Written evidence submitted by the Carbon Tracker Initiative

Introduction

1. **Carbon Tracker Initiative is an independent financial think tank** that carries out in-depth analysis on the impact of climate risk and the energy transition to help markets and state actors align capital allocation with the finite carbon budget predicated by the need to keep global warming within 1.5°C.

2. We welcome this opportunity to provide written evidence to the Environmental Audit Committee's (EAC) inquiry into the financial sector and the UK's net zero transition. Given the urgent need to phase out global reliance on fossil fuels as a means of meeting climate objectives, we commend the EAC's decision to explore the net zero commitments of financial institutions – **in particular their policies relating to fossil fuel investmen**t. This enquiry is also timely in the UK and international context, especially in view of what the climate science is telling us, as demonstrated by the recent IPCC reports.

Executive Summary

3. Emissions from burning fossil fuels such as oil, gas and coal, are a dominant cause of rising greenhouse gas emissions leading to global warming[i]. **Scientific research conducted by the Intergovernmental Panel on Climate Change (IPCC) informs us that emissions need to be reduced by 45% by 2030** -and reach net zero by 2050- if we are to keep global warming to no more than 1.5°C[ii]. The need to reduce our dependency on fossil fuels is critical to achieving this.

4. Taking into consideration Carbon Tracker's expertise in researching and analysing the financial risk tied to the fossil fuel industry, we have formed **a set of recommendations** to help inform policymakers on how they can encourage the financial sector to advance the UK's transition to a net zero economy:

- The Glasgow Financial Alliance for Net Zero (GFANZ) should take the lead and **publicly commit to ending support for fossil fuel expansion**[1] and commit to the International Energy Agency's (IEA) 1.5°C net zero scenario;
- Linked to this, **GFANZ signatories should commit to stop financing fossil fuel expansion** as part of their net zero pledges;
- As the overarching umbrella forum, **GFANZ should implement a more systematic tracking and reporting system** which encompasses all sub-sector alliances to provide comparable data on their progress towards meeting climate objectives;
- Net Zero commitments should incorporate **specific targets for financing climate solutions** and meeting clean energy investment needs;
- **Regulators need to urgently give guidance to auditors on fossil-related asset write-downs** as companies within the fossil fuel system are making financial disclosures where the assets of this system are assumed to be "going concerns" with no risk of asset impairment or write down. The

[1] By this we mean the funding of new coal, oil and gas exploration, including new licenses. We do not mean maintenance or health and safety costs, nor do we mean the continued funding of pre-existing fossil producing projects.

presumption must be that the assets of the fossil fuel system, its coal mines, oil wells and so forth, are written down, now, in line with a 1.5°C trajectory;

- **UK Government should limit gas usage**, particularly the base load as part of its commitment to reaching net zero. Gas is a particular risk given the current rebound from the Russia/ Ukraine conflict;
- In their reporting to the TCFD, financial institutions should demonstrate **stress tests** both for their sell-side analysis and buy-side teams, or business lending teams (where relevant). For stress tests that are not based on business as usual (BAU) outcomes, regulators should insist that one of the stress tests published is consistent with the IEA's 1.5°C net zero scenario, i.e. a 50% cut in fossil fuels over the next decade. What impact would 1.5°C consistent demand scenarios have on equity and bond ratings?
- UK Government should ensure that debt and equity markets are aligned with net zero by **formally investigating the merits of a moratorium on new coal, oil and gas IPOs, or bond placements**. At a minimum, the Financial Conduct Authority (FCA) in its role overseeing the admissions process of the London Stock Exchange (LSE), should require new fossil fuel issuers to set out why - given that 90% of listed reserves need to stay in the ground - they believe their reserves will have a market. Furthermore, the FCA should require that the LSE provide guidance notes as well as a "competent person's assessment" of climate risks associated with fossil fuel development as part of disclosure requirements in issuer prospectuses;
- **All fossil fuel owning companies registered in the UK should disclose the embedded CO2 in their reserves** and resources to regulators, government bodies and financial stakeholders;
- The UK's Climate Change Commission (CCC) should be mandated to assess the role **London plays as a financial centre for fossil fuels**. Currently this is out of scope for the CCC - which is an aberration - and needs to be corrected.

