TRANSCRIPT

Say on Climate and Deluge in the Delta

Featuring:
Gillian Mollod, ESG Researcher, MSCI
Florian Sommer, ESG Researcher, MSCI

Bentley Kaplan:

Hello, and welcome to the weekly edition of ESG Now, where we cover how the environment, society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for today, and on today's show, we're going to get into two climate stories. As we warm up for New York climate week. First, we'll get stuck into the new and somewhat controversial say on climate proposals that are started emerging through this year's proxy season. And then we'll take a look at how investors can take stock of Hurricane Ida and physical risks more generally in a world with more extreme climate hazards and more climate savvy investors. Thanks for sticking around. Let's do this.

If you're a regular listener, you'll know that we talk about climate change a lot on the show and with climate week in New York kicking off just days from now, it's a pretty good time to dedicate a whole episode to climate related investment questions. Climate related investment questions is exactly what is piling up in company inboxes accelerated by a combination of investor pressures, regulatory changes, and the bottom-line companies are having to engage with hard questions about their role in exacerbating climate change and how they plan to turn this big old ship around. And as part of the shift disclosure is improving not only on basic metrics like scope one and two emissions, but on upstream and downstream scope three emissions and emission reduction targets, and also in more comprehensive assessments of climate risk through frameworks like the Task Force on Climate-related Financial Disclosures or the TCFD, but for all of these developments and this improved disclosure, there isn't really a well-established route for shareholders to give a thumbs up or a thumbs down, particularly when it comes to a company's climate strategy.

Which is where something called the say on climate comes in, loosely modeled on the more well-known say on pay votes, essentially at a company's annual general meeting, some shareholders are being given the chance to vote on their company's climate strategy with a binary for or against, the old yay or nay.

Now back in May, as the first say on climate proposals of this proxy season was starting to feature at AGMS. Mike spoke with Florian Sommer, one of our corporate governance gurus based at MSCI's London office to get some insight on what these proposals that companies like Aena and Ferrovial and Vinci were all about. But since then more proposals have been tabled and voted on, which has giving us a clear idea of where investors may want to direct their attention. So I called up Florian again, to see how say on climate proposals have rolled out, and whether there were any early signs that gave credence to its proponents or its detractors, Florian Sommer:

Maybe the first thing to say is that momentum has really continued to build for this campaign initially started by TCI. They've picked up support from other asset managers. And also we've seen some prominent companies actually having these kinds of advisory boats on the climate plan. Typically those have been with management support, so management proposals, and they've picked up lots of support, HSPC for example, had more than 99% support from shareholders at the AGM for this vote on their climate plan. But at the same time, I think what's also going to continue to be the case is that there are still question marks about, maybe the benefits of this say on climate and also maybe about how best to do it.

Bentley Kaplan:

Right. So Florian mentioned TCI fund management, an activist hedge fund founded by Christopher Hohn. Hohn also founded the Children's Investment Fund Foundation or the CIFF, a philanthropic organization with an endowment of around $6 billion. And the CIFF and TCI have been the primary proponents of the say on climate proposal. And it seems that the main reason for this is to address a combination of poor disclosure by companies and the relative infrequency of votes on climate related topics at company AGMS. But for some that argument doesn't touch on two central questions. One being how well shareholders can judge the ambition, the feasibility and the suitability of climate strategies and the other of whether a strategically nuanced decision like this should be put to a shareholder vote instead of being decided by a company's board, the expert, and trusted to oversee many other strategic decisions of a company.

Now, the second point is one that really gets the governance experts going. And if it seems a little abstract to you, you're not alone. Think of it kind of like the Brexit referendum, for some, this complex decision should have been taken by the politicians and experts elected as the people's representatives and for others, the importance of the decision made it fundamental to put it out to a vote from the people directly. But of course remains to be seen with a say on climate or result in acrimonious campaigns from corporate governance, coalitions, or infamously branded buses. But the analogy should give you an idea of the shape of the argument on board accountability. Say on climate is by no means a straightforward idea. And the Florian, the detractors of say on climate are making some valid points.

Florian Sommer:

Yeah. So I think the skeptics need to be taken seriously. If you look at Shell, for example, they have this vote and they got a lot of support for it, but actually the plan that they put forward, their climate transition plan was criticized by TCI and others because they thought the plan was not adequate and actually not aligned with the Paris climate agreement. But in spite of that, they got a lot of support and it was approved at the AGM. So, this is just one example of something similar happened at total, you have these kinds of situations where you might think, well, maybe some investors, at least don't yet have enough expertise to actually evaluate these kinds of plans. On the other hand, that's why you have investor coalitions, like for example, the Climate Action 100 plus, that's why you have service providers consultants to actually provide the sort of additional expertise if an investor doesn't already have it.

So I think the ways around this sort of potential problem, and I think the key question here is, is this say on climate really a serious, additional opportunity for long-term engagement with the company on climate change? Yes or no. Two very important things that might determine that, one is the frequency of the vote. And the other one is what will happen if there's significant opposition to that proposal by the company. So on the first one frequency of the vote, we've seen Shell, for example, they've already said, we will do this on an annual basis. We will have an annual vote. Unilever has said, we will do this every three years. The second point about what happens when there's opposition, these votes are typically advisory only, even if shareholders reject the vote and reject the plan in this advisory vote.

