TRANSCRIPT

Uyghur Forced Labor Prevention Act and the US Supreme Court

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 effects and are affected by our economy. I'm your host, Mike Disabato. And this week we have two stories for you. First, we're going to discuss the operational guidance recently put out by the U.S. Customs and Border Protection for the Uyghur Forced Labor Prevention Act. And then we discussed the ruling by the US Supreme Court that truncated the EPAs ability to regulate greenhouse gas emissions. Thanks as always for joining us, stay tuned.

Mike Disabato:
The Uyghur Labor Prevention Act was signed into law by US President Biden on December 23rd, 2021. The law attempts to strengthen the prohibition against the importation of goods made with forced labor. In this instance, by blocking entry to the US any goods, wares, articles and merchandise, mined, produced or manufactured wholly or in part in the Xinjiang Uighur Autonomous Region of the People's Republic of China. If you're unaware, Xinjiang has been at the attention of US policy makers since around 2018, following reports of the mass internment of Uighurs in "reeducation centers" in China. The politics of this law is not what we're going to get into today. What we are interested in is how this law is going to be enforced. And this week, the commissioner of the U.S. Customs and Border Protection, the entity that will be enforcing this law, released the CBP's guidance on how they're going to be doing that.

Mike Disabato:
And it's all about supply chain transparency, which is under the 'S' pillar of ESG. So, first today, we're going to look into what industries are going to be impacted by this law and then we're going to dive into one of those industries in detail, the textile industry, to be specific. Remember though, this is part of a string of import/export controls that the US has enacted against China over a number of years. So I asked Miranda if she could first give us a quick note of context before getting into the new.

Miranda Carr:
The main point about this act and its implementation is that this increases significantly the risks in quite a number of different sectors. Originally, a lot of the targeting of the products from Xinjiang and any companies that were operating in Xinjiang, mainly concentrated on certain sectors. So cotton, Xinjiang produces about 22% of the world's cotton supply, agricultural products, as well as things like solar technologies and technology

and hardware. And this was companies that either were directly sourcing from the region or had operations and factories in the province itself.

Mike Disabato:
These were easy connections that could be made to a small number of companies that immediately came under fire by their shareholders. Volkswagen still has a manufacturing facility in the province that produces a small number of cars sold in China. It has been under scrutiny for some time by both its investors and the German government for it. The Washington Post reported that Apple was actually lobbying against the passage of this Uyghur Forced Labor Prevention Act back in 2020, after it was alleged that the company was heavily dependent on Chinese manufacturing and Human Rights Reports identified it as having used alleged forced Uyghur labor in its supply chain.

Mike Disabato:
Apple has denied these, but has tried to fix its supply chain nonetheless. This new law would make it necessary for Apple to prove that none of its products were manufactured using forced labor if they were going to come into the US. And now more companies are going to have to do what Apple and Volkswagen has to do if they want to import those products made in Xinjiang into the US. Because the Uyghur Forced Prevention Act broadens the scope of companies that can be seen as having a possible tie to the region.

Miranda Carr:
And this means that any company which has any product, which could be sourced from Xinjiang is then presumed to be using forced labor. So this means that whether you have direct manufacturing in the province, whether you have suppliers in the province, but even over and above that is whether you're potentially sourcing goods, which may have been produced in the province, but are sold elsewhere, means that you could be targeted or could have goods detained under this act. So if you've had something which was transported, manufactured in Xinjiang, but then maybe transported to the rest of China for then final export, then you still need to be able to trace that back to the source and prove that was either not made in Xinjiang, or it was definitively not using forced labor. Because the assumption is that anything which is produced in the province will now be, and that's why it becomes a much, much broader, much wider, much, much more problematic for companies who are potentially going to be facing these risks.

