

Strong economic case for coal divestment

By Al Gore and David Blood

The call for investors to divest from coal assets, one of the most carbon-intensive energy sources, has been primarily based on the harmful social and environmental outcomes linked with carbon emissions. These would by themselves be sufficient to convince many investors to sell coal assets. However, it is also a smart investment decision for purely financial reasons.

It is critical that investors understand the risks they are taking and ensure they are well compensated for them. The economic case for selling coal assets and investing instead in the transition to a low-carbon economy is strong today, and likely to become more robust in the immediate future for three reasons.

First, coal assets are threatened by the advent of attractive renewables, particularly solarphotovoltaic electricity, which are already penetrating the market. Solar powered electricity is becoming a meaningful part of the global energy mix because its carbon-free profile and widely distributed delivery model make it increasingly good economic sense.

Regulatory changes are also curbing demand for coal. Stricter environmental controls to reduce carbon emissions across the globe have resulted in a rising number of coal plants retiring early and have limited the feasibility of opening new coal power plants.

In the US, the Environmental Protection Agency's recent proposal to regulate greenhouse gas emissions from power stations has dealt another blow to coal plants already under pressure from previous environmental rules and competition with natural gas.

The third force influencing coal valuations is rising discontent with the negative consequences associated with carbon pollution. Notably, Stanford University earlier this year announced it will divest publicly listed coal mining companies from its \$19bn endowment, citing, like other fiduciaries as of late, the substantial environmental and social injury caused by coal as the justification for its decision.

The momentum behind divestment campaigns and other forms of protest against coal highlight that burning fossil fuels without regard for the consequences will not be tolerated much longer.

These three disruptive forces significantly increase the probability of a major market correction that will reprice coal assets unfavourably. For long-term investors, the risk of a significant loss within a portfolio as a result of a carbon-related event is no longer remote.

In fact, the repricing of carbon-intensive assets is likely to happen more suddenly and turbulently than many investors expect, as the growing negative effects of carbon emissions – and the market's reaction – will be neither gradual nor linear. Investors should therefore expect significant volatility in asset prices as valuations are adjusted to reflect the impaired ability of coal companies to maintain historical rates of return.

Some argue that coal will persist as an important part of the global energy mix because it is abundant, easy to extract, and currently cheap. However, this assumes coal will dominate as a profitable investment over other forms of cleaner, more efficient energy despite increasing action by the public and private sector to limit carbon emissions. And it implies that innovation and disruptive technologies will not yield viable alternatives, which we are already seeing is a flawed assumption.

Moreover, investors who are long coal are betting that the costs of carbon emissions will continue to be borne by public sector balance sheets, disconnected from coal companies' earnings. Yet as the financial impact of climate change is felt more deeply by governments, investors should expect these rising costs to be transferred back to coal companies and their investors. In some nations and regions, this process has already begun.

The investment implications of moving towards a low-carbon future will develop in convergence with key trends such as population growth in emerging markets, rapid urbanisation, and natural resource scarcity. A surge in resource and design innovation is already presenting interesting opportunities for investors to capture value as the global energy infrastructure, and other fossil fuel dependent industries, are undergoing a transformation driven by these macro themes.

Changes in transport (electric vehicles and fleet logistics), energy (solar and wind), buildings (insulation and lighting), materials (biochemical and nano materials), and water consumption (desalination and irrigation) are a few examples of the ways in which investors can allocate capital into assets that are positioned to succeed in this new economic reality.

Although the moral case for divesting from coal is a powerful one, the economic case for doing so is equally compelling. Of course, traders may find new opportunities to buy distressed coal assets and make money on a short-term basis. However, for long-term investors to be properly compensated for the risks of owning coal, they would have to believe coal will deliver sustained outperformance. Such a belief is increasingly difficult to reconcile with any credible risk-return analysis of long-term trends in the energy sector.

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