

Financing Sustainability Transition

REPORT & RECOMMENDATIONS

Following the High Level Group meeting on 27 September 2022

During its meeting on 27 September 2022, the independent tripartite High Level Group on Financing Sustainability Transition continued to ‘think outside-the-box’ on the financial and geopolitical aspects of the sustainability transition in the EU. These temporary think tanks were set up following an initiative in the Competitiveness Council.¹ The High Level Groups are an ‘open innovation’ approach between governments, business and academia, to inject innovative policy ideas into the EU political system.² Recommendations are outlined for the attention of the European Commission, the European Council and the Council of the EU for their ongoing and future policy initiatives.

The following points were discussed:

- 1. Dealing with the urgency: policy answer to the European energy crisis.** Members discussed how to manage the industrial and societal demand in a context of energy scarcity, and how to design proper emergency measures to mitigate the harmful impacts of the crisis on the economy and society in the short-term, without compromising the long-term financial viability and the EU climate objectives.
- 2. Improving the financial and banking system: implementation of the EU Sustainable Finance Strategy (2021).** Members took stock of the progress made in the implementation of the EU Strategy, and discussed the remaining necessary reforms of the financial and banking system to steer capital towards the transition.
- 3. Ensuring strategic autonomy and security of supply in the long-term.** Members discussed how to avoid new trade dependences on the pathway towards climate-neutrality.

¹ Council of the EU, 5-6 December 2011, Presidency Note.

² Members participate in their personal capacity. All recommendations for action and all ideas for further consideration have not always been agreed on by all members, but advice is based on a very wide consensus. The final version is written under responsibility of the chairman and the secretary general.

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1. Dealing with the urgency: policy answer to the European energy crisis

Following the Russian invasion of Ukraine in February 2022, the European Council and the European Commission agreed to reduce EU imports of Russian energy commodities, in particular natural gas, coal and oil.³ Meanwhile, Russia has imposed reduced or cancelled supplies of gas to a high number of Member States.

The current energy crisis typically raises **two types of risks** on the economy and society: (1) **economic risks** (i.e., high energy costs put at stake the financial viability of industries and households) and (2) **supply risks** (i.e., in case of an energy shortage, case-by-case curtailment decisions for certain categories of users may become unavoidable⁴).

To tackle those risks, the European Commission proposed a European Gas Demand Reduction Plan in its package “Save Gas for a Safe Winter” on 20 July 2022. It included a proposal for a Council Regulation on coordinated demand reduction measures for gas, adopted on 5 August 2022.⁵ The Regulation calls on Member States to reach a **demand-reduction target of natural gas by 15%** between 1 August 2022 and 31 March 2023 compared to the average consumption of the past 5 years. Similarly, a **demand-reduction target for electricity** has also been proposed on 14 September 2022.

Member States are free to implement their own measures to reach those demand-reduction targets, such as **market-based instruments** (e.g., auctions or tenders calling for offers to reduce gas consumption, swap contracts between industrial customers, interruptible contracts with gas providers, etc.) and **regulatory instruments** (e.g., tax incentives and subsidies, fuel switching via derogations to the maximum industrial emission limits,⁶ energy sobriety measures in buildings, etc.)

The High Level Group made the following observations:

- **Short-term crisis measures should not contradict long-term policy objectives.** Members of the HLG welcomed governments’ efforts to seek energy cost mitigation on the economy and society with support measures of all types. This is indispensable in order to maintain social cohesion and economic activity in Europe. However, they also emphasized the need to ensure that such measures do not bring an unbearable cost on society in the long-term, and do not send the wrong market signal to consumers.

³ European Council, *Versailles Declaration*, 10-11 March 2022; European Commission, *REPowerEU Plan*, 18 May 2022.

⁴ The EU legal framework already identifies a number of so-called “protected customers” (i.e., households and essential social services), for which an uninterrupted supply should be maintained as long as possible. EU Security of Supply (SoS) Regulation 2017/1938.

⁵ Council Regulation 2022/1369 on coordinated demand-reduction measures for gas, 5 August 2022.

⁶ Industrial Emissions Directive (IED) 2010/75, Art. 30(6).

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For example, energy subsidies have a cost on society by transferring the burden of rising energy costs on governments, while also increasing energy supply risks. The potential inflationary effects of certain support measures should also be considered. Therefore, it is important to ensure that support measures are well designed in scope and in time, and accompanied with structural improvements of the energy system and effective demand-reduction measures – as indicated in the following points.

