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TRANSCRIPT

Coal Expansion and SEC's Big Climate Move

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 have two stories for you. The first is on why our world continues to be awash in coal, and why there are currently coal expansion projects being proposed. And for the second, we give you the MSCI ESG research hot take on the new SEC proposal to enhance and standardize climate related disclosures for investors. This is a big one, so you want to stay tuned for that. Thanks as always for joining us. Stay tuned.

As global CO2 emissions rebounded to their highest level in history in 2021, there was one action that most of the scientific community agrees is necessary to prevent catastrophic global warming, but can be difficult in areas that are heavily dependent on it. The immediate phase out of coal. Everyone from the intergovernmental panel on climate change, to the international energy agency, to the United Nations says, "We need to stop using coal immediately, and we definitely shouldn't develop any new coal fired power plants or expand coal mines." Yet, that is exactly what the world is doing.

In our most recent Net Zero report published in March 2022, we found that not only is the world awash in coal, but it is expanding that coal capacity. So, why is that? Is it political malfeasance or operational difficulties when moving away from coal? Is it necessity versus idealism? And how should investors react to the continued presence of coal in their portfolios? To help answer some of those questions and others, I called up one of my colleagues, Sylvain Vanston, who worked on the Net Zero Tracker report, and I asked him to first do something for me that he doesn't usually do, to defend coal.

Sylvain Vanston:

Coal remains fairly cheap. It's available, it's flexible. It enables you to have a base load capacity in terms of power, notably, as a backup for intermittent power, typically renewables. And many countries are awash with coal reserves, coal mines, and an existing fleet of coal plants. So, it is always very tempting to use those plants when you have them at your disposal, despite the governed intensity of those coal plants.

Mike Disabato:

It's easy to forget the importance of coal for our industrialized world, and the importance extends into jobs. In regions where coal mining takes place, especially into developing markets, the effects of a transition away from coal can cut very deeply, especially in small remote mining communities where the local economy depends on coal for its wellbeing. So, that is hard for a government to navigate at a time like this. And it might be one of the reasons why governments haven't been quicker in removing their coal fired power plants from operation, because it's not like they don't know what's coming down the pike.

Only in the US is there a political party that denies the existence and threat of climate change. A majority of the world's governments understand the threat that climate change poses to our existence and want to do something about it. And coal has relatively more substitutes for it than say, cement does, which is another equally as important but high emitting carbon product. Yet, coal is still not a thing in the past, and it's actually being expanded upon by a number of companies and governments that have pledged to lower its use, such as China.

Sylvain Vanston:

Sometimes, I think China is half of the problem and half of the solution. Investments in renewables in China are massive. Investments in coal, including new coal expansion, are massive as well. It's pretty clear that China needs ever more energy supply, and coal is still part of the answer. Something which went a little bit unnoticed is that China also announced, for example, the building of a significant amount of new nuclear power plants in the next 15 years, both in China and abroad. And at the same time, they are still opening new coal plants because the demand for power is that big.

Mike Disabato:

Officially, China aims for non-fossil fuel sources to account for 80% of the energy mix by 2060. To do this, they plan to begin reducing the use of coal in 2026, and expect to reach a plateau of oil consumption before the end of the decade. However, China is also worried about a stable energy supply for its growing population. You may remember last year when China faced a coal crunch, that left a large portion of the country without power which jeopardized lives and livelihoods. That left the government worried about energy stability, and since China is still so dependent on coal, it meant coal was going to get more support until they could figure out how to meet the country's energy demands without these massive fluctuations in availability.

So the China Development Bank pledged to increase the support of coal, upgrade existing coal mines, and increase the capacity of their coal fired power plants. And that situation is kind of borne out in our Net Zero Tracker report that lists the major coal companies throughout the world, and shows which have expansion plans. And the Chinese State controls six of the top 10 largest companies by proposed coal expansion and megawatt hours. That includes China Energy, China Datang Corp, China Huaneng, and China Huadian. The other four on that list are either in India or Indonesia. So of those 10 of the largest companies by proposed coal expansion and megawatt hours, nine of them are state controlled. These expansion plans account for 139 gigawatts in new coal production.

That is much more than the 870 gigawatt hours of coal production that needs to be shut down by 2030, if we're to limit global temperature rise by 1.5 degrees celsius, according to the International Energy Agency. And that top 10 list only accounts for 29% of the new coal expansion plan for the world in 2022 and beyond. So, there's a lot more than what we've shown. But let's discuss the ownership dynamics of that top 10 list, because as I said, 90% of it is state owned. Which actually isn't that surprising, but it does have interesting effects on investors and shareholders of those companies, because they do have shareholders. Just because they're state owned, doesn't mean they aren't publicly traded and you can't buy shares in them.

