

Tracking climate- -related investments and finance flows

Implications of the EU Taxonomy

POLICY PAPER

Sustainable finance taxonomy and national climate strategies can often work to complement each other by bringing national contexts to provisions outlined in a classification system. Such a synergy offers useful input to the climate finance and investment tracking studies and creates an important basis for further discussions on the investment gap associated with the low-carbon transition.



Tracking climate-related investments and finance flows: implications of the EU Taxonomy

Project partners:

WiseEuropa: Zofia Wetmańska*, Maciej Bukowski

NewClimate Institute: Frauke Röser, Hanna Fekete, Julie Emmrich

I4CE – Institute for Climate Economics: Ian Cochran, Hadrien Hainaut

*Corresponding author – please contact in case of any questions regarding this publication



WiseEuropa – Warsaw Institute for Economic and European Studies

Aleja Jana Chrystiana Szucha 16/46
00-582 Warsaw, Poland
www.wise-europa.eu



NewClimate Institute

Clever Straße 13-15
50668 Cologne
Germany
<https://newclimate.org/>



I4CE – Institute for Climate Economics

Avenue Marceau 24
75008, Paris
France
<https://www.i4ce.org/home/>

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WiseEuropa Institute is an independent think-tank and research organization based in Warsaw that undertakes a strategic reflection on European politics, foreign policy and economy.

The mission of WiseEuropa is to improve the quality of Polish and European policy-making as well as the overall business environment by promoting the use of sound economic and institutional analysis, independent research and evidence-based approach to impact assessment.

In 2016 WiseEuropa has set up The Capital Market 25+ Research Program, which outlines the future development prospects for the capital market in Poland. Aiming to embed the ESG dimensions permanently in the financial sector architecture, WiseEuropa conducts analytical activities to facilitate transformation of a capital market into a driver of change needed to achieve a sustainable and inclusive growth.

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1. Introduction

It has become clear, both at the political and the public debate levels, that any progress in the transition to a low-carbon – net-zero economy is highly dependent on the ability to mobilize and redirect the investment flows towards low-carbon projects. At the national level, there are however several unknowns that need to be addressed in an analytical manner, in order for the processes to gain the efficiency needed to meet the objectives of the Paris Agreement.

In the first policy paper “Domestic Landscape of Climate Finance. Why systemic approach to climate finance matters?” (Wetmańska et al., 2019a) we have offered arguments showing that the implementation of the Landscape methodology is crucial for tackling one of the most important of such knowledge gaps i.e. understanding the current state of financial flows that support low-emission investments. We show that the methodology offers the evidence-base crucial for policy-making processes such as the development of both short- and long-term strategies for low-carbon transformation. It enables identification of current sources of finance and their use by project developers, the scale of investments and instruments used to channel climate finance flows. This information not only allows for an assessment of the efficiency of policies and financial flows they govern but when coupled with the data on the volume of investments needed for the low-emission transformation it enables estimation of the investment gap between the business as usual scenario and the pathway to a decarbonised economy.

In this paper, we aim to discuss another challenge – one associated with the identification of investments that can be accounted as low-carbon activities. The focus has been put on the EU Taxonomy, as in the near future it will have to be assessed to what extent this emerging tool can be useful for implementation of the Landscape methodology. Subsequently, we present the added value of linking countries’ climate strategies with investment landscapes. This study offers further recommendations regarding the solutions that help to reduce the gap between current financial structures and the objectives of the national low-emission transition.

2. Defining “climate investments”

As outlined in the “Domestic Landscape of Climate Finance” paper there is no single internationally accepted definition of climate investment and climate finance. The existing definitions have a common element of indicating the relevance of this type of finance for climate change mitigation and adaptation activities. However, such an approach does not offer sufficient information regarding the basis that enables accounting of projects that support the reduction of greenhouse gases in line with the warming limits fixed in the Paris Agreement or enhance the resilience of the economy. Thus, many attempts have been made to establish a framework that supports the identification of low-carbon investments.

