FIRES BURN SE ASIAN ASSETS

Indonesian Government Growth Down, Corporates’ Earnings Uncertain

Key Findings

- Ineffective governance drives fires resulting in industry anxiety
- Analysis projects Indonesian government could lose USD 35 billion in revenue
- Investors sell shares
- Supply chain contracts now in question
- Government agencies question license to operate
- Casualties cause potential future health risk liability

Financial Consequences Result from Burning Through Assets

Across Indonesia, an area half the size of Switzerland burned in less than four months this year, with investors’ capital going up in smoke. From July 1st to October 20th, 2015, 97,000 fires were detected in Indonesia, and over two million hectares of forest caught fire, one-third of which were High Carbon Stock peat forests. Sumatra and Kalimantan were hardest hit with over 800,000 ha burnt each. Papua has over 350,000 ha of land burnt. Investors may lose money as ineffective oversight and enforcement by plantation companies, as well as local and national government, has allowed fires to burn without proper control measures in place. The resulting haze in SE Asia is now a material financial issue for investors as governments, individuals, and investors consider legal and financial action.

Figure 1:

Thousands of hectares on fire in Muara Kendawangan, West Kalimantan, October 16-24, 2015.
Lack of SE Asian Governance Causes Fires, Results in Deadly Haze: Singapore has been suffering from the health consequences from Indonesian haze since the 1970s. Recently, Indonesia recently ratified the ASEAN Agreement on Transboundary Haze Pollution, opening doors for liability. While the annual haze is predictable, the public conversation and both public and private institutions focus on “who lit the match,” not on “what drives the fires.”

Poor Governance and Weak Law Enforcement: Fires emerge at the edges of cultivated land. Newly cleared plantation land commonly catches fire. Over the past decades, Indonesia has made numerous announcements to take responsible parties to court and hold them financially responsible. This rarely occurs on a scale matching the problem. In fact, the Indonesian government enables the haze by letting corporations off the hook and allowing smallholders to burn up to two hectares of land (Indonesia’s Environmental Management Act Nr. 32/2009, Art. 69(2)). Currently, while Indonesia’s Ministry of Environment and Forestry reportedly is investigating 276 cases involving companies causing fires, they have so far withheld the names. This can pose reputational risks even for responsible palm oil companies as investor concerns about the sector grows.

New Policy Shows Promise, Implementation Needed: Through a series of presidential and ministerial-level instructions, the Ministry of Environment and Forestry recently issued instruction to plantation companies banning the clearance and conversion of peatlands across the country. The move notably extends to existing concession areas. The government is also issuing a ban on the use of fire for new land clearing, as well as a ban on planting in recently burned areas in order protect them for future restoration. Prominent civil society groups hailed the move as a major step forward but warned “the policy must be made practical with a clear timeline for implementation, and given teeth through sanctions for non-compliance” and called for a binding presidential decree (perppu) to strengthen the non-binding government instructions.

Material Costs to Private and Public Sectors: The Indonesian government estimates the fires and haze will cost Indonesia USD 35 billion. These costs would amount to about four percent of Indonesia’s gross national product, wiping out all economic growth for 2015. With many direct and indirect socio-economic impacts, the total costs to Indonesia’s economy could exceed USD 50 billion.

Fires’ Health Impacts Make Children Sick and People Die: Approximately 40 million people are breathing in noxious smoke each day. At least 19 people in Sumatra and Kalimantan have died, and thousands, mostly children, have been hospitalized because of severe respiratory illnesses. The National Disaster Mitigation Agency (BNPB) states that the fires have put more than 500,000 people in six provinces – Riau, Jambi, South Sumatra, West Kalimantan, Central Kalimantan and South Kalimantan – at severe health risk resulting from acute respiratory infections. Studies estimate that fires cause life-threatening illnesses that kill an estimated 110,000 people every year across SE Asia, especially new born babies.

Contagion Financial Impacts: For example, Indonesian airline company PT Garuda Indonesia (GIAA:II) reports to have lost at least USD 8 million in September and October 2015 because fires delayed and canceled over 1,600 flights.
Singapore’s Trans-boundary Haze Pollution Act 2014: Several Indonesian plantation companies, including Asia Pulp and Paper, have faced legal action from Singapore’s Trans-boundary Haze Pollution Act, which allows fines up to $1.4 million for air pollution. Confidential interviews confirm further possible Singaporean government legal action against company directors who are responsible for the fires.

Palm Oil Production May Fall 10% to 20%: The persistent haze contributes to stunted fruit growth and disruptions in harvesting during peak production season, an IJM Plantations representative was quoted saying. The smog may also choke weevils, or beetles, which aid in pollinating palm fruits.

Fires Cause Loss of Landbanks and Estate Assets: For some smallholders and larger companies, their physical assets literally are burnt to ashes. Most losses are caused by mismanagement of operational risks, exacerbated by weak government oversight and enforcement, resulting in increased operational costs and greater revenue uncertainty. The Riau branch of the Indonesian Palm Oil Association (GAPKI) estimates significant losses for palm oil plantation owners as a result of the fires between August and September 2015.

