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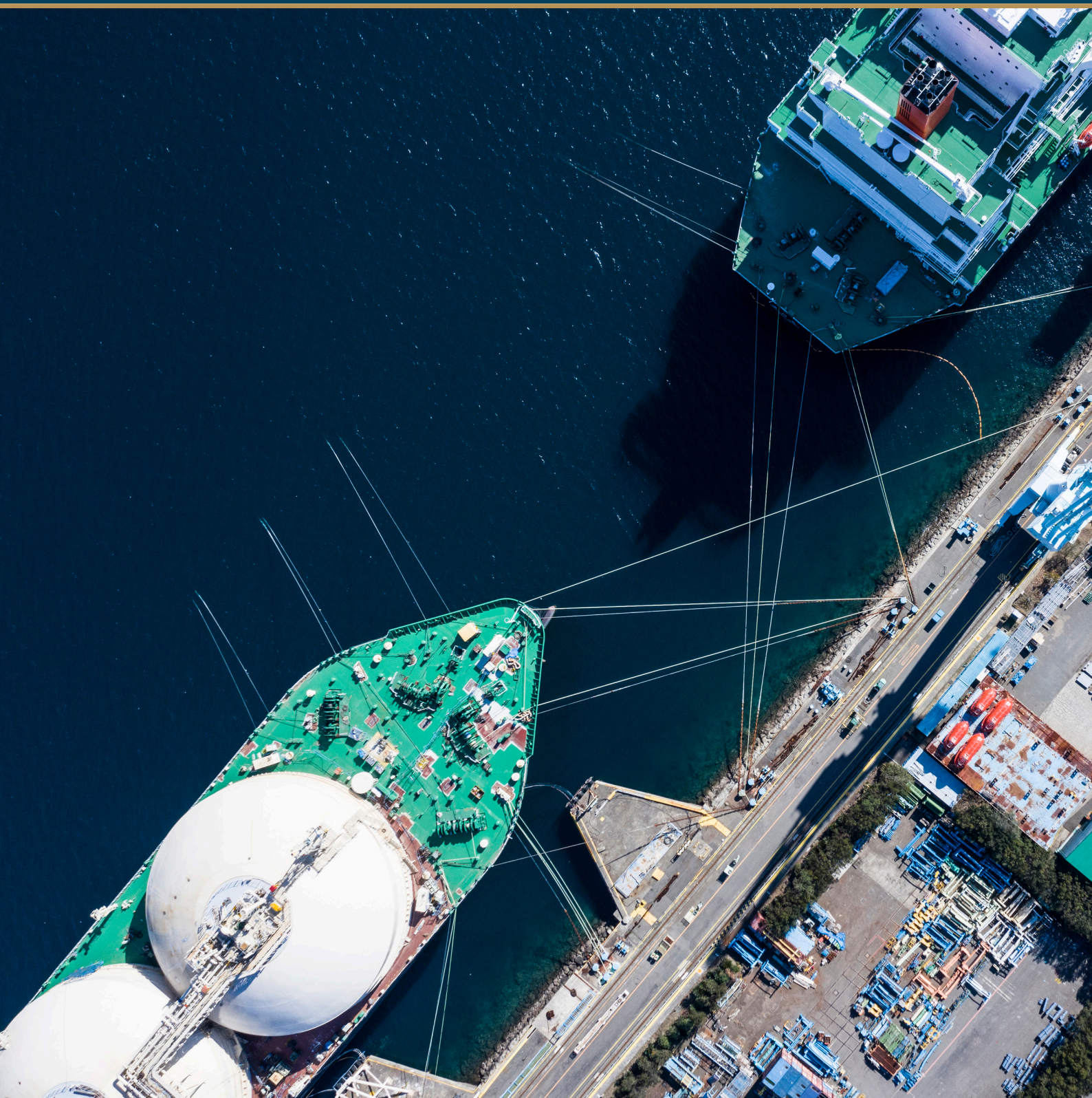
INVESTMENT MANAGERS SINCE 1984

The Energy Trilemma Series – Part 3

ESG integration in midstream investments

Global Listed Infrastructure
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Executive summary

Minimising stranded asset risk for certain midstream infrastructure assets requires an in-depth understanding of the complexities associated with climate risk management, stakeholder relations, legal and regulatory affairs and the pace of the energy transition. We believe that our approach to managing environmental, social and governance (ESG) risks and opportunities across the midstream sector is stringent but fairly balanced against other factors, such as the need for energy security and affordability. ESG factors are integrated into the Maple-Brown Abbott Global Listed Infrastructure investment process and supported by our targeted company engagements, collaborative memberships, proxy voting decisions and climate change scenario analysis.