Most of the existing initiatives have undertaken either climate target-alignment or taxonomy approaches (e.g. CPI (2019), I4CE (Hainaut et al., 2018), GermanWatch & NewClimate Institute (2018)). While the former methodology is focusing on the assessment of the extent to which the impact of the investment, asset or counterparty/client is aligned with the national or global long-term climate objectives¹, the latter is aiming to provide a list of activities that meet the pre-defined criteria and threshold conditions typically to identify if the impact has positive implications in absolute terms.

Despite the efforts to provide more transparency and guidance on how to initiate the process of recognition of the low-carbon investments, the heterogeneity in definitions implemented by individual methodologies remains problematic. The differences, which can initially be deemed as superficial, can potentially impose a burden on the projects and actors that must justify the sustainability of their activities, compared to those partaking in brown or neutral activities. In this regard, the challenges associated with data availability and the risk of “greenwashing” can substantially counteract the progress in the redirection of the financial flows towards climate investments.

2.1. EU Taxonomy

To establish a common understanding of which economic activities can be considered environmentally sustainable and avoid the problems linked with the existence of different classification systems on the market, the European Commission has undertaken a challenge of devising the European Taxonomy. In June 2019 the Technical Expert Group (TEG) on sustainable finance – 35 experts

¹ For an overview of the current state of discussions on the topic of Paris Alignment, please see Cochran, Ian and Alice Pauthier (2019) *Alignment with the Paris Agreement: Why, What and How for Financial Institutions?* I4CE – Institute for Climate Economics. <https://www.i4ce.org/download/framework-alignment-with-paris-agreement-whywhat-and-how-for-financial-institutions>



selected by the EC with an aim to facilitate the operationalisation of the Action Plan on sustainable finance, has published a report that outlined of such classification system (TEG, 2019).

Importantly, in line with the provisions of the legislative proposal on establishing a unified EU classification system of sustainable economic activities (EC, 2018), four conditions have to be met in order for an economic activity to be included in the EU Taxonomy:

- must contribute substantially to one of the six environmental objectives (i.e. climate change mitigation, climate change adaptation, pollution, waste & circular economy, water, biodiversity),
- must not significantly harm any of the other environmental objectives,
- must meet minimum social safeguards (ILO Core Labour Convention),
- must comply with technical screening criteria.

The Technical Report on EU Taxonomy provides information on screening criteria for activities across eight sectors that have been identified to substantially contribute to climate change mitigation and describes the methodology for the evaluation of which activities can substantially contribute to climate change adaptation. With that logic in mind, it is important to emphasise that the activities that have not been included in the list are not necessarily harmful. Furthermore, the ones that have been enlisted do not form a mandatory list of investments or define a standard.

The Report serves as a technical foundation for EU legislation. It explains the design of a complex classification system providing detailed examples of the performance thresholds for over 68 economic activities. At the time of writing this brief, the final wording of the regulation focused on the unified EU classification system of sustainable economic activities is dependent on the political processes and negotiations at the EU level.

The full taxonomy will be developed by the experts within the framework of the operations of the Platform on Sustainable Finance. The Platform will be responsible for the analysis of the sectors that have not been addressed by the TEG and for the regular update and revision of the full list of economic activities.

The design that assumes the evolving nature of the taxonomy is especially important, given that the taxonomy includes three categories (green, enabling and transition, see table below) of sustainable investments and that the technical screening criteria for the latter two types of activities need to be subject to regular revision. This thresholds revision is necessary to reflect any policy and technological developments as well as to facilitate a substantial reduction of emissions (in line with net-zero 2050 target) from the transition and enabling activities that require urgent decarbonisation.

Table 1. Classification of activities that make substantial contribution to climate mitigation

Type of activities	Definition	Threshold	Example
Low-carbon	Activities that have low GHG emissions in an absolute sense	Long-term not subject to revision	Production of electricity from wind power
Transition	Activities that have no low-carbon alternatives but are critical to the economy and have significantly lower GHG emissions than the sector average, which is delineated by a threshold that is subject to regular revision	Subject to regular revision and strengthened with time in order to achieve zero emissions	Cement manufacturing using advanced production technology
Enabling	Activities that enable improved environmental performance in other sectors of the economy	Not subject to revision if already low-carbon, otherwise subject to regular revision and increased stringency	Manufacturing of wind turbines

Source: TEG (2019)

While the TEG's definition of green and enabling activities are the easiest to conceptualise, more effort is required to define and identify the transition activities. This issue became the main axis of the discussions held within the negotiation process, as there are uncertainties of how to categorise investments in gas-fuelled power generation. Similarly, nuclear energy remains the other contested topic that requires further examination (see 2.2).

