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To:
Sustainable Finance Unit
Climate and Energy Division
Treasury

RE: Sustainable Finance Strategy consultation

Thank you for the opportunity for the Institute for Energy Economics and Financial Analysis (IEEFA) to present its submission to this consultation.

Regards

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Submitted via email.



Key points

Pillar 1: Improve transparency on climate and sustainability	3
Sustainability-related financial disclosures must include Scope 3 and influenced emissions	3
Transition pathways should focus on short-term, material, credible outcomes	3
A Sustainable Finance Taxonomy must be complemented by company-level assessments	3
Key considerations for a sustainable investment product labelling regime	4
Pillar 2: Financial system capabilities	5
There are still too many loopholes on greenwashing	5
The case for regulating ESG ratings as financial services	5
Systemic risks must be addressed	6
Transparency is needed over reporting of key data	6
Pillar 3: Australian Government leadership and engagement	7
More sustainable finance will be needed at household and SME level	7
Issuing Australian sovereign green bonds	8
Using the CEFC to catalyse sustainable finance flows and markets	8
Endnotes	10



Pillar 1: Improve transparency on climate and sustainability

Sustainability-related financial disclosures must include Scope 3 and influenced emissions

Concerns over the ability to assess all Scope 3 and influenced emissions should not delay the inclusion of most material emissions. For many companies, Scope 3 emissions exceed their Scope 1 and 2 emissions. For some, influenced emissions that fall outside the traditional Scope 3 definition are also more material than their total Scope 1, 2 and 3 emissions. To properly represent the climate risks faced by companies, climate-related disclosures should cover the most material climate-related risks faced by companies. These include:

- Emissions from the use of products sold by fossil fuel companies.
- Emissions associated with the transformation of products sold by metal ore miners – in particular iron ore and bauxite miners.¹
- Emissions from the use of products transported for energy networks, as well as ports and freight companies largely handling coal and liquefied natural gas (LNG) products.²
- Emissions associated with the financing of fossil fuel activities, even when it is off-balance sheet – for example of large asset managers.³

Transition pathways should focus on short-term, material, credible outcomes

Based on our observations, we advise that it is particularly important to ensure transition plans:

- Include short- and medium-term targets and actions, rather than just long-term targets.⁴
- Address all material emissions. As per our first point, transition plans should be focused on the most material climate risks, rather than Scope 1 and 2 emissions.⁵ Companies should give detailed plans for all activities, rather than cherry-picking which to disclose.⁶
- Are not overly reliant on unproven technologies. In particular, our research shows that many large emitters and fossil fuel companies rely on carbon capture and storage (CCS) for their emissions reductions, when CCS has a history of failure and underperformance⁷, and is likely to present more risks than benefits with no economies of scale.⁸
- Should not be overly reliant on carbon offsets as a way to reduce their emissions.⁹

There will also be a need to recognise that certain companies will not transition but instead will need to phase down as the world decarbonises, such as gas networks¹⁰ and coal-only ports¹¹. This is also likely to be the case for many fossil fuel companies, with no new investment required even in gas developments under any of the International Energy Agency (IEA)'s scenarios¹², and with extremely limited investments in clean energy alternatives¹³. This should be recognised in the language and tools used to describe expectations around transition pathways.

A Sustainable Finance Taxonomy must be complemented by company-level assessments

The upcoming Australian sustainable finance taxonomy, which is still in development, focuses on project-level assessment. This is a risk as green finance could help indirectly finance emissions-



intensive projects by freeing company capital for those projects. It will be important to add an assessment layer at the company level to ensure that green and transition finance can only go to companies that are genuinely transitioning and that other companies are not exploiting this loophole.¹⁴

Key considerations for a sustainable investment product labelling regime

A labelling system should be challenging yet achievable, and comprehensive yet clear. End investors – especially retail investors – must be able to understand the labels. The more complex the labelling and disclosure requirements are, the greater the risk of non-compliance, as seen with the European Union (EU)’s Sustainable Finance Disclosure Regulation (SFDR).¹⁵

Key considerations for the design of a sustainable investment product labelling regime include:

