

INTERVIEW

TRANSITION REQUIRES TRANSFORMATION, NOT JUST TRIVIAL IMPROVEMENTS



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Ladislav Smia is co-head of the Responsible Investment Research department at Mirova, an investment manager dedicated to responsible investment. Through a conviction-driven investment approach, **Mirova's** goal is to combine value creation over the long term with sustainable development.

Q1. Do you consider there to be any difference between high emitting industries which must be phased out, like power generation from coal, and high emitting industries that are allegedly “irreplaceable” like cement, aluminum, or steel?

At Mirova, we don't approach all high emitting industries in the same way. In electricity production, for example, renewables are becoming more and more economically competitive, putting pressure on polluting coal-based electricity. It's true that cement and steel are more technically difficult to replace, but we don't necessarily agree that cement and steel are “irreplaceable”. Wood can often substitute cement, for instance, even when building high towers. The Mjösa Tower in Norway is 18 stories (or 85.4 meters) tall; the skeleton

and the facade of the building are made of wood.

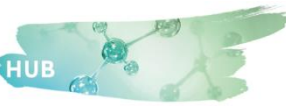
Q2. Selling off coal fired power plants has mainly accounting impacts: the assets usually remain in operation and continue to generate emissions. How can we overcome barriers to exit from some brown activities?

So long as brown activities remain cheaper and more convenient than green activities, it'll be hard to get rid of them. But efforts to put a higher price on fossil fuels have led to major social consequences in several countries. Focusing innovation on green technologies to make them more competitive and attractive could be a more effective and socially just path to achieving the energy transition. Coupled with a general movement to exit brown activities, pushed by public bodies, corporates, investors, and consumers, innovation could put pressure on brown activities. Corporates would then inevitably become less and less comfortable holding brown assets on their balance sheet. You're right that from a climate standpoint, decommissioning brown assets is obviously preferable over simply selling these assets, but it would involve incurring significant financial losses. I believe that public authorities have a strong role to play with regards to financing dismantlement. We cannot require companies to write-off existing brown assets without a regulatory push.



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Q3. Do you have examples of companies that have initiated substantial transformations of their activities or mix of activities?

There are a few good examples. Ørsted, previously called Dong Energy, has already achieved its transition by divesting its oil and gas assets and becoming the world leader in offshore wind. In the UK, Drax switched several of its coal-fired power generation units to biomass. Engie has an ambitious plan to dispose of its coal power capacity. Within the oil and gas sector, most players have changed the way they talk about climate change, acknowledging the need to fight climate change. But it remains unclear how they are going to transform their business model to face these new constraints. We have to bear in mind that the longer we delay non-incremental climate action, the tighter the remaining carbon budgets will be. Still, we must be cautious about the type of transformation we are aiming for. Increasing our reliance on biomass could lead to more deforestation, for example. Natural gas is also often cited as an energy source that can participate in the energy transition, but there is a growing consensus that its climate impact may be substantially worse than expected, as the methane leakage associated with unconventional gas may be higher than initially thought.

Q4. What are the key criteria to assess companies' transition?

We pay attention to both current performance (e.g. % of turnover derived from green activities) and forward-looking elements (e.g. green CAPEX, R&D). We also account for increasing energy efficiency, usually looking for at least a 30% gain, and absolute emissions levels. However, I strongly believe that these metrics must always be contextualized through qualitative assessment to adequately address specificities of the sector, location, and company. In terms of more qualitative criteria, we consider carbon lock-in risks, company positioning, and overall trends within the sector. We should keep in mind that the level of transition required to achieve our **environmental** objectives requires transformation, not just trivial improvements.

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Q5. Why do you think cement or steel industries are not yet in transition?

Most cement and steel companies display only marginal improvements, mainly based on cost optimization with co-benefits. Still, there are few transformative technologies. For steel, using green hydrogen (i.e. hydrogen produced by renewable energy through electrolysis using electricity) as reducing agent instead of coal might be a game-changer. For cement, we have seen clinker substitution mixed with an alkaline activator, enabling cold production by molecular reaction. The carbon intensity of such cement would be lower than that of existing cement. In both cases, these breakthroughs must still prove that they are viable at industrial scale.



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Q6. It is very challenging to assess the transition spillover of Use-of-Proceeds bonds because they hardly affect the overall climate performance of a company. In contrast, do you believe in KPI-linked bonds with a coupon step if pre-established decarbonization targets are missed?

The link between investment and impact is complex, whether in listed equity, fixed income, green bonds, or even unlisted assets. Nevertheless, at Mirova, we believe that finance has a role to play in fostering the transition toward a more sustainable economy throughout all asset classes. Green Bonds play an important role by creating transparency for the market and for investors, linking projects directly with impact. They're a good way to mobilize capital in favor of a more sustainable economy.

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Green Bonds cannot do this alone, though, so it is equally important to review how green bonds fit into the issuers' overall sustainability strategy, how the projects under the green bond would help them transition their business. In contrast, we are not very comfortable with KPI-linked bonds. Issuers of KPI-linked bonds may have to put their “money where their mouth is” with regards to being a sustainable company, and are motivated to do so because they can access to a lower cost of capital if they succeed.

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But from an investor's perspective, the step-up would mean that an investor looking for good return should invest in bonds where they think the issuer is unlikely to achieve its sustainability targets. This creates a misalignment of interests between the investor and the issuer, so I'm not sure it's the kind of investor behavior that should be encouraged.