It is important here to emphasize that the taxonomy predominantly aims to provide broad and conditional definitions of climate investments and typically does not offer guidance on whether such investments are consistent with national and global climate goals. On the other hand, national climate strategies enable identification of the level of ambition related to the individual investment projects that are required to achieve low-carbon objectives.

To this end taxonomies and national strategies can often work to complement each other by bringing national context to provisions outlined in a classification system. For instance, the TEG recommends inclusion of district heating projects when they "meet the definition of efficient district heat/cool systems in the EU Energy Efficiency Directive" (TEG, 2019). According to the Directive, this means the networks must use at least 50% renewable energy, waste heat or 75% cogenerated heat. In France, not all district heating networks currently meet this criterion. However, the French National low-carbon strategy (SNBC) states that developing district heating in urban areas will allow for greater use of renewable heat compared to individual systems. The French Multiannual energy plan (PPE) sets the goal of fivefold increase of renewable heat distributed through district networks by 2030. Such a comprehensive approach provides useful input to the climate finance and investment tracking studies and creates an important basis for further discussions on the investment gap associated with the low-carbon transition.

2.2. Can gas and nuclear energy count as green? – the transformational conundrum

Gas-fired power generation

The long-term Paris-aligned pathways only allow natural gas in exceptional circumstances, where no feasible technical alternative exists. In many cases, energy efficiency and renewables combined with storage options provide the economically more attractive solution, limiting the role of natural gas already today (Germanwatch & NewClimate Institute, 2018). Therefore, despite being characterised by substantially lower GHG emissions, every natural gas project should be put under scrutiny due to the absolute levels of emissions that are locked in as a result. The large-scale infrastructure that locks in natural gas use for many decades needs to receive particular attention. Given the ever-increasing climate ambition (e.g. EU Green Deal (EC, 2019a)), natural gas may, in the future, be as toxic an asset in investment portfolios as coal if investment in the gas sector were not scaled to match the demands of the low-carbon transformation of the economy. Aiming to achieve the net-zero target in 2050, it is necessary to reckon with the fact that this fuel will have to be almost completely replaced with alternatives such as hydrogen, biogas or synthetic gas, within a shorter than expected timeframe. The current gas boom will have to give way to rapid market contraction.

