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COMMENTARY

The transition from a fossil fuel-powered economic system to one run primarily on clean energy will involve difficult and expensive trade-offs. Few present a more pressing challenge than the exponential increase in demand for the minerals essential to the functioning of clean energy technologies, from wind turbines and solar panels to batteries and electric vehicles.

Under the International Energy Agency's Sustainable Development Scenario, total mineral demand from clean energy will quadruple in the next 20 years. Whilst central to the transition to a lower-carbon economy, it is a trend that could also help fuel economic development. But surging demand for the likes of lithium, cobalt, graphite and nickel comes with social and environmental consequences that threaten the security of global supply chains and considerable economic damage. The United Nations Environment Programme speaks of a "delicate balancing act" between the benefits of energy transition minerals and the risks that pervade the entire value chain.

How best to resolve or at least mitigate these tensions was the focus of the OECD's recent 'Forum on Responsible Mineral Supply Chains' in Paris. The conference brought together companies, policymakers, industry bodies, NGOs and a handful of investors to discuss how better to identify, understand and address this often-underappreciated but potentially material financial risk. Three members of Walter Scott's team were also in attendance.

A Question of Complexity

The global mineral supply chain is a complex web of inter-connected relationships and intermediaries. There are many stages along the path from initial extraction to end-user, from mining and aggregating to trading, transformation (often at multiple stages of the supply chain) and manufacturing. Risks exist at every stage. These risks are often heightened due to the location of significant mineral deposits in countries with weaker governance structures, limited financial resources and poor disclosure.

One conference discussion focused on Myanmar as one of the world's largest producers of rare earth elements, widely used across modern technology. The extraction of these vital minerals now often takes place in unregulated and illicit mines operated by paramilitary organisations. Environmental damage, biodiversity loss and human rights abuses are widespread. Overwhelmingly, processing takes place in China, from where these illegally sourced minerals inevitably find their way into products in Western markets. A representative of the US State Department stressed that it was impossible for the private sector to be sourcing responsibly from Myanmar today.

The situation in Myanmar gets to the crux of the problem facing so many mineral supply chains. Not only are they exposed to numerous risks that render them susceptible to major disruption, but measuring and addressing these risks is made extremely difficult due to a lack of access and disclosure. Yet the critical nature of the minerals means alternative options are limited, leaving companies facing potentially significant financial and regulatory risks.

Targeted Change

A conversation with the semiconductor manufacturer Intel highlighted the difficulties facing companies in this area. All manufacturers of chips and microprocessors require an array of minerals in their production processes and Intel outlined its work, undertaken for over a decade, to address risks in its supply chain, starting with so-called 'conflict minerals' from the Democratic Republic of Congo and adjoining countries. Since then, it has developed a framework to cover minerals originating from other conflict-affected and high-risk areas in alignment with the OECD's due diligence guidelines.

However, even a company the size of Intel acknowledges that the scale and complexity of its supply chain makes it difficult to trace source materials. This is further complicated by the fact that Intel does not procure any minerals directly, relying instead on a network of suppliers located around the world. It is far from alone in this. According to the Initiative for Responsible Mining Assurance, companies globally are finding that they can only get so far on traceability before hitting a brick wall.

Where Intel feels it can have an impact is at key "pinch points" in the supply chain. One of these is the smelting stage. Once a mineral is processed, identifying its country or mine of origin is challenging. Partnering with smelters allows Intel to interrogate the provenance of the minerals before this occurs. This is no silver bullet, however. Many smelters refuse to provide the information requested, whilst government data protection laws often prevent disclosure, notably in China and Japan. Indeed, some in the smelting industry complain that they are being asked to do too much and that more responsibility should fall on commodity traders further upstream.

Faced with these roadblocks, Intel is right to emphasise that there is only so much it can do as one link in a supply chain of thousands. The most powerful driver of change will be coordinated collaboration with other industry players, business partners, governments and NGOs. This is too big a problem to solve in isolation.

Collaboration is Key

Albeit from the viewpoint of a quite different industry, Intel's sentiments were echoed by Léo Daguet, the Chief Sustainability Officer of the Watches & Jewellery division of LVMH. As a leader in the world of luxury, LVMH aims to go beyond entry-level compliance by establishing best-in-class practices. It follows OECD guidance, maps its supply chain, carries out due diligence and makes sure all suppliers sign and comply with its supplier code of conduct. Like Intel, however, Mr. Daguet is acutely aware that this is an extraordinarily complex situation. LVMH's position at the end of the supply chain means that refiners and miners are typically several steps upstream in the supply chain.

Traceability is further complicated by the proliferation of artisanal and small-scale gold mining (ASM) in the company's primary mineral supply chain. Whilst there is a widely held view that most ASM is illegal, this is not the case. Many ASM miners operate within the law, albeit informally. Furthermore, the industry maintains millions of livelihoods and LVMH is committed to supporting legitimate players whilst collaborating to improve traceability. There are very real challenges, however. For example, in recent years the fall in the price of cocaine has prompted illegal gangs in Latin America to move into gold mining. Not only is there more money in gold, but it is also easier to conceal and transport. This is clearly not a problem that LVMH can address alone, so combined action with peers, governments and regulatory bodies is essential.

This was perhaps the overriding message of the conference. For mineral supply chains to be made more secure and sustainable, coordinated collaboration will be vital. Companies are still in the initial stages of getting their arms around the issue and are starting to recognise the limits of what can be achieved in isolation. To make collaboration effective, cross-industry standardised frameworks will be required, backed up by legislation, regulation and international diplomacy.

All this will naturally take time, so companies and investors are still very much in the foothills of addressing this issue in a coherent manner. Until then, it is incumbent on investors to work to identify and understand the risks in their mineral supply chains that threaten disruption and regulatory and reputational damage. Similarly, as long-term investors, we will seek to engage with companies where we believe this issue poses a financially material risk. As the global energy transition evolves, these risks will only grow more acute.

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