Sylvain Vanston:

Infrastructures, utilities are state owned... Or at least, partly state owned. So we can see this again in the energy, in the power gen sector. What happens there, of course, is that private investors have much less of a voice over the fate of those firms. They can't really engage them, at least not as equity holders. Maybe, some of them are emitting debt. So if you are a bond holder in those companies, then you could still engage with them as a bond holder. That also shows that those companies will depend totally, or at least very significantly, on the course of action and the policy decisions taken by their own governments. Well, so investors can, for example, join alliances such as the Asset Owner Alliance, the Banking Alliance, or the UN-PRI, and lobby for policy changes in groups that are designed to do this. But there's expansion plans pretty much everywhere, including in Europe, in North America. So, it's happening everywhere to various degrees. And here, you'll find a mixture of state owned, but also much more prominently, privately owned companies with whom engagements can be efficient.

Mike Disabato:

We've always had a list of companies in our data arsenal because that's what our business is. What is different about this analysis is we teamed up with an organization called Urgewald to use their global coal exit list. By the way, I'll link Urgewald's global coal exit list in the description of this podcast, as well as the Net Zero report if you want to check it out after listening. But what Urgewald does is it tracks where these coal expansion plans are happening in the world. It puts out publicly available data on who is planning it, where the projects are being planned, and how much wattage will likely come online. And it's fascinating because we can use that list to see what kind of world coal companies assume they can operate in, in terms of temperature rise. Remember, if we want our ecological systems to function normally, we want temperature rise to be below 1.5 degrees celsius ideally.

Now, we're going to blow past that probably, most scientists say. So at the most, we want to limit temperature rise to two degrees celsius. But here's the kicker. If you take those expansion plans into account that Urgewald has given us, and you look at the emissions trajectory of the largest coal producers in the world, you see that most companies on our list think they are going to be able to operate in a world that can handle over nine degrees celsius of warming. So, we calculated this using what is called an implied temperature rise. And I tell you that because Sylvain mentioned it, so I want you to know what's coming. But we need to give a quick spotlight sidebar here, because the coal industry is not a monolith. There are some companies in the industry that are heading the warnings of a warming world and making changes. One such company is AGL Limited, an Australian listed company, that is operating in a manner that would keep temperature rise below two degrees celsius.

Sylvain Vanston:

That makes them in line with the goals of the Paris Agreement. Why is that? Mostly because they are really transitioning away from coal into renewables and they have made some really ambitious commitments to decarbonize. Well, when you put these two together, that produces a low temperature ITL score.

Mike Disabato:

So AGL stands alone on the top 10 list, but there are other examples of this. And basically, what we were saying here, why we had that sidebar about AGL, is that the coal sector is not a monolith. There are certain companies that are planning expansion plans that should be looked at, and we need to understand why they're doing that and why they're moving in the opposite direction of what has been recommended by basically all of the world's scientific community, and what was explicitly agreed upon at COP26 during its coal phase out clause that was signed at the end of the meeting, that called for the end of coal as we know it. And it puts into stark relief for investors in the rest of the world, the reality of what is happening in the energy system even as we see shoots of green growth happening throughout the world.

Sylvain Vanston:

I think this probably shows that many of us in investment industry tend to think that renewables will trump everything and it's an unstoppable march for low carbon power. That is not really unfortunately yet what is happening. We can also see it again in the International Energy Agency figures and reports. And that alone should be a concern to us all because if we can't decarbonize energy, we cannot decarbonize the rest of the economy. If we can't displace coal, which is a technology that is relatively displaceable, say for example, compared to airlines or transport, there are alternative power sources. They are maybe more costly, more complicated, but they exist. Then if we can't decarbonize the power sector, then we're sure to fail climate neutrality. And that has severe consequences because this will be irreversible climate change.

Mike Disabato:

So, we can now do a parallel move from coal to carbon emission disclosures. In the US, the security and exchange commission, the SEC, issued a 500 plus page proposal rule this week that would mandate corporate disclosure of greenhouse gas emissions. The SEC said its intention was to ensure companies disclose their climate related risks in a fair and consistent manner. The SEC chief, Gary Gensler, said in an interview that, "This data is now considered material. Climate risk data is now considered material investor information by the SEC." That's a big use of material there. And so, it should be standardized like other investor material information. The quick overview of this 500 page report is that companies are required to disclose climate related risks and the impact climate change will have on its core business. They need to share emissions data.

This includes the all important Scope 3 emissions data, if it's important for the company, and the data would have to be vetted by an independent auditing firm before it could be accepted. If you have publicly declared some sort of climate related plan in this clause, you would then need to specify what it is that will get you there. You cannot just say, "We have a net zero plan," and move on. You need to say whether or not you're going to use carbon offices, for example. As with all proposed rules by the SEC, this has a common period for the next 60 days. And so, the plan is definitely going to go through changes before final vote is held to finalize the rule. But the rule is a huge deal for the financial markets. And so, we want to give you a quick take on the matter, which, don't worry, we will follow up once the rule is finalized. To do that, I called up our global head of ESG research, Linda Eling-lee, and asked her to give me her initial impressions.