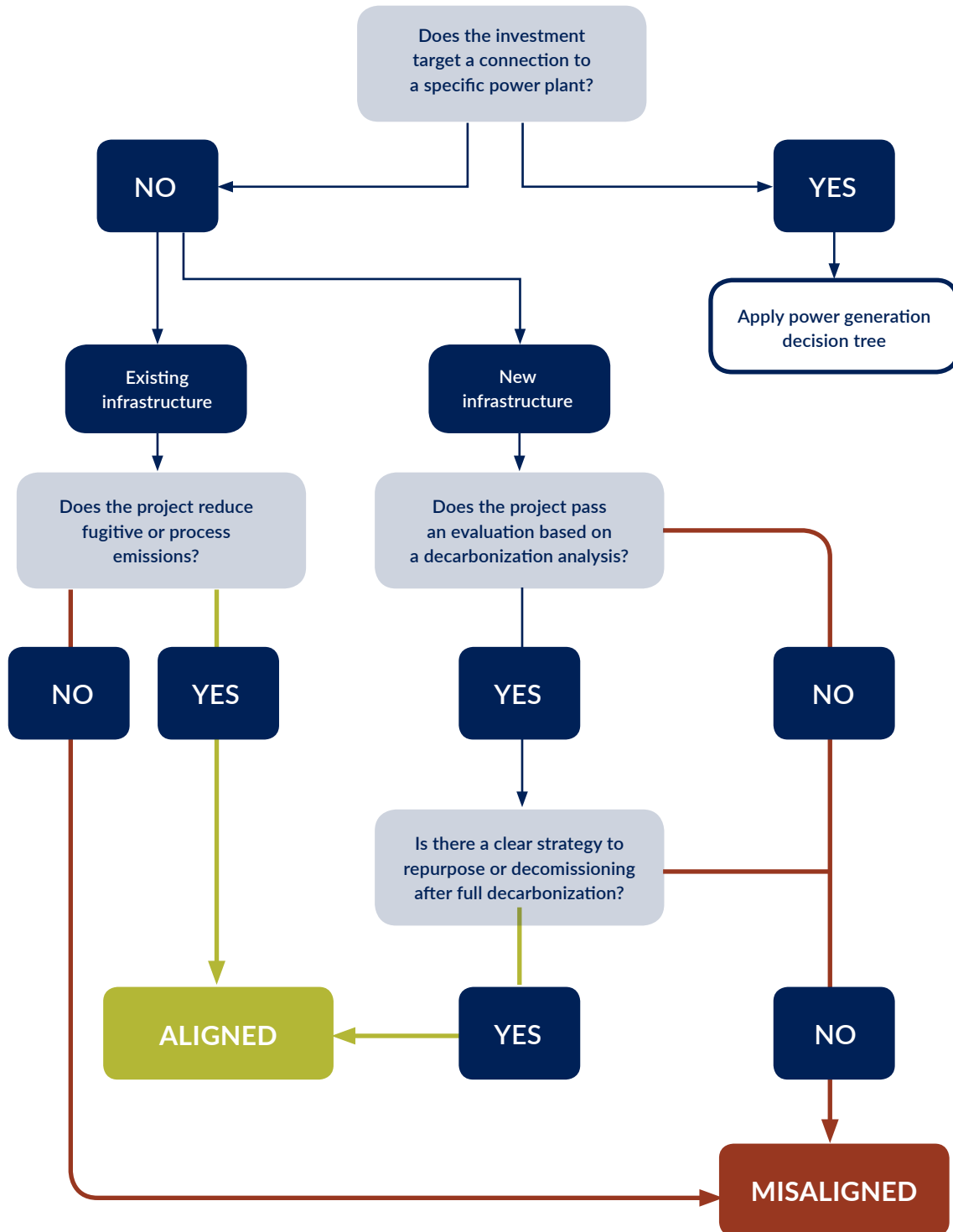
The use of gas is currently subject to numerous restrictions imposed by the EU policy frameworks. Already today, large EU institutions adjust their investment policies and present their take on fossil fuels within the operational strategies. The new lending policy of the European Investment Bank may serve as the best example, as in November 2019 the bank has announced that it will stop financing fossil fuel energy projects (incl. gas unless the benchmark of 250g of CO₂ per kWh is met) from the end of 2021 and adjust financing strategy with the goals of the Paris Agreement from the end of 2020 (EIB, 2019).

In this respect, the TEG (2019) report on the EU Taxonomy remains relatively consistent. The approach that is based on the evaluation of the emissivity of investments in the “absolute terms” rather than relative to the starting point, does not give a gas power generation any leeway and dismisses any arguments related to the reduction of emissions through coal to gas switching. Although the final technical screening criteria will be determined by the Platform, the current TEG proposal would not allow to include gas-fired power plants in the EU Taxonomy as the threshold for eligible power generation is set by the experts at 100g of CO₂ per kWh. In practical terms, this would only allow for the gas-fired power with carbon capture and sequestration to qualify (TEG, 2019).

Box 1. Categorising investments in natural gas infrastructure – potential approach

Germanwatch and NewClimate Institute (2018) provide detailed approaches to categorising investments in natural gas infrastructure, considering the specific circumstances of the investment:

Figure 1. Natural gas support infrastructure decision tree



Source: Germanwatch & NewClimate Institute 2018

Nuclear energy

Beyond construction-related emissions, nuclear energy is often considered to be a carbon-neutral form of power generation. From this point of view, it can contribute to decarbonisation of the energy systems and many scenarios modelling Paris-aligned pathways include this technology. Nevertheless, nuclear power generation implies some risks to the environment and society beyond climate change. According to the Paris Agreement, all mitigation and adaptation actions need to be in line with all sustainable development priorities and nuclear energy value chain may run a risk of compromising such a provision. It is, however, important to emphasise, that the approach of different governments to nuclear energy varies widely. While some countries have clear phase-out targets, others see it as an elemental part of their (low-carbon) energy future (Germanwatch & NewClimate Institute, 2018).

