CALL FOR EVIDENCE: E3G RESPONSE July 2022

ENVIRONMENTAL AUDIT COMMITTEE: THE FINANCIAL SECTOR AND THE UK'S NET ZERO TRANSITION

E3G RESPONSE

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Executive Summary

The current cost of living crisis has highlighted the risks if the UK Government does not proactively plan and deliver a managed approach to bring clean energy online across the UK. If the **British Energy Security Strategy** cannot be delivered and further crises will follow. Internationally, the UK has played a leading role in securing ambition on green financial reform, and credibly delivering the Net Zero Strategy will further advance the UK's diplomatic agenda. For example, the UK led the way on green finance by committing to creating the world's first **Net Zero Financial Centre and a Net Zero Financial System** and implementing several progressive green finance reforms, including the development of a new Sustainable Disclosure Requirements framework for businesses and financial institutions.

The financial sector is recognising the direction of travel towards net zero and the clear business opportunities associated with the transition, with high-profile coalitions such as the **Glasgow Alliance for Net Zero (GFANZ)** committing $130 trillion of private capital from over 450 financial institutions worldwide to "accelerating and mainstreaming the decarbonisation of the world economy and reaching net-zero emissions by 2050." However, despite these positive steps, UK banks and asset managers are responsible for nearly **double the UK's annual carbon emissions**. T**he June 2022 Carbon Tracker Unburnable Carbon** report showed that London is the fourth largest financial centre holding some of the highest embedded carbon emissions through its listed companies.

Tackling greenwash and accelerating sustainable investment will require the UK to set out a comprehensive plan for how it will deliver finance for the net zero transition across the country. The 2022 Green Finance Strategy will be an opportunity for the Government to set out such a plan and deliver clean, cheap energy solutions to communities across the country.

E3G's response to the Environment Audit Committee highlights the following three recommendations for Government when delivering net zero:

1. **Tackle accountability gaps in private sector net zero commitments**

   The UK must address accountability gaps within voluntary initiatives such as GFANZ to mobilise finance at the scale and space required to reach net zero. GFANZ guidance should not only include requiring the publication and implementation of net zero transition plans, but also strengthen the accountability mechanisms and governance structures for members with weak compliance. GFANZ should also develop clear requirements to phase out fossil fuel and coal investments.

2. **Establish a clear plan for financing the transition in the 2022 Green Finance Strategy**

   The revised Green Finance Strategy should deliver a plan that integrates all the tools in the government's toolkit to support a credible transition to net-zero and establishes the public policy coherence required to leverage private finance for meeting the UK's net-zero and adaptation targets.

3. **Support a managed phase-out of fossil fuel investment in the UK**

   The current UK public policy paradigm hinders rather than accelerates the transition towards clean investment required to deliver the UK's net-zero goals. Policy coherence should be established under the Green Finance Strategy to address this problem and minimise the risk of the cost of decommissioning stranded assets falling substantially upon the state.

Written Evidence in Full

1. TACKLE ACCOUNTABILITY GAPS IN PRIVATE SECTOR NET ZERO COMMITMENTS

> **The Glasgow Financial Alliance for Net Zero (GFANZ) is a voluntary alliance of financial institutions which have pledged to reach net-zero by 2050, with significant reductions in non-Paris aligned lending by 2030.** These commitments, underpinned by guidelines for implementation, are voluntary, and the accountability mechanisms as currently structured are not aligned with 1.5, nor do they enforce action in the case of inaction or weak compliance by members. This undermines the alliance's ability to achieve its objectives.

> **Financial institutions in the UK are continuing to drive investment towards high emitting sectors, which will weaken the UK's commitments to delivering a net-zero financial centre.** The **IEA Net Zero by 2050 Emissions Report (IEA NZE)** and **UNEP Production Gap Report**

warns that to limit global warming to 1.5 degrees, no new investments must be made to expand fossil fuel exploration, expansion, or development of fossil fuels and related infrastructure.

> **Global banks financed approximately $742 billion** towards fossil fuels in 2021, despite climate pledges they have made as members of the Net Zero Banking Alliance – one of GFANZ's umbrella initiatives. An analysis conducted by **RAN found that of 44 banks that had committed to net zero by 2050**, 27 did not have a meaningful no-expansion policy for any part of this fossil fuel industry. Without further scrutiny and oversight from UK regulatory bodies, private sector net zero commitments will maintain misalignment with the government's net zero and resilience targets. **Ongoing parliamentary scrutiny of private sector commitments, such as those made by GFANZ members, will be required to ensure that greenwash is tackled in the UK and that finance is redirected towards sustainable solutions.**

> **Aligning the future development pathway of the UK's financial sector with net zero will require the UK to set out a plan that best practice transition plans will, over time, include plans that phase out fossil fuel assets, as well as include adaptation and nature-positive planning.** The Government should also ensure that the outputs provided by the Transition Plan Taskforce are incorporated into regulation, including sectoral templates for financial sub-sectors and expansion of reporting requirements to all large companies across the UK.