- i. The labelling regime should apply reporting requirements uniformly to all investment products, to avoid a situation where only sustainable investment products have additional requirements, hiding the negative impacts of products with no sustainability ambition.
- ii. Minimum standards should be applied to remove subjectivity from labelling. To avoid inconsistency in sustainability ambition between labelled products, definitions and criteria for labelling should not be left open to interpretation by individual asset managers.
- iii. Minimum standards must be established at the label level to ensure a base level of ‘sustainability’ for each label. Additional process-relevant standards can then be applied on top of the minimum standards to further differentiate labelled products.
- iv. To avoid hindering innovation, managers should have leeway to set their own criteria for process-relevant standards, as long as these criteria are ratified by the regulator and can be monitored easily by a third party using non-proprietary data.
- v. Disclosures and information required for the labelling regime must be tailored and tiered based on the audience to avoid overburdening retail investors with excessive data.
- vi. Developments in other jurisdictions like the EU should be monitored to aim for alignment and harmonisation of approaches, which provides benefits to both regulators and market participants. Lessons can also be learned from experiences with the EU SFDR.
- vii. Consideration should be given to establishing independent mechanisms to verify or certify investment products’ sustainability claims. This may entail engaging third-party organisations or establishing a regulatory body to certify sustainable investment products.
- viii. Labels need to clearly differentiate among sustainability improvers; broad environmental, social and governance (ESG) integration; a specific sustainability theme/objective; and measurable impact achievement. This will require defining each type of labelling strategy.
- ix. The labelling regime should prioritise investor education and awareness, so investors can make informed decisions aligned to their sustainability preferences and values.

It is also equally important to formulate regulations to restrict use of names/labels for investment products offered to retail investors that do not qualify for a sustainable label or do not have sustainability as an investment objective. Such products should be prohibited from using subjective sustainability-related terms, including but not limited to: ESG; Climate; Sustainable or Sustainability or Sustainability-linked; Transition; Responsible; Green; Sustainable Development Goals (SDG); Paris-Aligned; Net Zero; or Taxonomy-linked.



Pillar 2: Financial system capabilities

There are still too many loopholes on greenwashing

Our experience is that there remain many loopholes on companies' greenwashing. In particular, if companies transparently disclose their actions, it seems nothing can be done, even though they could easily be misinterpreted by investors or consumers. Examples include:

- Companies overselling the decarbonisation potential of certain technologies, such as gas networks promoting renewable gas¹⁶, or companies basing future emissions reduction projections on CCS.
- Companies using inappropriate metrics to communicate their emissions reduction activities, such as using volumetric blends for renewable gases¹⁷, or using an emissions intensity target that does not require any reduction in emissions for fossil fuel-financed emissions.¹⁸ Fossil fuels with CCS solutions are also often promoted as providing clean energy alternatives, when CCS actually only captures a small percentage of the total emissions involved in the process.¹⁹
- Companies often focus public disclosures on green activities, and omit or only partially disclose their emissions-intensive plans. This for example includes disclosing plans for green investments but not for likely fossil fuel-based investments²⁰; using a smaller scope of disclosure for fossil fuel investments than for green investments²¹; or failing to mention plans for fossil fuel developments while publicly launching green finance products.²²

Urgent attention is needed to address loopholes in net zero commitments by financial institutions, particularly in attributing greenhouse gas emissions from off-balance sheet activities, commonly referred to as facilitated emissions. The lack of a standardised methodology, as seen in the case of the Glasgow Financial Alliance for Net Zero (GFANZ)²³, has resulted in misleading claims of achieving net zero portfolios. The lack of disclosure regarding off-balance sheet activities contributes to a continuous influx of investments into fossil fuel assets globally, including in Australia.²⁴ While some banks like JPMorgan, Barclays PLC and The Toronto-Dominion Bank have set targets, others, including HSBC and Citigroup, are waiting for a methodology from the Partnership for Carbon Accounting Financials (PCAF).²⁵ Australian regulators can take a proactive stance by urging disclosure of emissions from off-balance sheet activities, either by developing a methodology or adopting global standards. Transparent measures in this regard will position Australian regulators as leaders in promoting responsible financial practices and countering greenwashing in climate risk management claims.

The case for regulating ESG ratings as financial services

ESG funds and bonds are dominating the global market and are poised for further growth, highlighting the increasing significance of ESG ratings. The increasing reliance on such unregulated services in the securities markets raises concerns regarding potential risks around investor protection, market efficiency, risk pricing, capital allocation, and issues like greenwashing. In this context, it is crucial to regulate the ESG rating market. Here are several arguments supporting the regulation of ESG ratings as financial services:

- Inconsistent quality of ratings and inadequate transparency represent a form of market failure. In October 2022 IEEFA published a report analysing current ESG rating practices



and their shortcomings, and recommending ways to address the issues, including the need for regulatory intervention.²⁶

