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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Roads for Mdbs to Help to Close the Financial and Technical Gaps for Fossil Fuels Phase-Out in Developing Countries

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Abstract

At the G20 summit in 2023, countries agreed to triple global renewable energy capacity by 2030 and achieve global net zero emissions by mid-century. Achieving these goals will require a substantial scaling-up of investment and climate finance for which Multilateral Development Banks (MDBs) are expected to play a critical role. Nevertheless, MDBs have faced scrutiny over their continuous support to fossil fuel projects and failure to consistently allocate resources to low-carbon development projects. This brief describes two main areas where MDBs can play a central role in correcting course:

1. MDBs should work on four priorities: (i) updating their Paris Alignment methodology, (ii) updating Word Bank and joint-MDB country plans, (iii) joining international initiatives like the Clean Energy Transition Partnership (CETP), and (iv) increasing the quality of clean energy finance.
2. MDBs should focus on avenues for transition finance mobilization for fossil fuel producers, in particular State-Owned Enterprises (SOEs) and their host governments, which is a blind spot of current climate finance discussions. Here, we explain three avenues to engage with SOEs and their host governments to increase their ambition in climate change mitigation by affecting their credit ratings and finance conditionality, as well as providing fiscal and regulatory assistance for transition planning and implementation.

Diagnosis of the issue

Emerging markets and developing countries, excluding China, require over US$1 trillion annually by 2030 to transition to carbon neutrality (Songwe, Stern, and Bhattacharya 2022), but receive currently less than 27% of the necessary climate investment (Netto, Rizzo, and Feitosa 2023). Multilateral Development Banks (MDBs), of which G20 countries are collectively major shareholders, are expected to play a critical role in closing this finance gap. Until now, MDBs have faced scrutiny over their continuous support to fossil fuel projects and failure to consistently allocate resources to low-carbon development projects.

Fossil fuel projects support

In 2020, nine major MDBs stopped project financing for coal for the first time (IISD 2021b) and have not provided funding for coal since then (O'Manique 2023). However, funding for oil and gas (O&G) has continued and not been included yet (or only included partially) in the MDB finance restrictions policies (Neunuebel et al. 2023). Figure 1 shows the latest data on fossil fuel finance by nine MDBs for 2022 (energyfinance.org).

Despite the fall in direct fossil fuels project finance, indirect fossil fuel financing (e.g. policy-based lending, trade finance and intermediated finance) continues to be substantial (Neunuebel et al. 2023). This is at odds with the commitment to support a just and ambitious transition away from fossil fuels which MDBs have made at COP28(UNFCCC 2023).

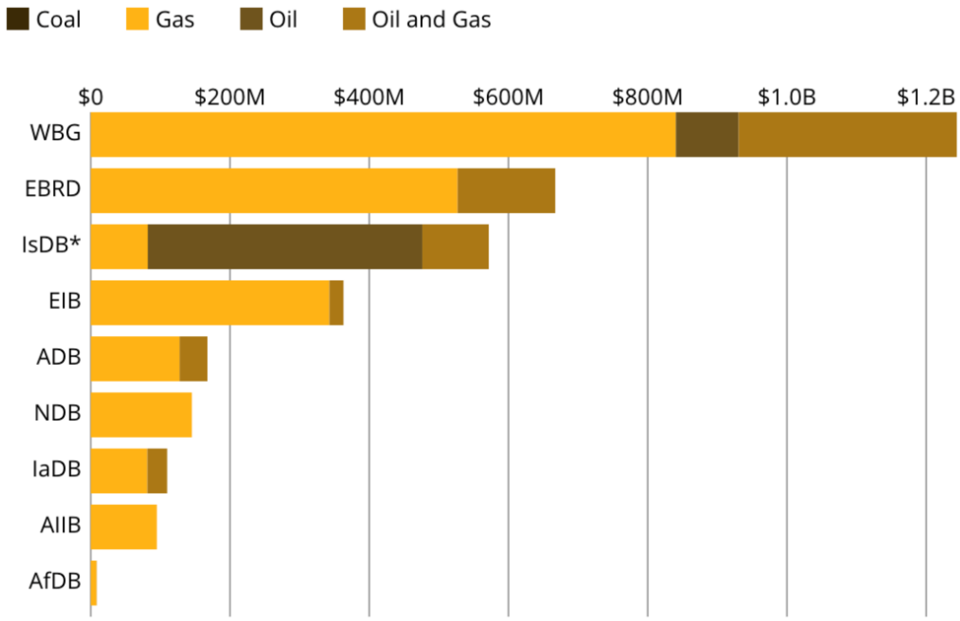

FIGURE 1. MDBs' Fossil Fuel support, annual average 2020-2022, USD billions

*Source: (*OCI 2024)

Of special concern is the deterioration of the quality of MDBs' climate finance reporting in 2021-2022. Important statistics previously included in their Joint Reports on Climate Finance have been omitted, making it difficult to track changes in fossil fuel project support (Neunuebel et al. 2023). However, there are strong indications that finance for O&G projects has increased since the invasion of Ukraine in 2022, in particular through indirect energy support (e.g. through financial intermediaries or policy-based lending) (O'Manique 2023).

