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PARAGUAY

PROMOTING PRIVATE SECTOR INVESTMENTS IN ENERGY EFFICIENCY IN THE INDUSTRIAL SECTOR IN PARAGUAY

(PR-L1146)

PROJECT PROFILE

This document was prepared by the project team consisting of: Maria Netto (IFD/CMF); Manuel Fernandini (CMF/CPR); Omar Villacorta, Gloria Lugo, Margarita Cabrera, Alex Vasa, Annabella Gaggero, Isabelle Braly-Cartillier (IFD/CMF); Filippo Berardi and Gloria Visconti (CSD/CCS); Emilio Sawada and Roberto Aiello (INE/ENE), Alonso J. Chaverri-Suarez (LEG/SGO); Daniel Hincapie Salazar (ORP/ORP); and Jorge Luis Gonzalez (FMP/CPR).

PROJECT PROFILE

PARAGUAY

I. BASIC DATA

Project Name:	Promoting private sector investments in energy efficiency in the industrial sector in Paraguay	
Project Number:	PR-L1146	
Project Team:	Maria Netto (IFD/CMF); Manuel Fernandini (CMF/CPR); Omar Villacorta, Gloria Lugo, Margarita Cabrera, Alex Vasa, Annabella Gaggero, Isabelle Braly-Cartillier (IFD/CMF); Filippo Berardi and Gloria Visconti (CSD/CCS); Emilio Sawada and Roberto Aiello (INE/ENE), Alonso J. Chaverri-Suarez (LEG/SGO); Daniel Hincapie Salazar (ORP/ORP); and Jorge Luis Gonzalez (FMP/CPR).	
Borrower and Executing Agency:	*Agencia Financiera de Desarrollo* (AFD)	
Guarantor:	Republic of Paraguay	
Financial Plan:	IDB (GCF, Green Climate Fund):	US$20 million[1]
	Local:	US$20 million
	Total:	US$40 million
Safeguards:	Policies triggered: B.13 Classification: Not required	

II. GENERAL JUSTIFICATION AND OBJECTIVES

A. Background and justification

2.1 **Economic context.**[2] Paraguay's economy has been growing since 2013. In the face of external conditions that have been not easy on the region during this period, Paraguay's GDP grew 4.1% in 2016 and is projected to reach 4.2% in 2017. Inflation remains below the target of 4%. Policy interest rates have been lowered twice in 2016,[3] but private credit growth remains weak, with an annual increase of only 1.2% in 2016 compared to levels close to 20% in 2013 and 2014.

2.2 **The local financial sector and credit availability.** Paraguay's financial system lacks depth and domestic productive sectors require more financing than the amount effectively available in the financial sector.[4] Capital markets are not

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[1] Green Climate Fund (GCF) approval for the use of resources for this operation is pending and expected to take place at the nineteenth meeting of the GCF Board, planned for February/March 2018. Use of such resources will be subject to the terms of such approval, the requirements set forth in document GN-2895, and the terms and conditions of the "GCF Accreditation Master Agreement between the GCF and IDB" (AMA) (once it becomes effective) and a "Funded Activity Agreement" (FAA) to be entered between the Bank and the GCF pursuant to the Clause 6 of the AMA.

[2] Paraguay: 2017 Article IV Consultation-Press Release and Staff Report, IMF Country Report No. 17/233, July 2017.

[3] Reference rate of 5.5% in 2016, down from 6.8% in 2014 and 5.8% in 2015.

[4] Demichelis, F., De Groote, R 2014, *Nota Técnica Sectorial – Sector Financiero* – Paraguay, IADB.

developed; thus, banks, cooperatives and other financial institutions dominate the market, making bank credit the main source of financing for economic activity.[5]

2.3 The banking system remains profitable and capital ratios appear sound. But after rapid growth over 2004–15, bank credit in Paraguay has decelerated because of lower commodity prices. Higher NPLs and higher provisioning has caused banks to be cautious in extending new credit. Further, authorities are gradually introducing risk-based bank supervision, including a new banking law (December 2016) to strengthen financial sector oversight.[6] Long-term credit availability in the system has improved, but the deposit structure still restricts medium and long-term lending.[7]

2.4 Under more relaxed financial conditions, bank lending is expected to resume and liquidity should be reduced. However, the system's historically high levels of liquidity may reflect conservative risk management policies, partly due to adverse effects of previous recurrent financial crisis. Altogether, the system is not able to meet the need for long-term investment lending and offers less attractive instruments, adjusted for inflation and with variable rates.

