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TRANSCRIPT

Deforestation and Coal Death at COP26

Featuring:

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Mike Disabato:

What's up everyone and welcome to the weekly edition of ESG Now, where we cover how the environment, our society, and corporate governance affects and are affected by our economy. I'm your host, Mike DiSabato. And this week, we are checking in on COP26 to talk about two of the big deals made at the conference [inaudible 00:00:16] taking place in Glasgow, Scotland. First, we discussed the deforestation pledge signed by around 100 world leaders. And then we talk about the agreement by countries to halt investment in new coal-fired power plants. Thanks as always for joining us, stay tuned.

Mike Disabato:

This week at COP26, there was an agreement by more than 100 world leaders representing over 85% of the world's forests, saying that they will halt and reverse deforestation and land degradation by 2030. Now, two of the countries with some of the largest tracks of untouched forests, Brazil and Indonesia, voiced dissent on the deal. Brazil's dissent was one of dereliction after its president, Bolsonaro, decided not to attend COP26. And Indonesia's environmental minister, Siti Nurbaya Bakar, called it inappropriate and unfair.

Mike Disabato:

So before we get into how this is going to affect companies, let me break down the deal for you. 12 countries will commit 12 billion in US dollars and public funds from 2021 to 2025 to protect and restore forests, tackle wildfires, and support indigenous rights. CEOs from more than 30 financial institutions will commit to eliminating investment in activities linked to deforestation. And governments that make up 75% of global trade enforce threatening commodities will commit to delivering sustainable trade and reducing pressure on forests, including bolstering support for small farm holders, and improving the transparency of supply chain.

Mike Disabato:

So that sounds pretty good. Okay. So you heard that CEOs and financial institutions are involved in this deal. So how are companies going to be affected by this? I asked my colleague, Leslie Swynghedauw, who covers the impacts of deforestation on the economy to put the whole problem into perspective and then get into how companies will try to address the issue of deforestation to adhere to this possible plan.

Leslie Swynghedauw:

So most tropical deforestation is driven by only four commodities, soya, [inaudible 00:02:24], cattle, and timber. So all the companies that produce those crops or that rely on these ingredients to produce the goods are likely to be responsible for deforestation either directly or indirectly through the supply chain. And the industry that is particularly in the front line is the agriculture and food sectors with more than 80% of tropical deforestation being triggered by agricultural expansion. And you also have to think about other consumer industries, such as the luxury good, or the personal care companies that are also relying on commodities at risk like leather or palm oil.

Leslie Swynghedauw:

And this data is actually confirmed by our controversy database where a large majority of forest clearance allegations that we have identified through our monitoring of news and NGO sources are indeed affecting consumer companies. Beyond the consumer sectors, you also have other industries that are responsible for deforestation, the ones to watch are the industry linked to logging, infrastructures, and extractive projects, because those are typically responsible for the remaining 20% of tropical deforestation.

Mike Disabato:

Okay. So that's agriculture, consumer goods, like the fashion industry, logging, and extractive industries like mining. So hypothetically, if this agreement were to be held up as [inaudible 00:03:49], the industry that would most likely feel the heat the most would be the food industry. The food industry, whether explicitly or implicitly, is involved in a lot of land disturbances as it's sources its products from a supply chain that is opaque and costly to monitor.

Mike Disabato:

If regulation that halted deforestation came into effect, the food industry would have to ensure it's set up systems to better trace where its commodities were sourced from. A prospect [inaudible 00:04:15] by our estimation only few in the industry, those that actually own the farms they contract with are prepared for. But it isn't just the food industry that is at risk due to deforestation, they would just be hit first and most. A lot of our economy is in one way or another tied to the survival of the world's forests.

Leslie Swynghedauw:

For example, some forestry and agriculture assets could suffer premature ride downs as regulation become more stringent on forest protection and greenhouse gas emissions reduction. The other way that this loss could manifest is through deforestation allegations that could trigger reputational risk for the company, and that could lead to losing business partners or clients or customers for that specific company. And we've seen that already for several palm oil producers that were affected in deforestation controversy, or lost their membership to the round table on sustainable palm oil. And I think this is something that also consumer companies have started to recognize as well. L'Oreal for example, evaluated that brand damage due to deforestation allegation could affect up to 1% of its operating profit.

Mike Disabato:

French company L'Oreal made $6 billion in operating profits in 2020, so that's $60 million at risk. To its credit though, L'Oreal is one of the companies that in our opinion, is taking best practice actions to protect their forests in their supply chains, mainly by trying to better trace its supply chain and cut out bad actors. But L'Oreal is in rarefied air there. Supply chains are way opaquer than you might realize. Take cattle. You might think a company that sells beef gets its product from a slaughterhouse, which gets its product from a cattle rancher. So it's a 1, 2, 3 type system.