Another point of concern is that the MDBs' joint Paris Alignment methodology excludes only coal and peat power as 'non-aligned' (World Bank Group 2018), leaving the door open for further finance of hydrocarbon projects, in particular in fossil gas, which is misleadingly touted as a "transition fuel" despite its well known lock-in risk, high climate and environmental impacts, and poor economic competitiveness compared to renewable alternatives (IISD 2021a). Indeed, the EIB is the only MDB that does not consider gas as a transition fuel, with most other MDBs still actively promoting it in project finance, development policy finance, and through financial intermediaries.

Renewable energy support

Global investments in renewables reached USD 499 billion in 2022, but they are still only one tenth of the amounts required to enable a Net-Zero scenario, which have been estimated at around USD 5 trillion a year between 2023 and 2030 (IRENA and CPI 2023; Jones and Mun 2023). Of this, it is estimated that investments in emerging and developing economies other than China need to increase fivefold, in particular in Africa, which currently only attracts 3% of global energy investment (IEA 2023b; 2023a). MDBs support for clean energy was $20.3 billion per year from 2020 to 2022, 3.3 times the support for fossil fuels, reaching a record high of $26 billion in 2022 (O'Manique 2023).

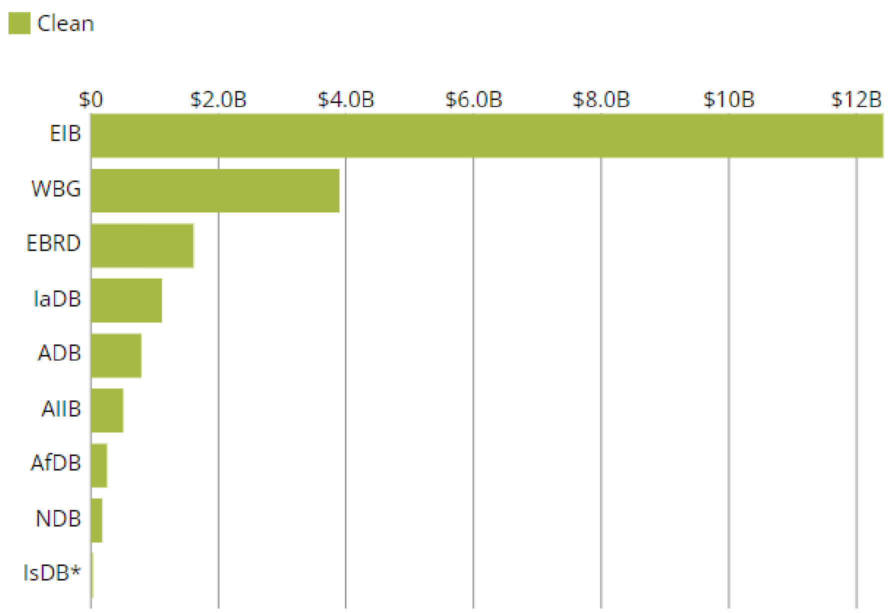

FIGURE 2 - MDBs Clean Energy support, annual average 2020-2022, USD billions

Source: (OCI 2024)

Despite the positive trends, finance for clean energy is still too small compared to what countries, in particular developing countries, require for implementing a transition to 100% renewable energy systems. Moreover, only a small fraction of the finance is concessional, and some of the supported projects have potential impacts on land rights and indigenous communities (Moreno et al. 2023), showing the importance of increasing not only the scale but also the quality of clean energy finance by MDBs.

Fossil fuel producers

Finance mobilization for fossil fuel producers, in particular State-Owned Enterprises (SOEs) in the extractive and energy sectors and their host governments in emerging economies (for example, Petrobras in Brazil), is a blind spot of current discussions around climate finance but will be central to enable a global transition away from fossil fuels. Here, we explain how MDBs can play a central role in addressing this blind spot.

The inevitable peak and decline of fossil fuels will expose fossil fuel producers, including SOEs in extractive and power sectors to a series of financial, economic, political and social risks. These risks will vary for fossil fuel SOEs, they are particularly heightened in the case of National Oil and Gas Companies (NOCs), given their political and economic weight in their host countries and their importance as source of state revenues (Coffin 2021; Manley, Furnaro, and Heller 2023). There is an urgent need for NOCs and their host countries to create transition plans, which financial actors could support.

