Analysis

Anthony Walker
ESG Specialist

Shifting ground, coal and finances... And a little ray of sunshine

Key take-aways

- We have seen some tangible, positive changes in South Africa recently, amounting to progress in our transition away from coal. These have come in the form of fresh global financing, new government policies on renewable energy and new company-specific plans. Both the public and private sectors have key roles to play in meeting the COP26 environmental targets.
- As active shareholders representing our clients, we also have an important role to play by engaging directly and helping guide companies through the complexities of this transition, while also ensuring we understand the complexities and clearly communicate the impact on investment returns.

While queuing for local elections, and its domination of the news recently, South Africans probably missed out on something happening just over 10,000 km a way. And although not as instantly dramatic as our transition to a free democratic nation, it carried a few of the same hallmarks – big promises, big transitions, uncertainty, and a difficult journey to not only save us, but future generations. Hope, mixed with some scepticism.

South Africa is one of the key nations that sits close to the spear tip of "Just Transition". We have a real and urgent need to shift away from coal, but being an emerging market, the costs and social implications are a tricky road to tread. Currently, South Africa's energy supply is 92% dependent on coal. Our energy supplier, Eskom, is listed in the Climate 100+ report as a target for reduction. But the costs and project timelines for moving away from coal are quite staggering, and even Eskom's ageing coal units are problematic. We live with this reality daily, so we can skip the background – no doubt a two-hour practical reminder will be in our areas shortly.

Although this experience has been bleak, in recent months the ground started to shift, and we have seen some tangible change. There is certainly more work to be done – more on that later – but there has been some credible movement that follows a lot of mere talk in prior years…and some surprises from the private sector space, all of which add up to signs of sunshine in our transition towards cleaner energy. So what we have seen?

COP26 financing and Eskom

One of the largest pieces of news, largely absent from major South African media, has been the announcement of a USD8.5 billion dollar (R125 billion) 'concessional finance' deal (or offer – the definition is already being debated) from international partners to help South Africa in its transition to greener energy. This is an exciting development arising out of the global climate summit in November (known as COP26), and it appears (although details are still emerging) that aspects could be used to help Eskom directly through non-coal projects. Partners to the climate finance deal include the US, UK, and European nations, and EU organisations.

The terms of this deal will be critical, but it is a very significant step forward. Along with our global parent M&G plc, we engaged Eskom in the past month (at time of writing) on their coal transition, though well before the COP26 announcement. It is clear South Africa cannot escape coal quickly, and there are some complex capital allocation questions and social-community issues that accompany our transition. The realistic outlook and frankness of the Eskom team we spoke to was something we do not always see when engaging a parastatal. While net zero emissions by 2050 is in doubt, what is encouraging is that pilot projects are underway on a small scale, there is a dedicated transition team, and members of this team have the ear of the President. Additionally, practicality appears front of mind, with dedicated specialist teams at Eskom, and some have been in service for a long period looking at these matters. This is no longer about talking – projects and small-scale pilots that can be rolled out on a larger scale are being tested already. Funding could potentially have a meaningful impact for the entity's journey. We – and the country as a whole – are not out of the woods, but a pathway towards meaningful carbon reduction is emerging, and we have international support.

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Following COP26, there has been an outpouring of concern that not enough has been done; agreed measures have been too weak and timing too delayed, and key players have not turned up with enough sincerity. These concerns will be well founded. However, It is important to recognise that we are seeing a shift, and real change is happening, even if the pace is of concern.

Public sector support

It is widely recognised that Eskom and local private players need government support. So what movement have we seen on this front in recent months? Notably, there have been two key changes: First, the changes to licensing around power generation levels. The new 100MW cap before licensing is very exciting and long awaited. Miners have been crying out to bring in their own power production via solar (also called photovoltaic, PV) or wind power, and we have heard their frustration in our engagements with them. This is not purely for the sake of green power and carbon footprint reduction, but also to remove dependency from the grid. Apparently government has finally heard them, too. Some miners commenced production of their own power before the announcement, in anticipation of it, making some of these projects advanced. It should be noted that new power cannot be easily fed into the grid (called 'wheeling') – this is more complex than one might assume. But on a national level, as our power production and consumption shift, it takes pressure off of Eskom and some of our coal production.

Speaking of national carbon emissions, the second, more radical, change from the public sector this year saw the South African government announce better Nationally Determined Contributions to reduce the target range of national emissions and better align with the Paris goals. It should be noted that this is a non-binding commitment, with intended ranges. The commitment itself, though, is another step forward, and we will be studying it for practicality in time.

The next critical step will be updating the Integrated Resource Plan from 2019 (IRP 2019), and the hope is that this will be revealed shortly, and reflects the current inertia.

