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Trade and investment finance after Paris: Navigating the transition to universal low-carbon energy

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Phasing out fossil fuels while expanding energy access for all

Meeting in Paris in December 2015, countries negotiated a breakthrough agreement on climate change. The Paris Agreement sets a long-term goal of greenhouse gas (GHG) neutrality in the second half of this century, which will require a phase-out of all fossil fuels except those offset by, e.g. afforestation, or for which carbon capture and storage will be possible (Art. 4(1)). Moreover, the Agreement sets an aspirational goal of limiting average temperature changes to 1.5C in this century, which requires global emissions to peak as soon as possible.

To meet this ambitious goal, 189 countries have put forward Nationally Determined Contributions (NDCs), which lay out their plans for reducing emissions and building resilience. NDCs will be reviewed and ratcheted every five years under the Paris Agreement. At the same time, the Paris Agreement recognizes the thousands of actions that cities, private companies, and other sub- and non-state actors are taking to combat climate change, and builds framework to support this groundswell of climate action going forward.

Key points:

1. In December 2015, countries committed in the Paris Agreement to effectively decarbonize the economy in this century.
2. In September 2015 countries agreed a set of Sustainable Development Goals, including providing access to affordable, reliable, sustainable and modern energy for all by 2030. Currently, 1 in 5 people lack access to energy.
3. The radical expansion of low-carbon energy required to meet these goals creates risks but also opportunities for export credit agencies and investment insurers, which collectively finance around US$2 trillion of trade and investment each year.
4. To manage these risks and achieve growth, export credit providers and investment insurers can cooperate via the Berne Union to set collective goals to:
    - Reduce and eventually phase out high-carbon financing
    - Expand low carbon financing
    - Increase access to energy

The Paris Agreement therefore adopts a "bottom up" structure in which implementation is the task national governments and other actors working individually and in coalitions.

In a related multilateral process, in September 2015 governments adopted 17 Sustainable Development Goals (SDGs) to replace the Millennium Development Goals. Goal 7 is "Ensure access to affordable, reliable, sustainable and modern energy for all" by 2030. Currently one in every five people lacks access to modern energy; in Sub-Saharan Africa the figure is two in three. The vast majority of these people live in rural areas ill served by traditional electricity grids.

Together, these universally agreed goals set the world on a pathway to radically expand low carbon energy infrastructure in the next decades. The question now is not whether this transition will occur, but rather *how quickly*, at *what cost*, and with *how much disruption*?

The transition to low-carbon energy for all: risks and opportunities

The low-carbon transition and expansion of energy access will deeply affect financing for trade and investment. The export credit and investment insurance industries include a wide range of public agencies, private banks and insurance companies, and hybrid organizations. The Berne Union is an international organization, founded in 1934, through which these entities cooperate on technical matters. Together the Berne Union and its offshoot, the Prague Club, contain nearly 90 export credit providers and investment insurance providers. In 2014 these entities provided around US$2 trillion in trade and investment financing.

While trade financing and investment insurance are important to many sectors of the world economy, they are particularly crucial in the energy sector, where large capital requirements, long time horizons, and complex technologies require sophisticated financial arrangements, and where public financing often plays a crucial role.

The unique role of this industry in the energy sector creates a number of potential risks.

- **Stranded assets.** As the low carbon transition accelerates, investors have become increasingly concerned that fossil fuel related assets will lose significant value. Such "stranded assets" could cause significant financial damage to large institutional investors, especially pension funds and mutual funds, with significant wider repercussions for the larger economy. To cite just one example, the four largest US coal miners were worth US$34 billion in 2011; today they are worth just US$150 million. Because export credit agencies and investment insurers are heavily involved in a number of fossil fuel-related projects, they face a heightened risk of stranded assets.
- **Fiduciary liabilities.** For these reasons, investors are increasingly pressuring firms and financiers to adequately account for and price the carbon risk they face. At the Paris climate summit Michael Bloomberg and Mark Carney announced a global taskforce under the Financial Stability Board to mainstream carbon risk report in companies regular financial reporting processes. Private companies that provide export credit and investment insurance that fail to adequately account for their carbon-related risks may face various forms of fiduciary liabilities.
- **Political backlash.** Public agencies that provide export credits or investment insurance may face distinct but even greater risks. While not typically liable in the same ways as publicly traded companies, government agencies found to be making uneconomical investments may face significant political backlash. With many governments seeking to reduce spending, there is increased pressure on export credit providers and political risk insurers to demonstrate the value of their work. It is therefore crucial for public agencies to manage potential risk from stranded assets.