> Investment in new thermal coal infrastructure has been problematic, and high-profile private sector activity, particularly when firms making such investments are members of the GFANZ, undermines confidence in GFANZ. **Recommendations to strengthen new guidelines from GFANZ for thermal coal include:**

  - **GFANZ should replicate Powering Past Coal Alliance (PPCA) new Finance Principles as a guideline for best practice policies for thermal coal power**. The PPCA finance principles are explicit in their objectives to end financial support for unabated coal firing. Signatories are required 1) to immediately end financial support for new unabated coal power, 2) to phase out financial support and services for existing unabated coal power within PPCA timelines, 3) Shift financial support and services to clean energy in a manner consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.
  - **GFANZ's Thermal Coal Policy Guidelines, a handbook outlining the exclusion criteria, should be strengthened with an explicit commitment to 'no new coal' criteria.** These have so far been adopted by first movers like Aviva, Intesa, and Swiss Re. The guidelines promote the gradual phase out of unabated coal compatible with a 1.5-degree pathway. This is misleading and highlights loopholes which financial institutions can exploit to carry on investing and underwriting thermal coal. The GFANZ guidelines fail to state outright that membership to GFANZ is conditional on strict Paris-aligned activities or science-based targets. There is an implicit

understanding that new coal investment is not commensurate with Race to Zero which must be strengthened by creating an explicit 'no new coal' expectation for GFANZ members.

- **In GFANZ's Thermal Coal Policy Guidelines, relative criteria must be backed up by absolute criteria.** The policy guidelines for target setting by financial institutions do not include requirements for absolute emissions reductions. Firms are left to decide whether they use intensity or absolute reduction[1] metrics. This is problematic because firms which only use relative emission reduction criteria continue to invest in many companies that are deeply active in the coal market. For instance, using 10% revenue criteria for application to companies may result in investment in a large, diversified utility/transport/mining company that is producing or burning millions of tonnes of coal a year. This is currently cited as a potential problem within the guidelines. However, a more robust solution to this problem would be to use an absolute criterion alongside a relative revenue/production-based criterion to assess companies for compliance.

> **Private sector investment in oil and gas, including by many members of GFANZ, continues at scale.** Recommendations to strengthen new guidelines from **GFANZ for managed phase outs for high emitting assets** include:

- **The GFANZ guidelines must raise ambition to include exclusions for all new oil and gas, exclusions of unconventional production, and plans to phase out financial service support in line with IEA timeframes.** The guidelines as they stand do not offer much detail on how financial services would be able to raise ambition and instead advocate disproportionately for stewardship and engagement with oil and gas companies to develop their transition plans.

- **Engagement is not enough; financial institutions need to adopt exclusion policies for oil and gas companies to redirect investments.** GFANZ oil and gas exclusion policy guidelines talk extensively about the need for engagement with oil and gas companies and improvements to the transition plans of these firms. These guidelines emphasise engagement over exclusion policies like those recommended for coal assets. However, this approach is unscientific and fails to address the **IEA 2050 roadmap**'s recommendation to cease all new fossil oil and gas investments if the world is to stay on track for 1.5C. Oil and gas investments must be treated with a similar urgency to coal.

[1] Emission intensity targets based on a relative criterion do not necessarily lead to a reduction in absolute emissions. Financial institutions can reduce emissions by either and decarbonizing the high-emitting assets within their portfolios or by increasing market share. For example, a bank or asset manager can reduce its emission intensity by increasing its investment in low-carbon assets at a faster rate than it invests in high-carbon assets. Yet, this does not necessarily reduce its absolute emissions. The institution could continue to grow the proportion of its high-carbon assets and/or keep it constant.

- **Exclusion policies should be advocated by GFANZ (see above section) if it is to have the same kind of galvanising and ratcheting effect in oil and gas investment as they are having for coal.** There is a lack of evidence to support the view that oil and gas companies are adopting transition plans to move away from fossil fuel production. Over 90% of upstream oil and gas companies have a fossil fuel share of revenue of 90%, and 95% of those same companies are **engaged in the expansion of fossil fuels**. There is little reason to think that financial institutions will be able to persuade them to cease investing in polluting projects just through investor engagement activities (e.g., annual discussions and AGM voting).

2. ESTABLISH A CLEAR PLAN FOR FINANCING THE TRANSITION IN THE 2022 GREEN FINANCE STRATEGY

> **The 2022 Green Finance Strategy presents an important opportunity for Government to send the right signals to the market and help unlock new business opportunities in the UK, shift investments away from fossil fuels towards net zero, and support a strong, credible transition**. Building a net zero financial centre will be necessary to support the wider economic changes that need to require to reduce the energy costs faced by households through support for renewable energy deployment and phase out fossil fuel and coal from the portfolios of UK financial institutions.

