EU Should reconsider its approach to climate finance

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The debate about climate finance

Climate change is a global challenge, and there is a broad agreement of the need for climate action. These actions were formalized through the Paris Agreement, adopted at the UN climate summit, COP21, in Paris in 2015. The Agreement emphasizes that all countries must take action, to reduce emissions; to strengthen our resilience and possibilities to adapt to the effects of climate change, and to deal with losses and damage caused by climate change.

While there is agreement on the need to engage, this quickly evaporates as soon as the discussion turns to the actions that need to be implemented and determining who should pay the bill.

For many years, climate finance has been a core part of the UN climate talks. Currently, this debate is very fractious and is blocking progress on many negotiations' streams. However, some agreements have been established on finance, and these should be guiding developed countries in their assistance to developing countries. Before presenting these agreements, it is important to understand the context that has shaped these discussions.

Scientists have shown that global warming is linked to human activities. Emissions, from our use of energy, our consumption and production, transport, agriculture and waste, have a dramatic effect on our climate. The impacts are demonstrated through erratic and extreme weather such as droughts and flooding. In accepting the link between our way of life and its effect on growth and development, we also acknowledge our responsibility.

The responsibility for global warming can be analyzed and interpreted in many different ways. There is no formal agreement that makes the link between responsibility and the need to offer support or to take action. However, there is a general recognition that developed countries should support developing countries. From a developing country perspective, this obligation is directly linked to discussions on responsibility. Countries who cause the problem should also contribute to the solution. This is the "polluter's pay principle", and a logic which most people around the world probably accept.

With this logic in mind, the Paris Agreement reaffirms the commitment of developed countries to mobilize US$100 billion annually from 2020 and beyond, as financial support for developing countries to take climate action.

The Paris Agreement also states that new financial targets should be set for 2025 and beyond. This decision is based on the recognition that global temperatures are likely to continue to rise and the need for mitigation and adaptation is also increasing.

Apart from financial targets, there are also a number of more or less concrete agreements on how climate finance should be mobilised and used. There is a general agreement that funds should be balanced between mitigation and adaptation and that climate finance should be "predictable". The latter is important, both for the possibility for developing countries to plan, but also for building trust and confidence.

Another principle, which has been contested, but is still on the agenda, is that climate finance should be "new and additional". This principle, which has been part of the climate change debate since Bali in 2007, is built on the understanding that climate change has created additional challenges for developing countries. Apart from ongoing work to fight poverty, improve food security, education and healthcare, and to build infrastructure and institutions, developing countries are now also facing complex issues due to climate change. These crises are primarily linked to emissions caused by developed countries, so the argument is that support should be on top of existing commitments for development aid.

This logic may seem easy to grasp, but it is important to note that there is no agreed definition of the meaning of "new and additional". In the recent "biennial reports" from developed countries, different definitions of the concept were offered with obvious differences in interpretations and viewpoints.[1] Definitions presented by the Standing Committee on Climate Finance, a UN body where developing countries participate, have also provided interpretations, which will add additional perspectives to this debate.[2]

In the UN climate talks, there is a general understanding that climate finance should be used to support poor and vulnerable countries. Firstly, this is justified because these countries, which have limited emissions, and thus responsibility, are in urgent need of assistance as they are already affected by climate change and lack resources to take action. Secondly, these countries have been the most vocal in the debates on climate finance, and the current agreements are in large part due to their work in bringing these issues to the world's attention. And finally, listening to developed country rhetoric and its calls for emerging economies to contribute to climate finance (finance ministers of EU member states, has, in their council (ECOFIN) also made this call formally),[3] it is easy to believe that these countries do not need climate finance themselves.

Despite the existence of many formal and informal agreements, there is a lack of rules on how to count and mobilise climate finance. According to the existing wording in the Paris Agreement and earlier agreements, countries are only committed to mobilise climate finance. No guidance is provided on the types of financial flow required and their modalities for developing countries. In practice, a significant part of climate finance is currently offered as loans, both concessional and non-concessional. A few countries include export credits, and many donor countries, as well as the EU, are looking into ways of including funding from private investors. A considerable part of climate finance is also provided as grants, either through bilateral arrangements, or via multilateral banks and initiatives. Donors usually count these funds as development aid in their DAC reports. It makes up part of their commitments to give 0.7 of their GNI as development aid to developing countries.

Developing countries are frustrated with this interpretation of climate finance. In political statements and negotiations, developed countries have promised support; but when the support arrives it is not what developing countries expected, neither in terms of size or allocations. However, in the absence of established rules or guidelines, all kinds of funds can be counted, and perhaps even double counted. The target to mobilize US$100 billion per year from 2020 may become an empty promise unless more strict rules are adopted.

EU is a vocal actor in the debates on climate finance. There is a genuine wish to provide support, but there are also strong concerns on how this support should be given and used.

