Institute for Energy Economics and Financial Analysis

Financing Just Transition Through Blended Finance

How to scale up blended finance for just transitions in the Global South

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Introduction

Global energy transition ambitions rely heavily on the climate trajectory taken by emerging markets and developing economies (EMDEs). If the Global South economies do not invest in accelerating energy transition in their respective jurisdictions, worldwide efforts to tackle climate change will hit a major obstacle. Clean energy investments in EMDEs need to more than triple from US$770 billion in 2022 to US$2.2-2.8 trillion per year by the early 2030s to help them reach their energy and climate goals.[1] Around 60% of this will need to come from the private sector.

Blended finance is an effective mechanism for strategically deploying development finance to address challenges like lack of infrastructure or high upfront costs, making energy transition projects financially viable and appealing to private investors. Hence, blended finance operates as a market-building instrument that helps to attract commercial finance.

Over half (US$109 billion) of global blended finance deals to date have tackled climate change, as per Convergence, a fry cry compared to capital needs for the global energy transition.[2] While most deals have happened in EMDEs, the transactions concentrated on Sub-Saharan Africa (SSA) (48% of transactions between 2020-2022), followed by Latin America and the Caribbean (24%). Hence, there is a need to scale up the quantum and diversify blended finance mechanisms across global south economies.

The clean energy transition brings significant opportunities but also several challenges. On one hand, it holds immense economic potential for communities across the globe. On the other hand, if not managed equitably, it could disproportionately burden vulnerable populations with high costs and unequal benefits. This will impact the livelihoods of at-risk communities and millions of people working in carbon-intensive industries. Hence, any energy transition has to be just and consider the negative social and environmental externalities it will have on people.

In this context, raising blended finance for financing just energy transition in emerging economies gains significance.

Focus Areas to Scale Up Blended Finance Mechanisms

For scaling up blended finance mechanisms successfully for just energy transition, it is essential to begin with the understanding that these interventions have lacked in both scope and size in emerging markets. There has to be a concerted effort by all stakeholders involved in a blended

[1] International Energy Agency. IEA-IFC Joint Report Calls for Ramping Up Clean Energy Investments in Emerging and Developing Economies. 21 June 2023.
[2] Convergence. State of Blended Finance 2023. 25 October 2023.

finance mechanism to ensure these interventions can successfully provide for just energy transition. Some areas that need focussed efforts include:

1) Identifying current bottlenecks in scaling blended finance in specific jurisdictions

2) Identifying the role of each stakeholder and ensuring collaboration among them

3) Leveraging past successful blended finance mechanisms for adoption as per local contexts

4) Identifying essential capacity-building needs in the short to medium term for the stakeholders

Identifying Current Bottlenecks in Scaling Blended Finance

Several emerging markets do not have an environment that enables raising capital through blended finance mechanisms for energy transition. A constructive dialogue with capital providers and relying on experiences from other emerging markets, where policy levers have helped create that enabling environment, can help identify these bottlenecks.

Economic viability is paramount for financing any asset through private capital to ensure that capital providers can generate the required returns. Policy support can, in part, establish this viability. For instance, in India, the renewable energy sector has long-term power purchase agreements backed by credible entities that de-risk these assets for investors.

Similarly, the Indonesia Just Energy Transition Partnership (JETP) has recently released a comprehensive investment and policy plan, detailing financing needs across technologies and sectors over the next several years.[3] Long-term visibility underpinned by policy support is favourable for investors when deploying capital in emerging markets.

Conversely, unfavourable policies can also bottleneck capital mobilisation for low-carbon assets. For instance, Indonesian financial regulators indicated they were considering a place for new coal-fired power plants in the country's green taxonomy.[4] Global investors may not consider thermal power, in any form, green. Indonesia's move may reduce investor confidence in its taxonomy and energy transition efforts.

[3] US Embassy & Consulates in Indonesia. Indonesia Just Energy Transition Comprehensive Investment and Policy Plan Launched. 22 November 2023.
[4] IEEFA. Indonesia signals it could abandon science-based taxonomy for coal power plants. 5 September 2023.

Identifying the Role of Each Stakeholder and Ensuring Collaboration Among Them

A typical blended finance intervention may include several stakeholders, including government (national and sub-national), philanthropies, multilateral development banks (MDBs), commercial banks, private investors, and small and medium enterprises. These stakeholders provide capital for a blended finance mechanism based on their individual risk-return requirements and varying developmental priorities. Ensuring that their respective roles in a mechanism are well defined and that there is constructive collaboration among them towards achieving the end goal of the mechanism is pertinent.

