

## Written evidence submitted by Carbon Tracker Initiative – (DUE0008)

### 1. Background

2. Carbon Tracker is an independent, non-party aligned, financial think tank that carries out in-depth analysis on the impact of the energy transition on capital markets and the potential investment in high-cost, carbon-intensive fossil fuels.
3. Our work includes engaging with energy, climate and financial regulatory and policy makers on relevant matters regarding the role of policy in the energy transition and its interaction with financial markets in this context.
4. Carbon Tracker seek to promote a policy framework that will best support investors in transitioning away from fossil fuels. We have responded around four themes arising from the Inquiry's Terms of Reference.

### 5. Executive Summary

6. The UK Government has announced its intentions to reduce UK domestic economy greenhouse gas emissions to net zero by 2050. We endorse the recognition that the right technologies exist to meet these targets – and that costs can be manageable – though further policy support is required. These targets, should they be met, would help put the UK at the forefront of national decarbonisation. The UK currently emits approximately 1% of global CO<sub>2</sub>.
7. Additionally, in an international context, the UK financial sector and regulators should be applauded for steps taken to consider and manage climate related risks and to develop green finance. Some further work is required to refine approaches to capital markets disclosure.
8. However, these UK-related developments mask significant issues that might call into question the UK's claimed global climate leadership. The City of London remains one of the world's major centres for 'brown' fossil fuel finance. At minimum, the City supports directly or indirectly, some 15% of global CO<sub>2</sub> emissions. 28% of FTSE100 dividend distributions come from oil, gas and mining. Separately, UK oil and gas regulators remain driven to maximise the value of UK hydrocarbon assets and the financial flows behind these.
9. The structure and content of the UK Government's July 2019 'Green Finance Strategy' essentially ignores these concerns. This could be the unintended consequence of fragmented government policymaking. At minimum, this risks sending mixed policy messages.
10. To unpack and address these issues, an understanding of scoping of national carbon budgets, climate change regulation and global capital markets is required. Such an assessment should also help surface opportunities for UK climate leadership.
11. **Theme 1 – scoping of UK decarbonisation, climate change commitments and finance sector**
12. Carbon Tracker supports the direction of travel set out by the UK Climate Change Committee (CCC) and UK Government to enable the UK to reduce its greenhouse gas emissions to net zero by 2050. We endorse their recognition that the right technologies exist to meet these targets – and that costs can be manageable – though further policy support is required. These targets, should they be met, would help put the UK at the forefront of national decarbonisation. The UK currently emits approximately 1% of global CO<sub>2</sub>.
13. We acknowledge that the UK is a relatively open, service based economy and that there is some contention about the degree to which emissions and potential emissions are, and should be, recognised through the importing of goods and services into the domestic economy. We have no comment to make in this regard.
14. But this does start to highlight the significance of the scoping of UK carbon budgets and in turn climate targets. We understand that such matters are determined by the CCC in its interpretation of the UK Climate Change Act and as set out by the Secretary of State. The focus

tends to be on the geographical location of the end-user's CO<sub>2</sub> emissions. Moreover, we understand that other national bodies will calculate their respective carbon budgets and climate pledges, commitments and 'demand side' policies, on a similar basis.

