The Sustainability Debate: A Question of Survival for Companies

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While the international community of nations, the national governments, regulators, institutional investors and experts have been talking about the need for commitment of business corporations towards Environmental, Social and Governance (ESG) goals, many thought it to be just a new fad and an irritant requiring mundane disclosures and lofty paragraphs in corporate communications. However, since the beginning of 2020 a confluence of forces have generated a strong and irreversible push towards companies having to have an early sustainability focus. Repetitive extreme-weather conditions across the globe, threat created by the COVID-19 pandemic, disgust at callous corporate behaviour, raising of voice by investors, analysts, advisors and consumers and sustained work by scientists, engineers and experts have created this momentum.

For the first time anywhere in the world, a judicial court in the Netherlands invoked the duty of care obligations regarding human rights of those affected by climate change to rule that the planned reduction in greenhouse gas emission by the Royal Dutch Shell was not sufficient and that it would have to accelerate the same. For implementing this order the group is estimated to cut oil and gas production by 3% a year and reduce the sale of petroleum products by 30% by 2030.But, against all anticipation that the company would appeal in a higher court against this order, interestingly, the company decided to refrain from filing an appeal. In the proxy season in the USA this year an activist shareholder having only 0.02% share in Exxon Mobil mounted a campaign that the company does not have enough focus towards sustainable environmental practices and it was able to mobilise support from the likes of BlackRock, Vanguard and State Street to force the election of three nominees to the Board of Directors of the company and rejecting the election of three existing directors. The shareholders of Chevron forced upon the management a resolution to set a strict emission targets from the product that it sells. The International Energy Agency (IEA) came out with its findings in May 2021 that if the Paris Climate Goals were to be achieved, all new oil and gas project will have to be stopped right now. In the same month, the German Cabinet approved a law, which required all coal- fired plants to close down much earlier than the target date set up only 18 months ago. The Group of 7 countries in their meeting this year reiterated their commitment towards controlling temperature rise to 1.5 degree Celsius and to end new direct government support for thermal power generation. In India, the SEBI came out with a new set of Business Responsibility and Sustainability Reporting (BRSR) requirement, which is more detailed, quantitative and comparable than the erstwhile Business Responsibility Reporting (BRR). This will be mandatory for the top one thousand companies from the next year. The International Integrated Reporting Council (IIRC) in the UK and the Sustainable Accounting Standards Board (SASB) in the US formally decided to merge under the IFRS umbrella to provide internationally comparable reporting standards on sustainability.

Investor's Pull

Workers saving for their pensions do not want their investment go into companies whose tailings dams can burst and cause hundreds of deaths in Brazil or destruct an ancient site of aborigines for some extra bit of coal reserves. People buying insurance policy for their life do not want business corporations to pollute the environment, damage their lives and those of the future generations. There is serious scrutiny and unprecedented pressure on the fund managers from their own constituents as to how money is being managed not only for returns but also for wider impact being created on the society.

In the next decades, most of the wealth will transfer to millennials- likely to be in trillions of dollars. According to a survey conducted by Fidelity in 2019, millennials are angry about the economic and environmental mess created by previous generations. Their social and investment behaviour is vastly different from those of the older generations. The percentage of millennials calling themselves philanthropists is more than twice the percentage in baby-boomers who called themselves philanthropists. This generation has a holistic view towards consumption, career choices, financial choices and philanthropy rather than treat each of these in separate silos. 87% of them want to work in companies that also follow social responsibility, 85% of them want to buy from responsible companies and 43% (v/s 12% for boomers) want to engage in impact investing. Similar surveys by Morgan Stanley and Allianz have discovered overwhelming backing for sustainable investment. No wonder that the likes of BlackRock, Vanguard and State Street are moving up the ladder, from raising their voice to actively taking action by voting on resolution and forming alliances with other investors to put pressure on company managements.

The case of Exxon Mobil is an important example to foresee how things are likely to emerge. The hedge fund Engine No. 1 argued during the proxy session this year that there was a slow transitioning to a low carbon economy and that there were not enough people on the board of the company with enough experience in oil and gas business and on sustainability issues. They proposed four candidates for Board directorship and three of them got elected. This resulted in three sitting Board members being ousted. This is something unimaginable even a few months back. But the trends in the minds of global institutional investors, proxy advisors and governance professionals have been very clear that climate change risk is on the top of the list of risks on which boards must concentrate. The institutional investors are increasingly asking the question whether the board is fit for mitigating this risk and capable to provide the oversight for the execution of the strategy. Unilever, Nestle, Glencore and a number of other large US companies have already agreed to introduce a vote on their climate strategy this year.