5. Finally, acknowledging the inquiry's decision to write to GFANZ signatories in order to assess the claims of signatories against observable practice**, Carbon Tracker would be pleased to analyse the responses as part of this assessment and to produce a memorandum for the EAC to publish ahead of COP27.**

CONSULTATION RESPONSE

Corporate Approaches on Fossil Fuel Projects: The Financial Sector and Fossil Fuel Funding

Summary: this section describes the problem

6. As the EAC has underlined the dominant cause of climate change is fossil fuels. In 2015 — the year the Paris Climate Agreement was signed — the fossil fuel industry and its products accounted for over 90% of industrial emissions, and roughly 70% of all human emissions. However, the Paris Agreement is an emissions reduction treaty and does not in fact mention fossil fuels at all. Since 2015, the production of oil, gas and coal has increased globally. Despite what the climate science continues to tell us – as starkly demonstrated by this year's reports from the UN-backed Inter-Governmental Panel on Climate Change (IPCC), the UNEP Production Gap Report of 2021 estimated that governments are planning production which will result in more than double the emissions by 2030 than is consistent with limiting warming to 1.5°C. We note that the EAC references the Production Gap Report of 2019: the conclusions of the 2021 report remain just as alarming, and the

UN Secretary-General recently highlighted his anxiety with the comment that to invest in new fossil fuel production would be "economic and moral madness"[iii].

7. It is important to set out this context. Turning specifically to fossil fuel financing, recent analysis of the world's 60 largest banks by the Rainforest Action Network (RAN) found that USD $4.6 trillion has been spent on financing fossil fuels since the adoption of the Paris Agreement, USD $742 billion of this spent on fossil fuel financing in 2021 alone[iv]. This is a major sum from just one of the financial sub-sectors and sheds light on the significant levels of capital tied up in fossil fuel production. Of the 374 billion tonnes equivalent of gas, oil and coal listed on the world's reserves, at today's prices these have a sales value of USD $113 trillion and a net present value of $45 trillion[v]. In a 1.5°C demand scenario the majority of these potential revenues will be forgone. We recommend that a thorough analysis of the tax revenue and potential income loss is considered in light of both financial stability concerns and the adaptability of governments, including the UK, to replace its lost taxes. With BP and Shell two of the largest dividend payers on the UK market, the unwinding of the fossil fuel system also has implications for pension funds dependent upon dividends to meet pension fund obligations.

8. Fossil fuel companies are reliant on equity and debt markets for the financing of capital-intensive projects: both to raise capital to finance new investment and to maintain existing production facilities. Financial centres facilitate, and profit from, both the primary equity raising and ongoing finance requirements for these companies, as well as secondary trading activities. To align with the Paris climate goals, we expect to see less capital being allocated to fossil fuel companies via fewer IPO listings and a lower number of secondary placements on global stock exchanges.

9. Carbon Tracker's 2021 report *A Tale of Two Share Issues*, however, found that there has been $640 billion worth of equity raised from global investors in about 2,360 stock exchange transactions managed by almost 450 investment banks, with many of the banks also appearing in the RAN report mentioned above[vi]. Even the UK hosting COP26 didn't prevent coal company Ben Creeks Group Plc listing on the London market, which shows a lack of willingness deter fossil fuel companies listing on climate grounds[vii]. Accordingly, we find that financial market regulators could play a significant role in ensuring that stock exchange listing rules, prospectus regulations and disclosure standards are fit for purpose, in a world where global energy needs are increasingly being met by renewables.

10. Building on this, Carbon Tracker's latest report, *Unburnable Carbon: Ten Years On,* revisits the major role that the world's financial centres are playing in enabling ongoing investment in fossil fuels, and the risks these financial centres are carrying in their exposure to the fossil fuel complex. Echoing the inaugural research's focus on climate change through the lens of financial markets, this report finds that financial centres heavily weighted towards fossil fuel producers are particularly exposed to the global energy transition, and that over $1 trillion of oil and gas assets risk becoming stranded; the majority (some $600bn) is held by listed companies[viii]. A number of stock exchanges and financial centres are setting net zero goals, yet they continue to enable the ongoing global expansion activities of the incumbent fossil fuel industry, in many cases to a far greater degree than national reserves.

