Financing a Low Carbon Energy Union

Over €1 trillion needs to be invested in the energy sector in the EU by 2020, or €2.5tn by 2030 by some estimates[1]. The vast majority of this is needed for capital-intensive low carbon infrastructure, including power generation, storage, networks and energy efficiency, and as the EU decarbonises and fossil fuel use falls, energy security and affordability will be increasingly driven by the cost and availability of infrastructure finance.

The finance sector has already taken big steps forward to bridge the gap between this aspiration and the current reality, but to mainstream and build on this progress the EU needs to take further action. The private capital needed is available, and most of the tools and mechanisms needed to facilitate the flow of this capital exist. The challenge for the EU is to create the right framework and send the right signals to the finance sector that will unlock this capital and increase its flow. This briefing note puts forward a series of recommendations to bridge this gap and accelerate the flow of capital to low carbon energy infrastructure across the Union.

This paper was written by the Green Growth Platform's Finance Advisory Council (ACIII). The Council draws on leaders from the European finance sector to advise on mobilising capital behind the low carbon transition. The recommendations herewith have been developed in consultation with ACIII members, which include senior representatives from Deutsche Bank, E3G, the European Investment Bank, HSBC, Natixis, and the Institutional Investors Group on Climate Change (IIGCC).

The Green Growth Platform[i] brings together European Ministers from Belgium, Denmark, Estonia, Finland, France, Germany, Ireland, Italy, Luxemburg, the Netherlands, Norway, Portugal, Slovenia, Spain, Sweden, the United Kingdom with business and parliamentarians to catalyse and champion a European policy and economic framework that supports the delivery of an orderly low carbon transition. The Green Growth Platform and its four Advisory Councils were established and are managed by the Cambridge Institute for Sustainability Leadership[ii] and the Prince of Wales's Corporate Leaders Group[iii].

A European Framework for financing a Low Carbon Energy Union

The Commission's aim of developing a European Energy Union to ensure secure, affordable and climate-friendly energy for citizens and businesses poses an important challenge to policy-makers and the finance community. How do we mobilise the €2.5tn that it is estimated is needed to upgrade our energy infrastructure over the next decade? And how do we ensure this capital flows to low carbon energy rather than high carbon alternatives that will be exposed to policy risk if they are incompatible with future climate policies? This briefing paper puts forward five key recommendations to address these challenges.

[1]DIW. European Energy Sector: Large Investments Required for Sustainability and Supply Security

1 *Create a certain and long-term policy environment for low carbon infrastructure investment*

Private finance owners need to be convinced by governments that there is a 'strategic long term plan' both setting a clear pathway for what the EU collectively understands it wants from an Energy Union, and concrete actions to achieve it. This plan must send the **right signals to investors and provide long-term certainty,** allowing them to allocate capital to low carbon projects in full confidence that the policy environment will remain consistent and supportive throughout the lifetime of the investment. This will ensure capital is provided at scale and on time to support delivery of the Energy Union in line with 2030 climate and energy targets. Greater policy clarity and long term objectives will also stimulate more robust Public-Private Partnerships (PPPs) over the longer term and ensure they leverage private finance for low carbon infrastructure projects.

Capital flows when it is financially justified, i.e. when it meets certain conditions relating to risk and return for the investor. **To unlock capital, governments need to agree long-term, stable policy conditions that do not compromise the financial viability of the projects during their lifetime.** This requires a series of structural reforms, including:

- **National infrastructure plans that are consistent with the 2030 climate and energy targets** and an EU governance framework that ensures these are met.
- **Credible and consistent scenario-based stress-testing of the financial viability of infrastructure choices,** both at EU and Member State level, under and a range of energy and carbon price scenarios, and under different climatic conditions.
- **A carbon price that is sufficient to tilt investment towards low carbon industries and projects;** this is estimated to be in the region of €30-50/t. This requires a Market Stability Reserve (MSR) in place as soon as possible and a real reform of the EU Emissions Trading System.
- **A phase out of fossil fuel subsidies and all subsidies for price competitive mature technologies** to provide a level playing field and ensure a well-functioning energy market with robust supply and demand side management.
- **Support for properly designed Feed-in Tariff/subsidy schemes** that level the playing field between conventional and non-conventional energy sources, and consideration of what steps can be taken to prevent or dissuade Member States from retroactive changes to these incentives. This could include, for example, co-investment of national public banks with private sector investors.

2 *Allow climate risk to inform public and private investment decisions*

There continues to be a poor understanding of climate risk in many parts of the finance sector and its' customers. Even when investors seek to improve the carbon performance of their investments, the tools at investors' disposal, such as underweighting fossil fuel stocks, are quite basic. In addition, it can be extremely difficult to discriminate between assets that are exposed to climate risk and those that are not. The EU can address this by:

- **Encouraging Member States to require listed companies to disclose their carbon footprint and exposure to climate risk.** Such legislation is currently being introduced in France.
- **Working with financial regulators to understand and respond to the risks to financial stability posed by the economy's structural bias towards high carbon infrastructure.** This can be achieved by adapting established stress -testing regimes used by regulators (e.g. within Basel III and Solvency II) to develop better understanding of such exposures. This would ultimately enhance regulators' ability to define appropriate regulatory capital requirements.