Mike Disabato:
So as a company, you need to prove to the Customs Border Patrol, the CBP, that your supply chain is clear of force labor. And the US CBP has told companies how they can do that when they've issued their guidance this week. They say importers just need to demonstrate due diligence, effective supply chain tracing, supply chain management measures that ensure they do not import any goods made in whole or in part by forced labor, especially from the Xinjiang region, which at first blush doesn't seem that bad. How hard is it for a company to know where it's buying its products from? Well, we will get into the difficulty companies have with supply chain transparency in our modern economy in a moment, when Liz comes on to talk about the textile industry. But before that, I just want to reinforce how broad this is going to be, because a lot of companies are indirectly intertwined with China and especially with the Xinjiang region, which I know Miranda agrees with because I'm just mimicking what she told me.

Miranda Carr:
Well, yes, because Xinjiang is a huge province and it's a very sort of agricultural and mineral rich province as well. As well as the cotton and the agricultural products, you also have quite a high degree of mining. And also the interesting thing is in the auto parts and the technology hardware. The Chinese government for quite a

long time, has done a go west policy, where it tried to encourage companies to set up, instead of in the Eastern provinces of China. They would get encouragement and subsidies in order to set up in the much poorer Western regions. And so you did actually have quite a lot of Western companies, either going to places like Xinjiang or going to places like Shangdu and [foreign language 00:07:09] in the Western provinces to set up and benefit from the cheaper manufacturing there.

Miranda Carr:
And that's why you have quite a lot of the suppliers in the region in places, like sort of the auto parts and the technology hardware, which you wouldn't normally associate potentially with the region. But because it's been part of the sort of the government's process of encouraging development in the region and economic development overall, then you've actually got quite a lot of pockets of specialist manufacturing there, which then will affect quite a number of the high tech sectors, as well as things like the textiles and the agricultural sectors, which are going to see an impact as well.

Mike Disabato:
That is the overview. UFLPA has broadened the possible companies that could have their goods turned back at us ports. The burden to proof is now more on companies to show that they have supply chain transparency. And it's likely that a lot more companies than currently disclosed have some sort of indirect tie to manufacturing in the Xinjiang region, due to both China being basically the world's factory and policies in China that encourage more manufacturing in its Western regions, such as Xinjiang. Let's now dive into the details here. What would it look like for a textile company, for example, to meet the requirements set by the U.S. Customs and Border Protection?

Mike Disabato:
For this, we're going to assume that the CBP is going to ask and practice what they said they would ask for in their guidance document. Evidence of supply chain transparency and management through due diligence practices and things like that. And remember, the reason I say, we're going to assume, because the guidance for this law just came out earlier this month, June 13th, to be precise. So there isn't much empirical evidence yet as to how this is going to play out. So what I did is I called up my colleague, Liz Houston, who covers the textile industry for us. And I asked her simply, how many companies that are clothing manufacturers actually know where their raw materials come from?

Liz Houston:
Very few, if you think about the journey that a piece of clothing goes on to make it all the way to your back. So let's imagine you have a lovely shirt that starts off at a farm level. That's cotton, that's farmed. It's then turned into bales of cotton, which is spun into thread, which is woven into fabric, which is dyed. It's treated, it's maybe coated. You've got polyester thread that will turn it into a garment because thread isn't made of cotton so that comes from somewhere else. You've got maybe embellishments, you've got buttons, you've got zips. And then finally, you've got a factory somewhere that cuts up all those pieces, sews them together and makes you a garment. And then maybe they send that directly to the US. Or maybe there's a third party that does a form of kind of middleman work that sources goods locally, and then sends them to the US.

Liz Houston:
So there are huge numbers of touchpoints within that supply chain and good apparel companies know all of their tier one suppliers. So the cut, make and sew, and a good portion of their material suppliers, like all the stages of material production, I would say very few know the details of every single touchpoint in that supply

chain, particularly post pandemic. Because given the supply chain disruption that we've seen, a lot of companies are saying that their supply chains don't look the same as they did two years ago, everyone was desperate for goods. People had to make changes. And now a lot of them are playing catch up to figure out who actually is producing the particular blue, shiny button that's now on the shirt. That's maybe different to the blue, shiny button that was on your shirt two years ago.