11. On this point, the emissions embedded on the London Stock Exchange (47 GtCO2) are 30 times greater than those of the UK's reserves (1. 5°C GtCO2), which reduces the credibility of the LSEG's net zero commitment for it continues to facilitate the activities of fossil fuel companies that are so clearly unaligned with global climate goals[ix].

12. Our research has also demonstrated that risks – notably the potential financial write downs of the fossil fuel system and the size of the fossil fuel system – are not being properly disclosed, eg in the UK, by companies in their financial statements and other reporting[x]. To rectify this, the existing accounting and auditing requirements for companies (and their auditors) to consider and disclose material related to climate-related matters should be properly enforced. In particular, the requirements for financial statements to include the quantitative assumptions and estimates used in the assessment of climate-related matters should be better enforced. The disclosure of emissions and climate-related risks should be in audited financial statements and annual reports, not in separate and unaudited literature such as a 'sustainability' report, as is typically the case.

13. Specifically relating to concerns that financial centres are not doing enough to align with net zero, we believe these requirements should be extended to those issuing on a stock exchange a new prospectus looking to raise new or additional capital through equity or debt offerings. In addition, we think that new listings or share offerings of fossil fuel companies should be required to explain why their reserves are necessary or will be developed ahead of other, already listed, fossil fuel companies. **We make a major recommendation on this issue of new fossil IPOs.**

14. Moreover, recent Carbon Tracker research shows that corporate investment in fossil fuel extraction remains a major problem. Absolute Impact, our analysis of the 15 largest publicly traded oil and gas companies, shows that the sector is still failing to commit to the absolute emissions reductions necessary to link their businesses to the finite limits of the carbon budget. One of the key findings of Absolute Impact is that the wind-down of existing assets is the most effective way both to reduce the climate impact of company activities and transition risk for investors.

15. The response to this challenge is clear to Carbon Tracker. Both state and non-state actors – and the pivotal role of financial institutions in this regard - need to commit to an orderly phase-out of fossil fuels and to invest in renewable forms of energy in line with the Paris goals. This is self-evident, and was responsible for signatories to the Paris Agreement endorsing Article 2.1.c: that "finance flows are consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."

<u>Potential Effectiveness of the Financial Sector: The Role of Net Zero Alliances, notably GFANZ</u>

Summary: this section sets out how GFANZ and its signatories can be an important part of the solution

16. Since the Paris Agreement was signed, pledges from countries and non-state actors to increase climate ambition have increased dramatically, including net zero pledges covering 90% of global GDP[xi]. A sizeable number of these have come from financial companies, culminating in the establishment of the Glasgow Financial Alliance for Net Zero (GFANZ) and seven strategic sub alliances to provide sector specific support.

17. Led by co-Chairs Mark Carney and Michael Bloomberg, who had a major platform at COP26 in Glasgow, the strategic forum coordinates efforts across sectoral net zero alliances and aims to support the economy-wide transition to net zero. The forum has seen a rise in signups from companies of all sizes and now represents a significant proportion of assets under management. These alliances have played a central role in making the concept of net zero more tangible by producing toolkits, guidance documents and providing thought leadership that accommodates companies at the start of their net zero journey and those with existing climate strategies/ emissions reduction targets.

18. GFANZ is part of the UN Race to Zero Campaign, a global campaign that rallies non-state actors to adhere to a baseline set of principles intended to reduce emissions across all emissions scopes swiftly and fairly in line with the Paris Accord. By joining GFANZ through membership of the seven sub alliances, financial institutions are required to adhere to the following UN campaign principles:

- Cut emissions by 50% by 2030, in line with what the IPCC requires to keep warming under 1.5°C;
- Within 12 months of joining, explain what actions will be taken toward achieving both interim and longer-term pledges, especially in the short- to medium-term;
- Take immediate action toward achieving (net) zero, consistent with delivering interim targets specified;
- Commit to report publicly both progress against interim and long-term targets, as well as the actions being taken, at least annually;
- Halving emissions by 2030 is therefore a significant requirement expected of financial institutions, and investors with net zero targets need to review all high emitting assets across their portfolios.