For catalytic capital providers, such as public capital, philanthropies and MDBs, ensuring that their intervention in a blended finance mechanism can price in just transition risk appropriately is necessary. There is a need for these stakeholders to realign to enable a just transition that would look at distributive and restorative justice. This is important to avoid a disproportionate burden on already marginalised people. For instance, in South Africa, the jobs related to the fossil fuel economy have a higher dependency ratio of 1:10, which means each job loss will affect 10x more people.

For national and subnational governments, a role is to ensure an overarching just transition strategy that supports blended financing. Transition is a longer journey than the agreement timeline of five years of most JETPs. The local government needs to ensure any JETP-like deal has a longer timeframe agreed with all the capital providers involved.

Setting up a blended finance deal for an MDB is a lengthy process to get all these stakeholders on board. And even after there is access to funding and investors on board, it needs to be ensured that the right fit of assets to finance is there. Thus, blended finance becomes a lengthy process from fundraising to deployment. While MDBs have advisory teams to shortlist appropriate assets to finance, a greater collaboration from the inception stage of the mechanism can reduce this fund deployment time.

There is also a need for domestic currency-denominated funding for projects generating returns in local currency to mitigate FX risks for investors. MDBs, even if providing local currency loans have low concessional elements, can still de-risk projects by mitigating currency risk. The MDB should work with foreign private investors to understand their risk appetite in the context of currency risk.

Leveraging Past Successful Blended Finance Mechanisms for Adoption as per Local Contexts

There are a plethora of instruments or interventions that can be used as part of blended finance mechanisms. Right from senior debt to subordinate debt, equity, grants, guarantees, results-based financing and technical assistance. What complicates this further is that blended finance mechanisms are highly context-specific. However, several emerging economies face similar circumstances while financing just energy transitions. Therefore, past experiences can be a starting point to propagate blended finance mechanisms in other jurisdictions.

Guarantees have effectively de-risked distributed renewable energy solutions in several emerging markets. According to World Bank estimates, every US$1 invested in improving creditworthiness leverages US$100 of additional private-sector financing.[5] One example is Kube Energy in Africa, which received a concessional guarantee from MIGA (World Bank) to cover its debt and equity investment in a hybrid solar power plant.

In EMDEs, currency volatility has often deterred consistent and substantive investment in climate initiatives. Blended finance can directly address currency risks in volatile and high-interest markets by strategically combining public and private capital. For example, TCX (The Currency Exchange Fund) has become a vital source for international funders in providing cross-currency swap solutions.[6] The use of long-term currency swaps underpinned by commitments from central banks of developed and developing markets and intermediated through organisations such as the International Monetary Fund (IMF) can also be explored.[7]

Identifying Essential Capacity Building Needs in The Short- to Medium-Term for The Stakeholders

To ensure that the availability of capital from a blended finance mechanism matches with the ability to absorb and deploy the financing for the assets and economic activities most in need, there is a need for capacity development for several stakeholders involved.

Financial markets currently lack fund selection teams doing a deep dive into analysing clean energy investment funds of even smaller sizes. While every large financial institution focuses on winning investment mandates for energy transition from institutional investors, the focus is not on analysing the investments in which these funds are deployed. There are often cases where investors are looking for opportunities with a history of exit while many new pipelines are not being scouted.

MDBs often lack an understanding of the local context and how to navigate the rule of the land. National development banks (NDBs) can be an important local partner for MDBs here to deploy capital at a disaggregate level to assets that have the potential to create the most additionality. However, very few NDBs are actively deploying capital for energy transition, even if that would be in the ambit of their developmental goals. MDBs must also work with local NDBs to help them align

[5] Urban Climate Change Research Network, The Climate School, Columbia University. Climate Change and Cities: Second Assessment Report of the Urban Climate Change Research Network, Chapter 7: Economics, Finance, and the Private Sector. 2018.
[6] Making Finance Work for Africa and The Currency Exchange Fund. Green Energy Project in Africa. 22 May 2023.
[7] Akhilesh Tilotia. De-risking developing country currencies for climate financing. 17 August 2023.

their operations with just transition financing. India's NABARD is a good example of an NDB actively raising capital from sustainable finance markets to provide for social development.[8]

For local governments, an essential capacity development need is the measurement, reporting and verification practices to instil confidence in capital providers. Often, the major impediment to financing just energy transition is the ability to measure the social benefits related to such a project. Understanding how well their intervention has helped achieve a development priority is important for other stakeholders.

Conclusion

To sum it up, blended finance, while still nascent in the context of climate, has a massive potential to ensure financing for just energy transition is available. There is a need to make concerted efforts to weed out bottlenecks with robust policy support, delineate the role of each stakeholder, leverage what has worked in the past and work on capacity development needs. In all these areas, there has to be more collaboration among the stakeholders to ensure that blended finance mechanisms that are workable and scalable are developed, providing maximum additionality.

[8] NABARD. Nabard Issues AAA-Rated Five-Year Social Bonds. September 2023.

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About the Author

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