A Collection of Expert Q&A Sessions:
Alfred Mayaki interviews Alain Stockli of Doric Partners (18/09/2020)

Alfred Mayaki, BSc, PgCert
The Open University Business School
The Michael Young Building
Walton Hall
Milton Keynes
MK7 6AA, England
United Kingdom

Personal Identifier: O8309334
Publication Date: March 2024
Website: https://business-school.open.ac.uk/

Foreword by Alfred Mayaki

Looking back at the last year, 2020 has indeed proven to be a pivotal year for the demand in renewable energy technologies such as the likes of offshore wind and solar photovoltaic. Ahead of COP26, governments across the world have come together in order to coordinate more ambitious net-zero targets and outlined their intentions to not only reduce carbon emissions by greater targets but to convert to cleaner forms of energy before 2050. What else has 2020 shown us? Well, there has been a cataclysmic rise in demand for a highly controversial form of energy called "liquified natural gas" or LNG to those in the gas industry. The controversy with LNG arises not because the fossil gas has in some instances a relatively high carbon footprint, but because it's becoming increasingly difficult for governments to categorize LNG's place as a bridge fuel within the scope of a just transition.

Remember the first lockdown in March? The price of LNG plummeted to just under \$3/MMBtu. But by the end of the second lockdown in December, the spot price had surged up to just under \$12/MMBtu. A rise of more than four-fold. The biggest importers remain in China and Japan. The European Commission with its new proposals has attempted to tighten up regulation surrounding new LNG infrastructure, known as Projects of Common Interest (PCI) across the European Union. So has the UK, by pledging to stop investing in offshore oil and gas projects. However, on a global scale, away from the UK and Europe, in Africa (Mozambique) and Latin America (Argentina), where there is abundant wealth in the form of natural gas, things remain tightly poised.

The idea that the maritime industry must contrast its use of green hydrogen (and hydrogen borne through renewables), against LNG over the next decade is incorrect. Its place as a bridge fuel holds considerable sway to the market (lobbying bodies such as the Sustainable Shipping Initiative or SSI for short and SEA/LNG have identified these transition advantages).

Today, IBR Group International will be speaking extensively with senior ESG expert Alain Stockli of Doric Partners, an experienced advisory firm that provides investment products and services to institutional and retail investors in aviation, real estate, and renewable energy. This interview is part of our Top Voices in Sustainability editorial. Our team at IB proposed a number of pertinent questions to Alain regarding recent events in sustainable finance, government policy, and financial markets. Alain is a private markets specialist with experience across investment banking, structured asset finance, and investment management with passion and drive to further the global sustainability and impact investment agenda in the primary and secondary markets.

Here's the transcript to the full interview:

Q: As an industry influencer, and as someone who is a thought leader in ESG, how would you interpret the key challenges of emerging regulatory and financing frameworks aimed at supporting a global energy transition?

Alain’s Response:

Addressing the global energy transition and decarbonization efforts is increasingly a finance problem, as much as a science or political one. At a time when governments will emerge from the Covid-19 crisis with crippling debt, unemployment and other social challenges, a large proportion of investments required to achieve the global energy targets must come from the private sector.

Unfortunately, climate change and the lack of internalization of negative environmental externalities is one of the biggest market failures in economic history, so the implementation of a comprehensive set of policies is required to get serious about the low-carbon transition. On a positive note, the green bond market has displayed promising momentum in recent years and still offers tremendous potential. In order to elevate the green bond market to the next level, stronger accountability as well as co-operation between policy makers, standard setters, capital providers and investors will be essential. This would help facilitate the worldwide adoption of climate-aligned green bond standards, which in turn will ensure that the targets of the investment community will be aligned with long-term sustainability mandates.