2.5 **Access to finance as a barrier to Energy Efficiency (EE) investments.** The lack of availability of long-term credit directly undermines firms' capacity to invest in new projects. Inadequate access to finance is an obstacle to narrowing technology gaps and boosting the productivity and growth of industrial firms, particularly small and medium enterprises (SME).[8] One type of such productive investments that is relevant to SMEs is innovation and EE.[9] Implementing EE measures can have a significant impact in the firm's energy consumption, contributing toward reducing company expenses and increasing productivity and competitiveness.[10]

2.6 But despite SMEs' desire to invest in more efficient technologies, EE investments in Paraguay are hindered by the above-mentioned credit constraints and perceived risks.[11] In the case of SMEs, difficulties are heightened by collateral requirements from local financial institutions (LFI), lack of credit history and documentation requirements, high transaction costs that translate into high interest rates, and lack of capacity to develop bankable business plans. In addition, the time it takes to realize returns on investments becomes incompatible with the conditions offered by the banking system, generating mismatches in loan amortization periods. Firm's perceived risks associated with EE technologies are related to high up-front costs,

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5 Domestic credit to private sector in 2016 was 53% of GDP. (World Bank, 2017, World Development Indicators, "Domestic credit to private sector").

6 Paraguay: 2017 Article IV Consultation-Press Release and Staff Report, IMF Country Report No. 17/233, July 2017.

7 According to data provided by AFD (March, 2017), only 11.4% of deposits in the system had maturities longer than 3 years.

8 New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, OECD, 2015; G20/OECD High-Level Principles on SME Financing, OECD, 2015.

9 The average payback period of these projects is 3.6 years.

10 Industrial EE and competitiveness, Working Paper 05/2011, United Nations Industrial Development Organization (UNIDO), 2011.

11 A market study has shown potential demand for credit for EE improvements in SMEs, in particular, in brick fabrication, sugar mills and agroindustry (Carlino, H. 2015. *Estudio de mercado que proporciona insumos para la estructuración de instrumentos financieros para proyectos con beneficios ambientales para* AFD).

lack of information or trust on the performance of new equipment, and availability of reliable service for its installation and maintenance in a rather underserved market. On the other hand, LFIs traditional asset-based lending approach limits firms' borrowing capacity, as future cash flows generated by EE investment projects are not included in the risk analysis.[12]

2.7 **Importance of EE and government initiatives in the sector.** Roughly 70% of Paraguay's primary energy production comes from large bi-national hydroelectric projects (shared with Brazil and Argentina). The remaining portion comes from biomass. Electricity prices are low and local demand leaves surpluses that allow Paraguay to benefit from power exports to their neighbor countries. But less than 20% of the energy consumption in the country corresponds to electricity.[13] In fact, 42% of total energy consumption in Paraguay is still based on biomass. At the SME industrial level, firewood and biomass waste source 83% of the energy consumed by the sector (especially for direct heat and steam)[14] and is often used very inefficiently. Although at present this source is more accessible and less expensive, biomass is primarily supplied by non-sustainable systems of production, instigating deforestation. As a result, restrictions of biomass supply have been imposed by the new Zero Deforestation Law (2524). As enforcement of this Law is strengthened and biomass markets become formal, biomass prices are expected to increase further and at a considerably faster pace.

2.8 Paraguay's National Energy Policy, adopted by Executive Decree 6092 on October 2016 acknowledges the importance of energy as a factor of economic growth, industrial development and social progress, and outlines EE as one of its prioritized objectives. Its Action Plan includes the promotion investments in EE in industry and provides for specific support to the improvement of technology, equipment and processes through its National Energy Efficiency Plan (2014) and its *Comité Nacional de Eficiencia Energética*.