Despite being carbon-neutral, such investments will still have to meet the rest of the criteria established by the TEG. Among them, the “do no significant harm” principle ensures that none of the investments that contribute to one of the environmental objectives harms other dimensions of environmental sustainability. At this stage, it was impossible for the TEG to conclude whether the nuclear energy value chain (e.g. High-Level Radioactive Waste) does not cause significant harm to other environmental objectives (TEG, 2019). However, having in mind that the EU Taxonomy will be regularly updated to reflect technological developments and that the TEG recommends further technical work on the “do no significant harm” aspects of nuclear energy, it can be stipulated that the issue of classification of the investments in the projects associated with the nuclear energy would be revisited.

Box 2. EU Taxonomy and national climate finance and investment tracking studies – a commentary

As ever more countries are attempting to diagnose the current climate investment landscape (e.g. within the Climate investment capacity project ²: Germany, Latvia, Czechia; and Domestic Landscape of climate finance project³: Poland), it could become more important to address the challenge associated with the need to consider different political realities and system complexities, while following a robust and comparable methodologies. Thus, the practical approach could be to exclude investments associated with natural gas and nuclear energy from the climate finance flows and to present them within the same Landscape as separate items without labelling such investments as sustainable. Such a unified approach towards identification of climate investments could make cross-country comparison easier and thus could support the process of exchange of best practices and lessons learned.

2 <https://www.ikem.de/en/portfolio/cic2030/>

3 <http://wise-europa.eu/en/landscape-of-climate-finance/>

3. National climate strategies and investment landscapes

In the paper published at the beginning of 2019 (Wetmańska et al. 2019a), we have shown that “[...] EU member states are still at an early stage of building systematic data frameworks regarding their climate investment needs, the status of current investment flows and any investment gaps they may face.” (Wetmańska et al., 2019a). Almost a year later only limited and uneven progress has been made. Initial assessment of the drafts of the National Climate and Energy Plans, that each member state has to submit before the end of the year, in the majority of cases shows the lack of strategic approach towards the assessment of the investment needs associated with the low-carbon transition. According to the Commission’s communication (EC, 2019b) out of the submitted drafts, only three countries have provided estimates of the overall investment needs and eight (incl. Poland) assessed them only partially.

Such a strategic approach can, however, be achieved with the support of the methodologies that enable tracking of climate finance and investment flows. These, when coupled with the results of the techno-economic modelling of decarbonisation scenarios (conducted both within the framework of NECPs and the long-term climate strategies), could enable identification of the additional investment needs at the scale of the whole economy as well as each of the sectors (I4CE, 2019). Quantification of additional investments that are required to meet the long-term climate objectives can, in turn, serve as an evidence-based benchmark needed to devise capital raising plans – frameworks that outline a comprehensive set of policy measures, which support redirection and mobilization of the financial flows across the economy to achieve the 2050 climate objectives.

These policy measures should equally target public and private capital, as both sources of finance have to play a substantial role in the process of financing the transition to the low-carbon economy. To this extent, climate investment tracking studies offer insights regarding the relative shares of public and private funding across different sectors and thus regarding their economic maturity. Importantly, careful analysis of the investment structure could aid the process of construction of tailored policy scenarios aimed at closing the investment gap and select the right economic instruments for mobilization of additional funds – subsidies or standards (Wetmańska et al., 2019b, I4CE 2018).



4. Conclusions

Creation and implementation of the framework for climate investment and finance tracking and forecasting at the national level can substantially aid the process of mobilization of the needed climate finance and ensure that the redirection of financial flows is being governed in a strategically most effective and efficient manner. Improving policy to mobilize additional climate investment and supporting financial flows will require looking at three main areas – 1) analysis of the characteristics of the climate finance at the national level, 2) assessment of an investment gap, 3) linking countries' climate strategies with the investment landscapes. In this paper, we have focused on two selected processes that are fundamental for such framework i.e. identification of which investments can be classified as sustainable and the analysis of the national climate strategies in the context of climate finance landscapes.