Although ongoing initiatives such as the European Green Deal and EU Taxonomy Regulations are a step in the right direction, they are mostly tweaks to existing mechanisms. In order to effectively align capital allocations with energy transition targets, more systemic changes in the design of financial regulation and public policy will be essential. Take for example the Basel Committee international banking regulations, which should include more regulatory incentives and solvency rules to help redirect funding towards the energy transition. Proper incentives for financial institutions could include higher capital ratios as backing for fossil energy loans, while decreasing the ratio of capital for loans that help reduce the carbon footprint. Another policy instrument is carbon pricing, which could be implemented either through the introduction of a tax on the carbon content of goods and services, or the creation of a more globally integrated cap-and-trade system of emission allowances. Other market-based instruments, such as the introduction of subsidies for clean technologies and a phasing-out of fossil fuel subsidies, follow a similar logic.

In conclusion, specific action plans with an intelligent mix of voluntary measures, incentive-based self-commitments and regulations would unlock some of today's barriers and help drive the transition to a low-carbon economy.

Q: Mrs von de Leyen, as we have said so many times, is implementing the beginnings of a European Green Deal and has set out unprecedented plans for a EU green recovery, but what role will the German Presidency of the EU Council play in pioneering sustainable finance as an element within this objective?

Alain's Response:

This is less a question of country-specific ambitions than the willingness of the international community to implement systemic change. In fact, Germany has hardly been a pioneer when it comes to sustainable finance and divestment in fossil fuels. Only last year, Berlin expressed its opposition to the European Investment Bank stopping its financing of fossil fuel projects. This left the perception that Germany wanted to promote its domestic agenda. At present, only a few legal instruments in Germany regulate the market for sustainable investments. In this respect, neighbouring France is playing a much more pioneering role at the European level with its Energy Transition Law, which requires asset managers to inform investors how they can take environmental, social and governance criteria into account in their investments. German legislators, on the other hand, are more reluctant to adopt regulations and prefer market-driven initiatives.

Lobbying associations have historically also influenced government activities. The car industry is a particularly sensitive topic in Germany in light of the European Green Deal's ambitions to raise the CO2 limits for cars. Irrespective of the above, Von der Leyen's pledge to deliver a green investment wave and to turn Europe into the world's first climate-neutral continent by 2050, the European Green Deal is largely composed of reshuffled money from existing EU funds and promises to mobilize private-sector capital down the road. Setting aside the fact that the €100bn per annum is so far fictitious, it does not come close to the funding needed to deliver the targets. Not to forget the commission's commitment to the austerian straitjacket of the stability and growth pact, which has condemned Europe to chronic stagnation. For these reasons, the promised Green Deal meets criticism and fails to inspire on the dimensions of size, composition, scope and practicalities of implementation. This underpins the conclusion that international effort requires a collaborative approach and common agenda between governments, regulators, policymakers, supranational organizations and private market participants.

Q: The European Union (EU)'s taxonomy report was officially published on 9 March 2020 after 18 months of work. The Technical Expert Group (TEG) who assisted the EU in developing this taxonomy consisted of various private sector influencers and thought leaders, how do you believe the Taxonomy has been received by the investment community since it was published a few months back?

Alain's Response:

The EU Commission's Taxonomy Regulation marks a significant step in sustainable finance. It serves as classification system that helps investors and companies define which economic activities are environmentally sustainable. The investor community will benefit from more stringent reporting disclosures from certain companies in order to assess to what extent their investments are really aligned with sustainable activities. Based on these disclosures, fund managers can better determine to what extent green-marketed products actually achieve sustainability.

There will inevitably be some teething problems, but such framework is a positive development and will help ensure that capital will be allocated to investments that promote and prove their green credentials. Despite the highly technical language surrounding the Taxonomy, there is reason for the investment community to cheer the forthcoming regulations. The Taxonomy should contribute to the prevention of greenwashing attempts and ensure that market participants invest in truly green opportunities that align with the Paris Agreement on greenhouse gas emissions.

Q: As you know, the EU has six environmental goals associated with the taxonomy: climate change mitigation and climate change adaptation being the first two objectives. Arturo Fraile of BBVA has highlighted a major theme absent from the taxonomy. Do you believe the expansion of the taxonomy beyond its environmental scope so it includes socially sustainable activities will be a possibility in the future?