- Regulators in jurisdictions such as India²⁷, Japan²⁸, the EU²⁹, and the UK³⁰, and international standards-setting bodies like the International Organization of Securities Commissions (IOSCO)³¹, have implemented various measures to enhance oversight of ESG rating providers.
- In a September 2023 commentary, IEEFA noted the importance of a coherent sustainable finance regime.³² In particular, given that greenwashing mainly concerns the misuse and misinterpretation of ESG ratings, the distribution and use of ESG ratings could be regulated through sustainability-related disclosures for funds and asset managers.
- In addition, IEEFA emphasises the importance of imminent broad public disclosure requirements in addressing the lack of transparency and clarity faced in the ESG rating industry. A high degree of information symmetry is key to tackling deception in rating descriptions and methodologies, particularly when end users and other stakeholders may not be direct subscribers.
- The regulation should also cover areas in organisation requirements and rating processes (referencing to regulation for credit rating agencies) to avoid conflicts of interest and safeguard the integrity of ESG ratings.

Systemic risks must be addressed

Many companies selling fossil fuels assume that, while overall demand for their products will decline, they are likely to see their market share increase.³³ This presents a significant systemic risk that individual transition plans will not add up to what is needed to achieve the Paris Agreement targets. This needs to be addressed in the way transition plans are assessed.

In a rapid fossil fuel phase-out scenario, the fossil fuel industry could see a dramatic change in its financial situation render it unable to meet its decommissioning liabilities. Action should be taken to mitigate this risk. A recent study by the Sabin Center for Climate Change Law recommended several measures for governments to protect themselves from future decommissioning costs.³⁴

In July 2023 IEEFA analysed potential under-reporting of fugitive methane emissions in Australia. Utilising IEA data, we found that fugitive methane emissions from coal mining and oil and gas had been likely grossly underestimated to date, by about 80% for coal and 90% for oil and gas.³⁵ This shows the importance of ensuring material sources of emissions are actually measured, rather than calculated based on average benchmarks.

Transparency is needed over reporting of key data

In line with the Government's objective to align financial flows with nature-positive outcomes, companies should be required to disclose their environmental impacts and risks more transparently. There are significant data and analytical challenges involved in accurately disclosing their sustainability-related financial disclosures. Two key issues for Australia's extractive industries relate to the accurate reporting of:

1. Methane emissions.
2. Water take (extraction), use and contamination.

Key recommendations for Government to address these challenges include:



1. Improving the monitoring of fugitive methane emissions, by utilising satellite data, and investing in site-specific surveillance such as infrared cameras to detect fugitive emissions. This should be coupled with transparent reporting of this data using established metrics in companies' disclosures on emissions.
2. Establishing and standardising company reporting requirements for water take, use and contamination risks.

Reporting accurate water-related risks and impacts from water extraction and contamination is critical for all businesses in Australia, but particularly for mining, coal seam gas and gas projects, which have a history of causing significant environmental harm and biodiversity loss due to contamination of water sources. There is no standardised framework for companies in disclosing their water take, use and contamination. Although companies report on water access licences and associated volumetric allocations, this is only a small fraction of the impact these companies have on water sources. Examining water-related risks is imperative for establishing environmental sustainability, because water-related impacts lead to broader environmental harm. In most cases companies do not report volumes of water storages and water captured under regulatory exemptions. Additionally, companies often do not report accurately on the risks of contaminated discharges of water from their site until it occurs, and even then, usually only after an investigation by the relevant State Environment Protection Agency results in penalties.

In Australia, there have been multiple instances of coal mines illegally taking water without a licence or over the amount permitted by their licence allocations. This has led to at least A\$9 million in direct costs to these operations in fines, legal fees, compensation payments, and enforceable undertakings and rehabilitation costs.

Australia's extractive industries generate large amounts of effluent and contaminated water. Releases of contaminated water occurs regularly. In some cases these releases are legal under current regulation, and in many cases they are illegal, but can be difficult to monitor and costly to investigate. The amount of intentional saline water releases and the likelihood of unintended contaminated water releases from coal mines increase during and following periods of high rainfall and flooding. This means contaminated water releases from extractive industries will increase as climate change increases the frequency and severity of wet weather events. These events are not rare in Australia, with more than 60 cases of illegal contaminated water discharges where coal mining operators were fined or prosecuted occurring between 2013 and 2023. In that period, coal mining operators and coal-fired power stations incurred over A\$5.6 million worth of fines, penalties and enforceable undertakings for water pollution and illegal water discharges.