Companies must also realise that increasingly larger amount of money is getting into sustainable funds. Last year, twice as much money went to sustainability funds than into general ones. There is also now data available to show that sustainability indices produced greater risk-adjusted returns compared to other funds – drawing more and more investors into taking active part on sustainable issues. In the USA, big four accounting firms have joined hands to set up a reporting framework for ESG as part of a move spearheaded by International Business Council (IBC) of the World Economic Forum. It is expected that more than 100 companies having membership of IBC will adopt this for their 2021 accounts. The Financial Stability Board (FSB) created a task force on carbon climate financial disclosure. CFD has created a matrix for disclosures on climate related activities by the companies.

The focus on sustainability is forcing companies into entirely new business targets and practices, all of which have huge consequences. Some oil and gas companies are reducing employees, cancelling share buy-backs and cutting dividends and some are moving into power trading, bio-fuels, solar developments and other low carbon areas. Last year, most of the large oil and gas companies had to write down value of their assets incurring significant impairment in their assets. There are projections available about what percentage of oil, gas and coal reserves will have to remain underground for ever if Paris climate goals are to be achieved. These will remain 'stranded'. At the same time, sustainability focus is also creating new business opportunities and new 'green jobs'. According to the US Energy Secretary, the value of global market for clean technologies is going to be $23 trillion by 2020.

Governments'/ Regulators' push

The climate debate is finally pushing national governments into making specific and time bound commitments. In 2021, the US has announced a cut in emissions by over 50% by 2030. Japan has almost doubled its 2030 reduction target. The UK has announced the cut by 40%-45% from the earlier commitment of 30% by the same timeline. China has announced that its emission will peak 2030 and by 2060 it would have net zero emission. The G7 Environmental Minister pledged to make accelerated efforts to limit temperature rise to 1.5ºC by 2050 compared to the Paris Climate Summit target of "way below 2ºC". The International Energy Authority (IEA) report earlier this year had estimated that all new oil and gas and coal projects will have to stop for the world to reach net zero emission by 2050, which is pre-requisite for limiting global warming to 1.5ºC above the pre-industrial level. The report also called for oil demand to shrink by 25%, gas demand by 50% and coal demand by 90% by 2050. India has announced net zero by 2050. The upcoming COP 26 Conference in November 2021 in Glasgow will be a testing ground as to how the announcements by different national governments are going to be actually translating into measurable implementable action.

While many analysts genuinely doubt whether countries are actually committed to set goals and whether they are willing to take necessary action but it is a fact that for business activities across sectors ESG challenges are no longer a matter to be decided in distant future. Also, while the targets and strategies might differ across sectors the thrust unmistakably towards "business as usual" scenario is no longer being an option. What is very clear is that the share of fossil fuels in global energy supply could have to fall significantly. According to the IEA report, solar will become the single biggest sources or 20% of the global energy demand. The British Prime Minister has announced that by 2030 all British households will be supplied energy from wind sources rather than from fossil fuels. The implications of these changes for business activities is not very difficult to understand.

The Dutch Court has ruled that the company had violated its core obligations regarding human rights of those affecting by climate change. The case was brought under "unlawful endangerment" clause under the Dutch Civil Court. This has implications much beyond the energy companies. A separate case is under way in France where 14 local authorities and several NGOs have asked a Court to ask the energy group Total to go further into curbing emissions.

The G7 meeting at the end of June this year also agreed to stop using government funds to finance new international coal power plans by end of 2021. According to the United Nations; more than 110 countries have pledged carbon neutrality by 2050. In July this year, the European Union adopted a series of legislative proposals to achieve carbon neutrality by 2050 in the entire EU and also prescribed intermediate task of reducing (from 1990 levels) at least 55% in Green House Gas (GHG) emissions by 2030. It includes several pieces of legislation including transport and land use, forestry, agriculture, emission standards for cars and vans, protecting and expending forest and creating green jobs. According to these targets, emission by cars will have to be reduced by 55% by 2030 and by 2035 emission will have to be brought down to nil. By 2026, road transport will be covered by emissions trading putting a price on pollution. Aviation and shipping sectors will also have requisite targets. Maersk has already announced the commissioning of its first carbon neutral container by 2023- seven years ahead of its earlier target of 2030 and aims to be completely carbon neutral by 2050.The plan also involves renovating 35 million buildings by 2030. All public buildings have to renovate at least 3% of the floor area every year. There is a binding target for renewable energy for the energy mix to 40% by 2030. In the US, the US President met Senators in July this year to obtain approval for the plan to tax import from carbon polluting countries to help pay for the $ 3.5 trillion proposed spending in child care and health care.