Linda Eling-Lee:

So, Mike, this proposal has been hotly anticipated throughout the investment community for about a year at this point. And at first glance, at least to me, it was well worth waiting for. I do have to clarify that my generally positive take on the proposal comes from the perspective of investors, especially long term investors, because we know that investors have really struggled with having consistent data from issuers on climate risk, which they really need to make capital allocation decisions differently in order to account for climate risk. I could imagine that issuers may actually have a less positive take on this proposal. In any case, right off the bat, what I was really especially looking for when the proposal was published were three things. One, whether Scope 3 would make it into the proposed disclosures. And it did, which is, I think, a big step forward. I have some reservations, I think, about who discloses what on Scope 3. But overall, I think this is a big positive.

The second thing I was looking for is whether disclosures that are related to physical risks. So companies' vulnerabilities to extreme weather, for example, whether that would be proposed in such a way that would improve our ability to provide more accurate projections, given different climate scenarios. Now, there were a number of places that exposure to physical risk was included in the proposal, but it's a bit complex in terms of the balance between qualitative narrative disclosures versus quantitative metrics. So for me, the jury is out on this one until we can actually analyze the fine print in the 500 plus pages of this document when it comes to physical risk. And then finally, I was looking for where the climate disclosure would have to be made, whether it's in the financial filings and financial statements, or outside of them.

So most of the disclosure such as the emissions data, et cetera, which are going to be the most useful, seem to be in a separate disclosure from the 10-Ks and Qs and so forth. But there are actually a few items that will be required in the financial statement footnotes. So again, we're going to be digging into that to better analyze the details. But I do think that having any climate related disclosures in the financial statements would be a big deal, and that really raises the bar on what companies will need to pay attention to. So Scope 3, physical risk, and financial statements, that's what I was looking for. But what I was not expecting, which I actually found super interesting, is the proposal on climate related goals, that companies that set carbon reduction goals, for example, would have to disclose more details about the timelines, and about how it actually intends to meet those targets, whether it's going to count carbon offset and so forth, as well as importantly, annual progress against those goals.

Now, the headlines that I saw immediately following the proposal were all about Scope 3 or value chain emissions. But to me, what really jumped out was this proposal on disclosures around the carbonization goals. I really think this could create some very interesting dynamics on whether companies will be more incentivized or less incentivized to publicly declare climate goals. But equally, I think if this is adopted, it could be incredibly helpful, really kind of a game changer to investors who are trying to project forward the trajectories of the investments in terms of their alignment with a low carbon or net zero economy. So, this one really I think is really interesting and really quite progressive.

Mike Disabato:

So I just want to remind everyone again, that even if the final rules are adopted in 2022, there would be a phase-in period for companies of all sizes, and an additional phase-in period for Scope 3 greenhouse gas emissions. But is there anything else in this proposal, Linda, that surprised you in any way? I know you already mentioned one, but is there anything else?

Linda Eling-Lee:

Oh, yeah. So one other thing that I was a little surprised by this is a... The proposal for Scope 1 and 2 emissions reporting will need to be assured in some way. So, this one I really did not see coming. I think the auditing firms are probably pretty happy about that as a new line of business.

Mike Disabato:

Yeah. I actually think that would be a reinvigoration of the accounting industry, if you could be a climate data accountant or a verifier of climate data. So this regulation deals with the companies that are in the US, and there are roughly 2,500 companies in the MSCI US IMI index, which we, and many other investors, use as a barometer of United States publicly listed companies. 21% of these companies have set climate targets. Does this mean that 79% of companies are going to have to institute some sort of data reporting system that stands up to auditor scrutiny?

Linda Eling-Lee:

From what I can tell, I think the proposal doesn't actually compel companies to set climate related goals. But to the extent that the 20% or so that have... And more, I think, will be pressured by their investors and bankers and even potentially insurers in the future to set these types of decarbonization goals. They can't actually just put a goal out there that they will go net zero and then leave it at that. They're going to actually, from these proposals, have to disclose the plans for how they're going to achieve those goals, and then the yearly progress against that goal. And honestly, I think that's pretty huge.

So MSCI has, as you know, developed a decarbonization scorecard for the 9,000 plus companies in our ESG coverage. And I can tell you that from our analysis, there is just such incredible inconsistencies in how companies actually set and report on their targets. It's pretty much impossible today for investors to compare those goals and compare the progress against those goals without a lot of sophisticated modeling and analysis. So, I'm really excited to see this and see whether or not this part of the proposal actually gets adopted. I think it will actually make some fairly significant inroads into the kinds of information that the investors are going to need as they reallocate capital for a net zero economy.

Mike Disabato:

And that's it for the week. I want to thank Sylvain and Linda for talking to me about this week's news with the [NZE 00:21:19] twist. I wanted to thank you for listening. I really appreciate it. Truly, I do. If you like what you heard, don't forget to write and review us. That puts us higher up on this. Some more people can listen to us. And if you want to hear me every week, don't forget to subscribe wherever you get your podcasts. Thanks again, and talk to you next week.

Speaker 4:

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