- **Optimise resource allocation in the European energy system in order to make it more resilient against supply risks.** It is said that the European energy system is not yet fit for a large scale electrification shift and higher renewable production capacities; transformations are required to optimise resource allocation. A reform of the EU electricity market design and a decoupling of gas and electricity prices may be part of the solution, yet more is needed:
 - *On the supply side*, investments are required into energy network infrastructures, cross-border interconnections and storage capacities in order to displace (or compensate) excessive (or reduced) energy supply from one part of the grid to the other.
 - *On the demand side*, flexibility improvements are also required to “track” individual energy demand and to alleviate the charge during peak hours, both for industry and households. The European energy system should become more flexible to cover all needs and to mitigate the impacts of consumption peaks and supply shocks.
- **Beyond the “traditional” demand-reduction and energy sobriety measures already being developed, investigate further ways to accelerate the transition towards sustainability with all possible policy instruments.** Member of the HLG discussed how to enable a permanent and socially viable reduction of energy demand and carbon emissions both for households and for industry:
 - *For households*, energy (and carbon) pricing is part of the solution (e.g., through the generalisation of split energy meter tariffs with more dynamic pricing), yet it also requires other complementary measures to enable the effective transition towards more sustainable alternatives and behaviours, such as incentives to switch to more energy efficient devices and heating systems, and support to accelerate building renovation.

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- *For industry*, efforts should be made to facilitate simultaneous investments into (1) marginal technological improvements that will gradually reduce GHG emissions in the short/mid-term (~2030), and (2) radically new technologies that will enable to reach the long-term objective of climate-neutrality (~2040-2050). The combination of the two typically raises balance sheet issues as short-term investment costs often withhold the long-term benefits. To break this “tragedy of the horizon”,⁷ new financial reforms and additional R&D support into long-term climate-neutral technologies are required – as outlined in the following section.

2. Improving the financial & banking system: implementation of the EU Sustainable Finance Strategy

The European Commission’s Strategy for Financing the Transition to a Sustainable Economy (thereafter: the EU Strategy) was adopted on 6 July 2021.⁸ Members of the HLG took stock of the progress made in the implementation of the EU Strategy and discussed the remaining necessary reforms of the financial and banking system to steer capital towards the transition. They discussed in particular the following points:

1. Extension of the EU Taxonomy framework to intermediate activities;
2. Incorporating sustainability aspects into the EU banking rules;
3. New EU rules and standards on corporate sustainability reporting;
4. Fiscal coordination and coherence in government expenditure;
5. The development of sustainable bond labels (green bonds, sustainability-linked bonds, etc.);
6. The balance sheet impacts of large-scale transition investments.

The High Level Group made the following observations:

- **More granularity is required in the definition of activities with an intermediary level of environmental performance.** The existing EU Taxonomy of environmentally sustainable activities could be completed with a separate “amber” category for activities with an intermediary level of environmental performance in order to stimulate a more gradual progression towards sustainability.⁹ Two necessary conditions were discussed:

⁷ Mark Carney (former Governor of the Bank of England and Chairman of the Financial Stability Board), *Breaking the tragedy of the horizon – climate change and financial stability*, speech at Lloyd’s of London, 29 September 2015.

⁸ European Commission, *Strategy for Financing the Transition to a Sustainable Economy*, COM(2021) 390, 6 July 2021.

⁹ A traffic-light system (green, amber, red) was proposed by the EU Platform on Sustainable Finance in its report on 29 March 2022 (Extended Environmental Taxonomy: final report on taxonomy extension options supporting a sustainable transition).

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- *Multi-speed approach*: Members of the HLG emphasized the need for a multi-speed approach, taking into account the long-term objective of climate-neutrality (i.e., based on the existing “green” taxonomy with ideal criteria that should eventually be met) and the short/mid-term possibilities of gradual GHG emission reduction that can be achieved earlier (i.e., based on a new “amber” category with intermediate criteria that should be met on the pathway towards climate-neutrality).
 - *Progress measurement*: The creation of a new “amber” category necessitates robust progress measurement methods in order to demonstrate the actual evolution towards sustainability (i.e., from “red” to “amber”, from “amber” to “green”). Verifiable and comparable transition pathways should show the relative environmental performance of companies and incentivise improvements over time.
- **Granularity will also help banks and capitals markets to better assess climate-related financial risks and, eventually, to reflect such risks into prudential requirements.** The complementary “green” and “amber” classification systems of economic activities is to be seen as a common language for banks and investors on the one hand, and companies on the other hand. More granularity (especially on the “amber” part of the spectrum) will contribute to better assess sustainability risks into financial terms. It can then serve as a basis for possible capital requirement differentiation in the future, depending on the environmental and social impacts of the assets held by financial institutions, while remaining fully adequate from a prudential perspective.
 - **Corporate sustainability requirements are required to improve market information on climate-related financial risks (and the long-term benefits of transition investments), provided that they are well applied, used and understood.** Members of the HLG welcomed the recent political agreement on the new EU Corporate Sustainability Reporting Directive (CSRD) and the “double materiality” perspective that will be reflected into European Sustainability Reporting Standards (ESRS).¹⁰ However, they also emphasized:
 - The need to develop user-friendly standards that can be smoothly implemented. Heavy reporting obligations might create a competitive disadvantage for European companies compared to international competitors and might not result in high quality and comparable information.
 - The strategic importance to push for further alignment at international level in the framework of the International Sustainability Standards Board (ISSB).

