How Private Fund Sponsors Invest in the Climate Transition Under the EU Sustainable Finance Framework

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Asset managers are increasingly offering funds that invest, via equity, debt or other securities, in businesses that support the climate transition. The climate transition is the transition by business and society to a low carbon and sustainable economy, in accordance with the 2015 Paris Agreement objective to limit global warming to 1.5oC above pre-industrial levels. The European Union (EU) has set a target to reduce net greenhouse gas ("GHG") emissions by at least 55% by 2030 compared to 1990 levels, and to achieve net zero by 2050.[1] Although this target binds member states, the EU is more likely to take action at the EU level if progress is insufficient. Investment in the climate transition supports climate change mitigation, defined in EU terms as activities that contribute to the stabilisation of global GHG emissions by avoiding or reducing them, or by enhancing GHG removals.

Many private fund sponsors promote climate mitigation in their investments. In this In Depth, we discuss how private funds formed or offered in the EU invest in businesses in the field of climate transition, whilst complying with the EU framework on sustainable investment, namely the Sustainable Finance Disclosure Regulation (the "SFDR") and the EU Taxonomy Regulation (the "Taxonomy").

Key Asset Classes to Invest in Climate Change Mitigation

Given the emissions produced in conventional ways to generate electricity, a key asset class for climate change mitigation is renewable energy generation, the production of electricity, and in some cases heat and cooling, by wind, solar, ocean energy, hydro and geothermal, or with the use of biofuels, biogas or waste products. This asset class includes upgrading or replacing renewable power plants or combining different renewable energy technologies at a single site, and distributed power generation, which is the generation of power at a local level, such as rooftop solar panels.

[1] Net zero is the state in which the total amount of GHG emissions produced is equal to the total amount removed from the atmosphere by natural or technological means.

Other asset classes that make a direct contribution to climate change mitigation are biofuel production, used to power transport; types of hydrogen production, which is used, inter alia, for low carbon emitting steel production; producing and operating low carbon transport, including electric rail transport and cars, and water borne transport, and installing related infrastructure, such as charging points; construction of energy efficient buildings; and producing and installing energy efficiency equipment for buildings, such as insulating products and heat pumps, and devices to control energy use. Carbon capture technology to remove GHG from sources such as power plants, and potentially the atmosphere, is another important asset class in the climate transition.

Strengthening land "carbon sinks", including through forestation and wetland restoration, which increases removal of carbon dioxide, also makes a direct contribution to climate change mitigation. Re-use and re-cycling of waste, as well as its use in fuel production, also contributes to climate change mitigation, by reducing the emissions related to the extraction, processing, and transport of raw materials.

In EU terms, activities that indirectly enable the activities listed above to contribute to climate change mitigation are described as enabling activities. This includes manufacturing renewable energy technologies such as solar panels or wind turbines; manufacturing and installation of energy storage and batteries; activities relating to electricity transmission; and technology and research and development for means to reduce GHG emissions.

The EU has also categorised transitional activities, which are heavy manufacturing activities, such as steel or cement, or certain transport activities, which emit high amounts of GHG, and for which there are no low-carbon alternatives available at scale, as within scope of climate change mitigation. Investment opportunities in this sector are directed at reducing the activities' emissions through means such as electrification or carbon capture, to reduce emissions levels in line with best performance in the sector.

Key Asset Classes to Invest in Climate Change Adaptation

Climate change adaptation is, in EU definition, the process of adjustment to actual and expected climate change and its impacts. Climate adaptation aims to increase the resilience of businesses, buildings and communities against these risks. The impacts here are physical, including floods, storms, droughts, soil and coastal erosion and high temperatures—either classified as chronic, which are long term climate changes such as sea level rise or soil degradation, or acute, being extreme weather events.

Activities for climate adaptation either directly make another economic activity climate resilient, such as flood defences or systems for rainwater run-off, or, as an enabling activity, provide a solution, such as expert advice or technology, to allow activities to become climate resilient. Adaptation solutions are either directed at a specific activity, such as flooding reinforcement for a factory, or directed at reducing climate risk on a broader scale, such as construction of coastal barriers or re-forestation to reduce flooding. The EU states that climate adaptation activities should reduce the risk of adverse impacts on the activity itself, as well as on other people, nature and assets, and should not, as an unintended consequence, increase the risk of adverse climate impacts in other locations, people, nature or assets. Solutions that also benefit biodiversity, such as green corridors or water bodies, are preferred.