Mike Disabato:

Well, not always. Not only is beef often sourced from a variety of smaller farm holders, there's even something called cattle laundering, where cows raised on illegally deforested land are shipped to ranches that follow deforestation laws right before they're slaughtered. Making it very hard for the slaughterhouse to tell which cow is legal and which is illegal, or look at palm oil. Palm oil has a number of certification systems set up around it, but usually, they're just to the mill and not to the plantation. So the mill can say, "We got this all from sustainable sources," but no one checks in whether or not the plantation is actually following any best practices. But it's not like companies don't care about this. Many, especially the commodity industry, see the threat to forests as an existential one to their way of business. And so some action is being taken.

Leslie Swynghedauw:

We are seeing growing attentions from companies on this topic. And I think this is mainly driven by the growing pressure from consumers, regulators, and investors that we've seen for the past two years. So how are they doing it? One of the first steps that we are typically seeing from companies when they start tackling these issues is to make a formal statement to commit to zero deforestation. What is important for us as ESG research provider is to verify whether this policy covers all relevant operations from the company and not only one business lines or one commodity at risk. And more importantly, whether that statement or that policy is time bound so the company can be held accountable. Then this policy is usually, but not always followed by programs to properly ensure that it is being implemented on the ground, that it is respected throughout the value chains of the company.

Leslie Swynghedauw:

Depending on the sectors you are looking at, this can manifest through the sustainable certification of raw materials the company sources, it can also manifest through systematic biodiversity impact assessments. Every time the company is developing a new infrastructure, extractive project, or every time the company is expanding that project are also through financial and technical support that the company can provide to farmers and smallholders to avoid forest clearance.

Leslie Swynghedauw:

The other growing initiatives that we are seeing from companies is offsetting initiatives and programs such as deforestation and afforestation to really balance off the deforestation they may have triggered through their operations. But here, we need to be particularly cautious because we like regulatory framework and standards to actually measure consistently the impact of these offsetting programs. And unfortunately, not all forests are [inaudible 00:09:01], so if you are reforesting, I don't know another locations to balance deforestation from rainforest, you may not be able to recreate the same level of biodiversity, and you may not be able to recreate the same carbon sink either.

Mike Disabato:

All this matters for the investment community, because all companies are affected by climate change. And climate change is exacerbated by deforestation, which not only accounts for 10% of the greenhouse gas emissions in our world, but removing forests means we remove the ecological balance that we depend on for our survival. One study by the World Economic Forum put half of our global GDP or 44 trillion US dollars of economic value generation, moderately or highly dependent on nature and its services. There's also the desire by many investors to ensure their portfolios are tied to net zero or low carbon or a variety of climate friendly goals. You see this in the massive influx of assets into climate-friendly investments and the issue of deforestation, an issue that this global commitment is attempting to address, which was signed at COP26, will have to be part of any sustainable finance plan if investors hope to achieve their sustainability goals.

Mike Disabato:

There was another big deal that happened at COP26, one that garnered less attention than the deforestation pledge, and another on limiting methane emissions that we actually didn't discuss today. 46 countries signed on to what is called the Global Coal to Clean Power Transition Statement that said among other things that "the end of coal is in sight." By signing, the country's leaders committed to four points all in the name of transitioning from coal to clean energy. The first was a rapid scale up of clean energy power generation energy efficiency measures being put into place. The second was an agreement to phase out coal by 2030 for developed countries and 2040 for developing countries. The third was to stop building new coal-fired power plants both domestically and abroad. And the fourth was to ensure that the coal phase out was done in a just transition way.

Mike Disabato:

Although 46 countries did sign up for the deal, five countries, the US, China, India, Russia, and Australia, which together account for 75% of the world's coal consumption and coal reserves, did not sign this. But does this mean that coal is safe in these countries, that we're going to be living with coal fired power stations for a lot longer than 2040, despite the agreement? And what role do ESG investors have, if any, in tackling this issue, given the strategic and economic importance of coal for these countries, which may offset any environmental concerns? Well, to help me answer those questions, I called up my colleague, Elchin Mammadov, who covers the energy utility sector for us. I first asked him whether companies were actually ready to phase out coal. And if he thought this step among a series of steps, limiting coal's use across the globe was actually worthwhile.

Elchin Mammadov:

I mean, some companies are ahead of the curve than others, be that shutting their coal plants or selling them. I mean, from an environmental point of view, it's always better if you shut them, but some companies don't have the choice to shut them, even if they want to because of the security of supply, et cetera. So for example, if you are in France, for example, that relies a lot on nuclear. If there are some issues with nuclear, the country generates more than 70% of its output from nuclear power. So you need some kind of a thermal power stations that are non-nuclear to provide that firm electricity.