19. This is particularly important for the fossil fuel sector, given the central role that oil, gas and coal production has played in causing climate change. However, GFANZ and sub-sectoral alliances differ in their approach to referencing fossil fuel investment:

- GFANZ has declared that it will accelerate the phase-out of fossil fuels, notably coal finance, and has emphasised the need to ‘restrict’ fossil fuel finance consistent with a credible 1.5°C net zero by 2050 temperature pathway, aligned with science-based interim targets[xii];
- The Net Zero Asset Owners Alliance (NZAOA) has the strongest references to fossil fuels, through its position paper on thermal coal and its 2nd Target Setting Protocol launched this year, which made clear that no more fossil fuel infrastructure asset financing a minimum requirement for members[xiii]. Conveners of the Net Zero Asset Mangers Initiative (NZAM) expect signatories to cancel investment in new thermal coal power projects and adopt a robust and science-based policy for the organisation in relation to fossil fuel phase out[xiv]. Moreover, NZAM invites signatories to disclose information on their fossil fuel policies, which makes them available for civil society to review[xv];
- The Net Zero Banking Alliance (NZBA) does not demand that members phase out fossil fuel financing, but requires them to transition all their operational and financed emissions to net zero by 2050 instead, using the best available scientific knowledge to develop their transition pathway[xvi];
- The same can be said for Net Zero Insurance Alliance (NZIA) members, though the alliance does also recognise the International Energy Agency’s (IEA) Net Zero by 2050 report[xvii];
- The Paris Aligned Investment Initiative (PAII), the Net Zero Financial Service Providers Alliance (NZFSPA), and the Net Zero Investment Consultants Initiative (NZICI) do not specify their positions on fossil fuel finance.

20. Since the latest IPCC report (and through it the NZE pathway) undeniably reflects the best available scientific knowledge today, financial institutions should be forging ahead with planning for the managed phaseout of fossil fuels. More net zero alliances should encourage signatories to disclose information on their fossil fuel policies to enable civil society to track progress made in ratcheting up fossil fuel exclusions.

21. In the light of these differences, we recommend that GFANZ modifies its overall approach and to require of its signatories detail about how they propose to phase out their investments in line with the 1.5°C pathway; and, given the growing urgency of the science, set ambitious Paris-aligned goals for reduced investments for 2030. Furthermore, as the overarching umbrella forum, GFANZ should also implement a more systematic tracking and reporting system that encompasses all sub-sector alliances to provide comparable data on their progress on meeting climate objectives.

22. Our recommendation comes against the publication last year by the International Energy Agency (IEA) (the benchmark authority for investors on the global energy system) of its first comprehensive scenario to align energy development with a 1.5°C limit on global warming. In this landmark report, the IEA said that, to align with 1.5°C, there should be no investment in new fossil fuel supply projects, and no further funding for new unabated coal plants[xviii]. This report represented a significant shift in narrative from the IEA. We believe that GFANZ should act on the IEA's recommendation, and ask the sub-sectoral alliances and GFANZ signatories to publicly commit to ending support for fossil fuel expansion and to the IEA 1.5°C net zero scenario.

23. Several recent research reports have also identified the ongoing and extensive financing of fossil fuels. The Banking on Climate Chaos 2022 report examining commercial and investment bank financing for the fossil fuel industry found that the financial sector continued to fund fossil fuels BAU despite setting net zero commitments and that levels of fossil fuel finance is higher than in 2016, a year after the Paris Agreement was adopted."[xix] Furthermore, Share Action reported in February 2022 that net zero European banks continue to finance oil and gas expansion despite the climate science, with 24 of the banks studied members of the UN-convened NZBA providing USD $33 billion to oil and gas expanders since joining the alliance last year, with USD $19bn of this sum originating from four of the founding members – HSBC, Barclays, BNP Paribas and Deutsche Bank[xx]. The investment decisions of asset managers have also been called into question by Reclaim Finance, who found that the largest asset managers still have not taken appropriate steps to tackle fossil fuel expansion, despite it being seven years since the Paris accord was signed. In their review of the 25 biggest asset managers headquartered in Europe and the five biggest asset managers headquartered in the US, none listed "no new coal, oil and gas projects" in their key demands for companies they engage in dialogue with, despite 25 out of the 30 pledging to achieve carbon neutrality by 2050 and following a 1.5°C pathway[xxi]. The report looks at the 25 biggest asset managers headquartered in Europe and the five biggest asset managers headquartered in the US.

