EMPEA Brief

ESG in Infrastructure

October 2016

This brief draws upon engagement with the EMPEA Energy & Infrastructure Council[1]. Members of the Council recognize both the importance and nuanced nature ESG issues have in infrastructure investing in emerging markets. This brief is designed to help articulate those nuances and help support practitioners understanding of ESG in the space.

In infrastructure investing environmental, social and governance (ESG) issues remain critical considerations for practitioners given the long-term time horizon and often relatively significant financial investment required. During the first half of 2016 US$1.8 billion of capital was invested in infrastructure and real assets in emerging markets[2]. ESG considerations and best practices evolve as capital is continually raised and deployed across the asset class. Relative to other asset classes such as private equity, infrastructure investing is comprised of a complex and nuanced mix of ESG factors including land acquisition, resettlement, community engagement and environmental impact. These complexities are revealed in the industry standards & guidelines and the types of risks, considerations and priorities that influence a firms ESG management system for infrastructure investing.

Industry Standards and Guidelines

Industry standards and guidelines are often the foundation for investors ESG management systems in infrastructure investing. The World Bank Group EHS Guidelines & Industry Sector Guidelines, the IFC Performance Standards, Equator Principles, PRI Principles, CDC Toolkit and Infrastructure Sector Profile are commonly cited references. The World Bank Group Environmental, Health, and Safety (EHS) Guidelines and the Industry Sector Guidelines are technical reference documents which can be tailored to risks and contexts of specific projects, including varying local regulations. Included in the EHS Guidelines are performance levels and measures that are typically accepted by IFC and believed to be realistic in" new facilities by existing technology at reasonable costs."[3] The IFC Performance Standards also provide a framework to manage environmental and social risks[4]. As a risk management framework, the Equator Principles (EPs) provide a base standard to support responsible decision making. EPs are designed to be applied globally and across industries[5]. The Principles for Responsible Investment (PRI) are six principles developed by global institutional investors to reflect the current ESG issues related to investments[6]. CDC's ESG Toolkit for Fund Managers is a comprehensive reference guide for ESG related issues. There is a specific section dedicated specifically, to helping Fund Managers (GPs) develop a tailored ESG management strategy.[7] In addition, GPs will benefit from the toolkit's infrastructure profile which is part of the guide's sector profiles. For practitioners active specifically in the energy sector, the Actis Energy Impact Model is a comprehensive tool that can be easily adapted.[8]

Maximizing the value of these standards and guidelines requires practitioners to tailor and customize them to align with the context of

Industry standards & guidelines

These are commonly referenced resources by practitioners active in infrastructure in emerging markets.

- The World Bank Group EHS Guidelines
  - Industry Sector Guidelines
  - IFC Sustainability Webinar Series
- IFC Performance Standards
- Equator Principles
  - Equator Principles Implementation Notes
- PRI Principles
- CDC Toolkit
- CDC Infrastructure Sector Profile

1 The Council represents interests in infrastructure-related private capital investments in emerging markets across the full spectrum of the sector, including energy (traditional, and clean and renewable, from generation to distribution), transportation (ports, airports, toll roads, rail, urban), water (including waste water) and telecom (mobile telephony and internet infrastructure).
2 Source: EMPEA 1H 2016 Emerging Markets Private Capital Industry Statistics
3 "Environmental, Health, and Safety General Guidelines." April 2007, http://www.ifc.org/wps/wcm/connect/554e8d80488658e4b76af76a6515bb18/Final%2B-%2BGeneral%2BEHS%2BGuidelines.pdf?MOD=AJPERES
4 "Environmental and Social Performance Standards and Guidance Notes." 2012. http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Our+Approach/Risk+Management/Performance+Standards
5 "The Equator Principles Implementation Note." 2014. http://www.equator-principles.com/resources/equator_principles_implementation_note_july_2014.pdf
6 "The Six Principles." https://www.unpri.org/about/the-six-principles
7 "About the toolkit." 2015. http://toolkit.cdcgroup.com/about-this-toolkit/
8 "Actis Energy Impact Model Explained." 2016. http://www.act.is/media/1404/final-actis-energy-booklet-april-2016.pdf

