

Impact of ESG risk on credit ratings of the US coal industry

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Introduction

The <u>coal industry</u>, due to its very large carbon footprint, scores high on risks related to <u>environmental and social factors</u>. Governments and investors across the globe are trying to lower their exposure to the coal industry in response to increased awareness of the need for low-carbon economies. This increases the risk of lower demand and higher refinancing risk for the coal industry. The current <u>pandemic</u>-induced slowdown in economic activity, leading to lower <u>energy</u> demand, has amplified demand risk for the coal industry. This article evaluates this risk from the perspective of major credit rating agency Moody's. The ESG-related risks were a factor that limited its ratings for the US coal industry. Of the five issuers in the US coal industry it rated, the credit rating outlooks for three have been revised to "Negative" and those of the other two have been downgraded since the start of the pandemic.

Moody's ESG framework

From humble beginnings as a socially responsible investing movement, ESG factors have grown to become a trending theme in global financial markets. While the initial focus was on equity_markets, debt capital markets are also becoming increasingly interested in ESG. Assessment of ESG risk in credit analysis has gained traction recently, in efforts to limit downside risk and allocate capital to sustainable projects.

Since 2015, investors have been asking credit rating agencies to systematically incorporate ESG characteristics in their <u>credit ratings</u>. The biggest challenge that credit rating agencies face when trying to integrate ESG in their rating process is the availability of ESG data and the quantification of ESG credit considerations. In a survey of more than 240 market participants conducted at Moody's annual ESG conference in London in October 2019, 52%

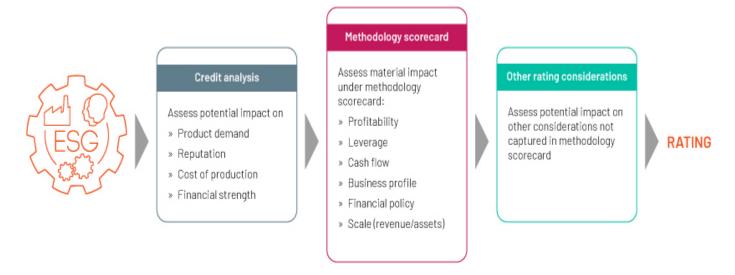
of the respondents regarded the availability of data and disclosures as the biggest challenge when integrating ESG issues into credit risk.

To overcome this challenge, Moody's has devised a framework for evaluating ESG-related risk and its impact on credit ratings. The framework largely entails recognising an entity's exposure to the relevant ESG-related risk, analysing the entity's performance in terms of managing such risk and assessing the potential impact of such risk on the entity's credit risk profile. The impact of ESG-related risk is generally negative, but it could be positive for issuers willing to mitigate the risk.

Moody's approach is to measure the impact of ESG considerations on

- 1. The issuer's cash flow and value of assets over time
- 2. The adequacy of cash flow and assets in relation to the issuer's debt and other financial obligations
- 3. The issuer's liquidity and ability to access capital

The ESG risk is factored into both qualitative and quantitative sub-factors of the rating grid, as well as outside the rating grid. In the event of sufficient visibility, ESG risk is incorporated quantitatively in key credit ratios through financial projections and scenario analysis. ESG risks, likely to emerge over a prolonged period or in instances where there is limited information available to quantify such risks, are incorporated into ratings through qualitative factors such as business profile, institutional strength, regulatory environment and financial policy. Some ESG risks can also be factored in outside the rating grid, if not already considered in the sub-factors of the rating grid.



Source: Moody's criteria dated January 9, 2019 on General Principles for Assessing Environmental, Social and Governance Risks

Negative rating action seen in the US coal industry due to heightened ESG concerns

With ESG factors playing an increasingly vital role in deciding the creditworthiness of a company, the US coal industry seems to be very badly hit by all the three risks, as explained below.



- » Due to the increasing environmental hazards of coal-fuelled energy, demand for coal has declined steadily over the years. Coal consumption by electric utilities declined to 539.4m tons in 2019 from 851.6m tons in 2014.
- This trend has been further amplified by the COVID-19 pandemic-induced slowdown in economic activity, leading to low demand for electricity and, therefore, for its major fuel coal. Coal consumption by the US electric power sector is expected to fall by 30% y/y in 2020.
- » Coal demand from the steel industry has also declined as steel producers idled blast furnaces in early 2020 in response to the coronavirus outbreak.
- The slump in coal demand is expected to last longer, as low natural gas prices, exacerbated by the current slowdown, would accelerate the reduction in the share of coal in the mix of fuels in electric power generation.
- » To factor in this trend of declining demand, Moody's expects US coal industry EBITDA to decline by 50% in 2020 and recover modestly in 2021.
- » Many investors are averse to investing in the coal industry amid intensifying ESG issues. Except for the top producers, the majority of coal companies have not accessed the bond and syndicated loan market since the start of the pandemic. As of early July 2020, most unsecured debt was trading below par, with yields that would not be economical for new issuances.
- Moody's believes this high refinancing risk will further deteriorate liquidity already being adversely impacted by lower cash flow from operations amid the current economic slowdown.
- Political developments unfavourable to the coal industry add to the social risk. This is reflected in regulation revising the approach to black-lung liabilities, requiring more collateral amid a weak market environment, and a recent US Federal Trade Commission ruling against the joint venture between Arch Resources (B1 Negative) and Peabody Energy (B3 Negative) in the Powder River basin that would have helped these companies compete against alternative fuels.
- High governance risk, reflected by the fact that the coal industry's credit risk profile did not improve despite favourable industry conditions over 2017-19, as companies paid out more than half of their operating cash flow to shareholders during the period. Moody's factors this in as a weak financial policy and governance framework, as management teams favour shareholders' interests over creditors' interests.

Due to the abovementioned risks, Moody's has taken negative action on most rated US coal companies in 2020. Credit profiles of coal companies are expected to deteriorate steadily as governments and investors look to lower their exposure to coal-based industries, resulting in lower demand and fewer capital resources for the industry. A revival of the credit profiles of coal companies seems less likely in the near term.

As <u>ESG</u> gains prominence in the credit rating process to meet increased investor demand,

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https://acuitykp.com/solutions/ratings-advisory/.

Sources:

Moody's criteria on 'General Principles for Assessing Environmental, Social and Governance Risks'

Moody's Survey the relevance of ESG in global credit markets

https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1236866
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