Alain’s Response:

The expansion of the EU Taxonomy Regulation beyond the environmental dimension seems unlikely in the near future due to the already complex and lengthy implementation timetable. The Taxonomy will start in 2022 with disclosures related to products with focus on climate change mitigation and climate change adaptation. In 2023, additional disclosures will follow for products with focus on water, circular economy, pollution or biodiversity. In order to avoid insurmountable implementation complexities from the start, it seems the correct call to start small and focus initially on climate change and other environmental challenges. Remember that the Taxonomy and the related Green Deal discussion go back a few years when climate change was identified as a potential systemic threat to the stability of the financial system. Aware of these long-term challenges, the G20 finance ministers and central bank governors asked the Financial Stability Board to review how the financial sector can best take account of climate-related issues. The main concern was that inadequate information could lead to a mispricing of assets and misallocation of capital and could potentially give rise to concerns about financial stability since markets can be vulnerable to abrupt corrections.

Although topics such as human rights, labor management and equality are important social issues, these are often more difficult to assess with quantitative measures compared to for example greenhouse gas emissions or resource depletion. The social topics are arguably also a somewhat less imminent threat to the stability of the global financial system than climate change and the environmental dimension.

Of course, the expansion of the Taxonomy to the social dimension is a wishful ambition and honourable goal, but the practical implementation is unlikely and could in fact distract from the ongoing efforts related to the environmental dimension. The highest level of complexity from the start does not necessarily translate into better practical solutions. It is therefore a sensible practical approach to start small with a focus on environmental topics, with a view to potentially expand into the social dimension at a later stage. Further developments related to sustainability classification systems, disclosure metrics and reporting frameworks will inevitably evolve over the next few years. The Taxonomy will therefore only be the starting point with further developments and transformations further down the road. One day in the not-too-distant future, this will likely result anyway in impact-weighted accounts as promoted by the Global Steering Group for Impact Investment, which pursues the goal of assessing and disclosing all economic activities beyond their risk and return profiles and include environmental and social impacts.

Q: The Australian Financial Review in its Chanciléer reported on the controversial omission of LNG from the TEG's plan. Sean Kidney, CEO of the Climate Bonds Initiative believes it is a step forward. However, there's been some fallout from the SEA/LNG who are a multi-sector industry coalition. Why was LNG omitted from the Green Taxonomy?

Alain’s Response:

While investments in coal are hardly sustainable and nuclear power will likely be excluded from the EU's green finance taxonomy, there are some grey areas. Although hardly anyone will argue that natural gas is green, there is a credible argument that converting old polluting coal-fired power plants into new natural gas ones can considerably reduce their carbon footprint in the short term, even though other technologies will be needed in the future to bring emissions down to zero. Similarly, replacing diesel trucks with LNG trucks is a relatively green move. These examples touch upon a central question in the energy transition - whether a clean break from fossil fuels is at all possible and whether bridge fuels like gas should be promoted in the transition to a 100% renewable energy system.

The green finance taxonomy will provide investors, pension funds and private equity firms with a common definition of what is green and what is not with a view to channel more capital into sustainable businesses and prevent greenwashing. To qualify, an economic activity needs to make a significant contribution to at least one of six pre-defined environmental objectives, such as climate change mitigation or adaptation, water preservation, pollution prevention, and recycling. In addition, any technology automatically disqualifies if it does "significant harm" to any one of the other environmental objectives.

Environmental groups have called on policymakers to promote only fully sustainable economic activities in the EU Taxonomy and exclude everything else - starting with fossil gas and nuclear power. Unfortunately, reality is more complex and it is unrealistic to aim for 100% renewable electricity immediately. The challenge for the EU experts will be to lay out thresholds to determine which economic activities can be considered sustainable.

