Unburnable Carbon:

Getting the signals right for investors in low- and lower-middle-income countries

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Ivetta Gerasimchuk, Vibhuti Garg, Yuliia Oharenko

If the commitments under the Paris Agreement on climate change are to be kept, more than two-thirds of the already-proven fossil fuel reserves will become unburnable carbon and must be left in the ground. Yet there is a large gap between this evidence in the context of the Paris Agreement and existing policies as signals that guide investors and donors around the world, including in Switzerland.

On the one hand, the plummeting costs of renewables and carbon pricing start making fossil fuels less competitive. Therefore, both developed and developing countries with fossil fuel exports anticipate competition for the opportunity to supply the last barrel of oil, cubic metre of natural gas and tonne of coal. This trend is particularly evident in the coal market, which stagnated in 2014–2016.

On the other hand, wishful fossil fuel market forecasts, "all-of-the-above" energy strategies as well as hundreds of billions of USD in public finance, subsidies and, in certain cases, development aid still support fossil fuel extraction and coal power. All these signals lock in investments in carbon-intensive infrastructure for the next decades. However, most of the new fossil fuel projects are incompatible with the 1.5 and 2 degrees climate targets and are likely to have shorter-than-expected lifetimes, leading to asset stranding. The International Renewable Energy Agency estimated the associated investment losses at up to USD 7 trillion for fossil-fuel-extracting assets and USD 1.9 trillion for fossil-fuel-based power generation on the global level.

Low-income countries (LICs) and lower-middle-income countries (LMICs) with significant fossil fuel assets stand to lose the most in asset stranding and impacts on their development. With less diversified economies and trade, they are more vulnerable to the vagaries of global energy markets. Both a literature review and our interviews with 27 stakeholders from different backgrounds testify to the increasing concerns about asset stranding in LICs and LMICs (see Annex 1 for the questionnaire underlying these semi-structured interviews). This report uses case studies of three LMICs with the largest remaining fossil fuel reserves (India, Indonesia and Ukraine) to illustrate the emerging challenges of unburnable carbon for development.

We find that the unfolding narratives on unburnable carbon are polarized, varying from deliberately negative ("stranded assets," "carbon bubble," "keep-it-in-the-ground") to more positive ("beyond fossil fuels," "just transition"). However, in LICs and LMICs, practical conversations regarding a just transition away from fossil fuels in these countries might best be framed in terms of national goals for sustainable economic diversification.

The ultimate question for LICs and LMICs is whether they view their fossil fuel reserves as a cash cow for exports or as strategic resources for supplying domestic energy to boost economic development. In the former case, economic diversification should support either alternative export-oriented activities, or replacement of imports. In contrast, if domestic fossil fuels are viewed as a resource for development, their combustion will ultimately conflict with the concerns about health impacts and air quality standards as well as climate commitments under nationally determined contributions (NDCs) to the Paris Agreement.

In the international arena, a growing number of actors recognize the mismatch between the ambitious goals of the Paris Agreement and resource-rich countries' development trajectories. Belize, Costa Rica, France, Ireland and New Zealand have all taken measures to curb oil and gas production, and 30 governments have launched the Powering Past Coal Alliance (PPCA) to phase out traditional coal power.

Such first-mover initiatives cover only a fraction of global fossil fuel supply. However, first movers see their restrictions on fossil fuel supply as a sign of climate action integrity and a signal to investors around the world. Thereby these countries address Article 2c of the Paris Agreement on "making finance flows consistent with a pathway toward low greenhouse gas emissions and climate-resilient development."

With no fossil fuel production or coal power, Switzerland potentially falls in the same category. Switzerland's possible engagement on unburnable carbon and stranded assets should play to its strengths as a country whose opinion matters for international finance, investments and smarter development policies. the country has already embraced some of this agenda, e.g., through its participation in the Friends of Fossil Fuel Subsidy Reform (FFSR) and the PPCA. But it can do more. The first two recommendations below are Switzerland-specific, the other two apply to all countries.

1. **Help shift financial flows away from fossil fuels.** Given its reputation as the world's predominant financial hub, the most significant contribution on the unburnable carbon agenda would be getting the signals right for Swiss and international investors, in both the public and private sectors. Switzerland should ensure that its own public finance institutions such as the Swiss National Bank and SERV use carbon-screening tools and shift finance away from fossil fuels. Switzerland should also use its voice in multilateral development banks, the Global Environment Facility and the Green Climate Fund to influence both institution-wide decisions and specific projects.

2. **Help develop a positive narrative on energy transition**. Switzerland's opinion matters when it comes to investment decisions. There is a role for Switzerland to support the narrative on the transition away from fossil fuels as financially savvy and innovative. Switzerland is also seen as a country that has neither a post-colonial nor a "new colonial" agenda. In this capacity and without being patronizing, Switzerland can help create a

positive decarbonization agenda that frames the clean energy transition as an opportunity for development rather than "carbon imperialism."

3. Ensure policy coherence. Coherence between climate action and other policies needs to be ensured among different agencies of the Swiss government, within intergovernmental organizations and international financial institutions (IFIs), and within different government agencies of aid-recipient countries. Within Switzerland, the policy coherence agenda can reference its international commitments such as the Paris Agreement or membership in first-mover alliances such as PPCA. PPCA's commitment on coal finance, for instance, means that Switzerland has undertaken not to provide through its public finance institutions loans or loan guarantees to traditional coal power plants.

From the aid recipients' perspective, there is an increase in requests to donors for technical assistance and financial products that can help them deliver NDCs. This can be used as an opportunity to align NDCs and long-term energy strategies of developing countries with evidence-based scenarios of energy markets developments.

4. Support economic diversification for a just transition. The energy transition needs to provide viable alternatives to workers, communities and countries that heavily depend on fossil fuels. The earlier and better the needs of a just transition are anticipated, the less disruptive the change will be for vulnerable groups. There is a growing body of best practices in this respect, including the lessons learned from coal phase-outs and transitions in other sectors, e.g., the nuclear phase-out in Switzerland.

Diversification often means the implementation of measures that lead to climate change mitigation and clean production. A lot of development aid that Switzerland provides already promotes economic diversification, such as the country's support to clean tech.

There are more avenues for economic diversification. Of particular relevance are all solutions that can help bring down the costs of integrating renewable energy into existing energy market systems as well as managing electricity grids with significant trading across borders. Equally important are financial innovation for financial security mechanisms in the energy sector and the development of bankable green projects and green non-financial products suitable for investors. The International Solar Alliance (ISA) and the group of finance ministers from climate vulnerable countries (V20) are examples of LIC- and LMIC-driven platforms that target this agenda. Switzerland can productively engage with both the ISA and V20. Switzerland can also work with the Clean Energy Ministerial where energy investment and finance activities, promoted by the Nordic members, can be of particular relevance to Switzerland.

The agenda regarding unburnable carbon outlined in this report requires large-scale, ambitious action, However, in the context of Swiss Development Cooperation, its implementation can be launched with several initial steps:

- An internal review and discussion within SDC
- A briefing for other federal agencies, including SECO, BAFU and other bodies
- A knowledge event in Bern or Geneva open to civil servants and broader public (possibly under the Traverse format)

- An international workshop with countries and IFIs that are first movers on limiting fossil fuel supply and power (possibly in cooperation with Chatham House)
- Policy briefs and other communication materials such as op-eds and articles in English, German and French. For LICs and LMICs, these materials can be also made country-specific.

IISD has both capacity and interest in supporting SDC in delivering these proposed steps.