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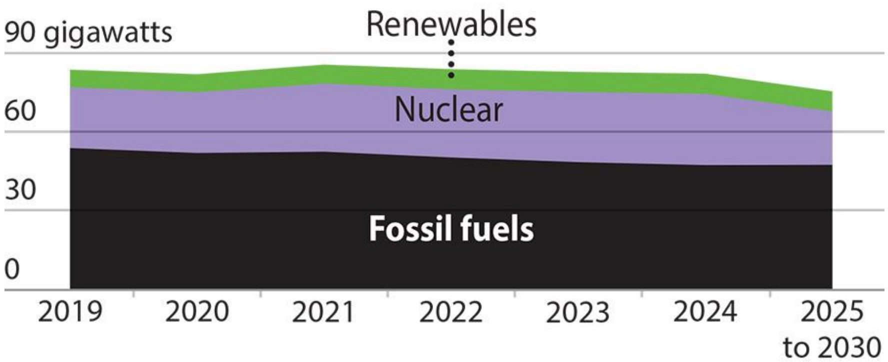
KEPCO's Green Bond Failed the ESG Market Test

While Oversubscribed, the Issuance Did Not Attract Leading ESG Investors

US$500m Green Bond

When a green bond is oversubscribed by a factor of 10, it is usually considered a very successful placement—but a closer look at the holdings of Korea Electric Power Corp.'s (KEPCO) recent green bond indicates the picture isn't as rosy as it might seem.

Fossil Fuels Lead KEPCO's Projected Capacity
Serious ESG investors are wary of funding the energy group's green projects if fossil fuels continue to dominate.



Source: KEPCO Investor Presentation, November 2020 **IEEFA**

In June 2020, KEPCO took what appeared to be a positive step forward and issued a green bond, raising US$500m from overseas financial markets.

According to its Green Bond Framework, the company's new strategy involves "focusing its resources on creating a clean and efficient energy ecosystem as part of its effort to cut down greenhouse gas emission[s]". For investors who are not familiar with KEPCO's role in Asian power markets, this language aligns nicely with South Korea's domestic shift toward renewable energy.

ESG Investor Advocates See Through Greenwash

While KEPCO's green bond was oversubscribed, IEEFA's analysis found that the mix of bondholders lacked breadth compared to other recently issued utility company green bonds, and many seasoned environmental, social and governance (ESG) investors passed on the issuance.

Many of the well-regarded ESG investors—both asset owners and asset managers—have committed significant resources to mapping their ESG research disciplines to new green bond strategies. This work brings together issuer-focused ESG research with a knowledge of fixed income markets, and the intricacies of green bond taxonomies and bond terms.

This is where KEPCO's green bond missed the mark. Based on holdings data and IEEFA's own market engagement, it appears that the leading green investors were unconvinced by the state-owned company's overall strategic direction related to climate risk management, with its recent track record of inconsistent and ambiguous investments and policies. Experienced ESG green bond investors are particularly reluctant to fund a company's "green projects" while the company has significant new coal projects in the pipeline.

This concern has particular relevance in KEPCO's case. KEPCO has been a target of unusually active equity investor engagement in 2020 due to its poor management of ESG fundamentals and its commitment to ongoing investment in overseas fossil fuel projects.[1,2,3]

Unlike equity holders, however, bond holders typically do not have the remit for ongoing engagement with issuers on operational matters post issuance, except in the event of default. ESG-aware, fixed-income investors looking at KEPCO's green bond would have been aware of the fact that in May 2020 notable KEPCO shareholders, including BlackRock and the Church of England, publicly urged KEPCO to cancel new coal-fired projects and demanded it establish a clearer strategic direction.