It is difficult to define an economic activity as green in absolute terms. This should rather be done in relation to the status quo starting point, which varies depending on local circumstances and geography. Importantly, the green finance taxonomy should also be aligned with other EU legislation, such as the Renewable Energy Directive, which does list bioenergy and biogas among eligible sources of renewables, alongside solar and wind power. Similarly, natural gas vehicles compatible with renewable gas should receive equivalent treatment in the Taxonomy, in line with the Alternative Fuels Infrastructure Directive and the Clean Vehicle Directive. This underpins one of the key issues of European legislation, which often lacks integration and is drafted independently without a cohesive approach in mind.

In order to be practical and credible, the EU Taxonomy should ensure coherence with existing policies. It is inevitable that elements of the framework, where certain policies and regulations are contradicting instead of complementary, will trigger discussions about interpretations. Objective conclusions are often difficult to reach due to political forces and diverging lobbying interests involved in the process.

Q: You explained earlier about the EU's six environmental objectives. Could you speak to our audience a bit about the "do no significant harm" principle from the EU's Green Taxonomy and why it is relevant to the taxonomy?

Alain’s Response:

As mentioned before, the six environmental objectives referred to are climate change mitigation, climate change adaptation, use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. In order to be environmentally sustainable, an economic activity must contribute to one or more of the six environmental objectives without significantly harming any of the other objectives. From a practical perspective, the "do no harm" test will exclude fossil fuels and nuclear power, which are seen to be undermining other environmental objectives such as pollution prevention and control.

We already concluded above that the EU Taxonomy as it stands focuses on climate change and other environmental challenges, as opposed to social and governance factors. In practice, however, the "do no significant harm" element of the definition serves as a minimum standard in assessing the particularly unsustainable nature of certain activities that might also go beyond the pure environmental dimension.
The Taxonomy and the "do no significant harm" principle ensure that sustainability is no longer in the eye of the beholder, but an objective set of metrics that can be applied in terms of alignment and accountability.

Q: Sean Kidney of the Climate Bonds Initiative was quoted as saying in the Japan Times in July 2019 that though the EU taxonomy will serve as guidance, Japan will be supported if their public policy so wished to implement its own green taxonomy and actually encouraged Japan to do so. However, fast forward to April 2020 and an article from the Responsible Investor reads, "Japanese researchers have proposed the creation of a "transition taxonomy", in another swipe by the country at the EU's flagship classification". What are some of your thoughts and concerns about Japan's intention to list a variety of natural gas projects as "transitional" and therefore admissible for investment under its potential taxonomy?

Alain's Response:

Japan achieved some impressive milestones in recent years in relation to the third arrow of Abenomics and the sustainability-related structural reforms. Japan has demonstrated genuine efforts to further the sustainability agenda, in particular also with the development and implementation of the country's stewardship codes since 2015.

In many Asian markets, policymakers and investors are however playing catch-up with Europe, which is arguably at the forefront of many ESG and sustainability-related efforts. Japan is a well-known critic of the EU Taxonomy and its associated regulation, which nevertheless will apply to all financial market participants that sell financial products in the EU. Japanese business associations and trade bodies have sought to water down the current EU Taxonomy, so there is little surprise that Japan advocates its own model.

From a practical and nationalistic perspective, it is understandable and legitimate that each country has its own views, beliefs and preferences on Taxonomy issues and the nature of climate-aligned business activities. The EU has made clear from the start that it believes its framework will be applicable globally, but with many countries working on their own taxonomies. Japan is not alone in wanting a classification system more geared towards the transition of its domestic economy.

The Japanese taxonomy seeks to classify projects, assets and activities that can transition from high to low carbon intensity and environmental impact, rather than ones that are strictly green. For this reason, projects that qualify as "transitional" under the Japanese taxonomy include the conversion of coal plants to natural gas or shifting from oil to gas fuel in shipping.

