Wavestone ESG Activity Report - 2020

ESG activity – March quarter 2020

Through the quarter our team had extensive contact with our portfolio companies in relation to the key risk factors identified with relation to COVID-19 and steps taken to mitigate them, particularly in an effort to keep employees safe and assets productive. We focussed particularly on our resources and energy companies given the remote nature of many of their operations, fly-in-fly FIFO) out workforces, complex supply chains and the interface with vulnerable local indigenous communities.

In particular our conversations with **BHP, RIO Tinto, Northern Star, Woodside and Oil Search** (as well as other non-owned companies) highlighted several key risks to maintaining employee safety and well-being as they faced the outbreak of COVID-19. With employees being the heart of their operations, the challenge of 'getting it right' was non-negotiable.

The most common theme emanating from our discussions all was an absolute commitment to safety, with operational planning for COVID-19 established in early January and well before government mandates kicked in. These moves saw a dramatic reduction in on-site personnel through change in rostering and deferral of non-essential maintenance. FIFO workers now undergo mandatory isolation on many sites before engaging in work practices and extreme social distancing measures including restrictions on interacting with local vulnerable communities have been enacted.

In addition to operational risk, we noted a substantial effort by many companies and in particular BHP to show strong "social leadership" in Australia and supporting the local communities by such measures as:

1. Bringing forward invoice payments to suppliers to support the viability of their businesses during COVID-19
2. Announced they would hire an additional 1,500 workers on a rolling 6-month basis to support operations. Many of these include trade workers stood down from the aviation industry, one of the worst hit sectors from COVID-19.
3. Contribute capital to community funds charged with delivering health, mental health and indigenous programs

So what was the outcome? The resource industries' pre-emptive work has paid off, with proportionately lower infection outbreaks at operational sites and operations remain relatively unaffected. From a social governance perspective, we have noted that the resource and energy sector has been given dispensation given to continue operations even when tougher restrictions for other parts of society have been enacted. While it's easy to assume a default position that the government needs the income from mining and would have let them operate anyway, in our view, this wouldn't have been possible if the sector hadn't addressed their ESG responsibilities and let COVID-19 spread through their operations.

ESG activity – June quarter 2020

During the quarter our team met with BHP, Fortescue Metals and Rio Tinto to discuss their approach to indigenous relationships and specifically land use agreements. Below we share some of these thoughts:

The catalyst for this investigation were the allegations against Rio Tinto for destroying the Juukan Gorge Caves without permission that were reported on the ABC on 29th May 2020. Like many, we were shocked by the relationship breakdown between Rio Tinto and the traditional owners of the land, the Puutu Kunti Kurrama and Pinikura (PKKP) people, which ultimately became aired in the public domain at that time.

Our concerns are two-fold:

1. Is the mining industry behaving in an ethical manner regarding Indigenous engagement and do they take it seriously?
2. Will the fall-out from Rio Tinto's actions negatively impact the industry structure for miners and impair the future profitability of their assets?

Regarding the first issue, our view is that miners generally seek to reach an amicable relationship with the indigenous community to develop and operate assets, which includes initial engagement, operational protocols and financial assistance. This approach is important given the long-term nature of mining operations a healthy co-operative relationship is required between all parties for a sustainable business to be undertaken.
Indeed, our experience is that the focus on indigenous communities has increased over time, not just by miners but also oil and gas companies. Meetings with the Indigenous Affairs teams at BHP and FMG during the quarter reinforced this view. That said this approach isn't perfect and tensions often arise given the complex issues

relating to land use agreements which can evolve over time and complicate the original foundations that underpinned the original development consent.

With respect to the Juukan Gorge Caves issue, we are of the opinion that RIO's behaviour and broader industry issues need to be separated. While we were able to have direct access to Rio Tinto Iron Ore Management and have conveyed our disappointment to them, our interactions didn't offer any additional insight than was contained in company press commentary which doesn't surprise given the scrutiny. RIO has since announced a Board-led review into its processes. We now have to await the findings/facts from these enquiries to be published to inform our views of subsequent actions that we may need to undertake.

The Western Australian Government is in the midst of consultation process for a review into the Aboriginal Heritage Act. With much of the consultation period already concluded, there appears a consensus that whilst the current statutory process works reasonably well it could be more contemporary. It is clear that indigenous stakeholders want to be empowered to take ownership of managing their heritage, and become strategically involved in land use proposals. In addition, the Government has also indicated that proposed reforms will also include an improved system for land use approval that strike the right balance between protecting Aboriginal culture and economic development. In our view, given the above information we are unlikely to see a material deviation from the current industry structure for the miners as a result of the industry reforms being considered.

ESG activity – September quarter 2020

We wrote about the Rio Tinto Juukan Gorge Caves issue in the last quarterly. We expressed the opinion that that RIO's behaviour and broader industry issues need to be separated. We were awaiting the findings/facts from these enquiries to be published to inform our views of subsequent actions that we may need to undertake.

