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Energy Blog

The Industrial Evolution: An Introduction to ESG Principles and their Importance to the Energy & Infrastructure Sector

05 June 2020

Before the COVID-19 pandemic, Environmental, Social and Governance ("ESG") was an increasingly popular topic among investors, companies and regulators, particularly within the energy and infrastructure sector. Despite the pandemic, we have seen nothing to suggest that the focus will dwindle. If anything, indications are that ESG concerns are increasing, as governments, businesses and investors are realizing that strong ESG management systems on average equate to more resilient physical assets, supply chains and workforces.

While the U.S. has yet to see robust ESG regulatory requirements, we are beginning to see the development of those requirements in other countries, which creates a ripple effect, including through investments in U.S. businesses by investors from those other countries, suggesting that all businesses and investors should continue to stay abreast of these issues, particularly in the energy and infrastructure sector. This introductory post explores some of the fundamental trends affecting ESG investing and integration today, and how they might be applicable to energy and infrastructure businesses.

What is "ESG"?

ESG, at its core, is a framework for responsible business practices. The "E" stands for "‘environment," which includes myriad ways that a business can impact the natural environment through its consumption of resources or output of waste, or ways that the natural environment can impact a business through the availability of energy or natural resources, climate change or natural disasters. The "S" stands for "social," which includes social capital issues (e.g., data security, human rights and customer welfare) and human capital issues (e.g., labor practices and employee health and safety). The "G" stands for "governance," including business ethics (including corporate governance, executive compensation and shareholder rights), supply chain management and other risk management and compliance.

When broken down in these terms, it's clear that the integration of ESG in practice is not a fundamental change in how businesses operate. Rather, it is a framework for measuring, comparing and improving existing business practices across organizations through the use of a common terminology and methodology.

What is driving "ESG investing"?

At a high level, we see *four* main drivers for ESG growth:

- *Growing Investor Demand*: According to Morningstar, sustainable mutual funds captured **$20.6 billion in new money in 2019**, almost four times the $5.5 billion seen in 2018. Deloitte predicted that U.S. ESG-mandated assets could grow almost **three times as fast** as non-ESG-mandated assets and that **an estimated 200 new funds** with an ESG investment mandate will launch **over the next three years**. While the aforementioned Deloitte predictions were likely developed prior to the COVID-19 crisis, recent Morningstar and MSCI analyses found that ESG funds on average **outperformed** traditional funds during the COVID-19 crisis to date. A recent BlackRock report attributes this resilience *not* to the sectoral differentiation of ESG funds' investment strategies (i.e., an underweighting of traditional energy companies), but *rather* to a range of material sustainability characteristics (e.g., job satisfaction of employees, the strength of customer relations or the effectiveness of the company's board) and an increase in investor preference (i.e., greater inflows) for sustainable assets during the crisis. Institutional investors have, in fact, begun publicly stating their preference to "build and maintain relationships with asset managers" that integrate ESG factors throughout their entire investment process to promote long-term value creation.
- *Regulatory Fluidity and Focus:* While investor pressure seems most often to drive companies or firms to develop *an* ESG program, regulatory considerations can drive a need or desire for a more *robust* ESG program. Spurred by "greenwashing" concerns and the lack of a common definition for ESG, regulators have started to take an interest in ensuring transparency in sustainable financial products. The European Union is leading the charge in scope and speed with its Action Plan on Financing Sustainable Growth and sustainability-related Disclosure Regulation. The

U.S. Securities and Exchange Commission and certain states (e.g., California) and other countries (e.g., the U.K., Canada, Japan and Malaysia) are also making moves.