Elchin Mammadov:

And that's generally coal and gas. Yeah. You do need to build new capacity. You do need to operate that capacity for some period of time to make sure there's no major blackouts, et cetera. So it's not as easy. However, the key concern as we all know is the fact that in Europe and Latin America, it's not where the major coal capacity additions are happening and not even been in the US, to be honest, it's mostly Asia, especially Southeast Asia, China plus India. So that's where a lot of concern is coming from.

Mike Disabato:

And China's continued dependence on coal, which provides 70% of the country's power generation has been put in stark relief a couple times recently. China's day of the output of coal hit about 11.67 million tons on November 2nd, rising around one million tons from early October, close to a record high this year, amid a raft of measures to ramp up production. According to the country's state planner, as told by Reuters. And there was also the electricity crisis in China in October, the worst it has faced in a decade caused by fluctuations in the price of coal and supply issues. It has been fixed now, but it just goes to show that fluctuations in the domestic production of coal in China will create economic and social dislocation. It's the same for countries and regions that rely heavily on coal for their energy production. Countries like India and regions like Southeast Asia. Investment has slowed in the west when it comes to coal-fired power plants, but due to a variety of reasons have remained high in the east.

Elchin Mammadov:

The fact that we're seeing very little investment in Western Europe and the US, when it comes to new coal-fired power plants, it's partly the function of the markets that the investors don't want the companies that they invest to plow more money into coal. I mean, you have a similar trend going on in oil and gas space as well, but when it comes to Southeast Asia, the problem there is that a lot of these companies, they're either state-controlled or state-owned like China, India. So yes, investors can influence it, but it's more you can influence it more in terms of the debt market. So when these companies issue new bonds or when it comes to ensuring these assets. So a lot of insurance companies are increasingly saying, "Okay, we're not going to be investing in reinsuring coal and fossil fuels." Unfortunately, the banks and these [inaudible 00:15:28] insurance companies, they're very slow at cutting the support for fossil fuels, but there's been some progress recently. It's just not fast enough.

Mike Disabato:

Not fast enough according to agencies like the International Energy Agency and OECD Intergovernmental Agency that issued a joint call in October for a halt to approvals of new coal power plants, unless they're fitted with systems that capture their carbon emissions before those emissions are released into the atmosphere. Which companies like Equinor, BP, Exxon, [Sonam 00:16:00], and other energy companies have invested in to position themselves for a low carbon future. And that's really the momentum here. Investment in general, in new coal-fired power plants are some 80% below what they were five years ago, which is exactly what this ruling at COP26 calls for. Signatories to the agreement committed to ending all investment in new coal-powered generation domestically and internationally. But that doesn't ask for countries to begin transitioning themselves away from coal by retiring or update their already running coal-fired power plants. It just asks them to halt building new plants, which we will see if that actually happens.

Mike Disabato:

Aside from the obvious emissions discussion, what makes this so tricky as an ESG investment story is because utilities are an odd sector of investment. For one thing, utilities generate reliable earnings that allow them to pay investors above average dividends. So even if they don't reinvent themselves to become low carbon, they could still provide investors with returns. And as we have already discussed, utilities, power utilities especially, are needed to ensure the smooth running of our economies in our societies. They're not going to become stranded anytime soon. To add to all of that is the fact that these utilities are co-owned by government. So even if the investment community moves away from coal and a region still needs coal, coal is going to stay until governments move away from it.

Elchin Mammadov:

Yeah, absolutely. And it's some kind of a... It's some sort of a government subsidy in a way, which is what renewable energy sector always complains about, the fossil fuel subsidies there, like in many countries, they're several times higher than what the renewable subsidies are. So yeah, it's definitely going to be agenda set by the government and it will be more or less financed by the government either directly or through these state-controlled utilities.

Mike Disabato:

Yeah. So it's going to be challenging for finance to push these targets forward that a lot of the industry wants to see happen and are behind. It might mean the financial community starts to work hand-in-hand with policy makers and other groups, or it might be something that is tried and true and we've talked about a lot, that the financial community continues to make a market for low carbon energy sources, which will drive down the cost of things like solar and wind and batteries until they can be as stable form of energy as coal is. Regardless though, what these meetings that COP26 are showing is that coal is on the cutting block and investments in the commodity are getting riskier by the quarter. And that's it for the week. I wanted to thank Elchin and Leslie for talking to me about COP26 with an ESG lens. I want to thank you so much for listening. If you like what you heard, don't forget to rate and review us and subscribe if you want to hear me every week. Thanks again and talk to you soon.

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