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Green Investments Are Not Immune To ESG Scrutiny

By **Michael Murphy and Kyle Guest** (July 27, 2021, 4:52 PM EDT)

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In the past year we have witnessed a significant acceleration of investment informed and motivated by environmental, social and governance, or ESG, considerations.

While many predicted the COVID-19 pandemic would suck the wind of out of ESG investing's sails, the disruptive force of the pandemic instead reinforced investors' imperative to view businesses through a holistic lens, which considers all stakeholders across the value chain.

ESG investors flocking to green technologies and climate change solutions, however, cannot afford to discard their new ESG lenses for green-tinted glasses. Regulators, consumers and the communities impacted by industry will not grant investments into renewables or other clean tech businesses free passes on the full range of ESG concerns.

Investors and businesses that consider and weigh potential ESG downsides with open eyes during diligence will be better positioned to manage reputational, operational and legal ESG risks, and to capitalize on ESG-related value creation opportunities.

In the solar power industry, for instance, concerns regarding forced labor in the supply chain have recently come to the fore. One of the principal raw materials used in the manufacture of solar photovoltaic panels is polysilicon, a high-purity form of semiconducting material used to make solar cells that transform sunlight into electricity.

Approximately 40%[1] of the world's polysilicon is manufactured in China's Xinjiang Uyghur Autonomous Region, or XUAR, where the U.S. has determined that the Chinese government is perpetrating cultural genocide[2] and crimes against humanity against Uyghur Muslims.

Domestic[3] and foreign[4] reports connecting solar technology component production to a Chinese-sponsored forced labor regime in the XUAR, and calling out the companies who are or may be directly or indirectly benefiting from forced labor, have multiplied since the turn of the year.

Due to these concerns, the Biden administration recently fired a first shot across the solar industry's bow by banning[5] the import of products with silicon-based components manufactured by Chinese

company Hoshine Silicon Industry Co. Ltd. This move could be widely felt in the U.S. solar industry, as eight polysilicon manufacturers responsible for more than 90%[6] of the solar-grade polysilicon output in 2020 have been mentioned by Hoshine as customers.

Importers of solar panels from these and other affected manufacturers must now assure themselves that polysilicon from Hoshine has not been used to manufacture their panels. This is a formidable challenge, given the notoriously obscure nature of Chinese supply chains, and the lack of transparency in the XUAR.

The Biden administration's action did not bar all polysilicon from the region. But additional bans from the administration or legislation[7] targeting imports tied to the XUAR are not out of the question.

Along with the potential for operational disruptions caused by any such regulatory activity, ignoring the potential of forced labor in the solar supply chain presents reputational and other compliance risks for solar companies and their investors.

Companies that have made legally mandated or voluntary commitments or statements with respect to the use of forced labor — e.g., signatories to the Solar Industry Forced Labor Prevention Pledge[8] — must take steps to comply with these commitments, or face investor revolt and litigation risk.

Solar companies or investors subject to human rights corporate disclosure and/or diligence laws, such as the U.K.'s Modern Slavery Act or France's Corporate Duty of Vigilance Law, must also evaluate their obligation to assess, disclose and/or — in the case of the Vigilance Law — actively mitigate forced labor issues in the solar supply chain.

Likewise, these entities should prepare themselves for similar or enhanced obligations that the EU may impose in the near future under the prospective corporate due diligence and accountability directive,[9] and the forthcoming Corporate Sustainability Reporting Directive.[10]

The solar energy industry, of course, is not the only climate-friendly sector with ESG problems in the supply chain. Many clean tech businesses have come under attack, for example, as flags have been raised with respect to the carbon footprint[11] of lithium mining, and lithium extraction's impact[12] on local environments and communities.

The water-intensive evaporation technique of lithium extraction has come under particular scrutiny in the water-stressed Lithium Triangle region within Argentina, Chile and Bolivia, where indigenous groups have protested[13] lithium mining's environmental impacts within their communities, and the disparate allocation of mining's economic benefits.[14]

Going forward, the general public is only likely to become more attuned to these communities' grievances, and any other issues in the cross-section of social justice and environmental degradation, if the Biden administration's prioritization and spotlighting of environmental justice is any indicator.

Environmental and social issues in supply chains, whether manageable or the intractable in nature, are worthy of serious attention from companies and investors. More and more companies are establishing supplier codes of conduct, which reaffirm their commitments to ethical business practices, and are setting the tone during the procurement process.

Contracts with suppliers, ideally, should provide companies with due recourse against suppliers that do

not meet ESG expectations. Companies can also require suppliers to report against ESG performance metrics, conduct audits of supplier facilities, support suppliers with guidance and training on desired behaviors — e.g., local community consultation and engagement — and develop their own mechanisms to source-trace supplies to prevent exposure to human rights issues.

For instance, in addition to uniting solar companies under the Solar Industry Forced Labor Prevention Pledge, the Solar Energy Industries Association has provided leadership in forced labor prevention by publishing a 40-page traceability protocol[15] to help its members identify the source of their products' material inputs, trace the movement of these inputs throughout the supply chain and meet ESG goals.

Independent, third-party audit mechanisms are among the core components of the protocol. Companies that tap their leverage to implement these supply chain management tools and mitigate human rights issues can do so knowing that they are exemplifying the responsible corporate behavior envisaged in the United Nations' Guiding Principles on Business and Human Rights.

More generally, companies that earnestly address the environmental and social problems in their supply chains can demonstrate their commitment to all stakeholders, strengthen their resilience and increase their enterprise value. In light of this, shrewd suppliers will recognize that many companies will likely be willing to pay a premium for supplies with relatively lower ESG risk profiles.

Some automakers have already started pressuring[16] lithium producers to develop more sustainable extraction techniques, and the over 200 signatories to the Solar Industry Forced Labor Prevention Pledge will drive demand for suppliers who can provide comfort that forced labor has not tarnished their products.

And while there are prominent ESG risks to be confronted in the supply chains of green industries, there has also been a ramping up of scrutiny of such industries with respect to ESG issues arising past the business value chain — at the end of product life cycles, and everywhere in between. There are mounting concerns regarding the environmental impact of the disposal of the lithium batteries used in the booming electric vehicle market, given the current difficulty of, and lack of capacity to, recycle such batteries.

Again, environmental justice features as an issue here, as the burden of lithium-ion battery disposal[17] has been shifting to low- and middle-income countries with less stringent environmental safeguards than the U.S. Environmental justice advocates will not pull their punches simply because a business is generally viewed as green or climate-friendly.

The White House Council on Environmental Justice, for example, recently released an interim final report[18] that listed carbon capture and storage projects as unhelpful to environmental justice communities, concluding they should not receive the benefits of President Joe Biden's Justice40 initiative.

Scrutiny of the ESG downsides of green industries and technologies commonly viewed as ESG-positive will continue to heighten in the near future. Ultimately, the ESG risks associated with such businesses can be mitigated, and ESG opportunities seized, if investors and businesses are ready and willing to confront these "inconvenient truths" and use their market power to force positive change.

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