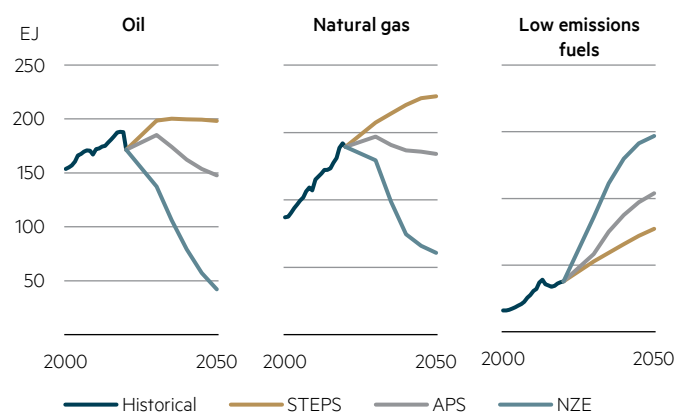
In practice, we remain positive on the North American midstream sector's ability to play a role in the energy transition. That said, our exposure to the sector has materially reduced in recent years as we have become more selective in our investments due to a combination of factors. Namely, we revised our growth outlook for some midstream infrastructure assets as the pace of the energy transition accelerates and new projects face ongoing headwinds. We have also stepped up our ESG efforts by more closely scrutinising companies' sustainability progress and performance while testing our ongoing assumptions related to stranded asset and climate change risks through scenario analysis.

In this final paper of our The Energy Trilemma series, we discuss our approach to ESG and how we specifically integrate these risks into our investment process to help balance the opportunities we see in the midstream infrastructure space. The first paper in the series introduces the three dimensions of the energy trilemma, namely – sustainability, security and affordability – and why governments need to balance long-term outcomes. The second paper highlights the unique role that the North American midstream sector can play in addressing issues in the energy trilemma and the stronger investment outlook for natural gas infrastructure assets. In totality, the three papers illustrate the Maple-Brown Abbott Global Listed Infrastructure team's latest thinking about the opportunities and trade-offs associated with the energy trilemma and how these can be managed to improve long-term returns.

Assessing ESG risks in midstream infrastructure

Governments around the world are grappling with the challenge of balancing the three interconnected pillars of the energy trilemma – sustainability, security and affordability – at a time of geopolitical uncertainty and upheaval. Heightened energy security challenges point towards the continued need for investment in certain industries, such as the North American midstream infrastructure space. However, as the world pushes to decarbonise the energy sector to limit the catastrophic effects of global warming, it is clear oil and gas midstream assets face material long-term uncertainties and stranded asset risks. These uncertainties stem from a range of factors related to the pace and scale of the energy transition needed to achieve the long-term temperature goal of the Paris Agreement.¹ Indeed, according to the International Energy Agency (IEA), global demand for natural gas would need to decline by 55% and oil decline by 75% by 2050, relative to 2020 levels to reach net zero emissions by 2050 and achieve the long-term temperature goal of the Paris Agreement (Figure 1).¹ Moreover, the same modelling shows that from 2021 onwards there can be no development of new oil and gas fields if this goal is to be achievable.

Figure 1: Oil, natural gas and low emissions fuel use to 2050



Source: International Energy Agency, World Energy Outlook 2021

Disclaimer: Forward-looking statements are provided as a general guide only and should not be relied upon as an indication of the future performance.

i The long-term temperature goal of the Paris Agreement goal is to hold global average temperature increase to well below 2 degrees Celsius – with 1.5 degrees Celsius being the ultimate objective – compared to pre-industrial levels.

For instance, in terms of market and technology changes, ongoing electrification of the grid and improvements in low-carbon storage technologies, could lead to reduced demand for traditional midstream services and increased customer credit risk and operational costs. Reputational impacts could also lead to increased cost of capital and financing challenges for new projects, particularly as the financial services sector becomes more stringent on lending facilities for fossil fuel-related activities.ⁱⁱ

That said, when considering these risks to the midstream sector there is a need to consider the value of the infrastructure as separate to the commodities being transported, but still linked, at least for now. This is somewhat akin to valuing toll roads based on long-term forecasts of traffic as opposed to solely the emissions profile of the vehicles travelling on the road. In other words, the potential for the midstream sector to diversify or repurpose assets to support low carbon fuels can often be overlooked. To achieve net zero emissions by 2050, IEA projects growth in low emission fuels, such as green hydrogen and RNG, would need to rise by 280% by 2050 as oil and gas demand falls, relative to 2020 levels (Figure 1).