24. On 15 June 2022, the UN-backed Race to Zero scheme updated its new criteria, following a five-month participatory process with over 200 experts and civil society groups. One key outcome was the decision to make it an explicit requirement for members to "phase down and out all unabated fossil fuels as part of a just transition"[xxii]. The announcement goes on to say that "this means corporations

and investors must restrict the development, financing, and facilitation of new fossil fuel assets, which includes no new coal projects" and acknowledges that timelines and exact pathways will differ across regions and sectors[xxiii]. As a participant, GFANZ will therefore be required to align with this new set of principles by June 2023.

25. To coincide with this, GFANZ published a set of related frameworks, tools and other resources to support transition planning across the financial sector[xxiv]. On fossil finance, GFANZ has not explicitly called for the ending of new expansion, and has instead continued to fund coal, oil and gas so long as they have a 'credible' net zero pathway, or if eventual asset phase down is planned[xxv]. It is therefore not taking the same position on fossil fuel finance as the UN Race to Zero scheme. Accordingly, GFANZ needs to publicly commit to ending support to fossil fuel expansion to align with the new UN Race to Zero scheme criteria.

26. It is also worth highlighting in this context that the governance relating to the overall status of Race To Zero is not established. Although backed by the UN, the continuance of Race To Zero is subject to the wishes of the COP Presidency. There is therefore a risk that it may not continue after the UK Government relinquishes its position as COP President in November; this argues all the more strongly to make GFANZ and its signatories directly and publicly for their policies on fossil fuel financing within the context of their net-zero strategies.

Pathways to Reducing Extraction in Fossil Fuel Investment: The Need for a Managed Phase-Out of Fossil Fuels

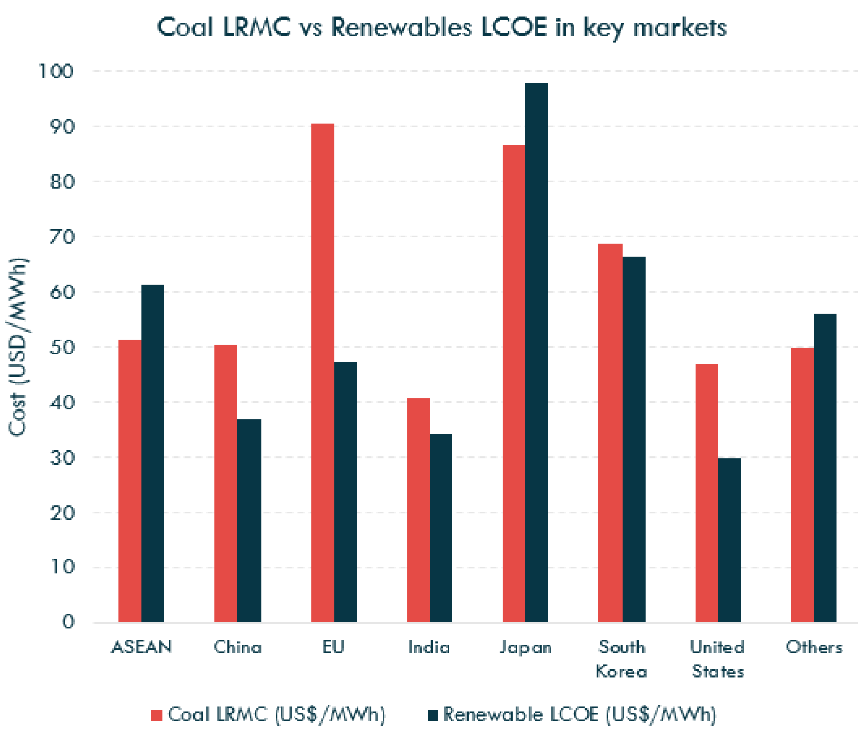
Summary: this section emphasizes the need to accelerate the low-carbon transition as a response to energy security and climate change objectives

27. The Russian invasion of Ukraine has significantly impacted energy markets, driving the price of oil and gas to their highest level in nearly a decade. It has prompted many countries to reexamine their national energy supplies, particularly in Europe, given its reliance on Russian gas. Given the surge in cost of fossil gas, the UK Government should focus on limiting gas usage and dependency to peaking capacity, with the dual aim of reducing the impact of the Ukraine crisis on energy security and achieving climate goals.