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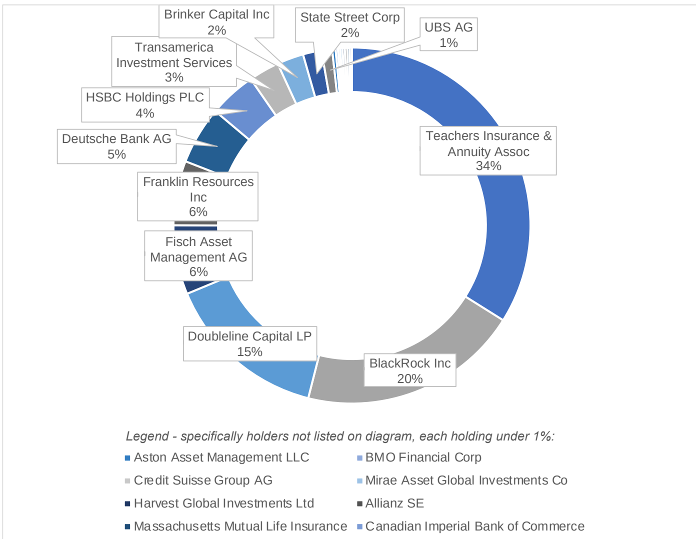
This group of investors would not have been surprised that only a few weeks after the green bonds were oversubscribed, KEPCO confirmed it would be investing in new coal power plants, Jawa 9 and 10 in Indonesia and Vung Ang 2 in Vietnam.

Coal is the worst kind of fossil fuel in terms of its contribution to the climate crisis. KEPCO's ongoing investment in fossil fuels is not only inconsistent with the company's green ambitions but also damages the credibility of the Korean government's Green New Deal which was announced in July 2020 and which is supposed to phase out coal financing.

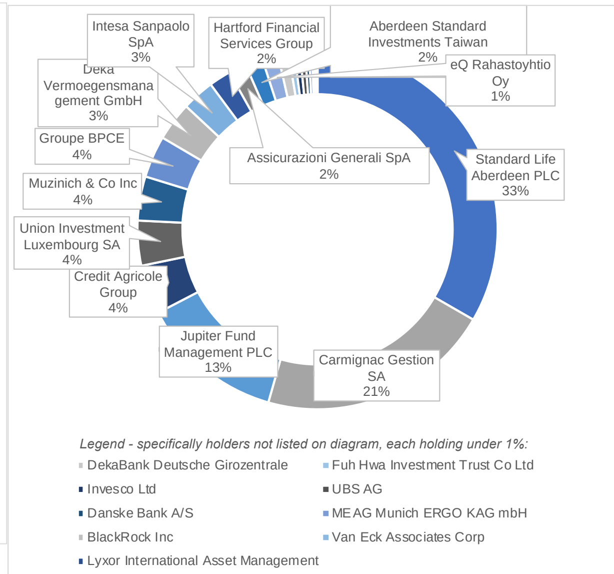
[1] Financial Times. Global investors warn South Korea's KEPCO over carbon emissions. 23 February 2020.
[2] IEEFA. Question Time for KEPCO's Board. 2 June 2020.
[3] Financial Times. Funds worth $3tn attack South Korea and Japan groups over coal project. 21 October 2020.