Mike Disabato:
So kind of the opposite of transparency, more so ambiguity, which actually I'll say for our research is really annoying. For example, I wanted to research what farms in the US might not be able to grow their crops in the next decade due to the change in climate. And so the companies that rely on those crops would've to switch up their suppliers or be at risk. But when I looked around, no one has data on which farms are used by which companies in the US. You'd basically have to do something like get to the bank loans that these farms get in order to see who is backing the loan via produce purchase plans. So it's really tough and companies don't yet really have the resources to make it happen. So does this mean for this law that no company can really adhere to the best laid plans by the U.S. Customs and Border Protection?

Liz Houston:
So if you are really big, it becomes easier to have direct relationships with all of the companies in the supply chain. So once you are big enough, you can source your own fabric directly. Some companies work directly with cotton farms. There are industry bodies that help the industry work directly with farms. So even if you are smaller, maybe that industry body will do it for you. A lot of this so far is based on kind of voluntary movements towards tackling the opacity of the supply chain. It's not clear from the outside that anybody has the level of detail that's potentially being asked for in this legislation. But it's something that more and more companies are going to have to work on getting. Because this is just one piece of legislation in a broader move towards mandatory supply chain due diligence.

Mike Disabato:
That could be especially true for textiles in the US, which has to contend with both the Uyghur Forced Labor Prevention Act. But also there is the New York Fashion Sustainability and Social Accountability Act, that if passed in the New York legislature will be the first US law to explicitly place sustainability requirements at the feet of large fashion companies. Companies subject to this act in New York would have to not only map at least 50% of their supply chains, but they would have to report on the social and environmental risks that their supply chains face. How regulations will play out though, are tough to predict overall and they could sometimes hurt those that are trying to help. But what the Uyghur Forced Labor Prevention Act and the New York Fashion Sustainability and Social Accountability Act point toward is a need for greater supply chain transparency. And with that need, hopefully solutions will follow.

Mike Disabato:
For example, if there are already murmurs of blockchain being used to assess the volume of, say organic cotton grown in an area, regulators can then check that area's report volume with how many organic cotton shirts are made using that region supply claiming to use that region supply. Volume assessments are actually one of the things that the CBP says it might use to check if a company is using raw materials or products from Xinjiang. Their guidance document says that they will look at evidence that the volume of inputs of component materials matches the volume of output for the merchandise produced. There are also more advanced systems being developed, where companies could use the molecular structure of a commodity to see where it was actually grown by cross checking their product with the molecular structure of a native plant. This will all require a lot

of capital to complete. But there does seem to be a new willingness in our world to make supply chain transparency more of a reality.

Mike Disabato:
As we record this on June 30th, the US Supreme Court has ruled to limit the Environmental Protection Agency's ability to restrict carbon emissions from power plants. It's another disruptive ruling this week by the US Supreme Court. The first was the overturning of Roe versus Wade, effectively ending the federal right to abortion that was upheld in the US for decades. We don't talk about Roe versus Wade this week, but we did do an episode on May 6th on a board efficient manufacturers after a memo was leaked from the Supreme Court that signaled the probable overturn of Roe versus Wade. And if you want to take a listen to that, I suggest you do it. But to give a quick take on the EPA ruling, I have with me, Matthew Lee, who covers the utility sector for us. And so Matthew, tell me what this ruling from the Supreme Court means in practice.

Mathew Lee:
Mike, so in plain speak, this method that was proposed under the Obama Administration under the Clean Power Plan of setting emission standards for power stations has been ruled by the court to not be legal. So that means looking ahead, we'll have to consider what are the other regulatory options that still are available and feasible as well as where the market is already moving, maybe perhaps ahead of the pace of current legislation. But the ruling today just says that what was proposed in the Clean Power Plan, which by the way, is no longer enforced, has been struck down, was not legal. So in fact tomorrow nothing changes on the books because there is no Clean Power Plan that's enforced anyways right now.

Mike Disabato:
What this does do is it removes the Biden Administration's ability to bring back the Clean Power Plan. That said by 2025 or by 2029, power plants have to already be decreasing their emissions by a certain pace. So that tool is no longer available and this has been such a big deal in the US because that tool is seen as a major one that could move the power sector in the US quickly and kind of uniformly. So what do you think is next for the energy sector in the US after this ruling?

