two utilities.

Joint ownership of infrastructure businesses builds markets and boosts local economies

Blended finance, with its original focus on the strategic use of finance for sustainable development, can be adapted to establish infrastructure businesses that are jointly owned by governments and institutional investors on local stock exchanges.

An example of a government investing in partnership through a local stock exchange is The New Zealand Government's holding of 51% of Mercury NZ Ltd shares, with the remaining shares being traded on the New Zealand Stock Exchange (NZX).

This arrangement leverages one of the key benefits of investing in infrastructure businesses as opposed to projects. Businesses can readily adapt, whereas projects are limited by their scope. In this case, Mercury NZ Limited power company has established an e-transport business that enables customers to buy e-bikes and e-scooters at a discount, and leases EVs. Mercury's ability to move into new opportunities that reflect the impacts of technological disruption would not have been possible under a traditional project structure that would limited activities to their traditional electricity generation roots.

Institutional investors and government investing together also offers the opportunity to grow markets, which can stimulate local economies.

This idea harks back almost 80 years, to Jospeh Schumpter's 1934 finding that the system for allocating capital has a substantial impact on economic growth. Renewed interest in this topic has recently been led by US economist Ross Levine, whose work confirms a strong correlation between financial development and economic growth.

Adapting the focus of blended finance towards institutional investors and government investing together in infrastructure businesses on local stock exchanges would provide a pathway to transfer knowledge between the parties that could support other investments.

A simple example is a pension fund in a developed economy whose investment and governance expertise would support the development of an infrastructure business in an LDC. In turn, the pension fund would learn about the operations and functions of the local stock market which would build confidence to make other investments.

Blended finance and net zero

The reality is that if we want to finance to support the transition to net zero, asset owners in developed countries need to use their expertise to support the development of markets in developing countries. Blended finance provides a pathway to do this.

It is proposed that a Blended Finance Taskforce is establish with responsibility to mainstream and localise blended finance using new models including institutional investors and governments co-investing in infrastructure businesses on local stock exchanges.

Notes from presentation by UTS Institute for Sustainable Futures Research Director Gordon Noble presented at the UNCTAD World Investment Forum session Getting Blended Finance Right at Scale held in Abu Dhabi from 16-20 October.