From an environmental perspective, the need to transform global energy networks from a primarily fossil-based system to a sustainable model is unequivocally clear. With the energy transition gaining momentum, governments around the world are on an urgent path to eliminate their dependence on fossil fuels and bridge the gap with additional capacity from renewable energy, energy storage solutions and low emissions fuels.ⁱⁱⁱ However, it is important that the energy transition occurs in an orderly and equitable way. In other words, the 'social' and 'governance' factors intrinsic to a secure transition must not be overlooked when responding to climate change. Indeed, the need for a fair and just transition is recognised by the Paris Agreement as an "imperative", most especially in the case of the world's least developed countries.^{iv}



Divestment does not equal decarbonisation

The push to divest from energy companies and certain fossil fuel-related activities has ramped up in recent years as investors have become more conscious of stranded asset risks and companies' overall environmental impact, particularly in relation to greenhouse gas (GHG) emissions. As part of this, similar trends can be seen with some companies looking to 'de-risk' themselves of certain fossil fuel assets to drive their emissions profile down and position themselves more palatably to existing and prospective ESG-aware investors. As at March 2022, the fossil fuel divestment movement is estimated to have garnered support from 1,500 institutions with assets totalling US\$40 trillion – a sharp rise from US\$15 trillion in 2021.² At present, the movement is primarily geared towards producers of oil, coal and gas, as opposed to companies that store, transport or use these fuels.

From a climate change risk perspective, it is certainly true that divestment of higher-risk midstream assets, such as oil pipelines, could help reduce the stranded asset risk profile of a company. However, while divestment may seem like an attractive solution at face value – from a single company's sustainability perspective – the stranded asset risk is simply transferred to another owner with no actual emissions reductions being achieved. Divestment merely shifts the risk or the problem elsewhere, often from public to private markets where there is less public visibility and stakeholder accountability. Herein lies a key philosophical debate in the ESG and sustainability space of stewardship through ownership versus divestment.

A willing buyer of fossil fuel assets could, theoretically speaking, be less concerned about managing the infrastructure with emissions management, environmental considerations and community consultation in mind. Indeed, it is fair to suggest that some buyers are solely concerned with financial returns. Again, from a sustainability perspective, this is clearly not a good outcome. One seller's ceiling could be another buyer's floor – in other words, a willing buyer's standards may not necessarily be as high as the incumbent's. If this is the case, and while a valid argument, shareholders must have comfort that the incumbent owner and operator is genuinely committed to driving more sustainable outcomes. Due to the rise of corporate greenwashing – a disconnect between statement and action – shareholders must cut through the marketing claims to make sure that ownership as opposed to divestment is warranted. Otherwise, companies may retain assets with high risk of becoming stranded because sustainability and emissions reduction outcomes are not being appropriately managed.

ii For example, as is evidenced by the commitments made by 40% of banks worldwide through the Net Zero Banking Alliance.

iii Low emission fuels include low-carbon hydrogen, hydrogen-based fuels and modern bioenergy.

iv See UN Framework Convention on Climate Change, Paris Agreement, preamble.

Divestment campaigns are not new. The trend to divest from certain fossil fuel-exposed companies by ESG-aware investors is borne out of a decade of momentum to divest from so-called ‘sin’ stocks, such as tobacco and defence companies. It is not quite clear whether the trend towards divestment has, at a general level, led to a material impact on company returns and their cost of capital over time.^v It is also worth noting that equity sell-offs can also trigger an unwanted domino effect. As a company’s share price falls, a company may become a more attractive acquisition target for private equity or state-owned national oil companies – such as those in Mexico, Saudi Arabia and Venezuela – which already control 55% of global oil and gas and 90% of reserves.³ Shifting from public to private ownership could reduce disclosure and insulate a company from external pressure.

In reality, companies and shareholders cannot simply divest away from assets to achieve decarbonisation and support the long-term goals of the Paris Agreement. In the listed infrastructure space, there are only a handful of energy-related companies that currently meet the criteria of being ‘low carbon’ and ‘green’. Indeed, most listed infrastructure companies will need to tread an expedited decarbonisation path that balances all three dimensions of the energy trilemma. There are no overnight solutions, and from our perspective, we find that sophisticated investors recognise this complexity and have therefore oriented their efforts towards active management – through direct and collaborative engagement and proxy voting – to bring about the necessary outcomes. Our preferred approach is not binary, and instead we prefer to use engagement and divestment as actions tailored to the specific circumstances. An [overview of our engagement approach](#) can be found on our website.^{vi}

Assessing ESG factors in midstream infrastructure

Given the heightened risks and opportunities that the energy transition presents for midstream infrastructure, ESG is a key pillar to our research and stewardship efforts across these companies. We conduct thorough research, and continually assess and monitor developments across a broad range of ESG factors for all investee companies. Our key focus areas for the midstream sector are highlighted in Figure 2.