Enormous growth potential

While the transition to a low-carbon world creates risks for the industry, it also creates enormous growth potential. Building low-carbon energy systems around the world will require trillions of dollars in trade and investment. Expanding energy access to the billions of people who currently lack it will require similar financial flows. The 189 NDCs countries submitted in Paris can be read as the largest portfolio of investment prospectuses ever assembled. If trade and investment financiers do not seize this opportunity, they could see one of their core businesses quickly erode.

The returns from these projects are potentially vast, but are challenging to realize. As noted, energy projects tend to involve long timeframes, complex regulatory issues, and other complications that generate market failures. Expanding energy access to those who currently lack it provides similar challenges, as rural areas are not typically well served by standard commercial models.

However, these difficulties play precisely to the comparative strengths of export credit providers and investment insurers. These industries occupy a unique niche in the larger financial ecosystem that allows them to connect the dots between supply and demand.

Managing the transition through cooperation: the Berne Union

Export credit providers and investment insurers can best manage the risks and opportunities of the transition to universal low carbon energy through cooperation. Fortunately, the Berne Union is already positioned to help the industry achieve this shift.

Indeed, cooperation on this front has already begun to emerge. For nearly a decade both public and private financers, including private banks, development banks, and export credit providers, have used the Equator Principles to assess the environmental risk of their investments. In advance of the Paris summit export credit agencies in OECD countries pledged to limit funding for the most polluting forms of coal. And the US and China, in their September 2015 joint presidential statement, set an aspirational goal of "strictly controlling public investment flowing into projects with high pollution and carbon emissions both domestically and internationally."

These steps can now be expanded upon in several ways. First, it is crucial to engage the entire industry. Otherwise competition can drive a race to the bottom, to the detriment of all. Second, it is important not just to limit support for fossil fuels, but to set positive goals around expanding the supply of renewables. Third, and related, the expansion of renewables should also include an effort to expand access to those who lack energy.

Beyond managing risk and seeking growth, this ambitious agenda grows from the industry's mandate to serve their clients. Countries have committed to decarbonisation and universal energy access. The "bottom up" nature of the Paris Agreement means that governments are looking to all sectors, and particularly those involved in the energy sector, to drive solutions. The Paris Decision explicitly welcomes all actors to take forward initiatives to contribute to the goal (Para 121). Moreover, the G20 nations pledged, in 2009, to phase out public subsidies for fossil fuels, though they have struggled to reach this goal. And this year, the Bank of England and the People's Bank of China are, under the aegis of the G20, chairing a new working group to identify new streams of green financing. In sum, governments have stated unequivocally where they want to go, but rely on operational entities to help them understand how to get there. This provides a key opportunity for the sector, and for the Berne Union in particular.

As a technocratic organization focused on joint problem-solving, the Berne Union provides an ideal setting to advance this agenda. Focused on serving its members needs, this global organization can help manage the competitive dynamics and provide technical support to coordinate export credit providers and investment insurers as they drive the low-carbon transition.

Next steps: setting collective and flexible goals

Through the Berne Union, export credit agencies and investment insurers can set collective goals on three key issues: phasing out fossil fuels (except those offset or subject to carbon capture and storage), expanding renewables, and increasing access to energy. While the exact targets would require discussion across the industry, an ambitious starting point would be:

1. **Phase out:** Stop new high carbon financing (without offsetting or carbon capture and storage) by 2025.

2. **Renewables:** Double low-carbon financing by the time the Paris Agreement comes into effect in 2020.

3. **Access:** Double the number of people served by your energy projects by 2025; quadruple it by 2030.

Flexibility is key. Individual agencies and firms may reach these targets at varying speeds and in different ways. What is important, however, is that the industry as a whole travels in the same direction.

Measuring and sharing progress toward each goal at regular intervals is essential. While some individual agencies and firms may not be able to publically report on their progress at high levels of granularity, it is possible for secure, independent third party verifiers to provide aggregate figures, as they do in other industries. A large range of technical organizations would be able to assist both individual agencies and firms and the industry as a whole with setting up and supporting these arrangements, as they do in other industries.

About the author

Dr Thomas Hale is Associate Professor in Public Policy (Global Public Policy) at the Blavatnik School of Government. research explores how we can manage transnational problems effectively and fairly. He seeks to explain how political institutions evolve--or not--to face the challenges raised by globalization and interdependence, with a particular emphasis on environmental and economic issues. He serves on the Steering Committee of Galvanizing the Groundswell of Climate Actions (http://www.climategroundswell.org). For his full biography, please see: http://www.bsg.ox.ac.uk/people/thomas-hale