Climate adaptation is both a consideration when investing in climate mitigation, such as the risk of sea level rise on wind turbines, and a business activity in itself. Adaptation involves an assessment of an asset's vulnerability to the changing climate, with models of future climate risk. Measures are physical, such as strengthening foundations against flood risk, or installing climate control in buildings; operational, such as emergency plans and monitoring systems; and nature-based, such as river floodplain restoration. Enabling activities in this sector include investment in financial services companies, especially in emerging markets, which extend credit or insurance to local communities to support, for instance, local regenerative agriculture or to insure against freak weather events; producing drought resistant crops and manufacturing heat resilient building materials.

Application of SFDR

Any EU fund sponsor, or non-EU fund sponsor that markets a fund in the EU, must complete standard disclosures on the environmental or social aspects of its investment objectives under the SFDR. Article 8 of SFDR requires sponsors to describe the environmental or social characteristics promoted by the fund, according to a template, which requires a clear description of the characteristics and a commitment to report on the related "key performance indicators" ("KPIs") provided to investors going forward. For funds that commit only to make "sustainable investments" by having sustainable investment as their objective, which means investments selected to contribute to a specific social or environmental outcome, the sponsor will be in scope of Article 9 of SFDR, with a similar template for the upfront disclosure and ongoing reporting.

The term "sustainable investments" is apt to describe all the types of activities listed above that contribute to the climate transition. Under the concept of sustainable investments, sponsors will define their criteria to select investments with clear and

measurable social and/or environmental benefits, with criteria to ensure those investments "do no significant harm" to other social or environmental objectives, and their checks to ensure investee companies follow good corporate governance practices. In time, the EU is expected to introduce a labelling regime, with stricter criteria, to replace the current Article 8 and Article 9 categories.

The majority of funds that invest in the climate transition will commit to make sustainable investments. Managers that may not want to commit to make sustainable investments, potentially through lack of data to report consistently against the "contribution" and DNSH tests, because, for instance, they are investing indirectly or as co-investors in relevant assets, may decide to use the broader Article 8 disclosure for funds that promote environmental or social characteristics. Article 8 also allows funds to commit to make a proportion of sustainable investments.

Under the SFDR templates, sponsors need to define the sustainability KPIs which they will measure and report to investors, in response to the template question "What sustainability indicators are used to measure the attainment of each of the environmental or social characteristics promoted by this financial product?". There is a wide range of KPIs available to measure contribution to climate mitigation, including the amount of renewable energy generated by the projects invested in, its efficiency in converting the natural resource into energy, and, potentially, the affordability of the energy produced. Some, but not all, managers calculate GHG emissions reduced or avoided by reference to the amount of renewable energy that is generated. GHG emissions avoided are generally measured relative to a baseline scenario. In simple terms, for renewable energy generation, avoided emissions are based on a comparison with the amount of emissions from burning fossil fuels (or, more precisely, the average emissions associated with the relevant energy grid) to generate the same energy. Avoided emissions are a hypothetical measure, distinct from direct reductions or removals of emissions from sources, with questions as to the baseline comparison used and whether the clean energy generation has actually displaced fossil fuel energy generation. The GHG Protocol's guidance on estimating and reporting avoided emissions stresses the importance of transparency on baseline selection and assumptions on displacement of fossil fuels.

Measuring the contribution of enabling activities for climate mitigation depends on the type of product or service. Managers may commit to measure the capacity and efficiency of a product such as batteries or transmission infrastructure, or the additional energy produced, or the efficiency gains or reduction in emissions or costs, in each case caused by a particular enabling product. Sponsors investing in companies that make any products in the renewable energy sector may measure the product's own life-cycle emissions—namely, scope 1, 2 and potentially scope 3 emissions, generated in the manufacture, use and disposal of the product, and how the life-cycle emissions relate to

emissions saved by the product when in operation. Other relevant data points include the operating lifetime and re-cyclability of a product.

Measuring contribution to the goal of climate change adaptation does not involve a similar measure of, for instance, avoided CO2 emissions, as for climate change mitigation. A sponsor will be able to report the climate hazards addressed and its capex on completed projects, potentially combined with data such as the reduced expected economic loss or number of people protected by the particular project, and the associated benefits for ecosystems.