2.9 The Intended Nationally Determined Contribution (INDC)[15] of Paraguay established a unilateral goal of 10% of national greenhouse gas (GHG) emissions reduction by 2030, and subject to access additional climate finance another 10%. To achieve these goals, Paraguay has developed a National Climate Change Plan and a Mitigation Strategy (2014), which includes: strengthening of institutional capacity to promote EE, the adoption of sector policies towards clean energy through measures oriented to private sector investment in EE equipment, mobilization of financial resources to improve energy systems, and the promotion of reforestation with energy purposes to diminish pressure on native forests.

2.10 Unlocking Paraguay's full EE potential requires a well-designed financial strategy that incorporates in-depth analysis and coordinates all relevant actors (including relevant government institutions, technology and service providers, LFIs and SMEs) to incentivize private investment in EE projects.

[12] Carlino, H. 2015.
[13] Electricity demand is affected by deficiencies in the lower voltage distribution grids.
[14] *Balance Energético Nacional* 2015, Viceministry of Mines and Energy of Paraguay, 2016.
[15] United Nations Framework Convention on Climate Change (UNFCCC), 2016.

B. Intervention proposed and program objectives

2.11 The problem that the program intends to address is the lack of adequate financing for SMEs operating in energy-consuming industrial sub-sectors in Paraguay, where a significant potential for implementing EE measures has been identified.[16] By increasing access by SMEs to medium and long-term financing, the program would enable the development of increased investment[17]. AFD will intermediate the program resources to eligible LFIs,[18] which in turn will provide sub-loans to eligible SME EE projects. This financial intermediation model also aims to generate a demonstration effect with LFIs that can contribute to transforming the local climate finance market in the long term. Further, the program will also result, in the long term, in potential productivity gains thanks to the energy savings.

2.12 The program's objective is to promote EE in the industrial SME sector in Paraguay, by providing medium and long-term finance for EE investment projects.[19] Successful implementation of projects financed will contribute to reduce GHG emissions, supporting the achievement of the country's climate change goals.

III. TECHNICAL ISSUES AND SECTOR KNOWLEDGE

3.1 The proposed program consists of single component of a global credit loan operation to be undertaken and executed by *Agencia Financiera de Desarrollo* (AFD), development bank of Paraguay. Financing for the program's credit loan operation includes US$20 million in reimbursable resources from the Green Climate Fund (GCF),[20] plus US$20 million from AFD. Additional US$3 million non-reimbursable resources from the GCF will be used for technical cooperation (TC) activities to: (i) reduce SMEs and LFI perceived risks associated to EE investments; (ii) support SMEs and technology providers in developing bankable sub-projects; and (iii) promote energy policy enabling environment for EE investments.[21] Disbursement of reimbursable funds will be made over a period of five years and based on rediscounting of eligible expenses from the executing agency.

3.2 The provision of adequate financing is made possible by using concessional resources from the GCF, channeled through and with counterpart resources by the local development bank, AFD, which in turn will provide financing to EE SME

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16 Carlino H., 2015.

17 IDB, GN-2768.

18 The program will operate with local regulated LFIs (supervised by the Central Bank) and non-regulated LFIs accredited by AFD according to its supervision and risk management policies.

19 Program activities include financing and non-financing mechanisms that aim to improve local technical capacity and knowledge on EE investments by LFIs and SMEs.

20 The GCF is a UNFCCC's financial mechanism that provides funding to promote mitigation and adaptation to climate change. The IDB is an entity accredited by the GCF to manage these resources. The framework for this relationship is established in the AMA approved by the IDB Board (GN-2895, Resolution DE-31/17). In addition, the FAA to be agreed between the IDB and GCF will establish terms and conditions specific to this program, and shall be signed prior to the signing of the loan contract. The program has Paraguay National Designated Authority's non-objection.

21 This will be achieved through two TCs aimed to: (i) support AFD to adequately engage LFIs, SMEs and technology providers in the program (PR-T1249); and (ii) support the Ministry of Energy to promote execution of its policies to reduce energy use in private sector. The TC support follows similar experiences implemented by national development banks - Energy Savings Insurance (ESI).

projects through its accredited LFIs. Sub-projects to be financed will be deemed eligible based on conditions established in the Operating Regulations (OR), to be agreed between IDB and AFD. The program will apply the procedures established by the IDB for monitoring and evaluation of investment operations, and will also be consistent with GCF requirements.