28. In Carbon Tracker's view, the energy crisis – and the high oil and gas prices caused by it – should prompt an acceleration of the low-carbon economy. The European Commission, in its REPowerEU plan, is showing leadership with its declared intent to diversify energy supplies and accelerate the roll-out of renewables with a new headline target of 45% of EU energy generation by 2030. GFANZ can likewise set a stronger lead for its members by recommending 1.5°C-aligned pathways that comprise both an accelerated investment in wind and solar, and a managed wind-down of oil and gas assets, in their portfolios.

29. A more ambitious decarbonisation pathway for GFANZ and its signatories makes sense both for climate-related reasons and in terms of finance and economics. Carbon Tracker research over the last five years has been consistent in demonstrating the greater relative cost competitiveness of wind and

solar compared with oil, gas and coal (see graph below). Our models show that, on coal, 77% of the global operating fleet (1,600 GW) incurs higher costs than would building new renewables today, with this figure rising to 98% by 2026 and 99% by 2030[xxvi].



Source: *Carbon Tracker report, Do Not Revive Coal: Planned Asia coal plants a danger to Paris* [xxvii].

The Responsible Retirement of Fossil Fuel Assets, Reducing the Risk of Stranded Assets and Meeting the UK's International Climate Obligations

Summary: this section introduces other finance-related policy recommendations

30. Across the EU27, there is a 109GW operating coal fleet with an average remaining lifetime of 10 years under a business-as-usual scenario. Under a Net-Zero scenario where finite carbon budgets are not exceeded, the average remaining lifetime of the existing coal fleet must be brought forward by 7 years, necessitating policy-induced early phaseouts.

31. Carbon Tracker has provided feedback to the GFANZ steering committee working on the managed phaseout of high-emitting assets, making clear why GFANZ members should:

1) ensure there is a focus on **coal-fired power generation**, and

2) **emphasise the importance of the role of the external auditor** as part of managing the phase-out of these and other high-emitting assets.

32. Our briefing note recommends that:

1) GFANZ initially focus its managed phaseout discussions on coal-fired power plants, as this is crucial to achieving globally agreed emissions reductions and temperature goals;
2) include the role of external auditors, as members of GFANZ (via the Net Zero Financial Service Provider's Alliance (NZFSPA)), in the managed phaseout discussions. Auditors are a key part of ensuring that financial institutions receive the requisite information for identifying and understanding a company's plan for coal-fired power plants (and other high-emitting assets); and
3) the NZFSPA integrate the external auditor's role in ensuring transparency of information about coal-fired plants and other high emitting assets into the commitments auditors make as signatories to the NZFSPA.

UK International Climate Commitments

Summary: the UK Government should not be helping to expand oil and gas production – expansion is not part of the solution

33. Although Carbon Tracker's focus within this enquiry is finance and investor policies and commitments relating to net zero and fossil fuel financing, we should also express a view on the connection between this agenda and the UK's international climate commitments under the Paris Agreement – not least because the British Government remains COP President until COP27 this November.

34. We would make three points:

- Carbon Tracker's base case is that it will not be business for usual for international oil and gas demand, given the probability of more ambitious climate policy actions by governments and the continuing fall in the costs of wind and solar energy. Is therefore risky for investors - in terms of capital investment and asset value - to rely on short-term market signals;
- This applies to North Sea oil and gas production. As the Climate Change Committee said in its letter to the Secretary of State in February; the best way for the UK to reduce its exposure to volatile oil and gas prices is to cut fossil fuel consumption "on the path to Net Zero". The Committee noted furthermore that an end to UK exploration would send a clear signal to investors and the public that the UK is committed to the 1.5°C Paris target;
- While the Chancellor of the Exchequer has now decided to impose a "windfall tax" on North Sea oil and gas producers, he also introduced a generous new tax relief to enable companies to avoid most of the levy if they invest in oil and gas. So the Government's existing approach on the North Sea and the risk of stranded assets on a business-as-usual basis is not the way forward, in our view.

Conclusion

35. In conclusion, GFANZ signatories should commit to no more fossil fuel expansion, in line with the IEA's 1.5°C net zero scenario. The forum - which currently fails to publish a position on this - needs

to set clear guidance for all members to adhere to. In addition, the listing rules and requirements for fossil fuel companies on the London Stock Exchange should be brought up to date to align with the UK's climate commitments.

June 2022

Footnotes

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