> **The Green Finance Strategy should set out an ambitious, whole-of-government strategy for aligning financial flows with 1.5C transition pathway.** The Green Finance Strategy should coordinate all the different regulatory bodies of government to work together on aligning financial regulation with fiscal, monetary, environmental, and industrial policy to finance the transition across every sector of the economy. Financial flows should be regularly and independently assessed to identify investment gaps hindering the UK from meeting its climate, nature, and adaptation targets.

> **Public investment and policy will play a critical role in driving a fair, rapid transition and reducing energy demand.** The government should scale up strategic public finance to create new markets and leverage private finance for sustainable opportunities that contribute to net zero. For example, the UK Infrastructure Bank should actively drive finance to decarbonise the built environment and assist by coordinating public and private sources of capital towards large-scale retrofitting projects.

> **The UK's financial regulation should reflect the role of the financial sector to invest in serving the UK's economic, environmental, and social goals by creating a science-based, robust legal framework**. Strong standards and market disclosure will not be sufficient in driving finance at the scale and pace required to reach net zero. Private sector transition plans must be embedded in robust legal and regulatory frameworks that incentivise and oversee

the implementation and are supported by access to high-quality data and analytics to aid financial decision-making**. Regulators should be given statutory objectives to align finance with the UK's climate and nature goals in the upcoming Financial Markets and Services Bill**, as this will empower them to actively advance innovative climate policies and drive through new climate-related regulations without having to wait for legislation.

3. SUPPORT A MANAGED PHASE OUT OF FOSSIL FUEL INVESTMENT IN THE UK

> **The IEA's Net Zero by 2050 Scenarios indicates that clean investment must triple this decade in order to deliver the necessary scale up of renewables, energy efficiency and other decarbonisation technologies to align with 1.5C**. The UK's domestic policy paradigm hinders rather than accelerates the transition towards clean investment required to deliver the UK's net zero goals.

> **To transition their investment portfolios at the pace and scale required, financial institutions require clear market signals, and an understanding of the direction of travel of government policy**. UK government oil and gas policy send mixed signals in this regard. The tax relief contained within the recently announced **Energy Profits Levy** on oil and gas producers provides an explicit incentive to reinvest profits into new extraction. Estimates suggest that this could provide up to **£5.7bn** per year to the sector, which would flow specifically towards the financing of new oil and gas fields. This presents an inherent risk as this new tax relief could render uneconomic fossil fuel projects economic.

> **Stranded asset risk is not appropriately considered by regulators and the UK government**. The UK continental shelf (UKCS) is a declining basin, with a relatively high cost of production compared to other jurisdictions. Research by the North Sea Transition Authority has also shown that it has historically taken an average of **28 years** for projects to progress from the first discovery to the first production of oil and gas. Over the same length of time (between now and 2050), the **Climate Change Committee's (CCC) 6th Carbon Budget scenarios** indicate that oil and gas demand will have fallen by 85% and 70% respectively. As alternatives to oil and gas end uses, in particular electric vehicles, wind and solar power and heat pumps **continue to fall in costs**, this will lead to faster than anticipated demand destruction in key export markets. Awarding new oil and gas licences, given the time taken for new projects to materialise, relatively high production costs, and falling long-term demand trends, would represent a failure of governance by significantly increasing the basin's exposure to stranded asset risks.

> **The GFANZ published guidance on managed fossil fuel phase-out in June,** which sets out their support for a company in developing a managed approach towards retiring high-emitting assets, rather than selling them off to another firm that may prolong its operations and emissions. It is positive that GFANZ is thinking about ways to deliver a managed transition. However, it is implied that **the costs of stranded assets will substantially fall upon the state**

as they are closed. The government should be doing whatever it can to enforce accountability for private sector decisions, and to avoid the creation of more stranded assets that could make future demands on the public budget.

> **Future government policy for energy and finance should explicitly consider the cost of stranded assets, including the opportunity cost where new fossil investments may have diverted investment from clean energy.** The **Office of Budget Responsibility's July 2022 Overview of Fiscal Risk and Sustainability** points out that the recent doubling of oil and gas prices and the rise of inflation rates have underscored the economic and fiscal risks associated with the UK's continued dependence on fossil fuel imports. It has also brought into sharper focus the fiscal choices and trade-offs involved in shifting the UK's energy mix to one which is compatible with net zero by 2050.

For more information, please get in touch with **eduardo.lopez@e3g.org**

About E3G

E3G is an independent climate change think tank with a global outlook. We work on the frontier of the climate landscape, tackling the barriers and advancing the solutions to a safe climate. Our goal is to translate climate politics, economics, and policies into action.

E3G builds broad-based coalitions to deliver a safe climate, working closely with like-minded partners in government, politics, civil society, science, the media, public interest foundations and elsewhere to leverage change.

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