KEPCO's Bondholding Lacked Breadth Compared to Its Peers

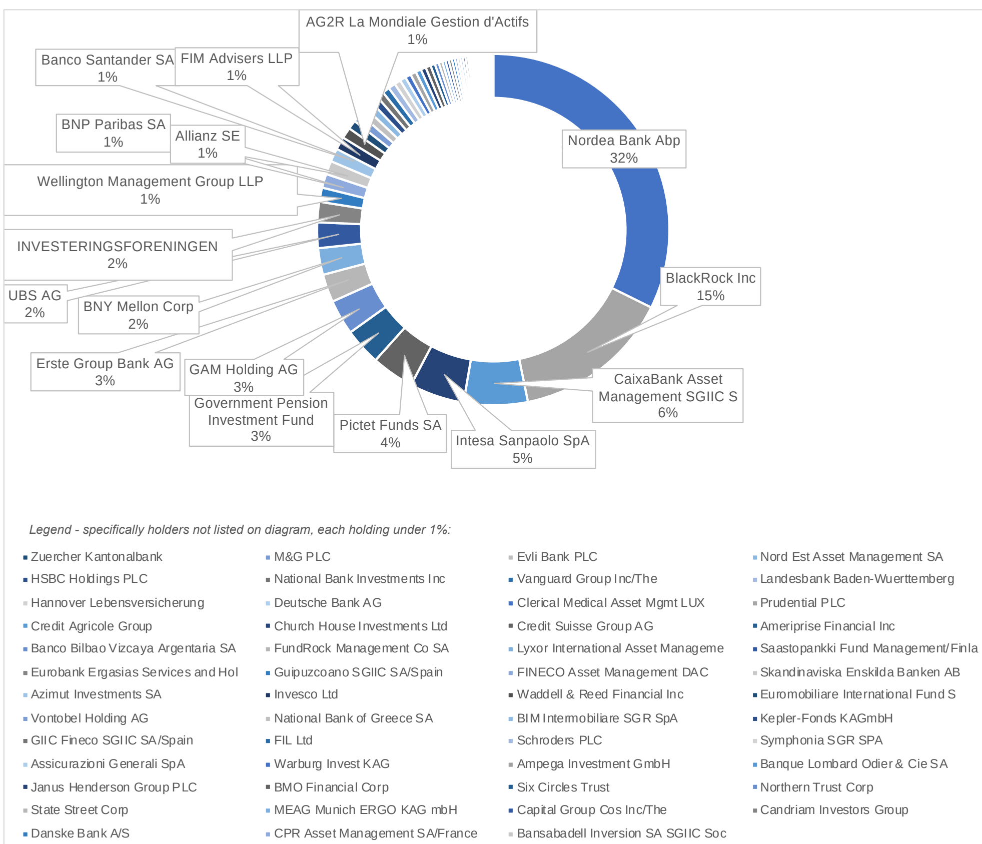
KEPCO bond holding



Vena Energy bond holding



E.ON bond holding



Source: Bloomberg (KEPCO ISIN US500631AU00 and USY4907LAB81, Vena Energy ISIN XS2122900330, E.ON ISIN XS2152899584).

Green Investors Take a Diverse Approach

It is not uncommon for investors including banks, insurers, pension funds and asset managers to invest in green bonds for common portfolio diversification, prudential risk management, or business needs. Like conventional bonds, the tenor and yield are key factors that drive investment choices amongst green bonds of similar credit quality. Some asset managers have also created green or 'sustainability' funds to meet the investment preferences of clients seeking bond exposure with lower environmental risk characteristics. Bonds with one of the recognized green labels certainly help to meet the portfolio criteria for such funds. However not all such funds necessarily apply a strict fossil-fuel exclusion policy.

Serious green investors, on the other hand, typically align their strategies to standards designed to reduce global greenhouse gas emissions and openly exclude environmentally harmful companies from their portfolios.

In November 2019, Deputy Governor Martin Flodén of the Sveriges Riksbank supported strategies designed to "focus on the issuers, and to make an overall assessment of how they work to promote a sustainable climate. Indicators of this could be, for instance, their greenhouse gas emissions. This is how we are now beginning to give consideration to sustainability in our new risk and investment policy. We will not invest in assets issued by issuers with a large climate footprint". As a result of its new investment policy, the Riksbank sold its holdings of Australian and Canadian sub-sovereign bonds—bonds issued by states "not known for good climate work".

IEEFA's research has found that green investors have diverse approaches to this emerging market and are often willing to reconsider their expectations on the risk-return spectrum for opportunities with seasoned green issuers that may carry a higher credit risk and/or lower yield than conventional bonds. There is enough diversity in the market that experienced ESG investors can use a governance lens to differentiate between KEPCO's AA 'light green' bond versus the higher quality standards of renewables specialists Vena Energy's BBB- and E.ON's BBB rated green bonds.