The next section examines EU climate finance, and how it relates to the points made above. A recent report from ACT Alliance EU, "An Analysis of the Climate Finance Reporting of the European Union," which includes technical information on calculation methods, provides an important foundation for this discussion.[4]

Flows of climate finance from the EU

Climate finance from EU takes various forms. It should first be noted that there is a difference between finance that is delivered directly by EU member states and that which is delivered by EU institutions. There are also significant differences in how EU member states interpret the commitments that were made in the UN climate talks. While some have strategies on ways to honour their commitments, others deliver very little and are generally not active in debates on climate finance. The differences amongst EU member states becomes clear when their contributions to climate finance is compared to their GNI. This is a commonly accepted method to assess donor performance with ODA, and it can also be used as a method to assess climate finance.

A few countries, such as Luxemburg and Germany donate considerable amounts in relation to their GNI (0.35% and 0.23% respectively). Other countries, such as Bulgaria and Croatia, do not seem to prioritize climate finance at all (0.00% and 0.00% respectively).[5] EU member states have a range of economic capacities, and there is no doubt that some countries have substantial domestic challenges. But compared to most developing countries, they are rich and they have signed the Paris Agreement, which included commitments by developed countries to provide finance for poor and vulnerable countries.

In 2016, the total amount of climate finance mobilized from EU member states was approximately €15.4 billion. This represented an increase from 2014, when the amount was about€11 billion.[6] There have been fluctuations where some countries like Germany have increased their contributions while others such as Denmark have decreased. However, the overall trend is increasing support.

The climate finance derived from EU institutions encompasses three institutions: 1) the European Commission (EC), 2) the European Development Fund (EDF), and 3) the European Investment Bank (EIB). The EC and EDF are both controlled by formal EU structures. The EIB is an investment bank, owned by EU member states, which also sit on the board.

Commitments made by EU Institutions[7]

Millions of €	2013	2014	2015	2016
EC+EDF	€964	€677	€1,517	€2,730
EIB	€2,047	€2,098	€2,276	€1,948
Total	**€3,011**	**€2,775**	**€3,793**	**€4,678**

Total climate finance from EC, EDF and EIB has increased from 2014 to 2016, largely due to greater contributions by the EC and EDF.

Adaptation vs. Mitigation

As mentioned above, there is agreement that climate finance should be balanced between mitigation and adaptation. Unfortunately, this commitment has always been difficult to reach with EU climate finance. For instance, in 2013, 80% of climate finance from EU institutions went to mitigation. In 2016, the focus on adaptation increased as a smaller share (66%) went to mitigation – an improvement, but still not a balance. The balance in climate finance allocations from the EU member states has more or less stayed the same. In both 2014 and 2016, 71% was directed to mitigation projects.

Shares of adaptation and mitigation[8]

	2014		**2016**	
	% Adaptation	% Mitigation	% Adaptation	% Mitigation
EC+EDF	49%	51%	45%	55%
EIB	3%	97%	4%	96%

EU member-states	29%	71%	29%	71%
Total EU	26%	74%	30%	70%

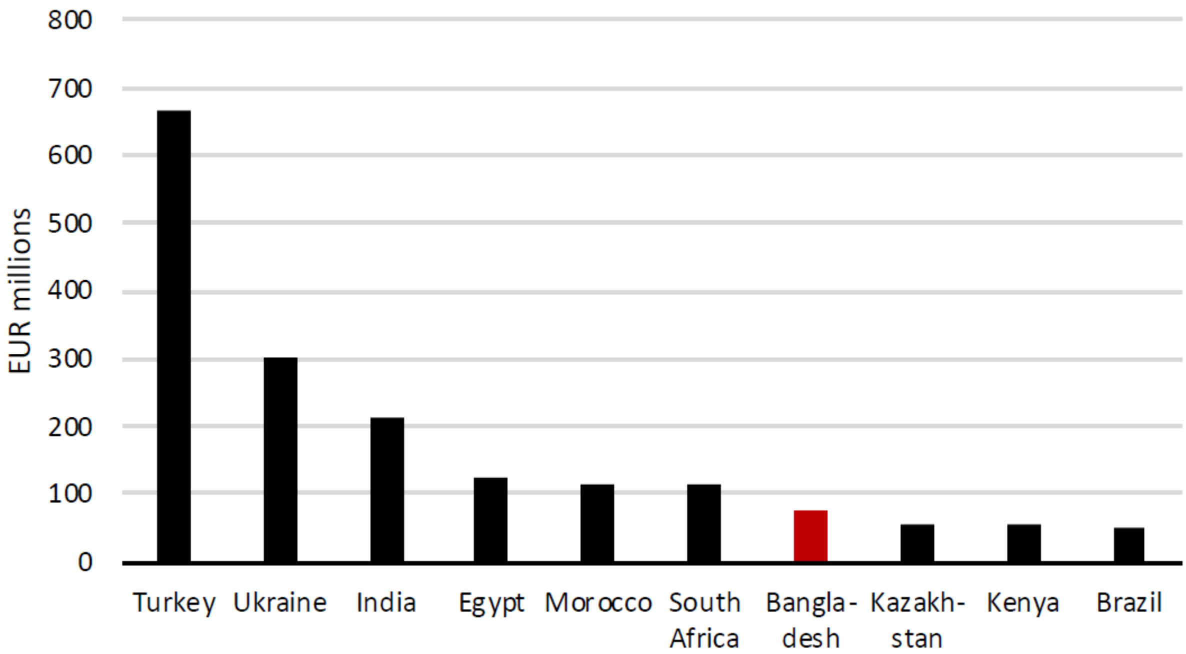
A closer examination reveals some positive developments. Among the EU institutions, EDF and EC have increased their focus on adaptation. Among EU member states, a few countries, for example Italy and Spain have also increased their focus on adaptation, but the increase has not been big enough to change the total balance.

