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The ESG effect: risk and opportunity

By *Michael* **FERGUSON**

As focus on environmental, social, and governance (ESG) factors increases due to their potential impact on profit margins, credit-rating headroom, and stakeholder confidence, we overview some of the most pressing risks affecting corporate entities and the ESG opportunities that are being unearthed.

China Three Gorges Dam

Infrastructure sectors are unquestionably among those most strongly affected by ESG factors. Transportation, transportation infrastructure, power generation, telecoms and regulated utilities networks all provide essential services, and the public expectation of reliable and affordable service must be met to avoid local criticism and political pressure. With these high stakes, ESG risks must be anticipated and mitigated before they impact entities' profitability and credit-ratings headroom.

Rising social risk

Globally, power generators and utilities are facing increased regulatory obligations to retire carbon-intensive generation and switch to renewable energy, with emission-related limitations and fines on the rise (see Graph 1). The intermittency of renewable sources, however, increases the likelihood of disruptions such as blackouts and power shortages, compounding the risk of local criticism or political pressure. Regulators' simultaneous focus on affordability to taxpayers and a renewed focus on sustainability could trigger further pressure on both sectors.

Renewable power generators are also sensitive to social risk given the opposition that facilities such as large hydro plants or wind farms can face from the local community – particularly if they have the potential to significantly disrupt lifestyles and landscapes. A key social challenge for the world's largest hydropower operator, China Three Gorges, is resettling people displaced by the reservoir of its mega-hydropower project development. Although it manages this risk with local government assistance, resettlement costs are still a major part of the company's development expenditure and could continue to rise.

Similarly, transportation and transportation infrastructure entities face social risks relating to land use as their impact on lifestyle, congestion, noise, and air quality is increasingly being brought to the attention of media, investors, governments and regulators. Risk, however, is limited given the critical nature of existing infrastructure and transportation operations, but exposure is likely significant for expansion or new projects, with social opposition limiting growth and ultimately raising operating costs.

A social risk pertinent to airports and rail operators that is often overlooked is social cohesion. Although a low-probability risk, these infrastructure classes represent high-profile targets for terrorist attacks, meaning that security is of utmost importance to maintain stakeholder confidence and overall sector operations. Bridges and tunnels, meanwhile, face the risk of low-probability, high-impact accidents such as the Genoa Bridge collapse, which caused the death of 43 people.

Governance risks exacerbate pressure

Though governance risks are best assessed on an individual entity basis, importance of oversight, a focus on sustainability, and interaction with stakeholders and regulators are concerns which apply largely across the board for infrastructure entities. A high level of board oversight is particularly necessary in the infrastructure sector due to the long-term nature of financing decisions that sometimes require short-term sacrifice.

Graph 1: Increasing number of global ESG regulations

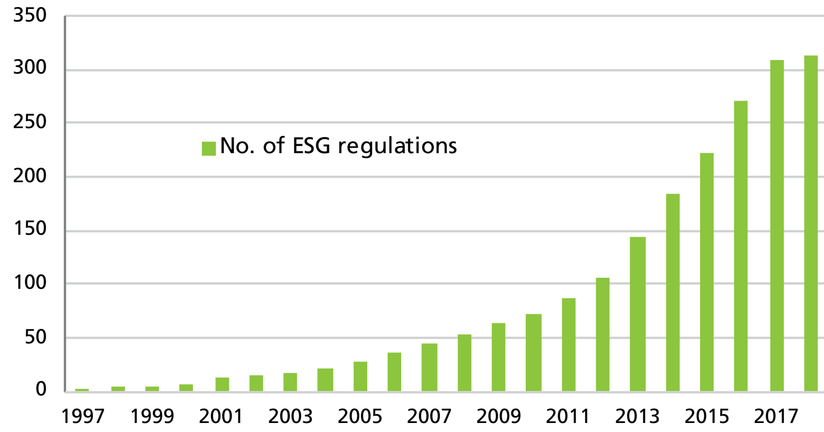
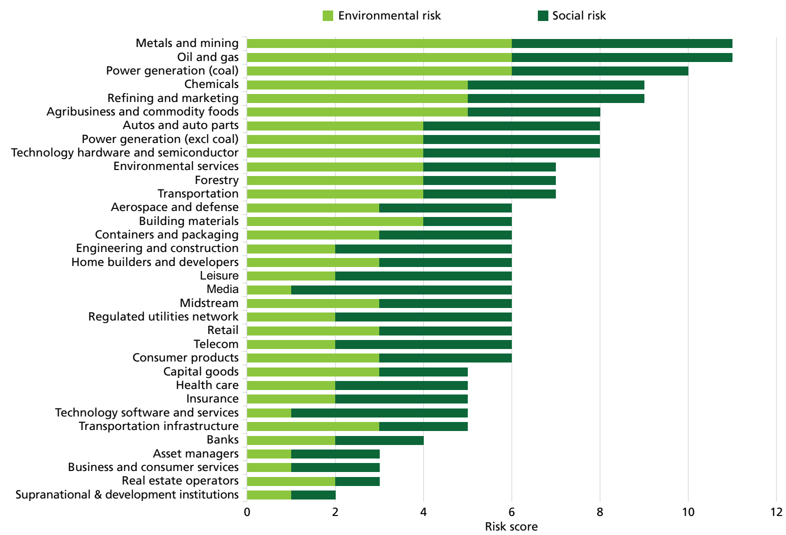