15. This reflects the character of the Paris Climate Agreement; the bottom up, global aggregation of these various country-by-country commitments (called Nationally Determined Contributions – NDCs) in relation to end-user emissions.
16. If it is accepted that much global economic and financial activity is international and cross border and does not directly correlate with these country-by-country, demand-side climate and energy policies, then many actors; private sector, public sector and non-state, are not directly bound by NDCs / Paris Agreement. Absent voluntary agreement to do be so bound, a competition dynamic between actors may mean that many in fact seek to exploit this lack of direct accountability. The inflation of the carbon 'bubble' phenomenon<sup>1</sup> is the consequence of this. In the policymaking sphere, 'beggar thy neighbour' attitudes can arise.
17. This provides a backdrop to various economic and financial taking place within the geographical boundaries of the UK:
  - a. The UK is a service-based economy with a world scale financial market in the City of London. The City remains one of the largest global centres for financing fossil fuel – it plays host to, amongst others, BP, Shell, Glencore, Anglo American, Russian oil and gas companies such as Gazprom and Rosneft. The vast majority of these companies' activities and revenues are located or derived from outside of the UK. The world's largest energy company, Saudi Aramco, recently raised \$US12bn via UK debt markets.
  - b. Depending on how it is measured, the City's hosting of these companies means that it currently supports, at minimum, somewhere in the order of 15% of potential global CO<sub>2</sub> emissions.<sup>2</sup>
  - c. The City of London's global impact is not acknowledged meaningfully in UK carbon budgets nor decarbonisation targets. Whilst there might be some recognition of the daily transportation of City bankers and fund managers, alongside the energy for heating their offices and their photocopying of documents, but this will be comparatively de minimis.

## **18. Theme 2 – the role of HMT and BEIS in decarbonisation of finance**

19. Taking into account the above, and whilst Carbon Tracker expresses no views as to the specifics of HMT's approach towards UK domestic Clean Growth Strategy, we nonetheless comment on the following broader roles of HMT and BEIS:
  - a. We view as positive various HMT support for promoting the City of London as an international centre for green finance activities and innovation;
  - b. We similarly view the following, non exhaustive, examples of BEIS initiatives:
    - i. UK Clean Growth strategy and Net Zero 2050 commitments under the UK Climate Act;
    - ii. Contributions, with the UK FCO and others, towards the Powering Past Coal Alliance;
    - iii. Their International Climate & Energy Directorate contribution towards ongoing Paris Agreement-related negotiations, as well as the intention for the UK to host the 'COP26';

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<sup>1</sup> See Annex A for a time series showing the inflation of the bubble

<sup>2</sup> See Annex B for context – figure derived by dividing UK listed reserves by global total. For further details see <https://www.carbontracker.org/reports/unburnable-carbon-wasted-capital-and-stranded-assets/>

- c. Nonetheless, from a climate perspective, we would question, the rationale and perhaps even the motivation behind, the following ‘off balance sheet’, (so largely outside the UK Carbon Budget) activities:
    - i. HMT – alongside the FCA and London Stock Exchange – competing with Wall Street, Hong Kong and Singapore, in bidding for Saudi Aramco’s full IPO (we note the Treasury Committee has expressed concerns here);
    - ii. BEIS – the ongoing sponsorship of the UK Oil and Gas Authority mandate to maximise the economic recovery of UK oil and gas assets (so, for instance, North Sea oil and gas fields). Potential bidders for these assets will need access to finance. To the extent these hydrocarbon assets are for export energy or industrial markets – the CO2 emissions effectively become someone else’s problem.
20. We see the Inquiry as the ideal opportunity to shine a light on the UK government policy anomalies raised under point c. above.
21. There are, however, significant potential roles for both HMT and BEIS to play in cementing the UK’s intentions to be seen as a global climate leader. Acting in this manner would also reduce the risk that the UK is decarbonising at home whilst financing carbon activities abroad. The following would assist in the decarbonisation of finance – bringing finance flows further in to line with the Paris Agreement:
- a. Promulgating an understanding across financial policymakers that whilst there is value in pursuing ‘green’ finance initiatives, these may not in and of themselves necessarily lead to less ‘brown’ finance.
  - b. Contributing to various efforts to create greater, more visible certainty over implementation of the ‘demand side’ policy mix required to achieve Paris Agreement goals. Greater certainty and visibility in itself incentivises finance flows. The UN PRI Initiative (whom have recently provided evidence to the Inquiry) is to shortly publish<sup>33</sup> detailed forecasts in this regard.
  - c. Assist driving global efforts to re-price the externalities of carbon. Re-pricing carbon is arguably one of the most powerful drivers of climate finance flows. Pursuit of this goal at global level would also promote a ‘just’ energy transition.
  - d. Promote efforts to create a more enforceable accountability and in a sense, traceability, ‘link’ between end user emissions (accounted for under the Paris Agreement), back through the energy chain, to the ‘upstream’ provider of hydrocarbons. This ‘supply side’ approach would reduce the carbon bubble and most importantly the self-propagating ‘carbon lock-in’ that undermines overall progress towards Paris goals. (There has been recent contention over whether and how fossil fuel should take responsibility for Scope 3 carbon emissions. It seems clear that they will not do this voluntarily.) An alternative framing of this approach would be to consider a legally binding multilateral ‘non proliferation’ agreement in respect of fossil fuel projects.
- 22. Theme 3 – the role of the UK financial sector in decarbonisation of finance**
23. In a global context, the UK financial sector, when compared to the national domestic ‘real’ economy is unusually large and diverse:
- a. Domestically: it provides banking services, savings products and insurance cover to UK citizens and businesses; conversely