Mathew Lee:
Let's take a step back and say, what are the regulatory implications for the energy sector? And so there are other options that can still pop up. So obviously Congress can always pass new legislation or the EPA can rely on some current air pollution provisions. Which actually in March, the EPA administrator had already said that he is aware that this ruling may come down against the EPA and plans to pursue other types of rules specific to coal plants, such as smog, other air pollutants, mercury, [inaudible 00:17:45] of waste into water systems. These other types of regulations that exist at specific to power plants that can raise the cost of operation and compliance for coal fire power plants, and still speed up, essentially, their closure.

Mathew Lee:
And even without these new rules in place, we're already seeing these types of rules giving companies a hard decision in terms of whether or not to keep operating their coal fire power plant. So Ameren Utility decided earlier last year to move towards phasing out its Rush Island power plant. One of its major coal plants due to the EPA slapping a large, sorry, the EPA ruling that they would have to install more smog scrubbing technology for it to continue operating. Due to Russia/Ukraine, they've decided to continue operating the plant for now, but it has bumped up the timeline of phasing out that plant specifically.

Mike Disabato:
So this EPA ruling is similar to Roe versus Wade, in that it effectively puts the decision to lower emissions in the hands of the state. So states still have their emission reduction plans in place.

Mathew Lee:
Definitely. So don't forget that state level policies like renewable portfolio standards are still going to be in place. Whatever is not, I think, states' rights that term we hear getting thrown around a lot, really is going to drive quite a lot of action and continued commitment towards renewable energy transition. But don't forget market forces, too. The top states in terms of install capacity percentage for renewables are actually Iowa, South Dakota, New Mexico, Kansas and then the top 10 also states like Texas. So the market is already moving a lot of states towards adopting renewables, whether or not state level policies are demanding.

Mike Disabato:
Last but not least, how are investors impacted by this ruling? Does it change perceptions? What's going on there?

Mathew Lee:
I think this doesn't affect the momentum from the investors demanding more energy transition related planning and disclosures for energy companies. Why? Because we have to remember two sides of the coin, even if carbon emissions related regulatory risks seem to be slightly lower as a result of this ruling, as we've discussed just now. The state level, other new legislation or subsidies or EPAs, other rules could still come into play. But the flip side is opportunities in renewable energy, which a lot of investors are really excited about and see this as an important growth prospect for energy companies to diversify their generation fleet in. And so falling behind there can still be a factor for investors to shift their evaluation of a company. I think what's going to become key now is that there's going to be this zone of uncertainty between a company saying, I want to be net zero by 2050 and having a real push to make interim progress as a result of no immediate legislation pushing them.

Mathew Lee:
So investors may want to demand more scrutiny in terms of reviewing company's interim net zero plans, as well as taking a look at their capital expenditures and generation planning to see how they're shifting in a five year span in the next five years, next couple of years, versus just the 2050 to evaluate progress. I think from a broader net zero alignment perspective, the slowdown is quite concerning for the world. The US power sector alone, which is 25% of the US' emissions. If you quantify that would be the fifth largest emitting country in the world, still ahead of Japan, Germany, South Korea, Indonesia, Canada.

Mathew Lee:
So it is contributing a lot to the warming potential of the world. And so if this ruling does stall progress towards that, we can be moving towards what I think the industry is now like to call a disorderly transition. So rather than the gradual shift to renewables, which has the least volatility and disruption to our economy, if we do make a net zero line transition, it could be more disorderly if this pushes back the timeline of us moving towards renewables. On the other hand, the physical risk side of climate change, the more certain that we are on a path towards exceeding that 1.5 C, more towards that two degree Celsius threshold, the more likely those effects are exacerbated and affect all companies and investors.

Mike Disabato:
We are all tied in with the dismal tide that this might bring. And that's it for the week. I want to thank Miranda and Liz and Matthew for discussing the news with an ESG twist. I wanted to thank you so much for listening. If you like, what you heard, don't forget to rate and review us. That helps us a lot and I really appreciate it. And don't forget to subscribe so you can hear me every week. Speaking of every week, we are going to be off next week for a little summer vacation. And we will talk to you again, after that.

Speaker 5:
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