

The Reformed SSA Trader:

High ratings, high risks

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Australia (Ticker: ACGB, average rating AAA), Austria (RAGB, AA+), and Province of Alberta (ALTA. AA) are three bond issuers within the sovereign, supranational, and agency bonds (SSA) segment that investors with climate mandates should pay close attention to given recent policy shifts that are likely to lead to higher emissions outcomes for investors.

Table 1. Select bonds with risk for adverse impact in the SSA space. Source: AFII, Bloomberg.

ISIN	Bond name	Currency	Outstanding amount	Issuance date	Label	Spread over govt benchmark	ECB eligible[1]
AU3TB0000200	ACGB 4.5% 06/2034	AUD	AUD7bn	06-Jun-24	Green	-0.1	No
XS2802866728	ALTA 3.125% 10/2034	EUR	EUR1.5bn	09-Apr-24	n/a	69.5	Yes
AT0000A2Y8G4	RAGB 1.85% 05/2049	EUR	EUR6.5bn	24-May-22	Green	52.6	Yes

Specifically:

- Australia recently announced a substantial extension of thermal coal mining licensing. This follows the country's issuance of its inaugural green bond in June (see Table 1). Pushing extension of thermal coal mining outside the perimeter of the green bond asset is what we call **balance sheet fungibility risk**. The ACGB green bond has exhibited stark underperformance since issuance.
- Austria recently held general elections, with the party complaining about "climate communism" getting 29% of the vote and potentially becoming kingmaker for the new government. The party's policy proposals chime poorly with the marketed strategy behind the long-dated green bonds that the country issued in 2022. Sovereign climate commitments that are supposed to last longer than the current electoral cycle are subject to what we call **policy legacy risk.**
- The Province of Alberta has announced intentions to use public funds (bond proceeds) to cover the costs of 'orphan wells' and expand oil sands extraction. It has also pledged to constrain the areas earmarked for renewables development. A substantial number of asset managers bought the newly issued EUR-denominated Alberta bonds while claiming ESG/responsibility/sustainability credentials. It is unlikely, in our view, that all end-investors in such funds are aware that their investments are financing these activities. We call this **end-investor representation risks**. The € ALTA bonds have substantially underperformed since issuance.

[1] Bond accepted as collateral within the Eurosystem.

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Australia – balance sheet fungibility risks

News that the Australian government would increase thermal coal mining broke at the end of September. Estimates suggest that the extension of licensing for the Nabarri (Whitehaven), Mount Pleasant (MACH Energy Australia) and Ravenswort (Ashton Coal Operations) would add another 1.3 gigatonnes of CO2e to global emissions.[2] The decision has been viewed as inimical to Australia's efforts to host COP31 in 2026.[3]

Figure 1. ACGB 4.25% 06/34 green bond was issued with a greenium (tighter spread than 'grey' bond) but has underperformed and now trades wide to the shorter non-green 3.75% 05/34 (AU0000249302). Source: Bloomberg.



The Australian green government bond was issued in June 2024, to much fanfare. It was even able to extract a substantial 'greenium' for the triple-A rated space.[4] The topic of thermal coal extensions was not featured in the investor roadshow materials, and where coal was referenced it was only in the context of the socioeconomic implications of moving away from coal-fired power.[5] Australia's green bond framework[6] only uses the word coal twice, again in relation to socioeconomics. The scarcity of references seems to understate coal's central role in Australia's energy mix and economy: 62.4% of the country's electricity generation capacity comes from coal, and coal is the country's second-biggest export.[7]

It appears that the market has already priced in the similarity between this nominally green bond and an equivalent vanilla instrument, fully deflating the initial greenium (Figure 1). However, the exact reason for this underperformance is unclear and is not necessarily due to a deteriorating appreciation of the bond's 'greenness'.

The Australia case describes what we call **balance sheet fungibility risk**, where the actions and strategies of the issuer's full balance sheet deviate from the intent signalled by its green bond documentation and marketing.[8] One defence against this may be that green bond proceeds are separable (i.e. not fungible) within the balance sheet of the issuer, even if the green bonds are not legally ringfenced. Having said that, many investors do consider the issuer and issuance jointly, and from this perspective and considering the thermal coal mine extensions, the green ACGB is problematic.