This trend is reflected in the move by Riksbank to sell liquid sub-sovereign bonds—investments that can offer a relatively high yield and good risk diversification—and take a more holistic view of an issuer's climate risk management credentials and bond terms. Making simple statements in lieu of a credible strategy for investment in green projects and assets is no longer sufficient to entice disciplined ESG investors that are now focused on building a solid track record in the new green bond asset class. These advocates scrutinise the issuer's credibility through analysis of the issuer's strategy, and the issuer's transparency and tracking of the use and governance of proceeds.

Transparency and Clarity Matter

In a market where quality green bonds are in short supply, it is easy to see when a seasoned issuer, like KEPCO, fails to attract high quality ESG investors to its green bond. KEPCO's Green Bond Framework is one of the many generic frameworks IEEFA has seen in the green bond market, and its policies do not go far enough for serious ESG investors.

How KEPCO's Green Bond Framework Compares

	KEPCO	Vena Energy	E.ON
Use of proceeds	To fund or refinance existing and future funding for the development and operations of: renewable energy; clean transportation; energy efficiency; SME support & job creation; and access to essential services projects.	To fund or refinance new or existing eligible green projects under development or operation from: hydropower; solar energy; and wind energy. Eligible projects are defined in accordance with the Climate Bonds Standard established by the Climate Bonds Initiative.	To exclusively finance or refinance the following new and existing eligible green projects, including related partnerships and joint ventures: renewable energy, energy efficiency; and clean transportation. Eligible projects are defined in accordance with applicable national, European and international environmental and social standards and regulations.
Project selection process	KEPCO's Treasury Department, Corporate Planning Department and other relevant departments and teams assess and identify projects that meet the criteria. Only projects that meet one of the two eligibility criteria may benefit from Green Bond financing.	The Investment Committee (IC) pre-approves the selected projects, based on a series of analysis and feasibility studies including environmental impact analysis, financial modelling, and due diligence. The IC also assesses the compliance of pre-selected projects with the criteria defined in the Framework and support the established funding process and financing decision based on financial and technical criteria (project scale, financial return, risk assessment, etc). Once a project is approved by the IC, the Sustainability	The sustainability guidelines and policies, which are in compliance with applicable national, European and international environmental and social standards and the EU directive on the promotion of the use of energy from renewable sources, define the project selection process and minimum standards for the business processes. The Sustainability department (SD) and Group Finance department at corporate headquarters identifies potential projects in the three categories. In

		Committee (SC) verifies the compliance of the projects with the Framework and its eligibility criteria, classifies them into Eligible Projects as defined in the Framework, and validates the final selection of the projects. The SC consists of senior representatives from the Operations Department, ESG/Sustainability Department, and the Treasury and Finance Department. Determining whether a project is eligible requires the unanimous approval of all three departments.	consultation with SD and experts from Energy Networks and Customer Solutions, the Controlling and Finance departments compile a list of eligible projects. SD is responsible for ensuring that eligible projects have no ESG concerns and comply with all relevant company policies and guidelines as set out in the Framework. Finally, a Green Bond Committee (GBC) carefully reviews the list, selects projects, decides how much funding each will receive, and monitors the Eligible Green Project Portfolio which includes: removing projects that no longer comply with the Eligibility Criteria or have been disposed of, and replacing them on a best efforts basis; as green bonds mature, removing the oldest projects for an equivalent investment amount, to ensure that green bonds continue to fund new projects. The initial Eligible Green Project Portfolio will not be older than three years. The GBC comprises representatives of the Sustainability, Energy Networks, Customer Solutions, Group Finance and other parties to be nominated as subject matter experts. The GBC meets at least annually.

