Asset Managers and Fossil Fuel Exclusion Screens

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Many asset managers commit to exclude certain categories of investments from their portfolios. These exclusions can broadly be divided into: (i) industries associated with high environmental impacts, either with high greenhouse gas ("GHG") emissions, such as oil and coal-fired power generation, and the mining and supply of fossil fuels, or those associated with deforestation or biodiversity loss, such as palm oil production; (ii) industries which are regarded as unacceptable for human rights, moral or reputational reasons, such as controversial weapons, gambling, tobacco and alcohol; and (iii) industries located in countries which are excluded because of international sanctions, or industries or countries associated with controversial business practices or poor human rights records. In practice, most managers publicize their exclusion lists to signal their conformity to industry norms, but in so doing risk controversy from particular types of investors.

A number of developments have prompted asset managers to scrutinise their exclusion lists. Several so-called "red" states in the United States have passed laws prohibiting state entities from contracting with firms that "boycott" certain industries, including fossil fuels and firearms. As a result, some asset managers have adopted more flexible approaches, focussed on detailed due diligence for potential investments in these industries, in place of formal exclusions. There has also been increased focus on how asset managers incorporate sustainability considerations into their fiduciary duties, and changing views on, for instance, investment in defence. This Debevoise In Depth explores how asset managers can design and qualify exclusion screens which relate to fossil fuel investments.

Overview of Fossil Fuels

Fossil fuels is a widely understood term, defined by the EU as non-renewable carbon-based energy sources such as solid fuels, natural gas and oil. The key solid fuel is of course coal, known as "thermal coal" when used for electricity generation in coal-fired power plants. Coal mining and the production of other fossil fuels are generally not considered aligned with the 2015 Paris Agreement, and the EU, when setting a benchmark for alignment with the Paris Agreement (under the EU Delegated Act which provides minimum standards for EU Paris-aligned Benchmarks), excluded companies that derive 1% or more of their revenue from exploration, mining, extraction, distribution or refining of hard coal or lignite,[1] with a similar restriction for companies that derive 10% or more of their revenue from oil. Banks and asset managers which are signatories to the Science Based Targets initiative's Financial Institutions Net-Zero Standard may not finance new coal, oil and gas expansion activities, such as expansions of existing mines and new infrastructure, and may only provide general-purpose financing to oil and gas companies until 2030. Legal prohibitions on certain types of fossil fuel drilling and exploitation exist in many countries.

Energy generation from natural gas has a lower carbon footprint compared to energy generation from coal, with the former's continued use for energy generation regarded as part of the energy transition. For example, the EU Taxonomy Regulation considers that generating electricity from sources such as natural gas can be environmentally sustainable, provided it meets certain criteria such as each kWh of electricity emitting less than 100g of CO_2 emissions over the life cycle of the power plant.

Fossil Fuel Exclusion Lists

When adopting a fossil fuel exclusion, an asset manager will need to specify the excluded business activities related to fossil fuels. In the EU's Sustainable Finance Disclosure Regulation ("SFDR"), the term "companies active in the fossil fuel sector"—one of the "principal adverse impacts" which managers in scope of SFDR may report on—means companies that derive any revenues from exploration, mining, extraction, production, processing, storage, refining or distribution, including transportation, storage and trade, of fossil fuels.

This covers the entire range of upstream and downstream activities relating to fossil fuels. It does not clearly exclude companies with incidental activities such as the retail sale of petrol by supermarkets. The European Supervisory Authorities have confirmed that this indicator is applied on a "pass/fail" basis, meaning that a company is active in the fossil fuel sector if it derives any revenue from any of these activities, although it may be open to funds to disregard a very small amount of revenue in this regard. It is not clear whether the definition includes companies which finance fossil fuel projects, facilitate trading in fossil fuels (for instance, through a software application) or otherwise provide a support service, such as engineering, to the sector. The definition

1 Hard or "anthracite" coal is the cleanest burning coal with the lowest moisture content. Lignite or "brown" coal is the most polluting coal when burnt, due to its high moisture content and volume of pollutants such as sulphur.

does not exclude companies in the energy generation sector which devote significant capital expenditure to reducing emissions from fossil fuel energy generation. In that context, some asset managers make the distinction between companies with unabated combustion of fossil fuels and those companies with concrete plans to reduce the emissions arising from this activity.

To address these concerns, an asset manager could set a fossil fuel exclusion by reference to a company deriving a specified percentage of revenue from fossil fuels, or where a particular activity exceeds a specified GHG intensity metric. Under the EU Delegated Act which provides minimum standards for EU Paris-aligned Benchmarks, for example, as explained above, benchmark administrators must exclude companies that derive a certain proportion of revenue from exploration, extraction, distribution or refining of coal, oil fuels and gaseous fuels, with different revenue thresholds set for each type of fossil fuel. The EU Taxonomy generally sets a threshold of 100g of CO_2 emissions per kWh for "clean" energy generation, combined with other conditions, which are challenging to meet in full. This approach may be suitable for an asset manager which is investing in the energy sector and which is able to obtain and scrutinise the relevant data in order to apply the exclusion.

As a more flexible approach, some asset managers do not exclude investments in fossil fuel-related sectors but instead commit to treat these investments as "high risk", requiring additional due diligence measures such as carrying out a detailed climate risk assessment and committing to engage with the company—typically meaning requiring the company to adopt a climate transition plan and other minimum safeguards—during its ownership period. Some managers may prefer engagement with fossil fuel companies over an outright exclusion, although any commitment to engage must be backed by appropriate resources. Other approaches include restrictions on unabated fossil fuel projects or oil and gas exploration and production companies without credible transition plans. Some asset managers commit to ensure that their investee companies adopt transition plans to phase out their reliance on a prohibited business activity, and commit for example not to invest in a company that plans to derive more than a certain percentage of its annual revenue from fossil fuels, beyond the fund's fifth year of investment.

Where an asset manager does not restrict investment in oil and gas, it may well place a restriction on certain types of oil and gas projects, generally those associated with high environmental impacts, such as Arctic drilling, the extraction of oil from tar sands or of oil and gas through fracking and fossil fuel exploration in protected areas such as High Conservation Value Forests or UNESCO Ramsar Sites.

How Indirect Investors Approach Fossil Fuel Exclusion Lists

Asset managers which are indirect investors—such as through a fund of funds strategy, investing in primary or secondary interests in other funds—will need to consider an appropriate approach. Typical concerns here are the lack of information on the underlying portfolio of assets which the fund will indirectly acquire in a secondaries transaction, and the challenge when acquiring a primary interest in agreeing a standardised exclusion policy with the underlying manager, typically as a side letter term.

To address the concern about lack of information on the underlying portfolio of assets acquired in a secondaries transaction, an asset manager can qualify its exclusion screen by stating that it will not invest in any underlying funds which, to the asset manager's knowledge at the time of its initial investment, include portfolio companies which derive a certain percentage of revenue from fossil fuels. To address the more general challenge of agreeing a standardised exclusion policy with the manager of a primary interest, an asset manager can qualify its exclusion screen by stating that it anticipates that any prohibited fossil fuel investments it indirectly holds, via interests in other funds, will only constitute a small part of its total portfolio or will constitute no more than a set percentage (such as 10%) of total commitments in the fund.

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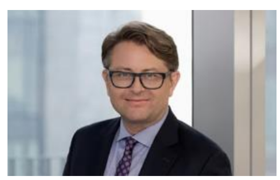

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