Investment Management Alert

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Fear Not: ESG Does Not Spell Doom for Energy Funds

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Traditional energy funds that target investments in fossil fuel industries continue to face strong and increasing Environmental, Social and Governance (ESG) pressures, especially from institutional and European-based investors. With increasing ESG regulation from the European Union, possible ESG disclosure guidelines from the U.S. Securities and Exchange Commission and heightened focus put on ESG by world health issues, there is little reason to believe that ESG scrutiny will abate.

While there is pressure in the area, there is also an opportunity for traditional energy funds to open themselves to the market of ESG investors without abandoning their traditional areas of investment focus. Since energy investment funds generally own and help operate underlying energy companies as opposed to acting directly as an energy company, there is potential for energy funds to present and position themselves as "good actors" with respect to their portfolio companies and to present themselves as conscious investors in the conventional energy sector. Conveniently, energy funds have at their disposal a number of well-established tools that can facilitate their continuation of—or transition to—a sustainable investment model. In our view, energy funds could proactively consider taking the following steps to position themselves as leaders in the ESG sector to potentially increase capital sources, without tremendously impairing or altering their investment criteria.

- **ESG Portfolio Company Reporting**: Adopting a system of ESG portfolio company reporting, with transparency regarding environmental compliance, investments in increased safety mechanisms and environmental impact mitigation strategies. Funds can follow disclosure standards set by the Sustainability Accounting Standards Board (SASB) or the Global Reporting Initiative (GRI) to communicate corporate performance on industry-level sustainability issues. SASB standards use industry-specific disclosure topics, accounting metrics, technical protocols and activity metrics to better identify and disclose financially material sustainability information. Similarly, GRI standards help portfolio companies identify and describe their significant impacts and stakeholder expectations to meet ever-changing global sustainability challenges. By requiring reporting against specific benchmarks set by established international organizations like SASB or GRI, energy funds can ensure that companies across their portfolios apply consistent, comprehensive and measurable standards to their sustainability disclosures.

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- **Highlight Broader ESG Standards**: While environmental criteria are a key part of an ESG strategy, they are not the sole focus. By putting in place reporting and portfolio company requirements and guidelines for worker safety, community involvement, promotion of diverse hiring and supplier retention, and corporate governance, energy fund managers could position themselves to harvest potentially "low-hanging fruit" in these areas that they could highlight to ESG-conscious investors (in many instances, funds may already be undertaking many of the steps and should take efforts to account for the efforts). SASB and GRI contemplate a number of social, economic and governance factors relevant to the energy industry that go beyond just the "E" in ESG. These include security in or near areas of conflict, job creation, community relations, diverse employee and supplier recruitment, workforce health and safety, sexual harassment, violence against community members, human rights, rights of indigenous peoples, business ethics, corruption and transparency. Fund managers can use these widely applicable standards to help their portfolio companies showcase themselves as responsible actors in all facets of their operations. In addition, following applicable standards has the additional potential to result in cost-savings in certain scenarios.
- **Possibly Segmenting Investment Focus**: If an energy fund shies away from certain types of investments that coincidentally may have negative ESG effects (independent of considering any ESG concerns), a fund manager should highlight that to prospective ESG investors. Funds can take this a step further by demonstrating their commitment to responsible investing by formally adopting the Principles for Responsible Investment (PRI) and/or promulgating specific ESG criteria to guide investment decisions, if practical in consideration of the fund's business model.
- **If Feasible, Establish ESG Target Setting**: To the extent that a manager's specific energy strategy allows for ESG targets to be pursued in a manner consistent with its business model, an energy fund manager could use target setting that is accompanied by the reporting standards discussed above and with a reporting system that is expected by ESG investors. The targets could encompass, where feasible, reduced consumption of raw materials, assisting in the transformation of waste from energy operations into other commodities and products, and exploiting energy saving efficiencies through improved design and innovation and other environmental offsets.
- **Adopt Responsible Investment Principles**: To lay the foundation for an effective ESG strategy, if practical for their business model, fund managers may wish to consider incorporating ESG factors into their investment decisions through the adoption of sustainable investment principles. Many funds and other institutional investors choose to do this by committing to the PRI. Chief among these is incorporating ESG issues into investment analysis and decision-making processes and being active owners who promote disclosure of ESG issues among their investments.
- **Create ESG Policies**: To the extent fund managers begin or continue to implement the steps outlined above within their funds or investments, they may want to consider establishing internal guidelines that set overarching principles and describe pathways to accomplish their ESG goals. Similarly, funds may want to consider adopting an investor-facing ESG "policy" to demonstrate their ESG commitments, if any, and the steps taken to fulfill those commitments.

In summary, by focusing on portfolio company reporting, highlighting successes across the full spectrum of ESG factors, considering segmented investment focuses and, if practical with the fund manager's business model, considering ESG target setting and responsible investment principles, an energy fund manager can potentially navigate the waters with ESG-conscious investors in a pandemic-altered world while retaining central components of its investment strategy and business methods.

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