ESG:
RESPONSIBLE INVESTMENT: ENVIRONMENTAL, SOCIAL AND GOVERNANCE PRINCIPLES IN THE RENEWABLE ENERGY SECTOR
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About us

Herbert Smith Freehills is one of the world’s leading professional services businesses, bringing together the best people to meet clients’ legal services needs globally.

Accessing our deep global sectoral expertise, as well as our local market understanding, we help organisations realise opportunities while managing risk to help them achieve their commercial objectives.

Operating as a single, globally integrated partnership, we work as a team, using innovative systems and processes to ensure client work is delivered intelligently, efficiently and reliably. When working with Herbert Smith Freehills, clients are assured world class, full-service legal advice and the best results.
Our Africa practice

Our premium Africa practice has been built over 40 years and is serviced by partners from across our global network of offices, including Johannesburg.

We have one of the largest teams of common and civil law lawyers advising almost exclusively in relation to Africa, comprising lawyers from a diverse range of cultures and backgrounds.

With experience advising in all of Africa’s 54 jurisdictions, we have an exceptional understanding of the continent’s legal systems, business practices, local cultures and socio-political considerations, and of the issues and realities of doing business in Africa.

Our Africa practice achieved a major milestone in late 2015 with the opening of the firm’s Johannesburg office – our first office in Africa. The combined strength of the Johannesburg partners and the firm’s other Africa specialists located across our international platform enables us to provide a true on-the-ground pan-African offering, wherever you are doing business on the continent.

Our experience in Africa spans all key industry sectors and includes advising on:

- public and private mergers, acquisitions and disposals
- private placements and international public offerings
- project finance, asset finance, debt capital markets finance, structured finance and corporate finance (including complex structuring and a good knowledge of local security and exchange control issues in African jurisdictions)
- project structuring and development, including in the context of large scale integrated extractive and associated infrastructure projects
- risk mitigation (including political risk and trade credit insurance)
- international arbitration between parties or with governments (particularly where disputes involve renegotiation, expropriation etc)
- in country civil and criminal litigation
- compliance
- crisis prevention and management
- environmental, social and regulatory matters
- business and human rights
- black economic empowerment and indigenisation
- public international law, including international boundary disputes
- employment issues

Market commentators appreciate that “they go beyond the legal analysis to provide practical advice on working in Africa. It’s a very complete service.”

CHAMBERS GLOBAL 2019
Introduction

For Africa-focused developers and sponsors in the renewable energy market, ESG is likely in the forefront of your minds and it is important to show knowledge of what is expected in the responsible investing market in order to ensure swift project development and to enhance bankability. This handy guide profiles the key factors relating to ESG which may impact your business. We hope that this guide provides you with a better understanding of the ESG expectations in the responsible investing market. We are keen to speak with you about your approach to ESG and how we can help you achieve your strategic goals in the Africa renewable energy space.

Please do not hesitate to get in touch with us.
What is it and why does it matter?

What is “ESG investing”?

“Responsible investing” or “ESG investing” is a strategy for investment or an approach to active business ownership that focuses on incorporating material environmental, social and governance (“ESG”) factors into decision-making alongside financial analysis and other means of portfolio construction in order to minimise risks and maximise returns.

Though not new, their importance has increased in recent years in the eyes of financiers, private investors, regulators and, therefore, management and shareholders themselves. Initially concentrating on good governance, given its obvious positive correlation with financial returns, increased public consciousness around environmental and social risks and opportunities has also resulted in these factors being incorporated more into corporate decision-making and investment strategies, the International Capital Market Association (“ICMA”) has noted. This followed the launch of non-sector-specific investor guidelines particularly, such as the UNEP Finance Initiative and UN Global Compact Principles for Responsible Investment; the OECD Guidelines for Multinational Enterprises; the Equator Principles; and the International Labour Organisation’s Core Labour Conventions.

While some ESG issues are globally relevant, such as humane working conditions and anti-corruption principles, others will be more or less pertinent depending on, inter alia, the sector into which the project falls, the project’s geographic location, and the legal jurisdiction(s) of the project.