While climate and transitions risks are not yet directly factored into credit ratings (Burke 2023; Financial Times 2023),the costs of securing debt may increase as financiers become more climate conscious and aware of fossil fuel stranded assets risk (S&P 2021). Despite the growing transition risks, there is still a disconnect between financial actors, including MDBs, and the need for fossil fuel producers' decarbonisation. In particular, as shown in Figure 3, NOCs' credit ratings are currently not correlated with their low carbon transition plans, in stark contrast with measures accounting for companies' progress toward global climate goals like the ACT score[1]. Given the heightened transition risks many NOCs face, those risks should be better reflected in credit scores. This is particularly relevant for NOCs operating in lower-middle-income countries where climate finance must be scaled up.

Direct and indirect financers (e.g. sovereign lenders), including MDBs, are a key source of financing for NOCs and their host governments, especially for non-commercial operations (e.g. fuel subsidy programmes) (Christiansen 2013). Analysts view this as a fiscal pathway for NOC host governments to circumvent sovereign debt limits (Lupo-Pasini 2021; WTW 2023), which gives MDBs and other sovereign lenders a unique point of leverage to drive credible transition plans within O&G producers.

[1]The ACT Initiative provides a corporate climate accountability framework with sectoral methodologies to assess companies' decarbonization strategies and transition plans (ACT, n.d.).

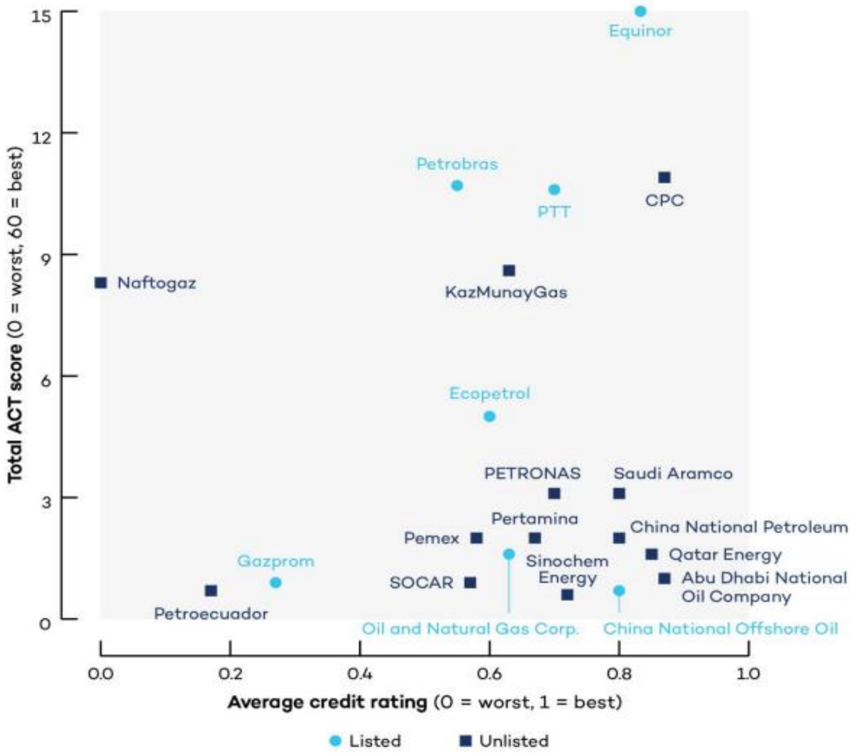

FIGURE 3. Credit ratings and ACT scores for NOC

Source: (WBA, IISD, and UCSB 2023)

This perspective can be a conversation opener between financers and host governments of NOCs, to make them see the implementation of economic diversification strategies and fossil fuels production transition plans, as a strategy to protect their credit ratings in a context where financers are increasingly aware of climate and transition risks.

Recommendations

Ending fossil fuels support and stepping up clean energy support

One way in which MDBs can make concrete progress on their promises to support the transition from fossils to renewable energy is to join international coalitions with concrete targets in this regard. Here, the Clean Energy Transition Partnership (CETP) could be a good platform for MDBs. At the moment, the European Investment Bank (EIB) and the East African Development Bank are the only MDBs that have joined (CETP 2024).

Signatories to the CEPT committed to shifting international public finance away from fossil fuels and into clean energy. A good example of shifting fossil to clean finance comes from the EIB which together with Denmark is the only CETP signatories that have shifted more international public finance to clean energy than they have divested from fossil fuels (Jones and Mun 2023). If other MDBs join the CETP and shift their current funding of fossil fuel projects to clean energy, several billions could be shifted yearly, contributing considerably to close the clean energy investment gap.