Sponsors will often obtain independent assistance to measure KPIs and verify the amount of GHG mitigation, with carbon removal projects, for example, being assessed under protocols such as the EU's Carbon Removal Certification Framework, or private initiatives such as the CDM Gold Standard.

Sponsors will also need to describe their approach to the "do no significant harm" test. EU guidance requires firms to use the SFDR principal adverse impact ("PAI") indicators in applying the "do no significant harm" test. PAI indicators are standard measures of environmental or social harm (including, for instance, GHG emissions and employee turnover) that can be applied to any company. One issue in practice is that, when investing in, for instance, renewable energy infrastructure, some PAI indicators will be of limited relevance, with the risk of environmental harm for the project in practice being addressed by steps such as an environmental impact assessment and having waste management plans in place. The "do no significant harm" tests in the Taxonomy are in each case tailored to the activity—see below.

Lastly, under SFDR, under ESMA's fund-names guidelines, funds using ESG or sustainability-related terms must hold at least 80% of investments in line with the stated strategy, and must comply with set exclusions lists. One complication here is that, whilst funds using the term "transition" or a similar term in their name must adhere to an exclusion list which does not make any reference to fossil fuels, allowing them to acquire fossil fuel related investments with a view to transitioning the investment to clean fuels, any other fund using an ESG term in its name must comply with an exclusion list that includes investments in businesses involved with fossil fuels. As a result, funds with transition strategies which include acquisition of fossil fuel related assets may need to include the term "transition" or a similar term in their name.

Application of Taxonomy

The Taxonomy is a single classification system for a wide range of environmentally sustainable economic activities. There is a regulation specifying all activities that the EU regards as environmentally sustainable to contribute to climate change mitigation and, separately, adaptation. There are also Taxonomies for water and marine, the circular economy, pollution prevention and biodiversity in the Environmental Delegated Act, allowing funds that invest in the climate transition to align their assets in the fields of waste and recycling, pollution prevention and nature restoration. The Taxonomy will be updated and expanded in the future, to include new activities which the EU considers as sustainable, such as enabling activities of manufacturing materials necessary for the green transition, such as copper, nickel and lithium.

The Taxonomy imposes in many cases stringent criteria for the "do no significant harm" test and includes numerous references to EU standards in the fields of environmental protection, including EU labelling and certification schemes. Whilst the Taxonomy overlaps with existing international standards and certification schemes for many activities, it is often hard in practice to qualify an asset within the Taxonomy—particularly non-EU assets, or existing assets, such as renewable energy infrastructure, where the construction records do not show evidence of compliance with the Taxonomy technical screening criteria.

There is a separate Taxonomy for natural gas and nuclear energy generation activities. Electricity generation from natural gas, which the EU classified as environmentally sustainable under some controversy, must meet a high bar of generating life-cycle GHG emissions of no more than 100g Co2e/kWh threshold, or a higher threshold of emissions where the activity replaces electricity generation from coal or oil.

The EU's Green Bonds Regulation is a framework for companies to issue debt to finance Taxonomy-aligned activities. Debt issuers, including portfolio companies and special purpose vehicles, can use the "EuGB" label, subject to external review and reporting requirements. See our separate Debevoise In Depth on this topic.

The key points for a sponsor of a climate transition fund are, firstly, whether to commit to any proportion of the assets of the fund as Taxonomy-aligned, and, secondly, how to report in practical terms on Taxonomy alignment of the assets, under the principle that any fund that promotes environmental characteristics must report on Taxonomy alignment, regardless of whether it committed to a proportion of the fund's assets as Taxonomy-aligned at the outset. Both points will be informed by the sponsor's confidence in applying and interpreting the Taxonomy technical screening criteria, whether the fund is investing in or outside the EU and whether the fund will specialize

in a particular type of asset—such as renewable energy generation—which is covered by the Taxonomy. In practice, most funds either make no commitment to invest in accordance with the Taxonomy or commit to small percentage, such as 20% of the portfolio, by reference to total fund commitments. It is possible to include flexibility to increase or reduce the proportion going forward, with investor consent. One method to determine a fund's level of Taxonomy commitment is to screen a prior fund's investments, or the fund's pipeline investments, as against the Taxonomy. Sponsors should note that EU companies in scope of the EU Corporate Sustainability Reporting Directive ("CRSD") will report on Taxonomy alignment, although the number of companies in scope of CSRD will be substantially reduced under the EU's Omnibus Directive.