ESG issues that are globally relevant to project development, many especially so in the case of renewable energy projects, include:

**Environmental**
- Climate change and greenhouse gas emissions
- Resource depletion (sourcing, use, reuse and recycling)
- Waste minimisation, reuse and recycling
- Dangerous substances and major hazards
- Pollution prevention
- Biodiversity
- Deforestation
- Water quality, use, reuse and recycling
- Decarbonising energy supply
- Innovative technology and new infrastructure

**Social**
- Human rights including modern slavery, child labour
- Community investment, involvement and development
- Indigenous peoples: (i) land acquisition and involuntary resettlement; (ii) cultural property and heritage
- Gender impact
- Employee relations: engagement and consultation
- Working conditions: health and safety
- Supply chain sustainability
- Consumer issues: fair disclosure, marketing and advertising
- Privacy and security

**Governance**
- Bribery and corruption
- Executive remuneration
- Board diversity and structure (organisational governance)
- Fair operating practices
- Political lobbying and donations
- Tax strategy
- Reports, accounts, audits and financial controls
- Shareholder rights, capital stewardship and corporate actions
- Regulatory and legal challenges
- Sustainability and corporate responsibility reporting

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1 The six Principles for Responsible Investment, to which investors may sign up voluntarily, are set out in the Signatories’ Commitment as follows:

“Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
Principle 6: We will each report on our activities and progress towards implementing the Principles.”
The term “sustainable investment” is used in a variety of ways: the ICMA defines it as incorporating “climate, green and social finance while also adding wider considerations concerning the longer-term economic sustainability of the organisations that are being funded, as well as the role and stability of the overall financial system in which they operate”. It is often used interchangeably with the term “responsible investment” (or “ESG investment”) or used specifically by the G20 to refer to financing that directly or indirectly supports the Sustainable Development Goals (“SDGs”).

Evidently, renewable energy projects have the potential to fall within all of these financing strategies: climate finance, green finance, impact investment (which may be purely philanthropic), or sustainable investment or responsible / ESG investment.

Why is it important for project developers to act with ESG principles in mind?

The Macquarie Infrastructure and Real Assets ESG Survey 2020 (“MIRA Survey 2020”) finds that “companies that consider ESG factors are better managed, with higher quality and potentially less volatile earnings” making for good long-term investments. The attainment of financial returns on investments, the avoidance of risk and the incorporation of ESG principles into the management of a business are not mutually exclusive goals.

The incorporation of ESG factors into a project owner’s approach as to how it conducts its business is not merely a “nice-to-have” but an essential determinant of the project’s bankability and legal compliance based on one or more sets of applicable regulations:

Morgan Stanley’s 2019 “Sustainable Signals” report found that 84% of respondents are interested in receiving a report on the impact generated by their investment, that is the “social and environmental return on their sustainable investment”. Overall, the motivations of financiers or individual investors, no matter the industry, are clear: project backers desire transparency on how their money is invested.
How do investors decide to back a project?

Knowing how investors often target projects may help a project developer realise how to attract that investment. Three common methods, identified by the Principles for Responsible Investment, by which investors whittle down a list of potentially attractive companies or their projects are:

- **The integration approach:**
  
  What aspects of the project or the project developer’s practices would bring it within or outside an investor’s purview?

  ESG issues are systematically included in investment analysis so as to manage risks and optimise returns, recognising the material influence that ESG factors have on corporate financial performance.

- **The screening approach:**

  Do any of the project developer’s practices automatically market it into or out of certain investors’ watch-lists?

  Filters are applied to include or exclude entire sectors, companies or practices. The filters are based on the investor’s values or ethics, or simply their preferences:

  - **Positive filtration techniques include:**
    - identifying specific products, services or business activities;
    - aligning investments with one or more SDGs;
    - concentrating on carbon risk-ratings;

  - **Negative filtration techniques include:**
    - noting countries in breach of UN, EU or US sanctions or ascertaining their status in a sector (e.g. EY Renewable Energy Country Attractiveness Index);
    - identifying companies that breach or risk breaching the UN Global Compact;
    - excluding companies for labour or human rights violations.

- **The thematic approach:**

  Can the project developer ensure that its own practices are compatible with specific investors’ brands, or are congruent with, even enhance, the investors’ reputation were the investors to finance the project?

  The investor seeks to combine attractive risk-reward profiles with the investor’s sought-after environmental or social outcome. The financial sector recognises that it can influence climate change, tax avoidance and social ills like modern slavery. The MIRA Survey 2020 recognises that, to safeguard their own reputations and manage their brands, investors avoid controversial investments.