Although the uptake of these processes poses challenges, their early implementation could ensure the reduction of the gap between the current scale of climate finance flows and the scale needed to reach the objectives of the national low-emission transition. They will not only provide investors with transparent information regarding which investment decisions can help to avoid the carbon lock-in but also will enhance the monitoring of financial flows and transfer of best practices.

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About the project

Landscape of Climate Finance: Promoting debate on climate finance flows in Central Europe

The transition to a low-carbon economy requires an unprecedented redirection of financial flows towards sustainable investments. The project aims to promote a strategic vision of the investment and a finance challenge raised by climate action. Its activities will focus on Poland and will be supported by experiences from Germany and France.

The main objective is to support the exchange of experiences between policymakers, experts, business community and civil society to improve assessment and design of domestic climate finance investment environments. In addition, the project will aim to raise the awareness about available financial tools to achieve climate policy goals and foster the transition towards a low-emission economy.

Promotion of best practices in assessment of current investment levels and supporting an increase in sustainable financial flows will be linked with an exploration of the potential of forward-looking analysis and production of investment plans as a part of national climate strategies.

Website: wise-europa.eu/en/landscape-of-climate-finance



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WiseEuropa is an independent think-tank and research organization based in Warsaw that undertakes a strategic reflection on European politics, foreign policy and economy. The mission of WiseEuropa is to improve the quality of Polish and European policy-making as well as the overall business environment by promoting the use of sound economic and institutional analysis, independent research and evidence-based approach to impact assessment.

Website: wise-europa.eu/en



NewClimate Institute

NewClimate Institute supports research and implementation of action against climate change around the globe. NewClimate Institute generates and shares knowledge on international climate negotiations, tracking climate action, climate and development, climate finance and carbon market mechanisms. They connect up-to-date research with the real world decision making processes, making it possible to increase ambition in acting against climate change and contribute to finding sustainable and equitable solutions.

Website: newclimate.org



Institute for Climate Economics (I4CE)

Institute for Climate Economics (I4CE) is a think tank that provides public and private decision-makers with expertise on economic and financial issues related to the energy and ecological transition. I4CE strives to implement the Paris Agreement and make global financial flows compatible with low-carbon development that is resilient to climate change. Since 2012, I4CE has conducted and published multiple iterations of the French Landscape of Climate Finance, a study that tracks domestic climate investment and analyzes how it is financed. I4CE will build on its experience and success in France in increasing granularity on climate finance data and linking this with national policy planning processes.

Website: i4ce.org

Energy, Climate and Environment Programme

Poland, Europe and the world are currently facing unprecedented challenges associated with the environment and resources. Avoiding dangerous climate change, improving public health and increasing resource security requires a profound economic transition. Taking advantage of opportunities and avoiding the associated developmental traps requires in-depth evaluation of the short- and long-term impacts of environmental protection and natural resource management policies. Under the Energy, Climate and Environment Programme, we prepare comprehensive sectoral and macroeconomic analyses, focusing on the broadly defined low-emission economic transition in Poland and globally. We are active in areas such as: Polish and EU energy and climate policy, domestic resource policy, improving resource efficiency in the economy, protection of the environment and public health by limiting harmful emissions, sustainable transport policy. This paper is a part of the Energy and Climate Project.



ENERGY, CLIMATE AND ENVIRONMENT

Other publications:

"Domestic Landscape of Climate Finance . Why systemic approach to climate finance matters?",
Bukowski M., Wetmańska Z., Śniegocki A., Röser F., Fekete H., Emmrich J., Cochran I., Hainaut H.

"Sustainable finance in Poland. The state of play and prospects for progress",
Bukowski M., Śniegocki A. and Wetmańska Z.; WiseEuropa, Warsaw 2019

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Bukowski M., Śniegocki A., Wetmańska Z. and Wis-Bielewicz J.; WiseEuropa, Warsaw 2018