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<sup>33</sup> Inevitable Policy Response <https://www.unpri.org/pri-blog/preparing-financial-markets-for-climate-related-policy-and-regulatory-risk/4564.article>

- b. Internationally: the City of London acts as one of the most international and cross border financing centres, across equity and debt capital markets, commodities, money markets and currencies trading.
- 24. Subject to the discussion below, we have few if any comments in relation to the role of UK domestic finance and UK domestic decarbonisation. We focus on the international role of the City.
- 25. Separately, we endorse the various comments made by, for instance, Mark Carney, that the UK is the centre for both renewable energy deployment as well as green finance initiatives. Allied to this, the City, as with other centres such as Paris, has seen a rapid rise in investment activities identified 'responsible' or 'ESG'. These activities aid the decarbonisation of finance globally.
- 26. We should not forget, though, our earlier comments that the City has entwined its prospects with that of fossil fuel's – its hosting of BP & Shell amongst others, means that large dividends, mainly derived from non-UK activities, are distributed to investors in UK markets (28% of 2018 FTSE dividends come from oil, gas and mining)<sup>4</sup>. It could also be argued that such distributions are the direct consequence of the lack of adequate pricing of the externalities arising from hydrocarbon activities.
- 27. In turn, this dividend distribution, often underpinned by a 'progressive' dividend policies that can commit to long term increases in dividend payout ratios, is arguably a significant barrier to the decarbonisation of finance – and the shifting of the 'trillions' in the energy transition. This is particularly so in a low yield investment environment. Many passive or discretionary investment managers and asset owners may see this dividend income as valuable to their investment goals.
- 28. Somewhat similarly, the recent \$12bn raised in UK debt markets by Saudi Aramco, suggests that a fossil fuel entity with a good credit rating, can issue long term bonds with competitive but relatively attractive 'coupon' rate, and can find deep investor demand. This bond transaction was apparently 10 times over-subscribed.
- 29. Since 2011, there has been growing discussion and debate about potential fossil fuel asset 'stranding' risk associated with 'unburnable' carbon; the overhang of total carbon assets to climate constraints. There are two additional concerns that may be exacerbating such risk:
  - a. Somewhat counter-intuitively, the rapid rise in sophistication of climate 'transition risk' management and modelling by banks, insurers and fund managers may be leading to moral hazard: a sense that the risks are now identified, understood and monitored - but there does not yet appear to be a substantial change in investment attitudes;
  - b. At least in relation to equity markets, there is currently little 'liquidity' risk in relation to fossil fuel holdings – there may be a belief that should there be a downturn in longer term prospects for their investee companies, investors can sell out of their investments within a short time period.

### **30. Theme 4 – the role of UK financial regulators in decarbonisation of finance**

- 31. UK financial regulators – those named in the UK Government 'Green Finance Strategy' – have been some of the world's most progressive and active in relation to climate change and finance, particularly the Bank of England/PRA.<sup>5</sup>
- 32. We endorse the direction of travel of much of their work; our focus, in particular, is in relation to efforts to put capital markets in a better position to understand and respond to climate 'transition' risk in respect of fossil fuel investment.
- 33. As such, we are supportive of the generalities of various FRC and FCA workstreams in relation to market disclosure and, allied with this, their recognition of the role that stewardship and long

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<sup>4</sup> IHS Markit/FT 20/5/2019

<sup>5</sup> Other active jurisdictions include the EU, France, Netherlands, Sweden and Australia

term investment does currently or should play in relation to markets' and investors' consideration of long term issues such as climate change.