Despite these small increases in adaptation finance, the overall picture remains the same with the EU favoring mitigation. Considering the different actors, this is unlikely to change. The main reason for this bias is the EIB, which makes up a significant part of EU climate finance. As a bank, EIB will always favor mitigation, which will make it challenging for the EU to fulfill the Paris commitments to adaptation. The only possible solution would be if EC and EDF, and/or member states compensate by shifting their focus to adaptation.

<u>Who receives the support?</u>

Climate finance from EU institutions is directed to a range of countries. The EC and EDF generally favor the LDCs, while EIB focuses on emerging economies. This is linked to the fact that EIB is a bank, and so it is most interested in investments that are likely to deliver a return.

Overall, EU institutions seem to favour middle-income countries in their climate finance contributions. For example, from 2013 to 2016, Turkey received almost the same amount of climate finance as the total provided to Least Developed Countries.



Figur1 Top 10 recipients of climate finance from EU institutions between 2013 and 2016[9]

While there are no formal rules requiring that climate finance goes to the poorest and most vulnerable countries, this is a general assumption in climate negotiations. So when such a big part of EU climate finance is directed to countries that EU often argue should be contributing to climate finance, the EU faces a political problem. This issue could affect possibilities for EU to reach agreements with poor and vulnerable countries on other elements in the climate debate.

<u>Accounting rules and practice</u>

A lack of rules and transparency makes debates on climate finance difficult. Parties have different interpretations and expectations. Allocations by developed countries, which they may expect merits praise, can meet with disappointment from developing countries. Developing countries continue to ask where the climate finance is, while developed countries respond that it has been disbursed. A lack of clarity leads to a lack of trust, which makes it difficult to move forward with international negotiations.

Luckily, the development of rules and increased transparency is on the agenda of the current climate talks. There is potential that an agreement will be adopted at the climate summit, COP24, in Poland in December 2018. From an EU perspective, these talks are important. Depending on the outcome, there may be new requirements for mobilization and reporting of climate finance, and the effect could be significant.

One example of potential impact relates to the widespread practice of using loans in climate finance. In 2016, 94% of the French climate finance was in the form of loans, and 16% of these loans were non-concessional. Such loans are not eligible as ODA and cannot be included in DAC reports. If current DAC practice were to be applied to climate finance, the French climate finance would decrease from €3.3 billion to €2.8 billion. EIB also includes non-concessional loans in their climate finance. According to the DAC approach to aid, the EIB support would decrease by 15%. None concessional loans could have an important role to play, especially for mitigation projects in upper middle-income countries. However, from a developing country perspective, following the same logic as applied in DAC, these loans could be counted on top of the existing commitments for climate finance.

From a developing country perspective, the use of loans in climate finance is highly controversial. They maintain that the root causes of climate change dictate that finance should be provided largely as grants and not as loans. The current use of loans means that developing countries are paying over time for climate finance themselves. A recent proposal is to count the grant equivalent amount of loans. This is consistent with developments in DAC, where donor countries have to report on the grant equivalent amount of their support.

The principle of “new and additional” is also being advocated by developing countries in talks on accounting rules. They are concerned that an increase in climate finance will lead to a decrease in ODA to meet other development needs, unless climate finance is earmarked as an additional flow. If this principle is adopted as an accounting rule, it could have big effects on existing climate finance flows. If the mentioned developing country concern were considered, developed countries would have to mobilise more funds to live up to both existing ODA targets and existing targets for climate finance. However, in relation to this debate it is important to take note of the fact that only few developed countries actually deliver on the existing target to allocate 0.7% of GNI as ODA.

