



# Climate finance and urban futures at COP26

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## The Liverpool City Region

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## Key takeaways

1. Findings from COP26 in Glasgow show climate finance is falling behind in meeting Paris agreement targets. In simple terms, climate finance flows in areas where it is profitable.
2. In the UK, the amount of capital needed for cities to reach net zero is beyond the reach of public finance. Investments would need to scale up to at least £50 billion per year by 2030 and remain at or above that level until 2050 to reach net zero. Emissions reductions in cities need to be supported and mainstreamed through regulatory changes of financial markets to meet the needs of cities, particularly those in Northern England.
3. A competitive bidding environment for local funding will only further exacerbate climate risks across and within UK cities. Stable funding streams for local authorities are required to plan long-term for climate change.
4. Northern English cities are particularly disadvantaged in paying for climate change due to a decade of austerity, a large concentration of high-carbon industries, and poor housing stock. Direct support by central government in the form of pooled finance mechanisms or blended financing models through public-private partnerships can help make Northern cities more attractive for climate finance investments.

## 1. Introduction

Nations recently met in Glasgow for COP26 with the aim to commit to keeping global temperatures increases below 1.5 degrees Celsius. A key issue discussed on Day 3 of the conference was the challenges and opportunities of climate finance. To combat climate change and reach net-zero, it will require tremendous effort, ingenuity and ongoing collaboration to mobilise resources at scale, coordinate delivery of a combination of financial instruments, and maximise the leverage of public investment.

Climate finance refers to local, national or transnational financing to support mitigation and adaptation efforts to address climate change. Mitigation involves strictly reducing greenhouse gas emissions in the atmosphere, whereas adaptation involves adjusting to actual or expected future climate change and reducing our vulnerability to its effects. The United Nations Framework Convention on Climate Change (UNFCCC) Standing Committee on Finance, defines climate finance as:

*"Finance that aims at reducing emissions, and enhancing sinks of greenhouse gases and aims at reducing vulnerability of, and maintaining and increasing the resilience of, human and ecological systems to negative climate change impacts."*

In 2009, developed nations promised to send at least \$100bn a year in climate finance to poorer countries by 2020. That understanding formed the basis of the 2015 Paris climate agreement which aims to globally reduce greenhouse gas emissions. At the beginning of COP26, donor countries admitted they had missed this investment target.

So, why are climate finance flows falling short?

The reality check behind mobilising \$100bn is that the private sector will be responsible for the majority of the investment needed. The UNFCCC recently estimated that more than 85% of all finance to address climate change will need to come from the private sector.

This has raised concerns that private finance will only flow in projects where there is a high return of investment that might not align with the climate priorities of struggling cities and developing countries.

To meet the 100 billion goal through 2025, several countries and financial institutions set out plans to increase their climate finance globally at COP26. This policy brief highlights the key insights on climate finance from COP26, including a discussion of the ongoing global climate financing gap, and its implications for UK city-regions. An absence of coordinated investment has contributed to uneven climate finance outcomes. Firstly, climate finance is mostly flowing to developed countries in the form of mitigation projects that can generate returns on investment where success is clear and measurable.

Adaptation, on the other hand, is lagging as it is more difficult to measure results and often offers lower returns on investment. This has created challenges for developing countries who are struggling to withstand and repair climate-related disasters. Secondly, the lack of a coordinated commitment to scale up or improve climate finance over the years has created barriers for some UK cities. Due to spending constraints, these challenges are particularly acute in Northern English cities and their ability to reach net-zero.

## **2. Climate finance at COP26**

Innovative solutions are required to stimulate private sector action and investment to support low-carbon and climate-resilient development. On Day 3 of COP26 there were several new financial commitments by UK government and businesses to increase climate finance. How many have provided details about the path from today to 2050? Very few. Some of the key promises on climate finance include:

### *More money for developing countries*

- The UK government announced £290 million in new funding, including support to countries in the Asia Pacific to deal with the impact of global warming. This will be a new capital market mechanism as part of the Climate Investment Fund (CIF), a multilateral fund based at the World Bank. This new initiative will use investment-grade bonds (such as green bonds) to scale up climate finance.
- The UK is launching an Urban Climate Action Programme (UCAP) in partnership with the C40 Cities network (representing 97 of the world's largest urban areas) that will provide £27.5m to at least 15 cities in developing countries across a three-year period. This will be used to decarbonise public transit and energy systems, improve climate risk assessments, and make waste management more environmentally sustainable.