> Acquiring and maintaining a social license to operate is essential in infrastructure projects in emerging markets.
>
> - Dean Alborough,
> *ESG Advisor, AIIM*

their infrastructure investment. Paul Winters, Managing Director, Chief Compliance Office and General Counsel for Denham Capital explains, "The operating environment is key. For each infrastructure project we incorporate and align the current operating environment context into our ESG strategy." Part of the operating environment also involves integrating local regulations and standards as well as individual ESG guidelines that institutional investors may have. Institutional investors will typically outline their ESG best practices, guidelines and procedures through legal commitments including LPA and side letters.

Key Challenges

Managing the social element

ESG factors in infrastructure investing create a unique set of challenges for practitioners. With best practices and industry guidelines many practitioners feel that the environmental element of ESG can be modeled and managed effectively under the appropriate ESG management system. The social aspect of ESG, specifically stakeholder engagement, land acquisition and resettlement are much more dynamic, unpredictable elements. Therefore, the social element of an ESG management system requires a much more nuanced and tailored approach. As stewards of investors capital it is critical that a firm maintains its social license to operate from the community, otherwise the financial and reputational ramifications can be catastrophic. IFC's Stakeholder Engagement: A Good Practice Handbook for Companies Doing Business in Emerging Markets is often referenced by practitioners and can be helpful in building out a firm's tailored approach.

When to consider ESG issues

Council members agreed that it is in the best interest of the fund to consider ESG issues at the earliest possible stage of the investment process.

In doing so, the fund will have the ability to:

- Better understand the potential risks
- Incorporate ESG requirements and procedures in the investment agreement
- Better align their ESG strategy with the current operating environment
- Identify potential areas for value creation

Establishing the right balance

Given the sensitivity and associated potential risks around community engagement, resettlement and land acquisition a key challenge for a firm is to create an ESG action plan that is both comprehensive and pragmatic. Dr. Archana Hingorani, CEO of IL&FS Investment Managers explains, "it can be a challenge to form an ESG action plan for the investment, which is both comprehensive in terms of risk coverage and is also pragmatic in terms of its implementation and monitoring." A comprehensive ESG strategy is virtually worthless if it is not feasible to implement.

About EMPEA

EMPEA is the global industry association for private capital in emerging markets. We are an independent non-profit organization with over 300 member firms, comprising institutional investors, fund managers and industry advisors, who together manage more than US$1 trillion of assets and have offices in more than 100 countries across the globe. Our members share EMPEA's belief that private capital is a highly suited investment strategy in emerging markets, delivering attractive long-term investment returns and promoting the sustainable growth of companies and economies. We support our members through global authoritative intelligence, conferences, networking, education and advocacy.

Lead Author

Abigail Beach, Manager Strategic Engagement

EMPEA Energy & Infrastructure Council

Denham Capital, Scott Mackin, Co-Chair
EMPEA, Jamil Kassum, Co-Chair
African Infrastructure Investment Managers, Jurie Swart
Armstrong Asset Management, Andrew Affleck
Crescent Capital, Aygen Yayikoglu
GEEREF, Cyrille Arnould
IFC, Lance Crist
IFC AMC, Reyaz Ahmad
IFC AMC, Darius Lilaoonwala
IDFC, Aditya Aggarwal
IL&FS Investment Managers, Dr. Archana Hingorani
Harith General Partners, Emile du Toit
Mubadala Infrastructure Partners, Philip Haddad
Norfund, Mark Davis
Norton Rose Fulbright, Simon Currie
Tetra Tech, Dean White
Warburg Pincus, Somit Varma
White Case, Someera Khokhar

Main drivers for ESG management in infrastructure investing

For our Council Members the main drivers for developing an ESG management strategy include:

- **Risk management**
  Firms recognize that level of ownership doesn't translate to brand risk. If a firm owns 15% of a company and that company fails to comply with regulations the firm's reputational damage is not limited to 15%. Firms see the opportunity to mitigate risk through an effective ESG management strategy.
- **Value creation**
  There is growing thought leadership around the idea that managing ESG issues can help support investment returns by creating value and identifying profitable investment opportunities.
- **Investor requirements**
  As institutional investors' level of sophistication around ESG issues continues to grow their ESG considerations and reporting will change.