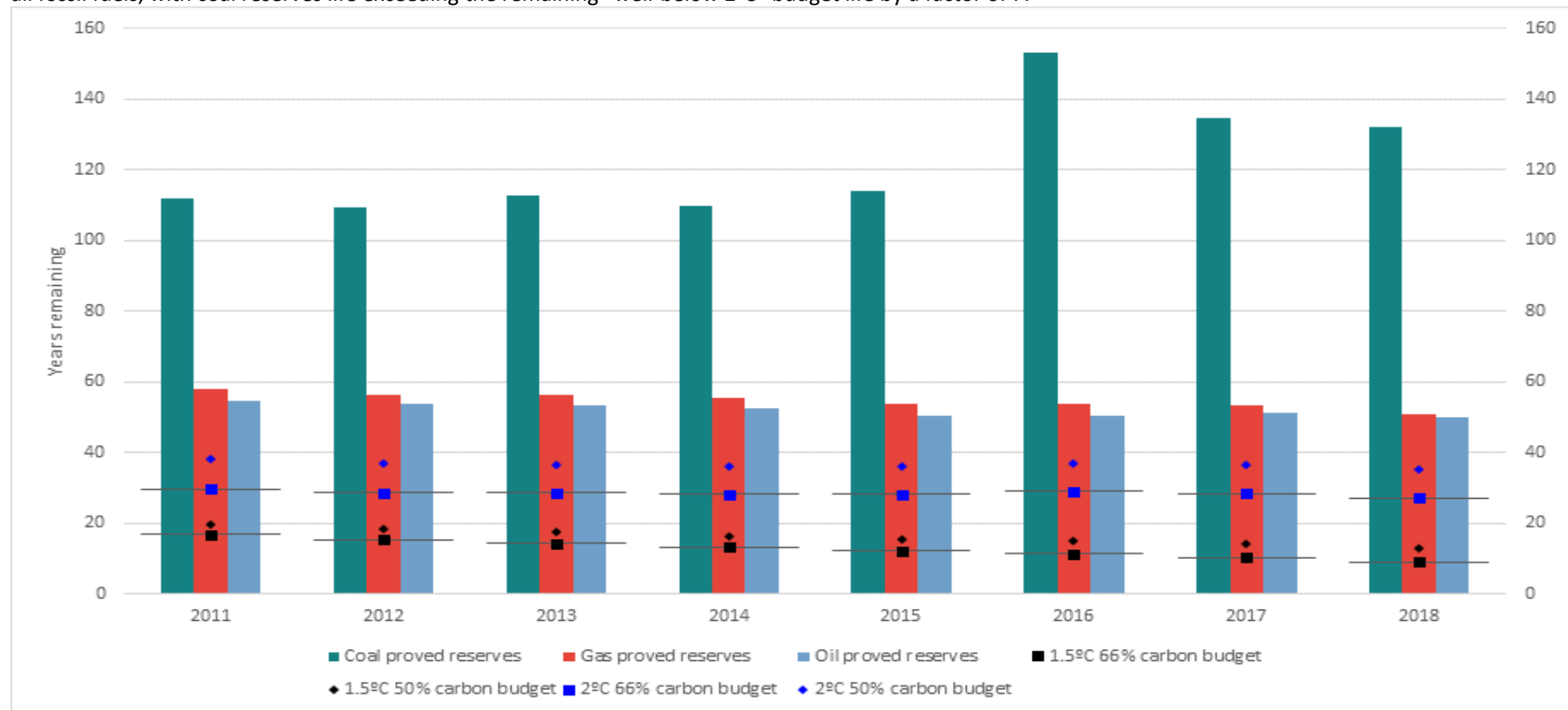
34. In this regard, though, we have two significant concerns;
- a. We are unaware of any regulatory step taken to this point that would necessarily lead to less fossil fuel finance occurring in the City of London. Indeed, the seeming regulatory and political actions to pursue the Saudi Aramco IPO, and the fact of the subsequent Aramco bond issuance, suggests that the FCA, acting as the Competent Authority for Listing, seems not to be directly bound by climate change concerns. This seems a paradoxical position given a recent FCA discussion paper on climate change and finance<sup>6</sup> stated 'The FCA must consider all major risks that have an impact on the markets and institutions we regulate, including those posed by climate change.' It may be that the FCA views that is constrained by the various provisions of the Financial Services and Markets Act (FSMA), from impeding potential capital raisings by fossil fuel companies.
  - b. Should such constraints exist within FSMA, or at least in the HMT and FCA policy approach to FSMA, it may also undermine the usefulness of the proposed climate change regulatory 'have regard' suggested in the Green Finance Strategy. A 'have regard' may be difficult to enforce. For instance, it's conceivable that the FCA could merely require a listed fossil fuel company, or applicant to listing, to include a standardised statement in corporate finance documents, to the effect that climate change risks or consequences have been considered. This is unlikely to have a material effect on fossil fuel finance in UK markets.
35. More positively, we make a number of suggestions in respect of further actions that could be taken by UK financial regulators:
- a. Capital markets disclosure related: Develop, with fellow regulators across other jurisdictions, a more consolidated and forward looking disclosure regime regarding upstream fossil fuel projects. This may mean further developing the IFRS6 accounting standard, the reserves and mineral expert reporting regimes and the incorporation of various climate and energy demand scenarios within this. Such an approach would seek to replicate the post 2007-9 financial crisis reforms, regarding greater transparency in respect of complex and illiquid financial instruments held within banking books.
  - b. Listing standards related: To take steps, in respect of 'brown' finance, to reduce the fierce competition between listing venues in pursuit of companies such as Saudi Aramco. This could reduce a 'race the bottom' in listing standards; and a further lowering of the cost of finance for fossil fuel companies. There may be a prevailing attitude that 'if we don't list or provide access to markets, somebody else will'. Some form of international agreement in this direction would help dampen this concern.
  - c. To the extent that financial policy is able to address public policy concerns such as climate and energy, (there are varying opinions to the extent that this is legally or politically achievable); pursue international incorporation of this into the policy/regulatory frameworks such as banking and insurance prudential regimes, (the much discussed 'green supporting factor / brown penalising factor'), as well as monetary and QE policy regimes. These matters are complex, so development of enhanced financial policy in this regard may take place over extended timeframes.