3.3 The program is aligned with the objectives of promoting investment financing through the financial system and enhancing the productivity and competitiveness of firms of the IDB Country Strategy for Paraguay (2014-2018) (GN-2769). The operation is consistent with the Institutional Strategy Update 2010-2020 (AB-3008), and is aligned with the challenge of productivity and innovation, and with the cross-cutting theme of Climate Change. The program is consistent with Bank's priorities as set out in its Integrated Strategy for Climate Change Adaptation and Mitigation, and Sustainable and Renewable Energy (GN-2609-1) and is aligned with the SME and Financial Access/Supervision Sector Framework Document (GN-2768-3) the Sustainable Infrastructure for Competitiveness and Inclusive Growth Strategy (GN-2710-5) and the Institutions for Growth and Social Welfare Strategy (document GN-2587-2). According to the joint MDB approach on climate finance tracking, an estimated 100% of total IDB funding for this project is invested in climate change mitigation activities and will contribute to the IDBG's climate finance goal of 30% of operational approvals by year's end 2020. The program will be jointly prepared by the teams of IFD/CMF, INE/ENE and CCS/CSD (triple booking).

IV. ENVIRONMENTAL SAFEGUARDS AND FIDUCIARY SCREENING

4.1 Due to its financial intermediation structure, and following Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703), the program does not require classification. Program preparation will include an Environmental and Social Management System (ESMS), to be fully integrated in the program's OR. Risks at the sub-project level are expected to be low. Nevertheless, the ESMS will provide a framework for the proper assessment, management and monitoring of individual sub-projects and overall portfolio, in accordance with the IDB environmental safeguards policies. The ESMS shall also integrate all applicable local systems and norms.

4.2 AFD has proven experience as a second-tier financial institution, channeling IDB loan resources to investment projects that promote economic development and job creation. It has a range of financial instruments and the capacity to engage LFIs in the provision of financing consistent with public initiatives and priorities. The project will support AFD in strengthening its capacities.[22]

[22] IDB has an extensive experience working with AFD, including with operations 1968/BL-PR; 2150/BL-PR; 2639/BL-PR; 2640/OC-PR; and 3354/OC-PR. In the last two years IDB has been providing technical cooperation support to AFD to strengthen its capacity in promoting green finance (ATN/OC-13944-RG and ATN/CF-15571-RG).

V. EXCEPTION TO BANK POLICIES

5.1 An exception to GP-104-2 “Guarantees required from the borrower” (OP-303) will be requested for approval by the Board of Executive Directors so that the sovereign guarantee from the Republic of Paraguay extends only to the monetary obligations of the loan, including repayment of principal, payment of interest and fees. Therefore, this guarantee will not include the provision of the local contribution required for the project or performance requirements or contractual obligations for project execution, all of which will be the sole responsibility of AFD.

VI. RESOURCES AND TIMETABLE

6.1 Distribution of the Proposal for Operation Development for Quality and Risk Review is expected on January 10, 2018; and the consideration of the Loan Proposal by the Executive Board of Directors is expected by May 16, 2018. An estimated US$100,000 administrative budget and 1.06 FTEs are required to complete preparation of the proposal (see Annex V).

CONFIDENTIAL

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Safeguard Policy Filter Report

Operation Information

Operation		
PR-L1146 Financial Innovation for Energy Efficiency in Paraguay		
Environmental and Social Impact Category	High Risk Rating	
B13	{Not Set}	
Country	Executing Agency	
PARAGUAY		
Organizational Unit	IDB Sector/Subsector	
Climate Change	FINANCING FOR ENVIRONMENTAL SUSTAINABILITY	
Team Leader	ESG Primary Team Member	
MARIA E. NETTO DE A. C. SCHNEIDER	{Not Set}	
Type of Operation	Original IDB Amount	% Disbursed
Loan Operation	$20,000,000	0.000 %
Assessment Date	Author	
1 Oct 2017	isabelleb	
Operation Cycle Stage	Completion Date	
ERM (Estimated)	19 Dec 2017	
QRR (Estimated)	23 Feb 2018	
Board Approval (Estimated)	{Not Set}	
Safeguard Performance Rating		
{Not Set}		
Rationale		
{Not Set}		

Safeguard Policy Filter Report

Potential Safeguard Policy Items

[No potential issues identified]

Safeguard Policy Items Identified

B.1 Bank Policies (Access to Information Policy– OP-102)

The Bank will make the relevant project documents available to the public.