3 *Align the wider EU finance agenda behind the 2030 targets*

Meeting the Energy Union's low carbon investment requirements is a major challenge that requires the wider machinery of Government to be aligned behind it. There is particular scope to maximise the synergies between President Juncker's Jobs, Growth and Investment Package, the Capital Markets Union process and the Energy Union concept, which should all include a specific focus on sustainability and long term planning.

Aligning the European Fund for Strategic Investment (EFSI) behind decarbonisation is particularly important. The EFSI could play a key role in delivering low carbon energy infrastructure as long as it is explicitly targeted at increasing the capital flow to low carbon projects and it rules out backing high-risk, high-carbon projects[2].

State-owned finance institutions can also demonstrate leadership by ensuring that their investment strategies are consistent with the goals of both the 2030 Climate and Energy target and the Energy Union. Equally, government-enabled mechanisms to attract alternative flows of private finance into infrastructure investment should be required to invest in low carbon assets. This should include European Long Term Investment Funds (ELTIF), which provide a potentially valuable means to support low carbon infrastructure investments but currently suffer low take-up. ELTIFs should therefore be reviewed with the aim of aligning them behind the low carbon Energy Union and increasing take-up.

4 *Share the risk*

Delivering a decarbonised Energy Union will require investors supporting new types of technology and business models that implicitly carry more risk. To keep the costs of capital down and to ensure private finance is actually deployed there needs to be a focus on targeted risk-sharing.

As a transition measure, while project pipelines build up, **risk sharing mechanisms such as public guarantees and 'first loss' finance would speed up capital flows. Clarity on the variety of relevant risk-sharing mechanisms available from EU institutions is required,** with new (or rationalisation of existing) mechanisms introduced if they are found to be inefficient or subscale, in close cooperation with the finance sector and institutional investors.

As noted above publicly owned banks, including the EIB and national banks, can play an important role in targeted risk-sharing, for example through supporting emergent green bond markets, accelerating direct infrastructure investment, and the re-emergence of securitisation markets that are fit for purpose.

There also needs to be a focus on ensuring structural barriers to deploying scaled capital to infrastructure are removed as part of the Capital Markets Union reform agenda as well as better quality information to enable investors to assess their exposure within their portfolios to the effects of a range of risks including companies not aligning business planning and investment strategies with the 2030 climate and energy package.

[2] E3G (2015) Making the investment plan work for Europe

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5 *Mobilise new sources of funding*

The size of the financing needs for energy infrastructure across the EU means that Governments need to work with the finance sector to mobilise new sources of private capital. Key priorities include:

- **Aim to mobilise the funds managed by institutional investors** - Large pools of reserves are managed by European institutional investors yet the share of climate-friendly assets in these portfolios is only 1-2%[3]. The recommendations in this briefing note would create the right environment to increase the investment by institutional nvestors into low carbon infrastructure, but the EU can also support the development of appropriate climate - friendly financial products such as Green Bonds by:
  - Encouraging public financial institutions to play a leadership role in developing and issuing bonds,
  - Exploring tax incentives for Green Bonds and other climate-friendly financial products,
  - Working with the market to help develop transparent standards that could facilitate the growth in Green Bonds.
- **Provide European savers with choice and incentives to invest in a low carbon future** – The bulk of the finance is derived from the 'investing public' through savings, pension plans and insurance premia, as well as private wealth and sovereign funds. These sources amount to tens of trillions of euros. Current incentives in this area, however, such as tax breaks, are not linked to public policy objectives. For example, the growth of French life assurance companies' assets closely correlates with the tax exemption attached to life insurance contracts – effectively a state subsidy of the finance industry. **By addressing this, and by supporting the integration of low carbon investments into mainstream saving and investment products, Europe's citizens' savings would help to finance its low carbon transition.**
- **Support the aggregation of infrastructure assets.** This will help to attract more potential investors and diversify risk across projects with different risk profiles, and is particularly important for the renewable energy sector, where projects are often numerous but small.

Sources:

[i] Green Growth Platform - http://www.cisl.cam.ac.uk/business-action/low-carbon-transformation/green-growth- platform

[ii] Cambridge Institute for Sustainability Leadership - http://www.cisl.cam.ac.uk

[iii] Corporate Leaders Group - http://www.cisl.cam.ac.uk/business-action/low-carbon-transformation/clg

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[3]European Commission (2015) Shifting Private Finance towards Climate-Friendly Investments