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<sup>6</sup> <https://www.fca.org.uk/publication/discussion/dp18-08.pdf>

## Annex A - The carbon bubble continues to inflate.

Despite the Paris Agreement and Carney's 'Tragedy of the Horizon' speech, the fossil fuel industry is not diverting from business as usual. There is an overhang in all fossil fuels, with coal reserves life exceeding the remaining "well-below 2°C" budget life by a factor of 7.



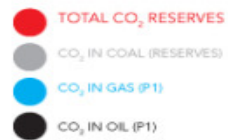
### Notes

Version 1.3 July 2019. Reserves, production and emissions data taken from BP's Statistical Review of World Energy 2018. 'Life' of reserves is defined by total annual proven reserves divided by annual production rates. Carbon budget years remaining is calculated as remaining carbon budget (based on global surface air temperatures) divided by annual emissions. Carbon budget data relates to total emissions (i.e. including industry and land use changes as well as energy sector) and sourced from the IPCC's Special Report on Global Warming of 1.5 °C, divided by total annual emissions sourced from the Global Carbon Project. A period of sharply lower oil prices has had very little impact on oil and gas reserves and prices have since increased. Carbon Tracker does not guarantee the accuracy of the data.

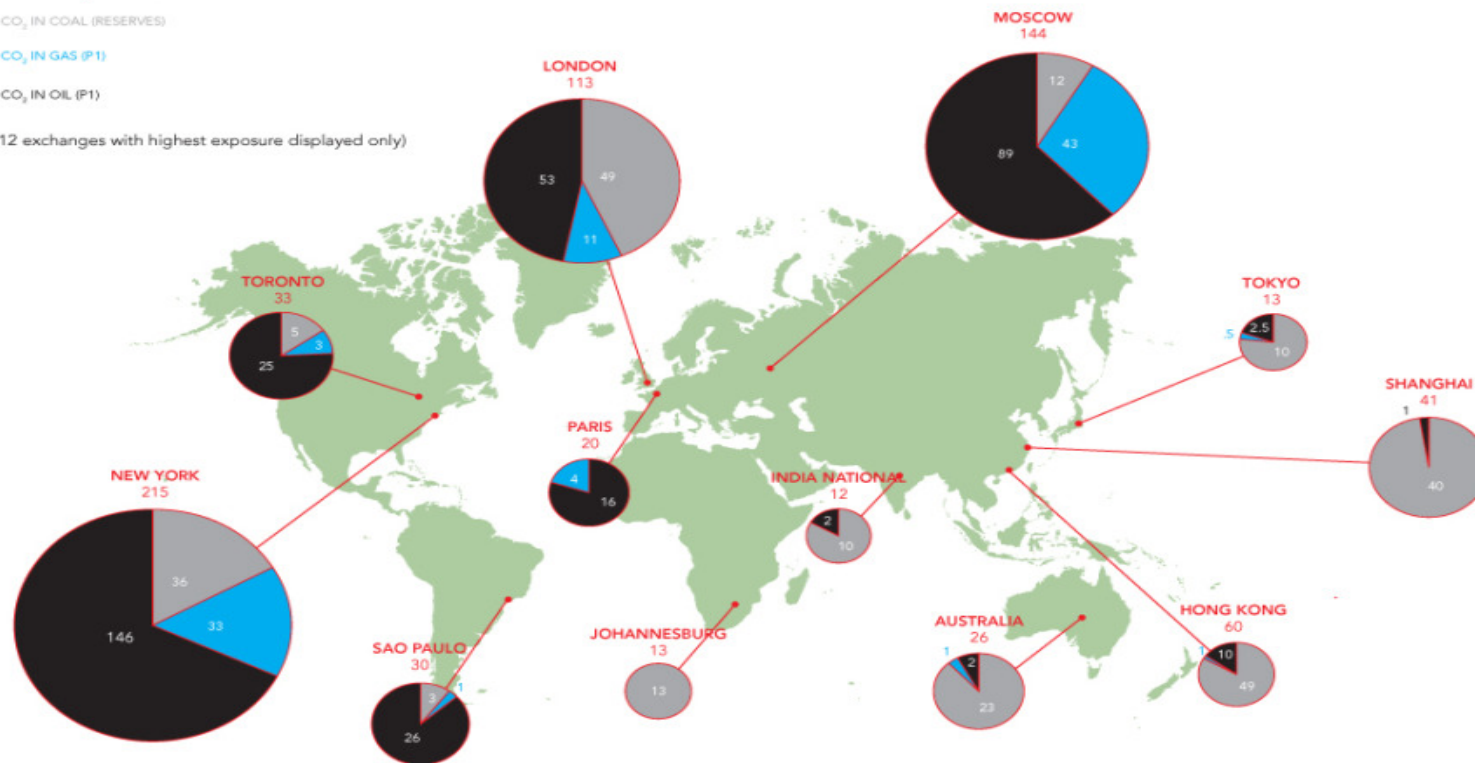
## Annex B – overview of distribution of fossil fuel reserves across global financial centres

MAP SHOWING THE GTCO<sub>2</sub> OF CURRENT COAL, OIL AND GAS RESERVES LISTED ON THE WORLD'S STOCK EXCHANGES.

KEY



(Top 12 exchanges with highest exposure displayed only)



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