Legally companies don't actually have to change anything. They don't actually have to change the plan. So the question is really how will then the company, how will management take meaningful, significant opposition into account? S and P for example, they've specifically said, if this vote gets rejected, we will reevaluate the plan based on shareholder input. I think that's significant.

Bentley Kaplan:

So sure. It's tough to decide universally with a say on climate is a good thing or a bad thing for investors that are hoping to push their companies to more aggressively reduce emissions or better manage climate related risks. It all depends. Without a standardized format, it can be difficult for investors to clearly assess a company strategy or compare it with peers. And since these are largely advisory votes, it leaves companies with a convenient backdoor. I put Florian on the spot to get his opinion on how these nascent trends might enroll into 2022.

Florian Sommer:

I do think that next year we'll continue to see these kinds of votes. A lot of them will be endorsed by management. The trend has been that those kinds of management proposals have been getting a lot of support. Will companies be committing to holding regular votes, will this actually be an opportunity to engage with the company or the regular, maybe annual basis? Will there be maybe more discontent next year? How will companies react, right? Is this actually something where companies will say, "Okay, at a certain level of discontent, we will then have to go away and think again, in terms of what we're doing on climate, how we're managing that risk," or will they say something like, "Well, this is just an advisory vote, unless a huge majority of investors votes against us. Maybe it's not that serious."

Bentley Kaplan:

So a lot of investors may be watching how the 2022 proxy season shakes out and weather say on climate proposals become a more regular feature, but climate change itself, the nuts and bolts of it is unfortunately moving on a bit of a shorter timeline. And for many angles of climate change, the physical risks in particular, we don't really have the luxury of waiting for the 2022 proxy season. And if you've been anywhere near the US Gulf coast in the last two weeks, you'll know what I mean. On the 29th of August, Hurricane Ida at that stage, a category four hurricane made landfall in Port Fourchon, Louisiana becoming the second most destructive hurricane in the state's history. Total damages from Ida had been estimated at more than $50 billion with more than 60 deaths and counting. And then onto the phrase, hurricane season, Ida made landfall exactly 16 years after Hurricane Katrina, the most destructive hurricane in recorded US history.

And we'll get into some of the consequences of these hurricanes and how current tools can and can't help companies and their investors. To do that, I wanted to bring back a serial guest on the show, Gillian Mollod out of our New York office. Gillian is a pro at working through the spatial dimensions of ESGN climate risk. So hurricanes are kind of a sweet spot for her. And even though Gillian lives in New York, more than a thousand miles from a Hurricane Ida made landfall in Port Fourchon, things actually got a little closer to home than she and many others anticipated.

Gillian Mollod:

After Hurricane Ida hit Louisiana and moved up towards the Northeast. And I live in New York City. We spent the night trying to keep water from coming into our apartment. And one thing that happened was that we got three inches of rainfall in one hour, and that's a lot of rain and my building's a hundred years old. So the infrastructure, maybe isn't so great here to withstand that much rainfall. So we saw that firsthand, when water was just pouring in.

Bentley Kaplan:

So taking Gillian's home in New York and extrapolating the hurricane back from where it made landfall in Louisiana, you get an idea of the hurricane's path and idea of where the damage might be. And I actually spoke to Gillian on this topic in early September last year in the wake of Hurricane Laura. Back then we spoke about investors knowing where their risks were, knowing where the companies in their portfolio had assets in the anticipated path of an incoming hurricane. Gillian was able to use MSCI's proprietary asset location database to model this and pick out which companies would likely to be most impacted. On that episode, we focused on knowing where a company's assets were and then layering over it in that case, the path of Hurricane Laura and getting hold of asset locations for a company is not straight forward even a year later. And that's without even trying to figure out the locations of key points in a company's upstream supply chain or downstream value chain.

But on this episode, we're going to put aside the question of asset locations. We're going to imagine an investor utopia, where you actually have perfect knowledge of the asset locations of your whole portfolio, what a world I'm all right. And from here, we're going to go a little bit deeper into investor questions about physical risk, because we're seeing the adoption of climate scenario tools by investors or even companies, which is a great start and something we touched on with Patrick Hellman back in August, when he broke down the impacts of flooding on physical infrastructure in Germany. But looking back on 2021 and even 2020, what do we see is these catastrophic events, hurricanes, and floods, and wildfires causing massive damage seeming to catch us off guard even with these new fancy climate models. So how do we put that into context? How do we square that circle?

Gillian Mollod:

One of the things that these climate models is that they incorporate historical data into the model and what they essentially are doing is they're modeling the Earth's climate and kind of interactions between what they've seen happen in the past and what they expect to happen with the atmosphere, having more carbon dioxide in it. One of the things we're seeing now is that some of these extreme events like the floods we saw in Europe this summer, the extreme flooding throughout China that caused the subways to flood. And then again, in the US we're seeing a lot of flooding events here, too, most of them after hurricanes. And one of the things that we're seeing is that a lot of these climate models don't necessarily model these extreme events. And some of that is because they're sort of new events that we haven't seen in the past, or they're such extreme events that we don't expect them to happen.

