A green label that sticks

Government faces lobbying pressure to label investment in fossil fuels as sustainable

MEDIA BACKGROUNDER
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Written by Alex Walker, Climate Finance Program Manager

environmental defence

A Taxonomy of Sustainable Finance in Canada

Introduction and context

Canadian environmental groups and experts are raising concerns about the federal government's sustainable investment labeling scheme - called a taxonomy - with worries that liquified natural gas (LNG) could be labeled as sustainable. This follows backlash from March 2023 when the government initially proposed labeling oil sands investments as sustainable. Renewed concerns come after the Fall Economic Statement signaled the government's intent to move forward with the taxonomy. Environmental groups from across Canada fear this could lead to misleading labels for LNG investment.

Kathy Bardswick, the former chair of the government's Sustainable Finance Action Council (SFAC) advisory body, recently made headlines in expressing her frustration over the government's slow progress in implementing the labeling scheme. She highlighted the considerable influence of the natural gas lobby in Ottawa as a significant factor in delays. This suggests a clash within the government between those seeking a science-based taxonomy and those influenced by the fossil fuel industry.

Over 50 environmental groups from across the country are joining forces to demand that the government exclude all fossil-fuel activities from the taxonomy. Canada needs a sustainability label that sticks, not more greenwashed guidelines.

What is a taxonomy

A taxonomy will label sustainable investments based on whether or not they align with Canada's climate goals and the fight against climate change. A clear and science-aligned label will benefit investors looking for reliable information on what constitutes a genuine climate solution. It is a specific piece of sustainable finance regulation, rather than a tool for the entire Canadian economy. Not every possible investment project will be considered, just those which may be related to the energy transition. By providing clear criteria, the taxonomy could also help prevent greenwashing in the financial sector - an issue that has recently received extensive scrutiny. Recent polling shows that 78 per cent of people in Canada support the government introducing new rules to address financial sector greenwashing, and a strong taxonomy could be one such rule.

The government's initial proposal, developed by the Sustainable Finance Action Council (SFAC), suggests a two-tiered system:

- Green Label: Awarded to projects demonstrably aligned with keeping global warming below 1.5 degrees Celsius.
- Yellow Label: For projects not yet meeting climate goals but crucial for the transition to a clean energy future (e.g., clean cement production). This "best-in-class" label is temporary and spurs continuous improvement.

While the final structure may have one or two tiers, the key takeaway is that all labeled investments should meet strict standards, ensuring transparency for investors and progress towards Canada's climate targets. When discussing the taxonomy, we prefer the term ‘sustainable investment labeling scheme’ for simplicity.

What isn’t a taxonomy

A taxonomy can be a difficult-to-comprehend idea. It is helpful to understand what a taxonomy *isn’t* when trying to understand what it is. The following are all examples of what a taxonomy is not:

- A taxonomy is not a ban on certain investments
- A taxonomy does not apply to the entire Canadian economy
- A taxonomy is not an investment rulebook
- A taxonomy is not a limit on what loans can be made
- A taxonomy is not a barrier to accessing investment if a project is excluded from this framework

Some critics of this labeling scheme fear that if a project is excluded from this framework, it won’t receive any investment. Evidence from the EU taxonomy, which has been in place for several years, proves that this isn’t the case. According to data from EY, 15 per cent of capital expenditure (investment for future projects) by companies in Europe was aligned with the taxonomy framework, while 85 per cent was not. This data suggests that the taxonomy does not limit any investments by companies, but it does provide clear evidence on what is sustainable. As we await data from the 2023 reporting year, we anticipate further evidence that the EU taxonomy is encouraging additional sustainable investments.

Why is LNG the sticking point?

According to reports, internal government conflicts around the place of LNG in the taxonomy are stalling its release. Liquified natural gas (LNG) is methane gas that has been cooled to a liquid state for transportation, typically to be burned as a fuel. Methane, the primary component of LNG, has a global warming potential around 82 times higher than CO2. Methane leaks at each stage of its lifecycle: extraction, production, processing, distribution and end-use. Additionally, governments drastically under-estimate the quantity of methane which leaks into the atmosphere. These leaks make methane a major contributor to climate change.