¹⁰ “Double materiality” focuses both on the impacts of climate change on the financial stability of companies (financial materiality) and on the impacts of companies on sustainability and climate change (environmental and social materiality).

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- **Fiscal coordination and rationalisation of government expenditure should be explored in order to better allocate resources towards sustainability.** Members of the HLG underlined the importance of a closer screening of existing environmentally harmful subsidies at EU level, which could be included in the European Semester. Efforts have been made to “green” the European Semester, yet more should be done in order to incentivise Member States to better align their efforts, in particular in the area of taxation. The design of the EU Recovery and Resilience Facility (which includes the “Do No Significant Harm” criteria of the EU Taxonomy Regulation) could inspire other EU and/or national budget programmes.
- Members of the HLG welcomed the pending work at the European Parliament and the Council on the European Green Bond Standard (EU-GBS), as well as the upcoming elaboration of a **general framework for labels for financial instruments supporting the transition of the economy**, as indicated in the EU Strategy and planned in 2023. Eventually the EU should become a front-runner in the definition and standardisation of sustainable bond labels that would cover both sustainable activities (green bonds, already Paris-aligned) and transition activities (contributing to improve sustainability, such as sustainability-linked bonds).
- **A reflection should be launched on the balance sheet impacts of large-scale transition investments in industry**, and whether accounting and amortisation rules could be adjusted to facilitate such transformations. Industry investments into radically new climate-neutral technologies typically generate large scale expenditure in the short-term, which will bring long-term benefits to society in the long-term. Yet, such investments are also a saving for society in the long-term and could be marked as such in the balance sheet.

3. Ensuring strategic autonomy and security of supply in the long-term

The transition towards climate-neutrality leads to new trade and production patterns in a number of strategic enabling sectors, such as for example the production of batteries, wind turbines, solar panels, and electro-mobility. In this context, it is important to consider that **the energy transition will likely lead to new supply dependences on certain critical raw materials**, such as lithium and cobalt for batteries or Rare Earth Elements (REE) for wind turbines.

The COVID-19 crisis followed by the Russian invasion of Ukraine have shown the risks of large-scale trade disruption in strategic value chains such as pharmaceuticals and energy. In the same spirit, **supply shortages, production bottlenecks and concentration of imports from a limited number of regions may jeopardise the European energy transition by putting at risk the development of renewable infrastructures** as well as the electrification of industry and transports.

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The High Level Group made the following observations:

- **Efforts should be made to mitigate new supply dependences during and after the energy transition.** This requires a series of reforms that have partly been initiated over the recent years, such as: tightened regulations on manufacturing to promote “circularity by design”; stronger recycling rules for all products containing recuperable critical raw materials (CRMs); harmonised recycling rules in the 27 Member States; increasing European capacities to collect and process secondary raw materials; developing substitution strategies to reduce the overall European demand for CRMs when it is technically possible.
- **Reindustrialise Europe for strategic value chains and materials, avoid supply concentration risks and build resilient value chains against external supply shocks.** Trade diversification alone will not suffice to avoid new dependences; the EU should also actively promote the development of strategic value chains that will enable the transition towards sustainable technologies in society. This includes the development of storage capacities for CRMs and a high level of secondary raw material integration. The upcoming EU Critical Raw Material Act (announced by President von der Leyen on 14 September 2022) should address such needs.
- **Strategic partnerships with reliable suppliers should be developed in sectors that contribute to the energy transition, while also helping third countries in their own transition.** This could be linked to the EU international partnership and development policy, for example by investing into sustainable and socially responsible mining projects or imports of green hydrogen. Mutual recognition and/or certification would help recognize the quality and sustainability of exchanged commodities. Stronger policy coordination between the various EU policies at stake is also desirable (i.e., trade, international partnerships, external action).

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