Table 1: Relative environmental and social exposures of a range of business sectors



Source: S&P Global Ratings.

And oversight is especially relevant for nuclear power providers, with the sector facing a need for strict policies that must be aligned with national safety regulators and governmental policies.

Telecoms, too, face heightened governance risk – particularly those operating in emerging markets. These operations can come with regulatory and litigation risk, and may be subject to service obligations in countries where telecoms are seen as a service – such as having to develop physical infrastructure in rural areas – that can affect capital expenditure and return on capital.

Persisting environmental risks

Although core infrastructure sectors are generally less sensitive to environmental risk due to their minimal emissions, they face indirect environmental risk >

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exposure (see Table 1). Transportation infrastructure faces indirect exposure to emissions and pollution from cars, ships and planes, representing a moderate environmental risk. Although this could signal increased risk, albeit indirectly, as emission-related regulations rise, current global mobility demand means that we do not expect demand for transportation assets will fundamentally change over the next decade.

Increasing regulations and fines are encouraging power generators to increase their focus on renewables – but this shift comes with its own environmental risk. Although nuclear has the benefit of zero-carbon emissions, it does carry the (low-likelihood but high-impact) risk of nuclear disaster, and the process of developing and decommissioning nuclear is environmentally intensive. And the land that renewable energy requires – particularly wind, solar and hydro – can have a huge impact on biodiversity and can increase methane emissions.

For electric utilities, regulation is not only increasing pressure, but, where insufficient, represents increased risk. In the case of the recent California wildfires, the courts' interpretation of "inverse condemnation" may hold rated utilities in the state liable for significant damages costs – in effect rendering them the state's reinsurer. However, we do not believe that an electric utility is sizeable, sufficiently diversified, or adequately capitalized enough to act as a reinsurer for the state. Indeed, this has already proven to be the case for Pacific Gas & Electric, which filed for bankruptcy following the devastating Camp Fire in 2018.

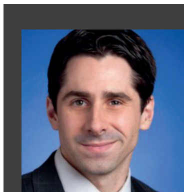
Taking advantage: ESG opportunities

There are some cases of infrastructure sectors taking advantage of opportunities that ESG presents. Australian electricity distributor, ETSA Utilities, has recognized and responded to the rise of renewable solar power in South Australia – where one-in-four residential customers has rooftop solar power – to efficiently manage the size and timing of future investments in its network.

And it's not just utilities that are using rising ESG concerns to stay ahead of the curve. Toll operator Transurban has installed solar panels to generate on-site energy, is advocating for electric vehicles, and is attempting to limit the time vehicles spend idle in traffic to anticipate potential future environmental risk exposure.

As exemplified here, the nature of ESG factors demands a longer-term perspective to comprehensively assess the associated risks and opportunities. Recognizing this, we have built a forward-looking perspective into the methodology of our non-ratings offering, the ESG Evaluation. The Evaluation – which provides a cross-sector, comparative analysis of an entity's operational performance based on the impact that ESG factors could have on its stakeholders and finances – goes beyond the shorter-term considerations relevant to traditional credit rating analyses to encompass emerging risks and an entity's agility in dealing with them further down the line.

As ESG awareness and disclosure practices take root, entities across the sector could be both better prepared for longer-term, emerging ESG risks and able to anticipate strategic opportunities, rather than playing catch-up – something that is increasingly important as such factors have an increasingly material impact on stakeholders and financial performance.



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