### *New commitments made in the UK context*

- The UK has pledged to make London the world's first net-zero aligned financial centre. Historic climate investment commitments from the financial sector that cover over £130 trillion of financial assets were pledged across their portfolio by 2050. This partnership is known as the Glasgow Financial Alliance for Net Zero (Gfanz). British financial institutions could be required to disclose their climate impacts, report on their progress, and to publish their net zero transition plans.
- The UK Green Building Council has announced plans for the built environment's net-zero pathway by implementing a Whole Life Carbon Roadmap - a tool to help businesses in the UK measure and cut carbon from materials, processes, operation and demolition. This will also include details for measuring, reporting, and reducing carbon emissions. The sector aims to cut emissions from 180 metric tons of CO<sub>2</sub> to less than 20mt of CO<sub>2</sub>.

Latest figures from UNFCCC report climate finance flows were 16 percent higher in 2018 than in 2015 to reach an annual average of \$775 billion. Although climate finance flows are increasing modestly, they remain relatively small in the broader context of other financial flows and assets. Climate finance account for just a small proportion of overall global financial markets and is considerably well below what would be expected of the investment needs that have been identified. For instance, adaption finance flows in 2017 were only \$29 billion although investment needs are between \$1.6tn to \$3.7tn per year to meet Paris targets. In addition, developing countries in East Asia and the Pacific attract almost half of the funding where the majority is being used for water and wastewater management projects.

### **3. Financing UK cities to a climate future: lessons from COP26**

One of the challenges for climate finance discussed by multilateral development banks and climate finance investors at COP26 was calls by the private sector for more accountability and transparency to be able to scale up investment. Banks want to see that their investments in projects can be directly linked to indicators and science-based assessments involving environmental impacts. This includes mechanisms for monitoring the impact of climate finance and better reporting of results. As with any form of investment, financial institutions aim to forecast their investment risk and sufficient returns.

Appeals by the financial sector for better reporting of their investments to turn a profit have created barriers for some English cities who may not have the technical capacity to meet these demands, and who have not been fiscally supported by the Central government to be able to attract the large-scale private sector investments needed to reach net zero.

Scaling up climate finance from COP26 initiatives to meet Paris targets will present unique challenges to UK cities over the next few decades. Cities are responsible for 71-76% of energy-related CO2 emissions. Figures suggest over the next decade the number of people living in UK cities is expected to grow significantly, adding strain on vital resources such as water, energy systems, and green spaces that will need to be upgraded and made sustainable. In order to achieve net zero pledges at the local level, new findings report that £206 billion would need to be spent on upgrading infrastructure in the London and the UK's core cities. It was disappointing to see no new funding announcements by UK government for local authorities to help pay for climate change effort at COP26.

As Sadiq Khan, London Mayor, reminded people during a speech at the Cities and Built Environment Day: "National governments can talk a good game, but then refuse to put in place the plans, action or funding we desperately need." Even before the COVID-19 pandemic, English local authorities struggled to access climate finance to decarbonise their economies. After a decade of austerity cuts to local budgets, many have seen dramatic reductions in core funding and are now facing a funding gap of £6.5 billion by 2024. Less than 1% on average of local authority expenditure is currently being spent on climate change, and further cuts to central grant funding in real terms will place further pressure on council budgets.

A competitive and short-term funding environment (where local governments must compete with one another to bid for central government money) will only further exacerbate climate risks across and within cities. Stable streams of funding for local authorities are required if we are truly committed to tackling the climate crisis in our cities. A competitive funding environment harms the ability of local government to plan long-term for climate change.

In addition, the fragmented state of England's energy infrastructure ownership and operations means there will need to be significant private sector involvement in decarbonising. England's energy network involves a mix of public-private partnerships, including the National Grid and other Chinese, US, Spanish and Australian investment groups who own parts of England's power and gas transmission networks. Regulatory measures on efficiency, long-term carbon standards (or mandatory carbon reduction obligations), and introducing a UK emissions trading system covering fossil fuel use, industrial emitters and power generators, would be ideal reforms to incentivise investments in greenhouse reductions.

The private financial sector has an important role to play, but should we be relying on banks to help our cities reach net zero?

Considering public sector borrowing caps, the amount of capital that is needed to reach net zero in UK cities is beyond the reach of public finance. Overall, to reach net zero, investments need to scale up to at least £50 billion per year by 2030 and remain at or above that level until 2050. To put these numbers into perspective, central government annual spending in 2020-21 was over £1 trillion, and local authority combined annual spending was £104 billion in England. This means that if it was left to local authorities to fund climate change policies, it would take up 48% of their current annual budget on average.

New instruments, such as green bonds, have potential to enable private climate investment. The popularity of these instruments has grown following cuts in federal funding for urban governments in the United States. Green bonds are used to fund projects that have positive environmental and/or climate benefits, such as GHG reductions or even flood defences.

Some research suggests that if green bonds were used by English local authorities through the municipal bond market, they would be competing against cheaper Treasury backed loans. The introduction of local green bonds in England is also complicated by strict limits on public sector fiscal borrowing, with the Borrowing and Investment Bill currently working through parliament likely to place further restrictions on local authorities borrowing to invest in 'non-core' activities, including net zero.