  The purpose of renewable energy projects is to provide a reliable energy source alternative to fossil fuels so as to reduce greenhouse gas emissions and improve the prospects of the planet in the face of the climate crisis. Among the WBCSD’s COP25 Key Policy Messages is that financing of green projects by governments is absolutely key to achieving this. When governments act with purposeful, strong policies, they can “give clarity and confidence to business to invest decisively in zero-carbon products, services and solutions”. This will create “positively reinforcing loops of climate ambition”. Project developers should look to attract not only private side investors but public funding too, where this is available, where it would have a positive impact on the project and would not conflict with the project developer’s governance approach.
How can sustainability performance be gauged?

While the UNEPFI Principles for Responsible Investment explain the meaning of ESG investing, they provide only broad guidelines as to how the Principles could be incorporated into investment strategies and carry these through to active ownership of companies.

There is no single set of ESG benchmarks, let alone model industry-specific benchmarks, to guide project developers as to how to incorporate ESG principles into their business models. What is more, legally regulated aspects of industries, not least the renewable energy sector, may vary from country to country. As WBCSD President & CEO Peter Bakker commented in a recent Euromoney podcast, “Over USD 30 trillion has been invested in ESG themed assets. Standardisation has never been more important...There are more than 600 ESG rankings and ratings, there are more than 4,500 ESG key performance indicators...We need to compress and standardise more.”

The difficulties encountered in attempts to analyse businesses based on their ESG-related performance are recognised and there are steps being taken to remedy this.

World Benchmarking Alliance
The World Benchmarking Alliance seeks to “develop transformative benchmarks” that can be used to measure and compare companies’ corporate performance in achieving the Sustainable Development Goals. These benchmarks “will be backed by the best available science, while leveraging existing international norms and standards” so as to “empower all stakeholders” whether employees, business leaders, consumers or investors.

EU Taxonomy Regulation
The EU Taxonomy Regulation, adopted by the European Council on 15 April 2020, sets out the framework and environmental objectives for an EU-wide classification system to provide businesses and investors with a “common language” and “technical screening criteria” to identify economic activities which are considered “environmentally sustainable”. It is specifically aimed at climate change mitigation but its screening criteria have a broader sustainability purview - the performance thresholds for achieving a sustainable stamp of approval are:

- make a substantive contribution to one of six environmental objectives (climate change mitigation; climate change adaptation; sustainability and protection of water and marine resources; transition to a circular economy; pollution prevention and control; protection and restoration of biodiversity and ecosystems);
- do no significant harm (DNSH) to the other five environmental objectives, where relevant; and

Though not touted as an ESG assessment tool per se, sustainable investing and responsible / ESG investing are often viewed interchangeably and so the Taxonomy should prove to be a useful development when we are seeking a cohesive guide.

EU Sustainable Finance Disclosure Regulation: Regulatory Technical Standards
Also highly anticipated among the regulatory developments of the European Union, and this time specifically identified as an ESG assessment tool, are the proposed regional standards under the Sustainable Finance Disclosure Regulation (“SFDR”). This regulation allows the European Supervisory Authorities “to develop Regulatory Technical Standards on the content, methodology and presentation of ESG disclosures both at entity level and at product level”:

<table>
<thead>
<tr>
<th>ENTITY-LEVEL DISCLOSURE</th>
<th>PRODUCT-LEVEL DISCLOSURE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Form</td>
<td>Public disclosure on the company’s website</td>
</tr>
<tr>
<td>Content</td>
<td>A statement on due diligence policies “showing how investments adversely impact indicators in relation to climate and the environment, and social and employee matters, respect for human rights, anti-corruption and anti-bribery matters”</td>
</tr>
</tbody>
</table>
ESG in renewable energy

Is ESG viewed differently in the renewable energy sector?

Essentially, the answer to this question is “no”, ESG standards are not assessed differently in the renewable energy sector, but the efficacy of their incorporation into a project developer’s business practices and adherence to those principles is scrutinised even more fervently by investors in this industry.