And just to sort of clarify what these are, it's the extreme rain events sometimes after hurricane, sometimes not after hurricanes and these extreme rain events are then leading to these flash floods as the temperature of the air increases, it's a direct correlation to a precipitation event lasting longer. And that's why we're seeing the amount of rain flow that you would see in one month happening in one day. For a company, kind of where this would appear in long-term planning is to improve aging infrastructure and creating a ways for absorption, better absorption into the soil around their assets.

Bentley Kaplan:

Right? So climate models are getting better, but they depend on historical data and work within probability limits. So extreme events or unprecedented ones tend to fall outside of those lines. And as Patrick made the point in August, so Gillian does in September uncertainty you should be driving better preparedness, better adaptive capacity. Governments and companies should be looking at vulnerable infrastructure with a critical eye and mulling environmental features that improve climate resilience like absorptive substrates, and running some cost benefit analysis, proactive versus reactive, but unfortunately for governments, for companies and investors, but most importantly for the human beings caught up in these climate hazards, it gets a little more complex because in some ways the hurricane itself is just the first act, the immediate wind precipitation and flooding have knock on effects that are equally hard to predict. And in some ways can be more devastating or longer lasting than the hurricane itself.

Gillian Mollod:

Yeah. So what happens afterwards is sometimes hard to predict. Some examples that I can think of right now is like with Hurricane Ida, when it hit New Orleans, the levees held, and this was a big deal because 15 years ago, after Hurricane Katrina, they didn't. But what wasn't expected was that the electricity would go out for so many days. And as a result, the many people were left without air conditioning, and there were deaths related to extreme heat. Some other things that we've seen is, with Hurricane Ida oil spills in the Gulf of Mexico, and this was something that, again, we knew it would hit certain areas where there's oil and gas infrastructure, but some of this oil and gas infrastructure was old infrastructure, that was very deep in the Gulf of Mexico. And no one expected that these would start leaking, but there's a big oil spill happening.

And companies will be held responsible in a crux external cost as a result. We just saw Hurricane Nicholas came through and as a result, LNG or Liquified Natural Gas plant in Texas closed. All of these are examples of things that we haven't necessarily planned for and modeled. One of the things that I think is interesting is that the IPCC report came out recently and said that even if we cut emissions today, we'll still see warming until 2050. So really preparing for these types of events is incredibly important. Even if the climate models don't model them perfectly, it's better than not modeling them at all. And as the sophistication gets better, we'll be able to, like I said, have more granular sense of what's going on.

Bentley Kaplan:

It is a weird and cruel irony that some of the deaths that resulted from Ida were from extreme heat rather than flooding, or that hurricane season has coincided with a time where Louisiana bears one of the highest case loads of COVID-19, putting a double strain on the healthcare system and that the oil and gas facilities that pepper the Gulf coast find themselves as both exacerbates and victims of climate change. After Hurricane Ida for about a week, more than 80% of oil output in the Gulf of Mexico was offline. And on the 14th of September, as Hurricane Nicklaus made landfall in Texas, Freeport LNG, the US's only liquefaction terminal shut down. We could probably spend a couple of hours on exactly how that might affect oil prices. And similarly, what the knock on effects of those oil prices could be. But I know our listeners are busy people, ultimately the social and economic dimensions of physical risk are deceptively complex.

Muddling the actual climate hazards is hard, figuring out what comes after is next to impossible, but I want to echo what Gillian said, even though the climate scenario tools that companies and investors have at their disposal are not perfect. They offer a significant improvement on what was available only five or 10 years ago, better accuracy, and a better understanding of complexity is almost inevitable, but we have to start somewhere.

The idea of having to start somewhere up as a thread through both of our stories, for the nascency on climate proposals, there are still many question marks, and there may be ways to address some of those with investors being better prepared to interpret climate strategies, more proposals to compare, and a clearer idea of how companies will act in the face of shareholder descent. But whether these votes will offer an opportunity for genuine engagement, rather than devolving board accountability remains to be seen. And for those facing weeks without power in Louisiana, those mourning the loss of loved ones, there may be a Sisyphean feeling to all of this. With memories of Hurricane Katrina, not yet faded into the distant past, but governments, companies and investors have a much more advanced toolbox at their disposal and climate scenario modeling will give them somewhere to start.

But facing companies in particular are difficult cost benefit debates about preparedness, how much to do and how soon, and how to weigh the cost of resilience measures with shareholder returns. And of course, whether these decisions should be taken by the board by companies, shareholders.

And that is it for the week, a massive thanks to Florian and Gillian for their take on the news with an ESG twist. Thank you as always very much for tuning in. Don't forget to rate the show, review us wherever you're listening to us and drop us a note. If there's an ESG topic you're dying to hear, we love the ideas. Stay safe out there, and we'll catch you again next week,

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