The developments at the government level and in Courts are also resonating in the action by regulators. The US SEC has adopted a development instances on climate under the new Presidential regime. It denied request from both Conoco Phillips and Occidental Petroleum to throw out shareholder's motion that would force them to layout detailed plans for their emissions. Both the companies had argued that these amounted to micro managing their operations. Banking regulators are asking banks to do a stress-testing of their loan portfolios from the climate change point of view. Insurance and pension regulators are also getting their act together on this issue. These developments pose a new challenge for companies in their quest for access to capital.

Technology upgradation is helping

The good news is that years of hard scientific and technological work has led to a sharp reduction in cost of energy transition. Serious trials are going on for use of Hydrogen as a green gas. Trials are going on in Germany to use Hydrogen as a direct reducing agent instead of coal to separate iron from ferric oxide. Experiments are going on in areas sustainable aviation fuel to low carbon concrete. The use of electric cars are already a reality. In battery technology, there is significant progress towards moving from lithium-ion battery to solid state battery, which can reduce the fire risk, take much lesser time for charging, is lighter in weight and gives double the mileage. There is hope now that the price of electrolysers used to make green hydrogen will fall sharply. Technology for power storage is also progressing rapidly, which will help in managing intermittent supply from renewable sources. Solar electricity cost have fallen 80% in the last ten years and even more in India and Middle East. Wind cost is down by 60% and batteries are 85% cheaper. In 2008, in the UK it was estimated that cost of reducing greenhouse gas by 80% below 1999 levels by 2050 would be close to2% of GDP. Now, the Energy Transition Commission estimates are of less than 1% of GDP.

Besides, what is reported and what is measured is no longer within the exclusive domain of companies. Technology has enabled remote analysis of volumes of publicly available data to find out the quality of air emission, discharge of liquids and its hazardous constituents, health of its tailing dams, state of the nearby sub-soil pollution and a host of other high frequency indicators-almost in real time and without waiting for quarterly disclosures from the company.

Measurement and Reporting

When the US SEC was created in 1930s, one of its most important tasks was to ensure fair and uniform disclosures about the true financial health of the different companies it regulates. It ensured setting up of uniform accounting standards, which were verifiable by an outside auditor and which were comparable across companies for investors or analysts to take an informed call. But the process took decades. Measurement and reporting of sustainability related efforts of companies has been facing a similar challenge. As the sustainability debate picked up, a plethora of organisations like CBP, CBSB, PRI, GRI, TCFD, IMP, IIRC, SASB sprang up to fulfill the need for sustainable measurements and reporting. At times these were working at cross purposes and in competition with each other creating frustration in the minds of investors. These often led to malpractices like green-washing. Absence of an agreed definition of net zero led to creative accounting for carbon. Issues like "avoided emissions", "carbon avoidance", the premium on green bonds,"greenium" and offsets also lead to incentives for reporting which created confusion.

But, in the last two years, there has been significant progress in harmonising the efforts. The regulators have also pitched in. In the last two years, there has been sustainable progress in coming to an international agreement on what is to be reported and the manner of reporting. The fact that four of the largest accounting firms have come together in the USA under the umbrella of IBC to help reporting from 2021 account is also helping. The important development is the merger of IIRC with SASB earlier this year by creating a new organisation Value Reporting Fund (VRF). VRF will function under the umbrella of IFRS trustees. SASB has already got reporting standards for 77 industry groups. The last excuse to avoid focus on sustainable business practices will also wither away.

Conclusion

The fact remains that while there is policy level commitment in large number of countries to focus on sustainability of the planet, there will be hiccups. There will be hard bargaining about who pays for the cost of transition and whether the rules and agreements are fair and non-discriminatory. But there is no doubt that business corporations do not have the luxury to wait for these debates to play out and then take a re-look at their strategy going into the future. Investors and regulators will force the companies in many cases to go for impairment of their assets. In many cases, some existing and unused assets will remain stranded. In many cases, companies will be forbidden by the national governments, regulators or national treaties to continue with existing activities. It will be increasingly difficult for them to take shelter behind flaws in different standards of reporting mechanism. Increasingly, the board of directors will have to take a more pro-active role in formulating medium and long term strategy.

It is going to be more a question of survival and what strategies the companies are going to adopt in this new environment. In case of Exxon Mobil, this is precisely the argument which the activist shareholders raised, the question is not of strategy on carbon reduction but how the failure to transition will lead to crumbling revenues, destroy investor capital and create an "existential crisis". The quicker a company and its board of directors realises that the business environment has changed irrevocably, the better it is for it. The heat is only going to intensify further.