Potential investors often look to conduct their due diligence on a project developer’s internal ESG policies and practices upfront. It is sometimes difficult, as the MIRA Survey 2020 notes, for potential investors and stakeholders in companies to collect in “efficient, reliable and useful ways” non-financial data on a company’s ESG performance, though performance data is becoming more available and research has advanced. Collecting data often needs to be done through (i) the inclusion of Principles for Responsible Investment-related requirements in a request for proposal; and (ii) due diligence on a particular company, whether through consultants or otherwise. Analysis of that data, once collected, should be made easier with the developments of the EU and the World Benchmarking Alliance.

Investors might push the project developer to correct regulatory failures in the jurisdiction in which it operates or to correct certain aspects of its way of doing business as a condition to investment (and the investor might employ a consulting agency to assist them in turning the developer around). It is also probable that, post-investment, the investor would take a hands-on approach to active decision making and potentially policy amendment in the company.

The MIRA Survey 2020 found that interest in ESG is deepening: 58% of investors increased their attention to ESG over the past five years and 91% expect it to increase over the next five years. The most common allocation in ESG investment strategies, attracting almost one third of investors polled, is renewable energy.

Assumption

The assumption in the market is often that renewable energy companies must automatically be a model of sustainability.

“E” is broader

Renewable energy projects have a head-start on the environmental front but production of clean energy should not eclipse other key environmental issues (eg impact on water sources of a hydroelectric power project; impact on biodiversity as infrastructure is installed).

Do not forget “S” and “G”

Studiously incorporating good business practices on the social and governance fronts is important too – these cannot be ignored to concentrate solely on pro-environment aspects.
What should a renewable energy project developer do now?

How can a project developer improve and implement its ESG policies and practice and attract investors? There is not a simple answer either generally or in respect of the renewable energy industry in particular, because there does not yet exist a single set of internationally recognised guidelines for renewable energy projects. As indicated above, some cohesive direction will be found in the development of the EU SFDR Regulatory Technical Standards and the EU Taxonomy Regulation (which, though binding in the EU, can certainly have global influence) and the SDG-related benchmarks being developed by the World Benchmarking Alliance though it must be borne in mind that these are not centred on the renewable energy industry alone.

For this reason, project developers might want to look at a multi-pronged approach to establishing good ESG policies and practices:

**Requirements and guidelines**

Which requirements or guidelines are relevant to your industry or project?
- legislated requirements applicable in the country in which your project is located; and
- national or international standards with which compliance is voluntary but your company / group has signed up or wants to sign up to them.

This can be determined by accessing reputable online databases eg the WBCSD Reporting Exchange is a free online platform that (i) compiles ESG reporting standards, both mandatory and voluntary, across 70 countries; (ii) categorises ESG indicators; and (iii) includes a global database of rankings, ratings and indices.

**Indices**

Are there indices against which your company could be measured, or against which you aspire to be measured?

In the renewable energy sector, examples of ethical investments indices are:
- ECPI Global Renewable Energy Equity Index: this index (one of the ECPI Thematic Indices) selects the 40 highest ESG-rated companies active in the production or trading of energy from inexhaustible sources.
- S&P/TSX Renewable Energy and Clean Technology Index: this index measures performance of companies listed on the Toronto Stock Exchange whose core business is the development of green technologies and sustainable infrastructure solutions.

**Governance: commonalities across industries**

There will be some commonalities in the approach to governance issues across different industries, for example:
- The power of the board of directors as part of the management team is emphasised in leading a company to long-term success while being accountable to all stakeholders (employees, suppliers, communities).
- A company’s vision is not profit-at-all-costs: among directors’ fiduciary duties is to ensure that the business of the company is conducted in a principled manner. Use tools such as management training, engagement of experts and online resources as guidance to align the company’s purpose and sustainability considerations.

**Emulate or learn from others**

Consider established companies that you may wish to emulate or from which you can glean what would or would not work for you, for example by examining companies’ published ESG goals in their annual reports or otherwise.

**Professional advice may prove helpful**

Query whether you would be interested in obtaining professional advice on integrating ESG principles into your business (consider specialist consultants, data organising experts and law firms). ESG rating agencies that certify compliance of a transaction, often by issuing an ESG opinion, include Vigeo Eiris and Sustainalytics.

**Transparency**

Transparency is key: as far as possible, disclose your policies and your processes for putting those policies into practice.
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