Fires Smolder Underground for Years: Peat fires are the main source of the haze, which is also more toxic than particles released from above ground burning. Planters report “tinderbox” dry conditions in the field. Fires may cover hundreds of hectares at once and reach up to 60 meters tall. Eerily, as fires smolder in the peat bed underground, fires may also spontaneously appear from 5 meters underground.

Indonesia Burns Because of Poor Management and Governance: Newly cleared plantation land commonly catches fire, typically a few months after companies have deforested and drained their land. Fires often appear at the edges of cultivated land from where they can spread in all directions directly impacting planted plantations.
Palm Oil Companies use Fire for Deforestation: Fire is the cheapest and fastest way of clearing land for plantation expansion. The extreme dry season caused by the global El Niño phenomenon in 2015, which all asset owners expected and many properly governed plantation companies planned for, has made fires historically destructive. The result is good governance pays as poor governance may degrade assets.

Poor Governance Causes Fires: Plantation companies are required to have fire prevention and mitigation measures in place as a precondition to various permits, particularly the Environmental Permit (Izin Lingkungan), which grants the right to commence land development. But there are strong incentives to evade this regulation as financial analysis has shown that land prices go up by IDR 3 million per ha after clearance.

Fires Burn Orangutan Habitat: Fires have destroyed orangutan habitat in High Conservation Value and High Carbon Stock forests on the plantations of Golden Agri-Resources Ltd. (GGR:SP), IOI Corporation Bhd. (IOI:MK), and PT Austindo Nusantara Jaya Tbk. (ANJT:IJ). These fires and the destruction of HCV and HCS areas undermine these companies’ No Deforestation, No Peat, No Exploitation (NDPE) commitments. The Indonesian National Disaster Management Agency (BNPB) recorded the loss of 2,398 ha of land biosphere and 21,214 ha of forestland caused by fires in 2015. In Riau, Sumatra, 30% of the fire hotspots were identified in conservation areas.

Reputational Risks: Regional and international media are investigating companies in connection with the fires and deforestation. The Indonesian Ministry of Environment and Forestry reportedly is investigating 276 cases involving companies causing fires, though it has so far withheld the names. In October 2015, it was announced that five tree plantation companies, two logging companies, and three palm oil companies...
were facing administrative sanctions. One of the companies being investigated includes IOI Corporation Bhd. (IOI:MK) subsidiary PT Bumi Sawit Sejahtera.

**Figure 4:**
Fires threatening High Conservation Value orangutan habitat area and High Carbon Stock peat swamp forests near the palm oil plantations of First Resources Ltd. (FR:SP) and PT Eagle High Plantations Tbk. (BWPT:ID) in West Kalimantan, September 2015.

Institutional Investors Seeking Opportunities That Avoid Burning: The Norwegian Government Pension Fund Global (GPFG), like many investors, is exiting from investments in palm oil companies because of the industry’s track record of poor governance and fires that increase operational costs, increase possible health care liabilities, and increase market risks as future revenue streams are degraded. In August 2015, GPFG announced that it was exiting its investments in Genting Berhad (GENP:MK), IJM Corporation Bhd (IJM:MK), and POSCO (005490:KS). The GPFG concluded that POSCO subsidiary PT Bio Inti Agro’s activities represented unacceptable financial risk as recent satellite imagery showed a significant portion of its newly cleared concession area in Papua New Guinea was on fire.

**Figure 5:** Fires in PT Bio Inti Agro’s new clearings in Papua (22-30 September 2015)
**Financial Risks from Losing License to Operate:** Palm oil companies face risks to their license to operate. The Deputy Governor of Papua recently called for the closure of palm oil companies found guilty of forest burning.\(^{18}\)

*Figure 6:*

Open fires in an Industrial Tree Plantation concession in West Kalimantan, September 14-22, 2015.

**CSPO Contract Suspension and Cancellation:** Given overwhelming evidence that Korindo Group is involved in large-scale deforestation and burning in Papua, its subsidiary **PT Tunas Sawa Erma** is at risk of being suspended from certified sustainable palm oil (CSPO) supply to **Wilmar International Ltd. (WIL:SP)** and **Musim Mas**, two customers of the Korindo Group.

**Investor Demands Driving Change**

**Investors Need Effective Governance to Enable Plantations to Commit to No Deforestation, No Peat, No Exploitation (NDPE) to Decrease Financial Risks:** NDPE policies contribute to effective governance while enabling operative fire risk mitigation and improved land management. Without transparent and verified NDPE commitments, plantation companies risk suffering from poor governance that often leads to greater risk of fires that hurt a company’s ability to meet achieve its revenue expectations. Without company action, investors may be left with stranded assets.

**Investors Demand Good Governance:** It is no longer viable for local and national governments to excessively lease out land to plantation companies regardless of their ability to ensure strong environmental, social and governance (ESG) standards. The recent wave of NDPE commitments by major palm oil traders has created much greater demand to support good ESG practices that ultimately reduce financial risks. Governments should support this development.
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