B.2 Country Laws and Regulations

The operation is expected to be in compliance with laws and regulations of the country regarding specific women's rights, the environment, gender and indigenous peoples (including national obligations established under ratified multilateral environmental agreements).

B.3 Screening and Classification

The operation (including associated facilities) is screened and classified according to its potential environmental impacts.

B.7 Supervision and Compliance

The Bank is expected to monitor the executing agency/borrower's compliance with all safeguard requirements stipulated in the loan agreement and project operating or credit regulations.

B.13. Noninvestment Lending and Flexible Lending Instruments

Ex-ante impact classification may not be feasible for this type of operation. This includes: policy-based loans, Financial Intermediaries (FIs) or loans that are based on performance criteria, sector-based approaches, and conditional credit lines for investment operations.

Recommended Actions

Operation has triggered 1 or more Policy Directives; please refer to appropriate Directive(s). Complete Project Classification Tool. Submit Safeguard Policy Filter Report, PP (or equivalent) and Safeguard Screening Form to ESR.

Additional Comments

Based on Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703), the Project is classified as a financial intermediary and as such is not categorized according to its potential environment and social (E&S) impacts and risks. It is expected that the guaranteed portfolio present low risk. The Executing Agency has a good institutional capacity to manage low to medium E&S risk projects and has been continually improving such capacity in collaboration with the Bank. Based on the information available at this stage as well as the intended use of proceeds as further described, this operation is pre-classified as low risk (FI-3). It is worth noting that the IDB has been executing very similar projects in Mexico, Colombia and El Salvador. Program categorization will be confirmed during due diligence and ESMS will be put in place to manage potential E&S risks.

ENVIRONMENTAL AND SOCIAL STRATEGY

I. BASIC DATA

Project Name:	Promoting private sector investments in energy efficiency in the industrial sector in Paraguay.
Project Number:	PR-L1146
Project Team:	Maria Netto (IFD/CMF); Manuel Fernandini (CMF/CPR); Omar Villacorta, Gloria Lugo, Margarita Cabrera, Alex Vasa, Annabella Gaggero, Isabelle Braly-Cartillier; Filippo Berardi and Gloria Visconti (CSD/CCS), Emilio Sawada and Roberto Aiello (INE/ENE), Alonso J. Chaverri-Suarez (LEG), Daniel Hincapie Salazar (ORP).
Borrower and Executing Agency:	*Agencia Financiera de Desarrollo* (AFD)
Guarantor:	Republic of Paraguay
Financial Plan:	IDB (GCF, Green Climate Fund): **US$20 million**[1] Local: **US$20 million** Total: **US$40 million**
Safeguards:	Policies triggered: B.13 Classification: B.13

II. INTERVENTION PROPOSED AND PROGRAM OBJECTIVES

2.1 The problem that the program intends to address is the lack of adequate financing for SMEs operating in high energy-consuming industrial sub-sectors in Paraguay, where a significant potential for implementing EE measures has been identified[2]. By increasing access to medium and long-term financing, the program would enable the development of increased investment[3] in the short term. Due to its model of financial intermediation through LFIs, it also aims to generate a demonstration effect that can contribute to transforming the local climate finance market in the long term.

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[1] Formal approval by the GCF is pending and expected to take place at the nineteenth meeting of the GCF Board, planned currently for February/March 2018. See footnote #15.

[2] Sub-sectors identified include sugar industry, brickmaking and ceramics industries, and drying processes for grains. Several factors were taken into account in the selection of the target sectors for the program, including: participation in country's GDP, relevant value chains, impact on generating positive foreign trade and job creation, among others (see Carlino, 2015).

[3] *Documento de Marco Sectorial de Respaldo para PyME, Acceso y Supervisión Financieros.* (IDB, GN-2768).