The issue is linked to present accounting practices of most OECD countries. When they mobilise climate finance from their domestic budgets, they are not allocating new and additional funds with a specific focus on climate change. Instead, they assess existing ODA based on so-called Rio markers,[10] to see if there are projects and programs that could be reported, to a bigger or smaller degree, as climate finance. This approach gives a good impression of how climate finance is mainstreamed into ODA, which, of course, is an important focus. But it does not necessarily show that there is a new focus on climate change, and if there is a focus, it does not safeguard other development areas from being sidelined.

The use of Rio markers for accounting is also problematic in other ways. The assessment of a specific project is made by staff that may not know much about climate change and in most countries with a fixed scale (in several countries 0% 40% or 100%). As a result, assessments can be misleading. One example is from Uganda where Danish ODA support to a water project was reported as 100% climate finance, but in fact, only had an element that could be eligible as climate finance.[11]

Scaling up

The current level of climate finance contributions from all developed countries is still far from the US$100 billion commitment for 2020. In addition, the United States has announced that it will reconsider and cut its climate finance, putting a lot of pressure on EU. A failure to deliver on this commitment will have a major impact on the EU's relationships with developing countries.

As noted above, there are some positive signs as some EU countries and institutions have increased their climate finance. But there is still much work to be done, and the current negotiations on rules of accounting and reporting are important as they also may effect which funds can be reported as climate finance.

A main priority should be to increase grant support from EU member states and institutions. This shift is needed to both delivery on commitment to increase climate finance, and to reach a balance between mitigation and adaptation. Grants are needed for adaptation, while mitigation can be more easily funded through loans and private investments, particularly for upper middle-income countries.

The current approach where Rio markers are used to identify how much climate finance is to be reported is a bottom-up approach, and is not linked to an increase of grants in climate finance. To scale up the amounts of grants, or climate finance in general, there is need for political decisions to ensure that more funds are allocated to mitigation and adaptation projects.

Another important consideration is the identification of instruments to mobilize private finance. This question will receive much attention from the EU as different possibilities are explored. They include the facilitation of private investments' contributions to climate action through incentives offered by governments and government institutions. However, an increased focus on private finance does not automatically lead to an increased amount of climate finance. Again, it depends on accounting and reporting rules, which UN Climate talks are currently negotiating. If developing countries have success with their positions, there will be strict rules for how to count private climate finance.

Turning money into action

There is an urgent need for action, to both reduce emissions and to help people and communities to adapt to climate change. UN agreements on climate finance should be turned into action as quickly as possible. The ongoing negotiations about accounting and reporting of climate finance may be technical and complex. However, in reality, they are crucial for the success of the Paris Agreement.

To ensure that money begins to flow and is effectively used, it is essential to have clear and transparent rules. There are currently many possibilities for developed countries to secure the funds they have promised to mobilize. It is true that the Paris Agreement refers to the commitment to "mobilize resources" without specification to the nature of these resources. However, this wording should not become a loophole for avoiding commitments to maximize concessional resources for climate adaptation and mitigation, particularly for the poorest and most vulnerable countries.

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[1]Interpretations of the term "new and additional" can be found in the third Biennial Reports from developed countries, Section 7.1.2. The reports can be found on the UNFCCC webpage www.unfccc.int/

[2]The Standing Committee on Finance has made a list with possible interpretations of the term "new and additional." It can be found in their 2016 Biennial Assessment and Overview of climate finance flows report, Section 3.2.3, and Annex Q. The report can be found at the UNFCCC webpage www.unfccc.int/

[3]ECOFIN conclusions on climate finance has several times stressed that emerging economies also should contribute with climate finance. See for example conclusions from 2015, §4 http://www.consilium.europa.eu/en/press/press-releases/2015/11/10/conclusions-climate-finance/

[4]The research was carried out by INKA consult at http://www.inkaconsult.dk/ and the report can be found on the ACT alliance EU website https://actalliance.eu/

[5]Figures are based on calculations by INKA consult in a report from the ACT Alliance "An Analysis of the climate finance reporting of the European Union." The report can be found at the ACT Alliance EU website https://actalliance.eu/

[6]Figures taken from the report from the ACT Alliance "An Analysis of the climate finance reporting of the European Union." The report can be found at the ACT Alliance EU website https://actalliance.eu/

[7]The table is based on calculations by an INKA consultation and includes data from the second and third biennial reports from the EU to UNFCCC.

[8]The table is based on calculations by INKA consult and includes data from the second and third biennial reports from the EU to UNFCCC.

[9]The figure is taken from a report from the ACT Alliance EU "An Analysis of the climate finance reporting of the European Union". The report can be found at the ACT Alliance EU website https://actalliance.eu/

[10]"OECD DAC Rio Markers for Climate" handbook can be found at the OECD website www.oecd.org

[11]Report from DanChurchAid, CARE Denmark and OxfamIbis, about Danish climate finance. The report can be found on the webpage of the Danish 92 group https://www.92grp.dk