The use of green bonds in UK cities is therefore unlikely to have a substantial impact in reaching net zero. Instead, there is a strong case to incentivise blended finance models through public-private partnerships and allow collaboration between local government, investors, and local businesses.

By providing up-front capital through grants and non-repayable funding, the remaining financing of capital from the private sector can be supported by available income streams that could be backed by the Treasury. This could be an incentive-based approach to encourage private investment in various decarbonising technologies or in low-carbon urban infrastructures. In addition, central government could support cities to standardise and aggregate small investments through pooled finance models to create liquidity through instruments such as securitisation. One example of this could be through an energy efficiency revolving fund to retrofit residential homes and buildings.

Going further, existing emission reductions in cities need to be supported and mainstreamed through regulatory changes of financial markets. This can be done through increased prudential policies and stricter taxes on banks, investment funds, insurers, and hedge funds, to levy more capital by the public sector. Lessons learned from the 2008 financial crisis need to be taken on board to avoid speculation and betting on risky investments that will have disastrous consequences of people and the environment.

#### 4. Decarbonisation for Northern cities

Fiscal constraints have placed Northern cities in an uphill battle to reach net zero. The current national government approach for infrastructure funding assesses schemes on universal criteria, advantaging stronger economic areas in London and the South East which yield more economic output for every pound invested. Assessing schemes on this basis has meant that cities in the North are effectively stranded from investments to decarbonise.

Considering Northern England's economy is more carbon intensive than the average UK region (0.51 ktCO<sub>2</sub> per £ gross value added compared to the English regional average of 0.44 ktCO<sub>2</sub> per £ gross value added - see figure 1), this will require structural changes in the way infrastructure schemes are allocated in order to unlock private sector financing geared towards a just transition.

The subregions of the north of England have some of the highest absolute industrial and commercial emissions in the country  
*Absolute industrial and commercial total emissions for regions of the UK (ktCO<sub>2</sub>), 2014*



*Figure 1: Regional comparison of UK emissions (IPPR, 2017)*

Reducing industrial emissions is one of the biggest roadblocks in decarbonising the economy. Emissions from industry accounted for nearly 20% of UK total emissions in 2014 and will require significant investments in new infrastructure and energy systems.

The geographically concentrated nature of these industries, with clusters in the Tees Valley, the Humber and in pockets around the North West, also means that any economic consequences associated with the low-carbon transition will be unequally distributed among communities within the North. Some industries have collectively come together to reduce emissions, such as the chemicals industry, where member companies of the Chemical Industries Association plan to halve their CO<sub>2</sub> emissions by 2035, and by 90% by 2050.

There have been some positives for the North from COP26. The UK government has given £1 billion for carbon capture and storage projects for two industrial clusters in Northern England: HyNet on the North Wales and North West coast, and the East Coast Cluster, in Teesside and the Humber. These projects are expected to capture and store 20-30 million tonnes per annum of carbon dioxide by 2030.

Northern cities have been hit by the biggest budget cuts since 2010. The top five worst cities impacted are all located in the North of England who saw on average 20% of their budget cut between 2010 and 2019 in comparison with 9% for cities in the South West and South East. Therefore, building back from high levels of deprivation, climbing social care responsibilities and a challenging fiscal environment, means there needs to be more available funding and low-cost financing to invest in a just transition in the North. In particular, domestic energy efficiency should be a focus for the north of England due to poor and inefficient housing stock as well as competing challenges of fuel poverty.

Northern cities have a very low percentage of households with an energy efficiency rating of A or B than the national average, and the highest proportion of households with a D rating. Nearly 90% of households living in fuel poverty in the North have an energy efficiency rating of D or below.

Housing retrofit, including improved insulation, switching gas boilers for heat pumps and replacing old and energy inefficient appliances, will be key to decarbonising residential property as well as reducing energy poverty for low-income households. Giving combined authorities greater control over energy efficiency funding and building standards, would be one way to progress to a low-carbon urban future. The bottom line is that cities need much more direct capital, and scalable and stable revenue funding from central government to be able to attract the level of private finance needed to close the climate financing investment gap.

## **5. Conclusion**

Investing across renewable energies, decarbonising buildings and houses, and electrifying transit – across all these agendas, there is still a long way to go. To close the gap of climate financing globally means reaching places on the economic margins that may be viewed as high risk investments – which includes developing countries that are grappling with climate risk reduction, and even deprived UK cities in the North that are decarbonising the remnants of deindustrialisation. This therefore requires very different ways of organising our basic infrastructure, and that includes how we finance it.

We need systemic changes to our financial systems through governance reforms that can subsidise and also “de-risk” those climate investments to enable sustainable development and develop a clear pathway to net zero.



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