2.2 The program's objective is to promote EE in the industrial SME sector in Paraguay, by providing medium and long-term finance for EE investment projects.4 Successful implementation of projects financed will contribute to reduce GHG emissions, supporting the achievement of the country's climate change goals.

III. IDB'S ENVIRONMENT AND SAFEGUARDS COMPLIANCE POLICY

3.1 Due to its financial intermediation structure, and following Directive B.13 of the Environment and Safeguards Compliance Policy (OP-703), the program does not require classification. Program preparation will include an Environmental and Social Management System (ESMS), to be fully integrated in the program's Operating Regulations (OR). Risks at the sub-project level are expected to be low. Nevertheless, the ESMS will provide a framework for the proper assessment, management and monitoring of individual sub-projects and overall portfolio, in accordance with the IDB environmental safeguards policies. The ESMS shall also integrate all applicable local systems and norms.

IV. ENVIRONMENTAL AND SOCIAL IMPACTS AND RISKS

4.1 Projects that promote the sustainable use of natural resources through the adoption of new technologies are expected to result in savings in water and energy consumption, for example, and thus generate positive environmental and social impacts.

4.2 However, such projects may have adverse impacts on the environment, for example, if it is not ensured that the replacement of obsolete modern technologies is not adequately managed. Due to the very nature of the project and its target beneficiaries, mainly small and medium-sized enterprises currently in operation, no major environmental or social impacts are anticipated.

4.3 It should be noted that AFD already has trained personnel in the area of environmental and social risk management and has an environmental and social risk management system for its first and second floor activities.

4.4 On this basis, this operation would be classified as low risk (FI-3), this classification will be confirmed during the due diligence stage.

V. ENVIRONMENTAL AND SOCIAL STRATEGY FOR THE DUE DILIGENCE

5.1 Consistent with the approach to financial intermediation operations, the Bank will conduct the analysis of the proposed program at two levels; one at the corporate level, specifically AFD's ability to manage and apply the Bank's environmental and social safeguards, identifying the capacity and expertise of areas within the entity to allow safeguards to be applied to projects and investments to be financed with IDB resources. The other level is in the analysis of specific projects or investments. In this case and in coordination with AFD, management tools will be defined to verify the environmental performance and therefore the eligibility of the sub-

[4] Program activities include financing mechanisms, as well as non-financial instruments that aim to improve local technical capacity and knowledge on EE investments by LFIs and SMEs. See ¶**Error! Reference source not found.**.

borrowers and identify the impacts and risks of each type of project to promote the rational use of natural resources for those who request funding.

5.2 In any case, during the environmental and social analysis of the program the following topics will be analyzed:

a. Normativity applicable to the project.

b. Institutional capacity of AFD in the management of environmental and social risks.

c. Management procedures to be applied by AFD to assess eligibility and mitigate the potential environmental risks of projects that promote the rational use of natural resources, including due treatment of the disposal of equipment that goes out of circulation.

5.3 The results of the analysis of the operation will be summarized in the Environmental and Social Management Report that will define the environmental and social requirements of the program.

SECTORAL WORK INDEX

Studies	Description
Sectoral studies	New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, OECD, 2015.
	G20/OECD High-Level Principles on SME Financing, OECD, 2015.
	Financial Development in Latin America and the Caribbean: The Road Ahead, Policy Research Working Paper 2380, World Bank, 2012.
	Industrial energy efficiency and competitiveness, Working Paper 05/2011, United Nations Industrial Development Organization (UNIDO), 2011.
	Carlino, H. (2015). Estudio de mercado que proporciona insumos para la estructuración de instrumentos financieros para proyectos con beneficios ambientales para la Agencia Financiera de Desarrollo de Paraguay.
	Balance Energético Nacional 2015, Viceministry of Mines and Energy of Paraguay, 2016.
	Prospectiva Energética de la República del Paraguay 2013-2040. Fundación Bariloche, 2016.
	Documento de Marco Sectorial de Respaldo para PyME, Acceso y Supervisión Financieros (IDB 2017, GN-2768)
	IDB (2017). Financial Innovation Lab. Energy Savings Insurance (ESI).
Execution mechanism, and fiduciary and control issues	Operating Regulations (in preparation).
Risk analysis	See Risk Management Appendix.

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