Private Sector support

Some of the larger 'surprises' we have seen this year have come from the private sector. We have become accustomed to precious metal miners pursuing green projects, and green energy (albeit in part to reduce grid dependency). Hydrogen-powered trucks are being piloted (quite literally) around some of our platinum mines. Other miners have lagged a bit, but the gold and platinum miners are proactive in projects and engagement. Having engaged them over the years, Exxaro has been pivoting towards greener energy, and mining greener minerals. The company's Capital Markets Day on 20 September showed some concrete evidence of this, tempered with caution around risk management. Exxaro will have coal exposure for many years to come, but we have seen them removing 'dirtier' coal mines and focusing on higher grades, and this is the next step for them. Some caution is required, but their presentation showed structured thought and strategy, and recognition that if the business should continue into the future as an energy or commodity producer, coal will need phasing out. For investors, the longevity of coal being an indefinite resource is no longer in question – exiting now comes down to "how ", rather than "if". . Do they want Exxaro to first work down the coal assets and exit, or pivot to green energy in that process? It becomes an interesting space of measuring risk, costs and opportunity for company management and analysts. "Greenfields territory" starts taking on a new meaning.

Sasol also recently held its Capital Markets Day, unveiling ambitious targets in respect of its vision for moving to net carbon neutral and long term energy sources of feedstock. This was encouraging to see, but in contrast with Exxaro, a bit less concrete, and more 'visionary'. Details were less clear, and some question marks around the base year. To be fair to Sasol, much will depend on acquiring and piping new feedstock. Building pipelines for hundreds of miles is not an overnight process. The company offered some details on PV power generation, but the scale needs interrogation. Its 2030 targets for emission reductions were also revised to much more meaningful levels.

What should investors consider -- and do?

"Hesitant optimism" is possibly the best reaction to all these developments, though more needs to be done. Practically, however, what do all these changes and signals mean for investors, asset managers, the public and the public sector?

For investment managers like M&G Investments, there is a need to recognise that change is not only required, but that practically we are seeing key players in the environmental challenge pivoting away from "greenwashing" (or simple window dressing of their practices), towards constructive planning and implementation. We must equally shift from being concerned about greenwashing to the practical aspects of achieving progressive change. Are the companies' targets reasonable, and are milestones in place to reflect this trajectory? What are the cost implications and opportunities – will their changing earnings impact our client returns? Do the entities have the right teams and expertise in place? In a world of opinions, visions, mission statements – what should this expertise practically look like? Finally, asset managers carry a fiduciary and contractual obligation to generate returns for clients – how should this be balanced against increasingly complex and sometimes conflicting social and environmental responsibilities? How should the latter be valued?

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In the broader sphere, asset managers need to engage regulators and indexes such as the JSE. We hold key amounts of capital, and we have an obligation to provide guidance. The assets are not our own, however, and clients need to add their voices. Additionally, industry associations can play a role, but there needs to be fewer and more concentrated efforts. There are simply too many projects, delegations, codes, taxonomies, and projects by vested-interest parties for asset managers to be meaningfully involved in.

For clients there is therefore a need to engage practically with asset managers. How will funds' return profiles change if there is screening out of certain companies? Philosophically, do they want to remain invested in companies that are responsibly shifting to better practices, and what will exclusion do – does it send a message and deny capital to offending companies, or simply shift assets to private equity investments where company accountability is impossible for public investors to achieve? There is also a need to engage meaningfully – we often receive client queries requesting carbon reduction (and investment universe reduction), but equally wanting to retain the same portfolio risk and return profile, and keep benchmarks that have high exposures to non-green companies. Asset managers in turn need to provide clear reporting and develop stances on complex matters to in turn guide clients in their decision-making process in selecting both managers and products.

In the public sphere, the commitments, regulations and cost implications (such as carbon taxes) need to be consistent, transparent and clear. Certainty is key for both investors and entities. This is true on all policy levels. Capex will be required for companies to transition, but with endless uncertainty on government policy in so many realms, they might be reluctant to undertake this expenditure domestically. We have one major listed entity exclusively exploring green energy overseas, simply because they view the local regulation too cumbersome, and the matters around land rights and licenses too uncertain. As mentioned above, asset managers can play a role here in supporting entities. Collaboration and collective representation will become key.

In conclusion, we are entering an exciting, changing space, and there is concrete action. We have moved from statements to policy, and this is translating into actual projects. We can breathe just a moment and find optimism. The next steps are complex and tricky, and no one should pretend to have all the answers. But we can celebrate a good week 10,000km away in Scotland, potential international finance, and some government progress. I think we can take a brief look back to see where we have come from. Next week we push forward, our path lit by a little ray of sunshine.

Anthony joined M&G Investments in 2007 as an Institutional Client Manager and in March 2019 was appointed as an Environmental Social Governance (ESG) Specialist. He is primarily responsible for M&G Investments' ESG reporting and related work. Prior to joining M&G Investments, Anthony worked as an attorney and an Employee Benefits consultant. He holds a Bachelor of Commerce degree in Law and a postgraduate LLB degree from Stellenbosch University.