Over the last several years, there has been a growing LNG export industry in Canada. Supporters of the product argue that exporting Canadian LNG to countries still heavily reliant on coal will switch them to a lower-emissions energy source and therefore bring down global emissions. However, producing LNG releases significant emissions across the supply chain, due to methane leaks. Despite arguments from the LNG industry, evidence suggests that exporting Canadian LNG to China produces 18.5 per cent higher emissions than China using coal.

LNG is not a sustainable product as it worsens the effects of climate change, and the health of Canadians living near gas extraction sites. LNG should not be included anywhere in the sustainable investment labeling scheme. To do so would undermine the international credibility of Canada's taxonomy. It would be better to have no taxonomy at all than to have one that includes fossil fuels of any kind.

Slow progress and lack of urgency

Despite describing itself as a "world leader in climate finance", Canada is lagging behind other countries in releasing its sustainable investment label. The European Union first started to work on its taxonomy in 2016. The Government of Canada began work in 2021 with the launch of SFAC to advise on the development of Canada's taxonomy. Some early efforts for developing a taxonomy in Canada collapsed due to fundamental disagreements between stakeholders. SFAC completed its initial guidance on a taxonomy in 2022, but the report was not released until March 2023. Before Canada even published its initial guidelines, finalized frameworks were released by Mongolia, the EU, China, Bangladesh, Chile, Russia and the Association of Southeast Asian Nations.

The Canadian government, after announcing it would move forward in the Fall Economic Statement, is expected to unveil its next steps in the summer. However, there is not yet a timeline for the final labeling scheme. Members of the public have noticed this and are calling on the government to act: **almost 4000 members of the public have written in support of a science-aligned taxonomy that entirely excludes fossil fuels.**

The taxonomy process in Canada has been fraught with delays, slow progress and conflict. While other jurisdictions are moving ahead with increasingly tight taxonomy frameworks, Canada is yet to join the race.

Why does the new sustainable investment label matter for Canadians?

While it may not initially seem like it, the Canadian sustainable investment labeling could have some important impacts on people in Canada. More specifically, a poorly designed sustainable investment label could create problems for Canadians. The following are ways that a taxonomy which wrongfully labels fossil fuels as sustainable could be bad for people in Canada:

- A greenwashed scheme could hinder climate progress. Currently, the private sector is underinvesting in the energy transition. If the taxonomy mislabels fossil fuels as green, it could divert investment away from clean energy sources like wind and solar. This would slow Canada's transition to a low-carbon economy and make it harder for Canada to meet climate targets. It's important that the private sector also contributes to the transition, along with other sectors.
- A weak sustainable investment label could worsen greenwashing. 76 per cent of people in Canada are concerned about greenwashing (false environmental claims) by banks and pension funds. A flawed labeling system would make it easier for banks and pension funds to greenwash their investments, eroding trust from customers. If the government says that fossil fuels are a green investment, it allows your bank to say the same thing. Canadians need clear guidance from the government to ensure trust in their financial institutions.
- A bad taxonomy could contribute to higher energy bills. Clean energy is cheaper and more efficient for households in Canada. More private investment in clean, renewable energy could help lower household energy bills for people in Canada. Without the investment that a good taxonomy could provide, Canada's clean energy infrastructure won't be built at the pace we need it. Canadians could be reliant on expensive fossil fuels for longer.
- A greenwashed labeling system will muddy the waters for consumers wanting to make informed investment decisions. There is no guidance for consumers in Canada who are looking to make sustainable investments. A bad labeling system that includes fossil fuels will make it substantially harder for consumers to make informed investment decisions about their personal finances. Figure 1 is an image from a report on an ETF available in Europe. It demonstrates the reporting that ETFs and Mutual Funds must do to show consumers exactly how sustainable an investment is. Canadians deserve this much clarity for their personal investment choices.

Did this financial product have a sustainable investment objective?

