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Carbon Neutral Bonds: Has China Set the Bar Too Low?

Further Reforms Are Needed to Encourage Market Participation

Funding Net Zero Emissions

It's been a busy time for China-focused investors trying to calibrate the government's commitment to the painful but necessary steps needed to green China's financial markets.

The process moved into higher gear with President Xi's surprise net zero emissions by 2060 announcement in September 2020. This has the potential to be a hugely significant announcement, but market experts have been forced to question the pace of change following the release of a disappointing 14th five-year plan that showed little change to the role of fossil fuels in China's energy mix.[1]

Details on meaningful market incentives to push high carbon industries to accelerate their transition have been slow to emerge. However, recently there has been progress in the financial sector. The 2021 Green Bond Endorsed Project Catalogue, released in late April, officially removed all fossil fuel-related projects, including 'clean coal', from the definition of 'eligible green project'.

This is a big step, not only for ESG investors who are eager to invest in China's domestic green bond market, but also for the Chinese central bank, the People's Bank of China (PBOC). PBOC Governor Yi Gang has stressed that government funding alone will not be sufficient for China to meet its net zero goals—which are forecast to require an estimated CNY 140 trillion of investment (around USD 22 trillion) from 2021 to 2060—and therefore, market participants must be encouraged to step in to fill the gap.[2]

Government funding alone will not be sufficient for China to meet its net zero goals.

China's progress towards meeting the Paris Agreement depends partly on how successful its fragmented policy measures are in mitigating greenhouse gas

[1] Financial Times. China's economic plan short on climate goals as ministries tussle. March 10, 2021.
[2] Bank for International Settlement. Yi Gang opening remarks: Green finance and climate policy. April 15, 2021.

emissions. The PBOC has shown leadership on green finance and Governor Yi is on the record expressing realistic concerns about the health of China's financial institutions due to significant systemic exposure to unmanaged carbon-intensive assets. He notes that the major Chinese banks "are faced with grave risks and should begin their green transition right away".

Inevitably, the PBOC will need to play a huge role in shaking up the market. Governor Yi has signalled that, among other things, mandatory climate-related disclosures will be enhanced and required for listed companies, financial institutions and other market players. This is certainly the right move. However, if China's bond market is going to be a meaningful catalyst for greening the country's energy and financial sectors, further critical reforms of green bond market practices are needed, especially for its high-carbon, state-owned power enterprises (SOEs).

Need for Credible 'Use of Proceeds'

In particular, it's time for China's financial market regulators to take a serious look at how high-profile SOEs are using the proceeds of their green bonds. Enforcing the right policy settings will be critical to PBOC's efforts to build confidence in the market in the wake of the controversy around troubled issuers like China Huarong.[3]

One urgent priority should be to create more credible rules covering the use of proceeds for SOE green bond issuers. Notwithstanding the recent Green Bond Catalogue enhancement, up to 50% of SOE green bond proceeds can still be allocated to working capital—that is, the funding of day-to-day (and not necessarily green) operations, or repayment of existing borrowings.

In February 2021, some of China's largest SOEs, including China Energy Investment Corporation, China Huaneng Group and State Power Investment Corporation, issued Yuan-denominated carbon neutral bonds—a form of green bond that must comply with the Green Bond Endorsed Project Catalogue published by the PBOC. According to the bond offering documents, 30% of the proceeds were to be allocated to working capital.

IEEFA's analysis of two issuances amounting to CNY 7 billion (USD 1 billion)—by China Energy Investment Corporation and China Huaneng Group—estimated total funds assigned for working capital to be CNY 2.1 billion (USD 326 million). This amount could have otherwise delivered roughly 105 megawatts of renewable energy capacity from wind and solar.[4]

The bond offering documents also stated that each SOE's current coal-fired capacity is around 75% of its total power assets and that the coal power segment will remain a core part of the business. Limited information was provided about future energy capacity or the plan to phase out fossil fuel energy sources. Based on IEEFA's analysis of the bond documents, it is not inconceivable that the proceeds earmarked

[3] Bloomberg. Huarong Debacle Highlights Problems at Hundreds of Chinese Banks. April 16, 2021.
[4] IEEFA estimates based on Bloomberg New Energy Finance December 2020 data.

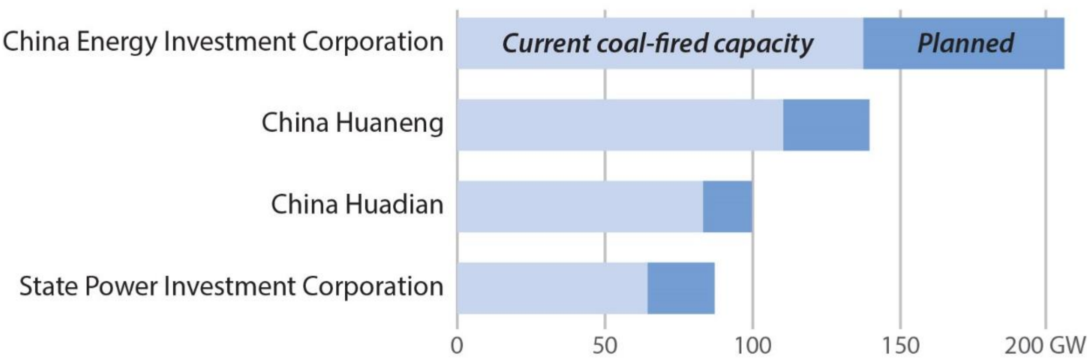
for working capital would be spent on maintaining a steady (if not growing) coal business, as new coal assets remain in the pipeline.