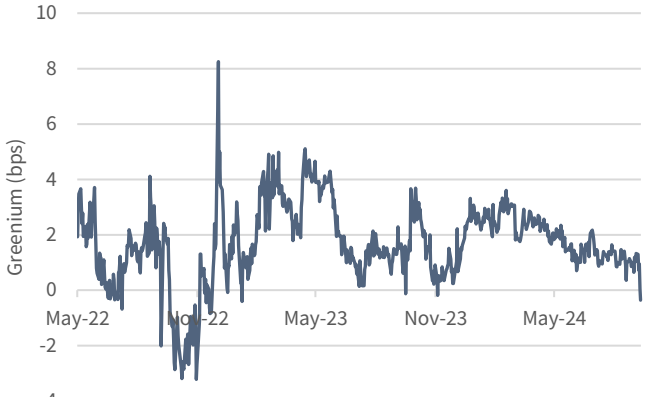
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[2] "Australia clears coal mine expansions in hit to green goals", Mining.com, 24 Sep 2024.
[3] "Australian Extensions for Coal Mines Angers Pacific States", AsiaFinancial, 2 Oct 2024.
[4] "Australia Commands Rare Premium in First Green Bond Issuance", Bloomberg, 4 Jun 2024. The greenium was reported to be 1.5bps. As an investor noted: "It is an example of the government channeling their full efforts toward making the transition a success".
[5] "Green Treasury Bond Investor presentation", Australian government, accessed 7 Oct 2024.
[6] "Green Bond Framework", Australian government, accessed 7 Oct 2024.
[7] The top four industries are Iron Ore, Coal Mining, Oil and Gas extraction, Liquefied Natural Gas, see IBIS World, accessed 17 Oct 2024.
[8] Note Australia's considerable efforts to sell bonds to retail investors.

Austria – policy legacy risk

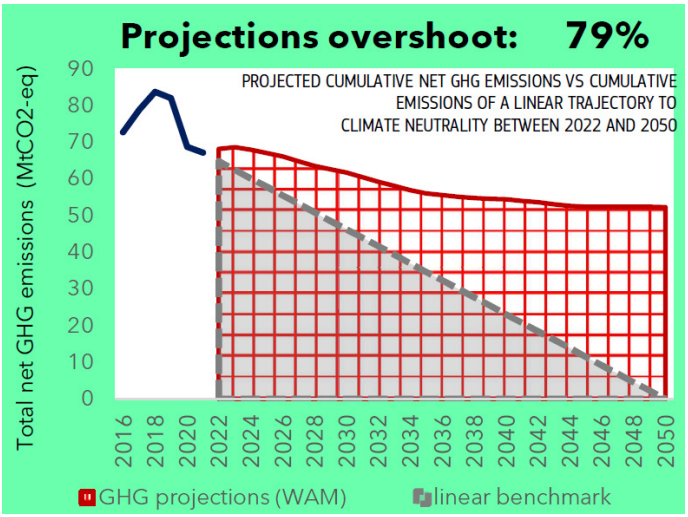
Austria held general elections in September. The FPÖ party – known as a 'climate sceptical'[9] group – emerged from the contest with almost 29% of the vote.[10] The FPÖ believes that climate disasters lead to climate hysteria, which will in turn lead to a form of climate communism. They also argue that Russian fossil gas is essential to Austria's energy system. These are not the messages conveyed by Austria when it issued green bonds in 2021-22.[11]

Figure 2. Greenium for the RAGB 1.85% 05/49 bond versus the 0.75% 03/51 bond on a spread versus bund basis. Significant coupon and maturity differentials so not an exact measure. Green bond was wider than 'grey' at issuance, now flat. Source: Bloomerg, AFII.



Moreover, Austria's emissions trajectory is already misaligned with EU-wide climate goals. Indeed, the European Commission projects that Austria is on track to overshoot a 2050 net-zero target by 79% (Figure 3).

Figure 3. Climate Action Progress Report 2023, Austria. The graph indicates a 79% cumulative emissions overshoot for Austria with current policies. The average number for the EU is 34%. Source: European Commission.



It is unclear how Austria's climate policies will evolve because of the recent elections and the FPÖ's ascendancy. The point here is that 'green' commitments made under one government may not be carried over by their successors. This is what we call **policy legacy risk**. The variability of sovereign climate commitments has also been discussed on other sovereign green bond issuances, namely the Swedish green government bond (XS2226974504, issued in Sep 2020) and the UK green gilt (GB00BM8Z2S21 and GB00BM8Z2V59, issued in Sep 2021). In the Swedish case, the green bond was issued under a left-green government. However, the succeeding right-wing and populist-supported government have since enacted policies that increase emissions from the transport sector.[12]

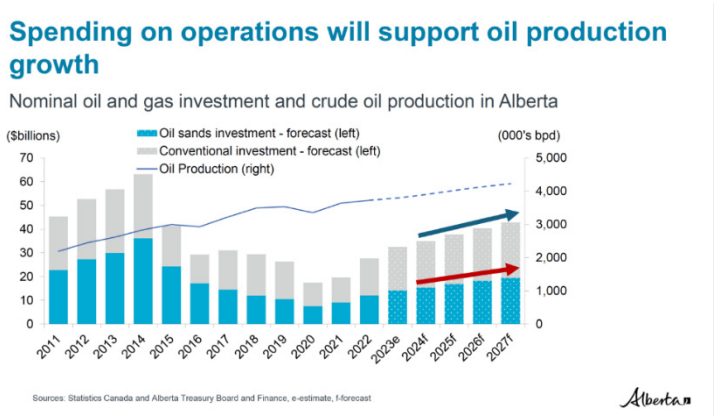
In the case of the RAGB 1.85% bond, changes to the investment policy of the European Central Bank (ECB) may have pricing implications. Frank Elderson of the ECB suggested that going forward the central bank could switch from investing in Eurozone sovereign bonds to EU supranational bonds "*to minimise potential climate and nature-related risks and to better align our balance sheet with the general economic policies in the EU*".[13]

[9] "From populism to climate scepticism: the role of institutional trust and attitudes towards science", Huber, Greussing and Eberl (2022), Environmental Politics 31:7.
[10] "Austria goes back to the future as voters embrace far-right party founded by Nazis", Politico.eu, 29 Sep 2024.
[11] For example, see "Publication Green Bond Framework and SPO", dated April 2022.
[12] "Report 2024", Swedish Climate Policy Council, 21 Mar 2024.
[13] "Sustainable finance: from "eureka!" to action", Speech by Frank Elderson, ECB, 4 Oct 2024.