  Members noted that private capital investing is a people business. People have varying views and objectives. This leads to a diversity in the ESG drivers. To maximize utility, firms should understand the individual drivers behind each of the stakeholders they engage with.

Fit for purpose

An effective ESG management approach will consider and take into account the current realities of the business operating environment. A key challenge in infrastructure projects, especially brownfield projects, is tailoring an ESG management strategy so that it is what Dean Alborough, ESG Advisor, AIIM calls "fit for purpose" in the given context. Creating a strategy that is fit for purpose will require practitioners to understand the current context, business procedures and practices for each infrastructure project.

Implementation

Even the most comprehensive and tailored ESG management strategy is useless if the strategy cannot be implemented appropriately. Infrastructure investing requires engagement with a diverse set of stakeholders, each of whom may have different practices and procedures. Ensuring that a firm's ESG management strategy is communicated and implemented appropriately across the supply chain can be a challenge. It is advisable for practitioners to therefore think about how their ESG policy will be communicated, implemented and monitored early in the strategy development phase.

A firm's level of ownership can impact its ability to implement its ESG management strategy. In infrastructure projects where firms have majority stake in the investment it can be relatively easy to execute on a strategy. In the emerging markets context, many firms take a minority stake in investments. In cases where ability to exert influence is limited it is critical that a firm's ESG requirements and conditions be negotiated early in the investment process. Dr. Archana Hingorani, CEO of IL&FS Investment Managers illustrates this point and explains "our Fund's ESG policy and the implementation of such a system, and its monitoring, is built into the investment agreement." Dean Alborough, ESG Advisor, AIIM offers that "limited influence doesn't necessarily mean a firm has to have low influence." Instead he suggests that firms develop good influence over an asset by building relationships of trust with the investee company's leadership over time.

Nature of the project

The nature of infrastructure projects (brownfield v. greenfield projects) can impact a firm's ESG strategy. Greenfield projects imply that initial ESG due diligence assessments and environmental and social impact assessments (ESIAs) will be required. These assessments can be done under the supervision of the firm. According to Andrew Affleck, Managing Partner, Armstrong Asset Management, "construction phase impacts, which are normally the most important, need to be managed as part of greenfield investments." For brownfield investments Mr. Affleck notes that "assessment of legacy impacts and retroactive review and improvement of E&S management at the corporate and project levels needs to be carried out."

Developing an ESG Management System

Leveraging industry standards and guidelines and understanding the key challenges related to ESG in infrastructure investing will help practitioners build an effective ESG management system (ESGMS). The rationale for developing an effective ESGMS is that doing so will create a framework to manage ESG risks and opportunities associated with infrastructure assets. According to the CDC ESG Toolkit for Fund Managers, "ESGMS are now well established as good practice in the private equity industry."[9] Typically, the objective of an ESGMS is to create a systematic approach to incorporate ESG material issues across the investment lifecycle.

[9] "ESG management systems (ESGMS)." http://toolkit.cdcgroup.com/fund-esg-management-systems/

The Value of ESG management systems (ESGMS)

The CDC ESG Toolkit for Fund Managers provides comprehensive guidance for creating effective ESGMS. According to the Toolkit, "a well-designed and properly implemented ESGMS should add value to the fund and its stakeholders by":

- Integrating ESG factors across the investment life cycle
- Creating a framework to manage ESG issues at the fund and investee company level
- Identifying potential value creation opportunities
- Establishing a framework to engage with stakeholders
- Supporting a fund's ESG monitoring and reporting activities

The CDC ESG Toolkit for Fund Managers provides comprehensive guidance for creating effective ESGMS:

