



POINT OF VIEW »

WILL CUTTING CARBON AND ADDING RENEWABLES WIN ESG POINTS? THE ‘FREAKONOMICS’ OF UTILITY INVESTING

The NPR program “Freakonomics Radio” recently took on a thorny question: [“Are E.S.G. Investors Actually Helping the Environment?”](#) (Spoiler alert: probably not.)

The hour-long podcast highlights a recent study by Yale finance professor Kelly Shue that challenges a key outcome of investments driven by environmental, social, and governance (ESG) priorities: the diversion of capital away from “brown” companies that don’t score well on climate metrics in favor of “green” firms that do. An extension of this ESG rubric would suggest that starving the utility sector of capital would drive its demise, taking the carbon emissions with it.

Specifically, the study questions whether denying access to capital or raising the cost of capital for higher-emitting firms might actually *increase* carbon emissions by penalizing the very companies that are best positioned to address the issue.

This happens because ESG scoring encourages redirecting capital denied to “brown” firms into “greener” companies with overall lower emissions. However, these are often financial, software, or communications firms with inherently low direct environmental impact that aren’t physically positioned to cut future emissions.

We couldn’t agree more. The utility industry—historically and currently among the largest carbon emitters in the world—has the necessary knowledge and expertise on this topic and is well positioned to meaningfully address it. Yet embargoing capital to the extreme of utility extinction would likely force increased use of even “brown” alternatives such as diesel generators to maintain reliable power.

In the real world, utilities are actively reducing their carbon output, and have been for a decade or more. Since peaking in 2005–2007, U.S. carbon emissions have fallen 18%, primarily thanks to the power sector’s replacement of legacy coal-fired generation with natural gas, facilitating greater use of renewable wind and solar energy.

Regulated Utilities’ ESG Advantage

Regulated, power-generating utilities are uniquely positioned to profitably disrupt their own business by reducing emissions. How? Unlike enterprises that earn profits on sales, the utility earns a regulated return on capital employed in its business (the rate base in utility-speak). While subject to oversight by state regulators, investments that allow substitution of new and cleaner resources for less efficient and often fully depreciated coal generation facilities often lead to a trifecta: lower fuel and operating costs for customers,



enhanced earnings and dividend growth for the utility, and reduction of CO2 and other emissions to achieve public policy goals.

Unfortunately, static ESG rankings often lack context, failing to factor in utilities' myriad carbon reduction strategies and the results achieved thus far. Sometimes, the existence of a single coal or nuclear plant can tank an ESG ranking and block investment. Worse, it can steer capital away from a sector that is generating positive returns by actively investing in emission-reducing technologies.

On the surface, ESG doesn't appear to be hurting utility access to equity capital; the sector currently trades at less than a 10% discount to the S&P 500 on one-year forward price/earnings. However, about \$2.5 trillion is today invested in ESG-related vehicles, a chunk of capital the utility sector can't simply ignore.

Debt financing may be more directly affected: the major credit rating agencies have begun incorporating ESG-related factors, such as the potential impact of severe weather, flooding, and drought, into their risk evaluation protocol, which could pressure ratings and raise capital costs. In some instances, credit investors have turned down utility debt offerings due to ESG-related blockers.

Addressing the Broader Trend of Thematically Driven Investment

The business of rating and ranking companies and industries on ESG metrics has become an entire industry, and the sheer number of scoring mechanisms can be overwhelming. But ESG also seems to reflect a

broader trend toward thematic investing built around everything from climate issues to artificial intelligence.

Under this approach, investable capital is allocated to sector "buckets," with individual stock selection often delegated to specialty fund managers, many of which rely passively on algorithmic screening. This top-down, data-driven investment leans heavily on macro factors and trends and far less on company and sector-specific research.

The utility industry and specific utilities have gone to great lengths to communicate progress and commitment to climate and other sustainability initiatives. Some of those efforts have attracted a broader investor audience and more robust valuation metrics, but it's uncertain how effectively this message resonates with index funds, three of which collectively own roughly 20% of the S&P 500 and themselves have faced criticism on [ESG and other political issues](#). To generalist investors and advisors, utilities are seen as an arcane, highly regulated corner of the market, not a sector to get excited about, which partially explains the concentration of ownership among specialty hedge funds. To an algorithm, a utility might "screen" as an obsolete relic that's dooming the planet, while in fact it is actually smoothing the transition to cleaner energy.

There is considerable market interest in climate-related investment, but the utility sector's current and expected contributions have been overlooked by current ESG trends. That's unfortunate. Given the power sector's demonstrated ability to lower emissions, utilities need to amplify their message of achieved and targeted emission reductions and their crucial role in furthering the transition to cleaner energy.