Province of Alberta – end-investor representation risk

ALTA visited the euro-denominated bond market in April 2024 with a €1.5bn issuance that drew substantial investor interest.[14] It may be somewhat surprising that an issuer with clear oil sands investment expansion expectations (see Figure 4) would attract euro-focused institutions, given that many such investors have exclusion policies that cover this type of fossil fuel production. Recent news also indicates that Alberta will use public funds to subsidise the oil and gas industry's cleanup of so-called 'orphaned wells',[15] which have come into focus after yet another end-of-life-well-operator bankruptcy.[16] For SSA investors, the way the public purse is used for such cleanups should be scrutinised, as there are very clear risks involved with the indirect subsidisation of extractive industries.[17] Alberta will also, in a brazen policy move, constrain the development of renewable energy sources by 'safeguarding' vast land areas from renewables development.[18]

Figure 4. Excerpt from Province of Alberta investor presentation. Annotations indicating increased oil sands investment (red) and conventional (blue) added by AFII. Source: Province of Alberta.



For investors, these developments are concerning as there are a number of 'ESG' funds invested in the recent euro ALTA bonds (Table 2). We understand that such funds often do not extend exclusions and exposure limits for controversial activities to (sub-)governmental issuers like ALTA.[19] However, we believe it likely that a majority of the ultimate investors in these funds are not comfortable with the fossil fuel policies and actions of ALTA, giving rise to what we call **end-investor representation risks.**

Table 2. Holders of ALTA 3.125% 10/2034s with ESG-related labelling in fund name. Incomplete dataset. Source: Bloomberg, AFII as of 14 Oct 2024.

Asset management company	Fund name
Deka International SA/Luxembourg	Deka-Nachhaltigkeit Renten
BLACKROCK INC	iShares Global Aggregate Bond ESG UCITS ETF
BlackRock Asset Management Ireland Ltd	iShares EUR Aggregate Bond ESG UCITS ETF
Swisscanto Asset Management	Swisscanto LU Bond Fund Responsible Global Rates
AMUNDI ASSET MANAGEMENT SAS	AMUNDI INDEX EURO AGG SRI UCITS ETF DR
Credit Suisse Asset Management Schweiz	UBS CH Index Fund - Bonds Global ex CHF Aggregate ESG NSL

[14] "Alberta returns to euro with enlarged €1.5bn print", GlobalCapital, 9 Apr 2024.
[15] "Public money could help finance Alberta oil and gas site cleanups: ", GlobalNews, 16 Sep 2024.
[16] "Number of orphan wells in Alberta will soon double as controversial oilpatch bankruptcy settled", CBC News, 1 Oct 2024. This is a theme that also expands beyond Canada, e.g. see "Oil Industry Unlikely to Pay Mounting Debts Owed to America", Powering the Planet, 4 Jun 2024, and "Rocky Mountain Highs and Lows", Carbon Tracker, 27 June 2024.
[17] See for example "The ECB and Alberta's oil production holiday", AFII, 26 Oct 2020.
[18] "Alberta government proposing additional restrictions on wind and solar energy", CBC, 14 Oct 2024.
[19] AFII has covered a number of these situations over the years, please see "ConocoPhillips: a Marathon journey towards exclusion", AFII, 30 Sep 2024; "Oil, gas and bond pipelines: the case of Aramco/EIG/BLK", AFII, 5 Feb 2022; "ESG Bond ETFs: Passive aggressive investing?", AFII, 17 May 2022.

Conclusion

Accusations that corporate activities are increasing carbon emissions are rife, perhaps as a function of the corporate space catering both to equity as well as fixed income investors. However, many of the more climate-harming decisions in the past year have been made by sovereigns, rather than companies.

This note highlights three such cases that could significantly increase cumulative greenhouse gas emissions and introduce risks to sustainability-focused investors . Australia recently issued a green bond and then shortly after extended thermal coal mine licensing. Austria has elected a parliament which is poised to diminish an already insufficient climate policy, reducing the impact of the sovereign's green bonds. Finally, the Province of Alberta's wholehearted support of oil and gas and tar sands appears to be poorly aligned with the ESG statements of the investment products/funds that invested in Alberta's recent re-entry to the euro-denominated bond market.

These cases suggest a need for vigilance on behalf of investors when it comes to the non-corporate bond space.

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