- Getting started
- Fund Environmental and Social Management Systems

Buy-in and ownership

ESGMS are only effective if the firm's leadership buys into the strategy behind it. To facilitate this firms may choose to have their Board adopt or even help develop an ESG policy. Acquiring executive leadership approval is only part of the equation, the other vital component requires the development of clear ownership, roles and responsibilities. Even the most comprehensive ESGMS will be virtually useless without someone (or some people) managing it. Many firms choose to dedicate a full-time resource or resources to manage the development, implementation and monitoring of their ESGMS. However, there is no standard approach to ESGMS ownership, instead firms should organize roles based on individual expertise and capacity. Firms may also choose to work with an ESG consultant or advisor initially to build up internal capacity to manage their ESGMS in the future. The most successful ESGMS owner(s) will have the ability to communicate the strategy and empower their investment professional colleagues to take responsibility for ESG performance and help manage it through their daily business activities.

Monitoring

A valuable ESGMS will include benchmarks or KPIs to help evaluate the ESG performance across infrastructure assets. These benchmarks or KPIs should be reevaluated periodically to ensure that they align with the firm's ESG priorities and are relevant to the current operating environment. It is also critical that projects that fail to meet the benchmarks or measures be provided with action plans to address disparities between firm expectations and project realities.

ESGMS will provide a firm with a great deal of data often at varied levels of granularity. This data can be valuable, even actionable data if it is appropriately disseminated and incorporated. It is critical for firms to provide formal reporting and communication channels across the firm structure. Individual asset's ESG reports need to be effectively and efficiently incorporated into Board and LP reports. Any information and decisions made at the executive level then need to be appropriately communicated to investee companies. To optimize this process many firms choose to conduct formal quarterly reports which feed into their larger annual reports and any other reports required by their investors. Aditya Aggarwal, Partner, IDFC notes that his firm "has a framework for ESG information dissemination which goes all the way to their LPs." This regular monitoring and reporting of the projects helps to ensure ESG issues at the project level are managed in accordance with the firm's broader ESG strategy.

It is important to periodically review an ESGMS and incorporate lessons learned and changes in the firm's strategy or portfolio. This will help to ensure that the ESGMS is relevant and fit for purpose.

ESG Trends in Infrastructure

As capital is continually deployed in the space lessons learned and trends start to formulate. Notable trends in the space include:

Acknowledgment of potential value creation opportunities

Andrew Affleck, Managing Partner, Armstrong Asset Management describes, "a move from viewing ESG management as purely about risk management towards an understanding the ESG management can create value and also positively differentiate the fund from others." As drivers for ESG management evolve the issues considered and approaches to best practice may change as well.

Impact of local regulations

Local regulations are critical considerations in any private capital investment, but regulatory changes can have relatively large impact on infrastructure projects. Aditya Aggarwal, Partner, IDFC notes that recent changes to India's land requirements and sustainable development for land losses have led to a fine tuning of their ESG strategy. This is why it is key to have an ESG management strategy that can easily adapt to reflect changes in the operating environment.

> E&S is not a compliance issue it can be a value add proposition if managed appropriately.
>
> - Darius Lilaoonwala,
>
> *Co-Head, IFC Global Infrastructure Fund*

Enhanced reporting

LPs are seeking enhanced reporting around ESG. Members noted an increased interest in reporting on key material issues and having a better line of sight. For additional information on ESG reporting please refer to the EMPEA ESG Reporting brief & Reference Guide. As LPs have become more sophisticated around ESG issues individual reporting requirements have changed.

Emphasis towards clean & renewable energy

Members noted that greater interest in climate change issues and the overall enhanced emphasis on ESG considerations has created a trend of constructing a renewables and clean energy heavy portfolio.

Conclusion

The illiquid nature, long-term time horizon and potential social and environmental impacts of Infrastructure projects influence ESG considerations in the space. Practitioners who recognize these nuances, leverage industry guidelines and make their ESG strategies fit for purpose are better positioned to manage ESG opportunities and risks.

Additional Resources

Practitioners in the space may find this sample of publicly available resources related to ESG issues in infrastructure useful:

- Actis Energy Impact Model
- ERM chapter on effective management of ESG risks in major infrastructure projects
- GEREEF Impact Report
- PGGM Responsible Investment in Infrastructure
- Responsible Investment in Infrastructure—a case study compendium from PRI