As we outline in a separate In Depth, where an investment is deemed Taxonomy-aligned, it will in most cases also qualify as a sustainable investment under the SFDR. Few sponsors currently report on the reasons, such as lack of data, why an investment is not Taxonomy-aligned. If an investment is in scope of the Taxonomy but not aligned against the Taxonomy technical screening criteria, this should not preclude a sponsor from qualifying the investment as a sustainable investment, if the sponsor has defined and disclosed its own clear criteria to meet the contribution and do no significant harm tests. Sponsors often use international standards and independent checks to demonstrate compliance with these criteria. However, sponsors may need to consider certain red-flags when classifying certain activities as sustainable investments that do not qualify under the Taxonomy. For instance, whilst biofuel production is capable of being Taxonomy-aligned, this excludes biofuel manufactured from food or feed crops, limiting Taxonomy alignment to biofuel from waste, residue or dedicated energy crops. The production of biofuel from corn is common in the US, and from sugarcane from other countries, and sponsors will need to consider the contrary EU view on production of biofuel from food or feed crops (and the consequence for the "do no significant harm" checks) before classifying that activity as a sustainable investment. Under the Taxonomy, power generation from solid fuels (principally coal) may never qualify as environmentally sustainable, reflecting the EU's view that coal fired power generation produces an excessive level of carbon emissions and other pollutants. As a consequence, managers will generally not classify coal fired power generation as environmentally sustainable, regardless of the efficiency measures implemented in the plant.

Investment in Transition Asset Class

We discuss the treatment of transition investments under the EU sustainable finance framework in a separate In Depth. For some investors in the climate transition, transition investments, such as the conversion of carbon-based energy infrastructure to

green energy infrastructure, are a significant opportunity. The key points for this asset class are as follows.

The Taxonomy has some coverage for transition investments, including activities such as renovation of buildings for energy efficiency, reduction of emissions in certain industry sectors and (as above) electricity generation using natural gas that displaces oil or coal powered generation. In time, the EU will introduce a separate taxonomy for transition investments which will include criteria to specify improvement targets and timelines, with criteria to ensure the investment does no significant harm to other environmental objectives.

When converting a facility to reduce its impact on climate change, an investor may classify the capital expenditure (capex) as Taxonomy-aligned where the capex is based on a plan to expand or upgrade activities to make them Taxonomy-aligned, meeting certain conditions, in particular, that the plan aims to expand or upgrade activities within five years.

Under EU guidance given in 2023, the sustainable investment concept, and specifically the condition that the investment "does no significant harm" to any environmental or social objective, does not currently accommodate investments doing significant harm at the time of the investment, even where a transition plan is in place which aims to achieve that the "whole investment" does not significantly harm any environmental or social objectives. This removes from the scope of sustainable investments the acquisition of many "brown" assets, such as fossil fuel infrastructure, with a view to converting them to environmentally sustainable assets – at least until the point the asset is converted. Whilst it is not possible to classify the investment as a sustainable investment if it does environmental harm at the point it is acquired, it may be possible for the sponsor to classify the capex expended by the fund in converting the asset as a sustainable investment.

Conclusion and Best Practices

Direct investment in assets and activities associated with the climate transition requires investment teams with expertise and access to a pipeline of investments, and often external technical support. In EU terms, it requires precise descriptions of the assets targeted and the KPIs to be reported to investors, with policies to observe the "do no significant harm" principle and to promote good corporate governance. Data availability, particularly in emerging markets, remains a challenge. Most sponsors in this field will apply the Taxonomy to some degree and will need to study the qualifying technical criteria in depth.

Best practices are: (i) describe a clear and "auditable" investment thesis for mitigation and adaptation, with KPIs specified for each topic; (ii) evidence the "do no significant harm" test using the SFDR PAIs, as well as by checks specific to the particular activity; (iii) screen for the Taxonomy where feasible, also bearing in mind the possibility of classifying capex for Taxonomy alignment; and (iv) develop a methodology for KPIs reported (e.g., for avoided emissions) aligned with accepted frameworks, applied in a consistent way, and ensuring that the KPIs are reviewable by independent experts.

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