The promise of green bonds and sustainability-linked bonds and loans is that they encourage accelerated energy transition. Unfortunately, the SOEs' use of proceeds could damage the carbon neutral bond label in China's nascent green bond market and the credibility of key energy SOEs.

The SOEs' use of proceeds could damage the carbon neutral bond label.

China State-Owned Power Producers Issue Green Bonds

Issuers own the largest coal-fired power plants in the world and plan to add capacity



Sources: Global Energy Monitor, Urgewald Global Coal Exit List **IEEFA**

Separate research conducted by the Climate Policy Initiative found that every SOE green bond issuance from 2016 to 2019 had some funds allocated to working capital—averaging around USD 95 million per issuance (or around 47% of the average proceeds).[5] In addition, the research could not conclusively identify the use of proceeds due to the lack of a standard reporting framework and limited transparency in the Chinese green bond market.

Need for Transparency

This brings us to the second critical issue that should be tackled soon to ensure that the market sits on healthy foundations: governance.

Investor-focused governance and accountability policies have not been the focus of SOEs as they are well aware of their strategic importance to the central government and are not accustomed to the level of scrutiny typically faced by public companies. As a result, fundamental elements of governance, such as internal controls,

[5] Climate Policy Initiative. Green Bonds in China—the State and effectiveness of the Market. Escalante, Choi, Chin, Cui, Larsen, June 2020.

monitoring and evaluation, external reporting and independent verification, are commonly known to be weak spots.

Based on IEEFA's review of the February 2021 carbon neutral bond documents referenced earlier as examples, it was not possible to confirm the following issues:

- How does the SOEs' use of proceeds relate to their short- and long-term transformation plans, including any plans for phasing out fossil-fuel energy sources? Setting and disclosing such targets would not only provide transparency to external stakeholders but it would also put any use of proceeds investment decisions in a clear financial and reporting context for future disclosure.

- Who within the SOE is making decisions about eligible green projects and what are their credentials? Is there Party-committee and/or board-level oversight of decisions related to the use of proceeds and has a committee comprising of independent environmental specialists been established?

- What are the SOEs' processes for identifying and deciding what would constitute an eligible green project?

- How would bond proceeds be managed? For example, what are the SOEs' internal controls for ensuring that the green proceeds would not commingle with general funds, or that the proceeds would be utilised specifically for 'eligible green projects'?

Clearer disclosure pre-issuance would be warranted in light of post-issuance reporting obligations. For example, it's notable that the bond documents state that third-party verified post-issuance reporting will be published every six months. This commitment is unusual for these issuers but should be applauded, especially as they are not known to be experienced external reporters. If it is expected that these SOEs will be raising more public debt in the future, they would be smart to build credibility by ensuring that the following items are addressed, in detail, in the reports:

- Project-level information that is comprehensive and comparable year-on-year, particularly in relation to the use of proceeds and the impact of projects, including details of absolute emissions avoided

- Transparent, clear and consistent methodology used for impact assessment

- An outline of the experts' work as part of the third-party verified post-issuance reports. The experts' work should include:

    - verification of the allocated and unallocated proceeds

    - evaluation of the effectiveness of the design and execution of processes around project selection and the use and management of proceeds

- confirmation of the existence of eligible green assets and the accuracy of the impact or performance measures.

The first post-issuance reports are expected in August 2021 and the quality of reporting will be a key deciding factor for high quality green bond investors. Greenwash-wary leading ESG investors are reluctant to fund issuers that lack transparency and that continue to be fossil-fuel focused, and they have a practice of scrutinising a company's track record, overall actions against plans, and management commentary.

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Addressing the Issues

China's onshore bond market is preparing for around CNY 500-800 billion (USD 78-124 billion) of green issuance in 2021[6] which, coupled with the recent raft of policy announcements, could move the country in the direction that meets its green ambitions.

However, until leading foreign ESG investors have more evidence that market discipline for China's SOE green bond issuers has improved, domestic banks, insurers and asset managers—the main holders of domestic bonds so far[7]—may be forced to single-handedly plug the SOE financing gap that concerns Governor Yi.

[6] Bloomberg. China Urges 'Market Forces' to Fill Gap in Green Bond Program. March 22, 2021.
[7] IMF. The Future of China's Bond market. Alfred Schipke, March 13, 2019.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

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