Improving financial conditions for fossil fuel production phaseout

Here we propose three routes for MDBs to use their dual roles as lenders and assistance providers to engage with key fossil fuel producers, including SOEs and their host government to increase their ambition in climate change mitigation and supporting a just and ambitious transition away from fossil fuels, which has been announced as a key action area for MDBs at COP28(UNFCCC 2023).

First, MDBs could create strategies and mechanisms for protecting positively the credit ratings and cost of debt of fossil fuel producers committing to a transition away from fossil fuels. Second, MDBs could create finance lines targeted to fossil fuel producers with ambitious transitions plans. This is of key importance, considering that three-quarters of MDBs climate finance is not concessional (Neunuebel et al. 2023). Third, MDBs could provide technical assistance to fossil fuel producers in the enhancement of their Nationally Determined Contributions, Long-Term Strategies, and just transition and economic diversification plans.

Scenario of outcomes

Brazil's commitment to fostering sustainable finance within the G20 framework will be central to increase global ambition to mitigate climate change and transition away from fossil fuels. The Finance Track of the G20 offers and effective channel for Brazil to lead on translating current promises into tangible actions by large financial actors to support the transition.

However, Brazil's commitment to increase the ambition in fight against climate change seems to still be largely disconnected from the need for fossil fuels production phaseout. Indeed, Petrobras (Brazil's NOC) is one of the largest O&G producers of the world, and is currently planning to almost double its oil and gas production by 2030 (SEI et al., 2023). Brazil joined the OPEC+ as an observer in 2024, strengthening their intention to remain a significant oil producer. Petrobras representatives, researchers, and government officials still argue for the need of O&G revenues for financing the transition, reaching sustainable development goals, and avoiding financial market instability (Bearak 2024).

Bringing those concerns and contradictions, typical of emerging economies dependent on fossil fuels production, to the table in the upcoming Finance Track of the G20 could be a strategic opportunity for Brazil to elevate the discussion of specific climate and transition finance needs for fossil fuel producers to international forums. In this briefing, we have highlighted two important areas of action for MDBs, which should be addressed in the G20 meetings.

First, MDBs could play a central role in enabling closing the finance gap for clean energy, by shifting billions of international public finance away from fossil fuels and into clean energy. We propose four key priorities for MDBs that G20 countries can advocate as MDBs' main shareholders:

- **Updating their Paris Alignment methodology to exclude all fossil fuel projects** along the entire value chain (as opposed to only coal and peat power) and stop promoting fossil gas as a transition fuel.

Updating individual MDB methodologies such as the World Bank Climate Change Action Plan (and joint-MDB country plans) to exclude all fossil fuel support and strengthen support for a just transition for both fossil fuel consuming and producing countries.

- Joining international initiatives such as the Clean Energy Transition Partnership to translate intentions into concrete targets and actions for **shifting international public finance away from fossil fuels and into clean energy**.
- **Improving the quality of clean energy finance by MDBs in addition to increasing its scale**, by focusing more on concessional finance and on projects without potential human rights, social, and environmental impacts.
- **Strengthening co-financing among MDBs**, which can be of great value for scalability and to tap into the expertise of other peer MDBs.

Second, MDBs could help enabling transition finance mobilization for fossil fuel producers, in particular fossil fuel SOEs host governments in emerging economies. Here, we propose four routes for MDBs to engage with key fossil fuel producers to increase their ambition in a transition away from fossil fuels:

- Creating strategies (e.g. new credit rating methodologies) and mechanisms (e.g. debt guarantees, risk sharing instruments, insurances, etc.) that **encourage efforts of fossil fuel producers** (including fossil-fuel SOEs and their host governments) taking bold steps to transition away from fossil fuel production.

- **Creating finance lines targeted to fossil fuel producers with verifiable ambitious transitions plans** that will include concessional support conditional on achieving key transition milestones such as producer fossil fuel subsidy removal, moratoria of new fossil fuel projects, or just transition measures for fossil fuel dependent economies and communities.
- **Providing fiscal and regulatory assistance for fossil fuel producing countries** in the enhancement of their Nationally Determined Contributions, Long-Term Strategies, and just transition and economic diversification plans (e.g. in areas such as investment needs estimates, green budgeting, sectoral pathways development, and fossil fuels subsidy reform). For countries unwilling to include fossil fuel production in their climate commitments the Climate Change Development Reports (CCDRs) of the World Bank and joint-MDB country platforms can become an entry point for MDBs to support transition away from fossil fuel dependency.

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