As discussed before in the case of Germany, each country will seek to promote or protect its industrial landscape and certain domestic key industries. While this might be the car industry in Germany, this includes shipping in Japan. For this reason, some countries like Japan aim to develop their own transition frameworks, which allow for a flexible approach and consider the specific circumstances of countries and regions.

Irrespective of the different country views, it is a promising step in the right direction that agendas, targets and transition frameworks are developed in order to accelerate the climate change journey and actively embrace sustainability topics. Any effort is better than no effort. It should be a matter of time until different approaches will converge and become closer aligned, as global efforts will continue to find common frameworks, principles and standards.

Q: Responsible Investor reported recently after a study of 75 investment houses that 6 of the world's biggest fund managers reported "poor" on ESG. The fear is that fund marketing for ESG is being treated fundamentally as a "box ticking exercise". Will you agree that greenwashing in the world of ESG is a big hurdle for many equity investors to overcome? If so, what can be done about this?

Alain's Response:

As environmental, social and governance (ESG) principles become increasingly mainstream and with asset managers under increasing pressure to embrace the trend, the question of how to avoid greenwashing becomes more prevalent. Although there is no magic formula to avoid greenwashing, certain factors are worth taking into consideration. The level to which fund managers are embracing ESG principles depends on how sustainability considerations are analyzed and integrated into their business models and decision-making processes. If applied as an extra filter, there may be a greater reason for skepticism that it is a box-ticking exercise rather than a key process at the heart of the approach. If the fund produces impact assessments of portfolio holdings this can also help to reduce the risk of immaterial characteristics in underlying investments being dressed up as green or sustainable.

Looking at whether a fund manager relies on in-house or third-party research can also reveal certain clues. Standard ESG ratings from various specialist data providers are generally backwards looking, whereas ESG assessments also include forward looking considerations. Ratings are helpful, but the scale of disagreement between different agencies and the generally low correlations show that they should not be relied upon in isolation.

Until standardized objectives and uniform disclosure standards are sanctioned by actual mandatory - rather than voluntary - legislation, the risk of greenwashing at any level of the investment chain will remain. The EU Taxonomy is a vital instrument that aims to prevent greenwashing and facilitate the financial sector to align with the commitments of the Paris agreement. However, as the Taxonomy does not clearly outline criteria for countries outside the EU, implementation is challenging for investments in emerging markets.

It is encouraging that leading sustainability reporting organizations are increasingly working together to agree a shared vision of what is needed to converge to global standards and help resolve confusion surrounding sustainability disclosure and develop a more coherent reporting system. The recent announcement of five leading independent framework and standard-setting institutions - including GRI, SASB and CDSB - and their commitment to working towards a comprehensive reporting system is a step in the right direction. And most recently, the world of sustainability reporting and disclosure took a major step forward with the announcement of a new set of universal ESG metrics and disclosures to measure stakeholder capitalism, developed in collaboration with Big Four accounting firms Deloitte, EY, KPMG and PwC. This is a great opportunity to walk the talk and to make stakeholder capitalism measurable.

Q: What do you see in store for the next 12 months in terms of a) the climate change response to COVID-19 and b) the response of the sustainable finance industry within this environment?

Alain's Response:

The ESG and the sustainability landscape has been evolving rapidly over the last few years and will become more mainstream. I am convinced that capital allocation decisions will continue to be increasingly ESG and sustainability-focused, be that in alternative energy or health and wellbeing. The year 2020 is shaping up as the first real test of the era of stakeholder capitalism. Consumers, governments and investors are all watching very closely how businesses treat their stakeholders during the crisis. This trend and the shift in attitude will last.

Many of this year's developments are likely to favour trends driving sustainable considerations, such as healthcare innovation, broadening healthcare access, economic empowerment, knowledge sharing and communication, and even things like resource efficiency. Those are all things that were already important before the crisis, but they are only going to prove more important as we exit. The disruptions of 2020 have underscored the critical importance of organizations managing and reporting their impact on the economy, the environment and society, and their increasing connection to long-term value creation.

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