Pillar 3: Australian Government leadership and engagement

More sustainable finance will be needed at household and SME level

IEEFA research shows that Distributed Energy Resources (DER) represent a large untapped opportunity to reduce energy system costs.³⁶ Accelerated electrification offers the potential both to deliver large gas demand and emissions reductions and to significantly cut consumer energy costs.³⁷ In industry, switching from gas to heat pumps presents substantial unrealised savings.³⁸ While those solutions usually entail lower lifecycle costs, they often come at a higher capital cost.



Those opportunities will therefore require innovative financial solutions to make them affordable for households and small-to-medium enterprises (SMEs). There will be a need for finance at scale at the household and SME level, which is different from traditional green finance offerings.

Issuing Australian sovereign green bonds

IEEFA welcomes the Government's recognition of a robust sovereign green bond program for net-zero capital mobilisation. Starting with a common standard is a positive step, but widely used standards like the International Capital Market Association Green Bonds Principles have flaws. The Climate Bonds Standard or the impending European Green Bond Standard (EUGBS) may be more suitable. Developing a high standard tailored to Australia's funding needs is also an option.

The eligibility of the use of proceeds should be sound and well-defined, and fully determined by a credible and science-based Taxonomy. The fact that the EU had issued its NextGenerationEU Green Bond program prior to the adoption of its EUGBS means its outstanding green bonds are not aligned with its own standard – a lesson from which Australia can learn.³⁹

High transparency should be prioritised, both pre- and post-issuance. The pre-issuance framework must clearly justify how the green bond contributes to national net-zero goals, ensuring additionality. At issuance of each instrument, project pipelines, concrete investment plans and timelines should be disclosed in detail. Timely allocation of proceeds (with a committed allocation timeline), complemented by a short, limited lookback period, is important to ensure timely realisation of environmental impacts. The allocation of proceeds should be published at least once a year, including details by project for each instrument. The amount, management and plan concerning unallocated proceeds for each instrument should also be disclosed.

High-quality impact reporting is important for investors to measure, compare, aggregate and/or quantify environmental outcomes and impacts. Disclosure should include the implementation of the investments versus plans, and the final environmental contributions versus intentions. Metrics should be disclosed under a credible framework to illustrate each project's additionality. There are some market-led initiatives for reference, e.g. the Global Impact Investing Network (GIIN), and the International Foundation for Valuing Impacts (IFVI).

An external review of reporting ensures integrity. "Reasonable assurance" by a third party on every element in the pre- and post-issuance reporting would provide robust safeguards.

Using the CEFC to catalyse sustainable finance flows and markets

The Clean Energy Finance Corporation (CEFC) has been instrumental in mobilising public and private commercial capital, especially into large-scale renewable energy projects in Australia. It has leveraged public capital primarily through direct financing in the form of equity financing, concessional debt or asset financing. This mode of financial intervention has achieved a leverage factor (private capital mobilised per dollar of public capital investment via CEFC) of 1.25-2.

However, given the Government's ambitious renewable energy targets (82% renewable power by 2030), and several existing financing barriers (higher cost of capital, low debt to value, lower debt tenors, etc.) being observed in the sector, the CEFC's role needs to be enhanced. It should be more catalytic in nature, which can also lead to a higher leverage factor.

Recommendations to enhance the CEFC's role as a catalytic and risk capital provider include:



- **Introducing risk mitigation instruments:** Instruments such as partial credit guarantees can be critical in lowering the cost of debt and hence the cost of capital for clean energy project developers.
- **Providing long-term low-cost debt:** Currently, banks are not providing debt with tenor more than 6-7 years. Globally, 10-15 years of debt is a norm for typical large-scale renewable energy projects, which is necessary given such projects' high upfront capital costs. One solution could be to access green bond markets, which are known to provide longer-term debt capital and on-lending such capital to developers.
- **Project preparation facility for private capital mobilisation:** It is important to explore investments in initiatives that can facilitate scaling up of project development. The CEFC, in collaboration with the Australian Renewable Energy Agency (ARENA), could provide funding and advisory support for emerging clean energy infrastructure projects, such as green hydrogen and large-scale battery storage. This involves guiding the projects through the selection, design, structuring and implementation phases to ensure delivery of high-quality, sustainable, financially viable projects to the market.
- **Increasing debt-to-project value:** Currently a typical large-scale renewable energy project in Australia can secure only 60% of the total project cost as debt, whereas the global standard for comparable projects is 80%. This discrepancy increases overall project costs and ultimately discourages equity investors. The CEFC can act as a junior debtor in the financing of a project and incentivise commercial banks (senior debt) to provide a higher proportion of debt.

To implement any of the above measures, the federal government must enhance the CEFC's mandate, transitioning it from solely generating returns to becoming a provider of risk capital and facilitating market development.



Endnotes

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