☐ Yes ☒ No

☐ It made **sustainable investments with an environmental objective:** __%

☐ in economic activities that qualify as environmentally sustainable under the EU Taxonomy

☐ in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy

☐ It made **sustainable investments with a social objective:** __%

☒ It **promoted Environmental/Social (E/S) characteristics** and while it did not have as its objective a sustainable investment, it had a proportion of 22.02% of sustainable investments

☐ with an environmental objective in economic activities that qualify as environmentally sustainable under the EU Taxonomy

☒ with an environmental objective in economic activities that do not qualify as environmentally sustainable under the EU Taxonomy

☒ with a social objective

☐ It promoted E/S characteristics, but **did not make any sustainable investments**

Figure 1: Source

Risk of international pressure

The experiences of the EU should be informative for how Canada moves forward. The European Union has faced legal suits for including nuclear and 'natural' gas power generation in taxonomy and labeling them as sustainable investments. Environmental experts have launched legal cases against the EU for this greenwashing, while several EU member states came out strongly opposing the inclusion of these projects.

This negative response from environmental experts should be instructive to Canadian decision makers. If the Government of Canada pursues a sustainable finance labeling system, it should be rigorous and credible to avoid international scrutiny.

How do taxonomies from around the world compare?

The Government of Canada is looking to implement a 'made-in-Canada framework'. However, many companies in Canada operate around the world, and must adhere to international sustainable finance frameworks. It is important that there is coherence between Canada's definition of a sustainable investment, and other frameworks already existing around the world. In a similar vein, there is ongoing work to create coherence between the EU and Chinese taxonomy frameworks.

Figure 2 summarizes key information from other frameworks globally. Note the clear criteria from several frameworks in relation to natural gas. Canada should adopt similar or more stringent emissions standards for any potential projects, in order to increase clarity, credibility and coherence with other taxonomies.

Taxonomy	**Status**	**Nuclear**	**Gas/LNG for electricity generation**	**CCS/CCUS related to oil and gas**
EU	Adopted by government - mandatory alignment for some companies in EU		Electricity generation from gas: max emissions from plant of 270g CO2 equivalent per kWh (received significant backlash)	Enhanced Oil Recovery is Explicitly Excluded
Association of Southeast Asian Nations	Published by government-voluntary alignment for companies		Electricity generation from gas: max emissions from a plant of up to 510 gCO2r/kWh for amber tier/ 100 gCO2/kWH for green	
Singapore-Asia	Published by government-voluntary alignment		Electricity generation from gas: lifecycle emissions from plant up to 100g CO2e/kWh for green tier	Enhanced Oil Recovery is Explicitly Excluded
South Korea	Published by government-voluntary alignment		Energy production based on LNG is eligible in the South Korean Taxonomy under the transition sector.	
China (CBI)	Published by government		Thresholds unclear	
South Africa	Published by government-voluntary alignment			Criteria unclear
Colombia	Published by government-voluntary alignment			
Russia	Published by government - mandatory alignment			
Thailand	Published by government-voluntary alignment		Retrofit only	

Figure 2: This table was compiled using data from the 'Climate Bonds Initiative', as well as analysis of taxonomy documents. A more detailed version is available upon request.
Green = included with easy to meet criteria, Orange = included with stringent eligibility thresholds, Red = excluded, Grey =unclear

Background: the need for sustainable finance policy in Canada

- Climate-aligned finance policy is the missing piece of Canada's climate plans
- Canada has been described as a 'low-regulation jurisdiction' for sustainable finance by the United Nations Principles for Responsible Investment
- Canada's banks finance fossil fuels 2.6 times more than they are funding clean energy. In order to reach a net-zero energy system, clean energy needs financing at four times the rate of fossil fuels (4:1). In the absence of climate-aligned financial regulation, Canada's banks are have flipped this ratio and are investing at a ratio of 3.9:1 in favour of fossil fuels over clean energy. Canada needs new regulatory tools to leverage private investment in clean energy
- Canada has $100bn of assets that are at risk of becoming stranded by 2036 in the global energy transition. Stranded assets are investments that stop generating an income far before the end of their expected economic lifespan. Stranded assets can cause a significant drop to the value of an investment, and as such are economic risks. Sustainable finance regulation is needed to protect Canada's economy from stranded assets.
- Climate-induced extreme weather events cost the insurance industry over $3 billion in 2023 and also in 2022
- Up to 10 per cent of households in Canada will not be able to afford home insurance in coming years because the risks of climate change will make it prohibitively expensive
- Climate change is set to cost the Canadian economy $5.5 trillion by 2100

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For more information or to request an interview, please contact:
media@environmentaldefence.ca