

On the Trail of ESG

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Recently, Texas landowners have been hearing about opportunities to earn income by dedicating their land to carbon sequestration, the practice of using plants to capture carbon from the atmosphere and deposit it in the soil. The general idea is that they can earn marketable carbon credits by reducing their carbon footprint. Because there is no thriving market for carbon credits, many have questioned the viability of this emerging trend.

An investigation of this emerging demand for carbon sequestration elicited references to ESG, an initialism for environmental, social, and governance.

What is ESG, and How Did It Originate?

Although ESG didn't really start emerging as a factor influencing corporate decisions until after the pandemic—indeed, some even suspected it was an attempt to politically manipulate business decisions—the concept was first introduced in 2006 by the Principles for Responsible Investment (PRI), a network of investors supported by the Global Compact of the United Nations. The network is made up of voluntary “signatories” pledging to invest in sustainable entities. It began with 75 signatories in 2006, expanded to 1,785 by 2018, and exploded to around 5,400 in 2023.

Takeaway

Since the pandemic, the principles of environmental, social, and governance (ESG) have had a growing influence on corporate decisionmakers. The most visible impact for Texas landowners has been in the growing demand for use of their land for carbon sequestration. While this seems to provide lucrative opportunities for landowners, many regard the market for carbon credits as too young for this to be a viable trend.

Signatories consist of 737 asset owners, 4,140 investment managers, and 534 service providers. Many of these entities are well-known firms. Nearly 20 percent of signatories list the United States as their headquarters country. The UK is home to 14.3 percent; France, 7.5 percent; and Germany, 5.5 percent. Together, these countries account for nearly half of the total.

In 2005, signatories established six principles for investors to incorporate into their investment strategies. Believing that compliance with ESG imperatives would affect investment performance in the long run, they argued that

investors had a fiduciary responsibility to evaluate whether companies conformed to those principles, and to what extent. As signatories strove to make ESG a cornerstone of their analyses, they drafted the following commitment:

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time).

We also recognise (sic) that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

For an introduction to ESG, read “[Down to Earth: Carbon Credits for Landowners](#),” on the Center’s website.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress towards implementing the Principles.

The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General.

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

To encourage compliance with these principles, the PRI has developed a set of 17 “sustainable development goals” (see figure). A description of each of these goals plus a list of targets to achieve them can be viewed [here](#).

The 17 Goals

In 2015, countries adopted the Sustainable Development Goals (SDGs). They embarked on a journey to achieve the 2030 Agenda to promote prosperity, address inequalities while protecting the environment. The 17 SDGs offer the most practical and effective pathway to tackle the causes of poverty, violent conflict, human rights abuses, climate change and environmental degradation.



Source: PRI and United Nations Department of Economic and Social Affairs

Controversies Surrounding ESG Ratings

Such ambitious goals essentially demand that companies desiring access to capital be cognizant of the ESG process. Many enterprises have begun examining the size of their carbon footprint, and many have taken measures to reduce it to raise their ESG score (a low score suggests careless or harmful behavior related to the three criteria of environmental, social, and governance).

However, the processes used by providers (the firms that evaluate companies and calculate the ratings) to assign ESG scores remain murky at best. Most models involve a staggering number of variables designed to measure aspects of each of the components. In addition, the validity of data needed to analyze those variables is often questionable.

In an August 2022 working paper, *ESG Ratings: A Compass Without Direction*, Stanford University researchers noted that the European Securities and Market Authority regarded the market for ESG ratings to be “immature,” and that institutional investors expressed concerns ranging from inaccurate data to inexperienced analysts. Many doubted ESG quality could be effectively summarized in a single score.

They identified patterns and unexplained differences in ESG ratings, noting that large companies’ average ratings were higher than smaller companies’ ratings, possibly because large companies had more resources to devote to ESG. Finally, scores for European companies average higher than U.S. companies, while emerging market firms have scores below those in developed economies. They also found low correlations in rating across providers despite stated goals of evaluating the same issues. One study they cite found that divergences among providers resulted from fundamental methodological variations across rating firms. A follow-up study found, surprisingly, that corporate disclosure of ESG information *increases* these variations.

Another study—*Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions*, which reviewed more than 1,100 peer-reviewed papers between 2015 and 2021—concluded that results

from ESG investing had been “indistinguishable from conventional investing.” Meanwhile, *ESG Performance and Disclosure: A Cross-Country Analysis*, in a regression analysis, found Bloomberg and Sustainalytics ESG scores had no statistically significant effect on returns overall. In a separate, country-focused analysis, only the Bloomberg score produced a marginally (10 percent level) significant result, reducing returns by 0.0799 percent in the United States. The negative coefficient suggests ESG investors may pay a premium for stocks in companies with high ESG scores.

Impact on Texas Landowners

Despite these results, ESG continues to impact strategies of firms focused on responsible investing, and PRI continues to support their signatories in pursuit of the 17 goals. Businesses, mindful of the large pool of capital managed by signatories, have worked to improve their ESG scores.

The most visible impact for Texas landowners is in the demand for using their acreage for carbon sequestration. Reducing the carbon footprint should enhance the landowner’s ESG score, but that motivation may pale in comparison to subsidies provided by the Inflation Reduction Act passed in 2022. Those increased subsidies have inspired renewed activities aimed at capturing and sequestering carbon both in plots of land and in underground caverns.

The latter targets industries that emit substantial amounts of carbon dioxide. Plans call for capturing it at or near the plants releasing the gas, transporting it to a disposal site, and pumping it into a sealed underground cavern where it will be permanently deposited. Owners of land situated over the cavern would receive lease payments for the storage. The Texas Gulf Coast seems to be uniquely suited to this activity.

ESG investment criteria and the Inflation Reduction Act subsidies currently combine to drive demand for landowner contracts for carbon sequestration. 🇺🇸

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