Management of proceeds	The Treasury Department shall be responsible for the management of proceeds. Net proceeds will be deposited in its Treasury portfolio. *Unallocated proceeds may be used for the payment of all or a portion of outstanding indebtedness* [emphasis added], and/or temporarily invested in cash, cash equivalents, investment grade securities or other marketable securities and short-term instruments.	The Sustainability Committee is responsible for the management of proceeds and overseeing the reporting. Proceeds are deposited and managed in a dedicated Green Finance Account that will be tracked periodically until full allocation. Unallocated proceeds will be earmarked and managed in cash or cash equivalents accounts by the Treasury Department until full allocation. A list of exclusions was also provided.	Risk management measures in capital allocation decisions are applied and supported by a company-wide planning, reporting and controlling system. Unallocated proceeds will be held and / or invested in its treasury liquidity portfolio (in cash or cash equivalents, money market funds, etc).
Reporting	The Company will provide an allocation of proceeds and impact report on an annual basis, until the proceeds have been fully allocated to Eligible Green Projects.	Until the proceeds are fully allocated: the Company will provide an allocation of proceeds and impact reporting on an annual basis; and the allocation of proceeds will be audited on an annual basis by an independent third party and an annual assurance report on the compliance with all material respects of the Framework will be provided.	Until the proceeds are fully allocated: the Company will provide an allocation of proceeds and impact reporting on an annual basis; and a limited assurance report from an independent auditor will be issued annually confirming that an amount equal to the net proceeds of the bonds has been allocated in compliance with all material respects of the Framework.

Source: Company Green Bond Framework/Report.

Given the rapid evolution of the green bond market, the terms of specific issuances can vary widely. IEEFA found that KEPCO, among a number of green issuers in the market, has sought to retain the ability to use the unallocated proceeds to refinance or repay existing debt. However, it is unclear whether the outstanding debt could include that of ongoing fossil-fuel-based projects of the state-owned company or its related parties.

In addition, governance-focused investors will notice that KEPCO's Treasury and Corporate Planning departments are responsible for assessing which projects meet the definition of 'eligible green projects'. However, the framework has not described, for example, the credentials or capabilities its Treasury and Corporate Planning departments have with sustainable or green projects, how the selection of projects against the eligibility criteria works, or how proceeds will be tracked and segregated from the company's other funds once they are deposited into the 'Treasury portfolio'. These are processes that require sound governance. KEPCO's Framework also makes no mention of providing an independent assurance report on the allocation and management of proceeds at the end of every year until the proceeds are fully allocated.

At a recent investor roundtable,[4] Todd Schubert, Managing Director and Head of Fixed Income Research at Bank of Singapore, commented, "As investors, we must demand disclosure and accountability to ensure proceeds are going to where they should be when investing in green, social and sustainability bonds". A fellow panellist Jean de Kock, Principal, Fixed Income Boutique at Mercer, said, "You have to do a lot of work to understand what [a] green bond is being used for. The use-of-proceeds declaration is often wishy-washy and there's not enough regulation to make sure [it] is consistent."

KEPCO and other companies that have decided to pursue a greener business model should be working hard to demonstrate to the market that they are taking the right steps to align with ESG investors. At this stage, however, it is unclear whether KEPCO has the appetite to seriously transition into a world-class renewable power company and catch up to its ambitions.

Just 10 days after KEPCO approved the acquisition of a stake in the controversial Vung Ang 2 coal power project, the utility company stated at the Korean National Assembly that it plans to cancel or convert the remaining overseas coal power projects in its pipeline into LNG—another fossil fuel albeit less carbon-intensive—and that it has no further plans to pursue overseas coal power projects. KEPCO's first allocation of proceeds and impact reporting is expected mid next year.

One thing's for sure, this is a report that will either make or break KEPCO's reputation with green bond investors.

[4] Virtual roundtable titled, "Giving ESG more credit: how to create resilient Asian fixed income portfolios". October 2020.

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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