Following the publication of the inquiries as well as the Senate submissions it became clear that systematic failures were evident in RIO's approach to Indigenous Heritage and also lack of appropriate governance processes to prevent these issues occurring. In our view it appeared there was also an underlying culture issue residing within the Iron Ore business within the company, which not only contributed to the Juukan Gorge blast but also other incidents that have occurred within the business over time, including the treatment of key contractors.

We were also concerned that board's initial response to its own review was inadequate, given the significant impact of the above incident and need to restore credibility with indigenous communities. We engaged with an Australian based NED as well as a formal meeting with the Chair, Simon Thompson. However, during these meetings we felt that our concerns weren't being fully addressed and that RIO Tinto could become 'uninvestible' unless more dramatic steps were undertaken . Subsequently, we were a signatory to letter on the inadequacy of the actions to restore credibility with the indigenous communities that we believe ultimately contributed to management change being announced.

From here RIO faces a significant challenge on a number of fronts.

1. Firstly, the company's social license to operate continues to remain under threat as the fall-out of RIO Tinto's actions are digested. Confidence in the board remains low given their handling of the above fiasco and while legally, RIO doesn't appear to have broken the law in its actions, a financial settlement with the Indigenous community may be necessary to provide a 'clean slate' to move ahead.

2. Secondly, RIO has to rebuild their executive ranks with both the CEO's position and head of their most profitable division, iron ore, need to be filled. With limited bench strength and the prior events transpiring we expect an external hire to be strongly considered by the board. This change may impact the current strategy of the company and subsequently impact our investment case.

3. Lastly from an operational perspective, we think there remains significant risk on RIO's forward production profile in iron ore and in particular the view that production would rebound to 360Mtpa once the new Koodaideri development is commissioned in 2022. The risk is that development consents are delayed for its new mines and at the extreme aren't granted. Subsequently, we have lowered our future production forecast for the company's iron ore division.

Wavestone is also pleased to announce that it is one of 8 inaugural signatories to the Hesta 40:40 Vision which launched during the quarter. The initiative was set up to increase the proportion of women in senior leadership across Australia's largest listed companies to at least 40% by 2030. We believe gender diversity at a Board and management level promotes superior corporate DNA and can help firms make better decisions to deliver long-term shareholder value. To find out more about the pledge, visit hesta.com.au/4040vision.

ESG activity – December quarter 2020

We engaged with Santos through the December quarter regarding ESG, particularly regarding their emissions policy. Of particular interest was the company's plan to become a net zero CO_2 emitter by 2040 despite aiming to increase production by 36% to 120mmboe over that same period.

The strategy involves two interim targets. Initially, Santos aims to reduce emissions by 26-30% by 2030 and then a further reduction to net zero emissions by 2040. The centrepiece of Santos strategy is the planned investment in Carbon Capture and Storage (CCS) followed by an investment in hydrogen production. Outside of this Santos will continue its business as usual practice of energy efficiency projects and investments in land based offsets.

Santos CCS investment is likely to begin in 2021 through the 1.7mtpa Moomba project. The project is FID ready and is awaiting the qualification for Australian Carbon Certificates which is anticipated to occur in the 2nd half of 2021. Construction is expected to take 3-years with startup due in 2024. In our view this project is likely to attract considerable interest given that globally carbon capture and storage has been met with scepticism due to the cost of developing these projects and also the ability to guarantee storage of CO_2 once it is harvested.

The Moomba project has some distinct advantages that address the above concerns. Firstly, Santos already separates CO_2 from at its Moomba gas plant and secondly given production started in 1963 from the area, there are a large number of depleted gas reservoirs sitting under the plant infrastructure where the company has good data measuring the veracity of the reservoirs to meet desired performance criteria. With these two factors in mind, Santos believes the first stage could be delivered for a capital cost of A$125-$155m and operating costs of A$6-8/t of CO2. The all in break-even price for the project would be A$30/t$CO_2$.

With Santos existing production under its baseline CO2 levels, the company is likely to sell carbon credits produced from Moomba to third parties who need to reduce their own emissions and generate revenue. At present, with the current Australian carbon pricing (ACCU) at $16-$17/t CO_2, the project would be cash positive but not economic unless the price for carbon increases. The case for an increase in carbon prices revolves around further tightening of carbon emission limits in Australia as well as parity to global prices. We note that current European credit prices are €33/t.

If the Moomba CCS is successful, Santos plan to expand the project considerably both at Moomba (which is STO's largest CO_2 emitter) as well as other hubs, such as at the GLNG development. In addition, CCS is a critical enabler of STO's hydrogen plans, whereby STO would commence production of blue hydrogen initially to fuel ancillary power at Moomba before expanding to become an export using its existing infrastructure network.