- *Expanding Views of Corporate Purpose and Fiduciary Duty:* The World Economic Forum's Davos Manifesto, the Business Roundtable's new Statement of the Purpose of a Corporation and BlackRock CEO Larry Fink's letter "A Fundamental Reshaping of Finance" reflect the case for an expanding view of corporate purpose by some business leaders — one that goes beyond the exclusive purpose of serving shareholders and towards commitments to all stakeholders, including customers, employees, suppliers, shareholders and communities. This goes hand-in-hand with a growing discussion of whether and how fiduciaries are *obligated* to consider material ESG issues in investment and ownership decisions and some countries (e.g., Canada, the U.K., the EU and Sweden) are taking regulatory steps in that direction. Certain fossil fuel opponents have made the fiduciary duty argument to advocate for the divestment of fossil fuel investments.
- *Sustained ESG Shareholder Resolutions:* **At least 429 ESG shareholder resolutions** have been filed this 2020 U.S. proxy season (up from 366 in 2019, but down from 500 in 2017), and more than 300 of those resolutions were expected to go to a vote at annual meetings, according to a Proxy Preview 2020 report by As You Sow, Proxy Impact and the Sustainable Investments Institute. According to the Climate Proxy Voting Guidebook by sustainability nonprofit CERES, at least **131 climate-related shareholder proposals** were filed in this 2020 season (many of which were focused on energy and infrastructure companies), including with respect to lobbying disclosures, carbon asset risk, greenhouse gas emissions reductions and board oversight.

How do ESG approaches vary between market sectors and businesses within those sectors?

Environmentally intensive sectors (e.g., energy and infrastructure) tend to have stronger "environmental" capacities and face greater scrutiny with respect to climate change. Human capital-focused sectors (e.g., technology and healthcare) often face more scrutiny as it relates to "social" matters, although all businesses have been challenged during the COVID-19 crisis and current civil unrest to enhance their focus on diversity and inclusion, occupational health and safety, customer relations and employee assistance.

Geography matters just as much as sector. EU-based businesses, on average, have more mature ESG programs than their counterparts in the U.S. and other developed countries, followed by emerging markets.

Generally, we find that public corporations tend to have more mature ESG programs and more dedicated resources than their private counterparts, but there are certainly examples of ESG leadership and robust capacity within private equity funds, lenders, insurers, real estate funds, large privately held corporations, family offices and hedge funds.

How is ESG being integrated into business transactions and governance?

In this rapidly evolving legal, regulatory and financial environment, ESG matters are being considered and integrated in business transactions and governance in several ways:

- *Governance:* the development of **ESG policies and procedures** and formalizing of **ESG roles and responsibilities** of directors, executives and committees;
- *Fundraising:* the negotiation of **ESG-related investment requirements and restrictions** imposed by certain investors and the raising of capital consistent with environmental or social **impact** purposes;
- *Disclosures:* the communication of risks and policies in **ESG disclosures** to regulators, investors, lenders and other stakeholders;
- *Due Diligence and Value Creation:* the evaluation of **ESG risks and opportunities** in transactional **due diligence** and throughout ownership to maximize value;
- *Risk Mitigation:* the allocation and mitigation of **ESG risks** through contracts and other means; and
- *Regulatory Developments:* staying abreast of evolving **ESG regulatory developments** to inform compliance procedures and strategic decision-making.

Our Sustainable Investment & Global Impact Practice will be publishing additional posts about ESG and Sustainable Investing trends specific to the energy and infrastructure sectors in the coming weeks and months. In the meantime, if you are interested in reading more:

- "Three Key Developments in ESG and Sustainable Investing" (*Kirkland Alert*)
- "FSB Climate Disclosure Framework Poised for 2020 Traction" (*Law360*)
- "How Cos., Asset Managers Can Plan for Physical Climate Risk" (*Law360*)
- "Managing ESG Consultants in Private Equity Transactions" (*Law360*)

- "The Ripple Effect of EU Taxonomy for Sustainable Investments in U.S. Financial Sector" (*Harvard Law School Forum on Corporate Governance*)

Read more insights from Kirkland's Energy & Infrastructure blog.

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Suggested Reading

- 17 July 2022 Energy Blog Commerce Department Issues Proposed Rule Suspending Solar Tariffs
- 22 June 2022 Energy Blog FERC Order Revokes Solar Facility's QF Status
- 11 May 2022 Energy Blog New Framework Announced for Assessing and Reporting Nature-Related Financial Risks