Figure 2: Key ESG focus areas for the midstream sector

Environment	Social	Governance
<ul style="list-style-type: none"> - Emissions management and targets (particularly scope 3) - Fugitive emissions (such as methane) - Spills and leaks - Waste management - Stranded asset risk 	<ul style="list-style-type: none"> - Safety - Indigenous relations - Community relations - Permitting and consultations 	<ul style="list-style-type: none"> - Board independence - ESG skills on the board - Board oversight of ESG risks - Remuneration structures - Political lobbying - Regulatory oversight

We integrate the above-mentioned ESG factors into our investment process, which helps guide our engagement and proxy voting efforts. For midstream companies, the terminal value is an area of particular importance because it often comprises a meaningful proportion of the overall company valuation and reflects our assessment of stranded asset risks relative to new investment opportunities, among other longer-term factors. We utilise asset-level long-term scenario analysis to help inform our terminal value assumptions. Additionally, given the heightened ESG risks in the midstream sector, our assessment of companies’ management of ESG risks – for example, through the setting of net zero targets, appropriately incentivised remuneration structures and historical track record – plays an important role in the investment process. These factors are primarily reflected in our management and corporate governance scores we assign to companies, which in turn influences portfolio construction.

Overall, we currently prefer midstream companies that have diversified their business models somewhat to facilitate an orderly energy transition – including the potential for repurposing of pipelines for cleaner fuels, developing carbon capture opportunities, and the electrification of operations that are potentially accompanied with renewable energy development. We see a growing list of initiatives across the midstream sector that have the potential to contribute to a more sustainable energy future.^{vii}

v For example of tobacco companies, see: CalPERS, ‘[Five-Year Divestment Review](#)’, March 2021.

See also: FT Moral Money Forum, ‘[To engage or divest: how should investors clean up the world’s dirtiest companies?](#)’, May 2022.

vi In 2021, the Maple-Brown Abbott Global Listed Infrastructure strategy became a signatory to the Net Zero Asset Managers Initiative (NZAMI). For details see Net Zero Asset Managers Initiative in the Appendix.

vii Some of these initiatives were discussed in Part 2 of this series in the box ‘Examples of sustainability-led investments in the midstream sector’.

Managing midstream ESG risks in practice

Collaborative engagements – CA100+

We are an active member of the Enbridge engagement working group and have made some meaningful contributions on the topics of emissions target setting, variable remuneration aligned to emissions reduction objectives, fugitive emissions management and political expenditure transparency in relation to climate change. We continue to see value in our membership through the group's influence on shaping the company's ESG direction.

Proxy voting

We actively engage with companies and use proxy voting decisions to help drive more sustainable long-term outcomes for investors – with our approach aligned with the Principles for Responsible Investment (PRI).

In 2022, we wrote to Enbridge's CEO and Chair of the Remuneration Committee outlining our rationale for voting against the company's remuneration report on the basis that its short-term incentive plan (STIP) did not provide a sufficient and detailed weighting to environmental and social factors. We have engaged with Enbridge – directly and through the CA100+ engagement working group – on this topic in the past and so this was an appropriate next step in our efforts to encourage greater alignment.

We also shared feedback on a shareholder resolution calling on Enbridge to revise its net zero target to include scope 3 emissions and align capex investments with this revised target before the end of 2022. While we supported aspects of the resolution, we felt the resolution could potentially be destructive to shareholder capital and was too restrictive within the timelines set. We communicated our reason for not supporting the proposal and therefore voted in line with management.

Scenario analysis

As part of our commitment to implement and report on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and our broader focus on ESG integration, in 2021 we undertook climate change scenario analysis on all investee companies to analyse the breadth of potential transition trajectories by using different modelling assumptions. The process of undertaking this analysis was an important exercise to inform and test our thinking on the pace and scale of the energy transition and what the varying assumptions could look like in a 'real world' sense.

As detailed in our inaugural [TCFD report](#), through our analysis, we found that a faster paced energy transition scenario presents some long-term challenges for midstream infrastructure companies due to the sharp decline in demand for natural gas and crude oil. The impact is less severe for LNG terminals, as demand for LNG is anticipated to be more resilient through to 2030 and then taper off in the long-term depending on the pace of the transition scenario. Our analysis concludes that midstream infrastructure is sensitive to faster energy transition scenarios, but the valuation upside to stocks we own compensates for this risk.

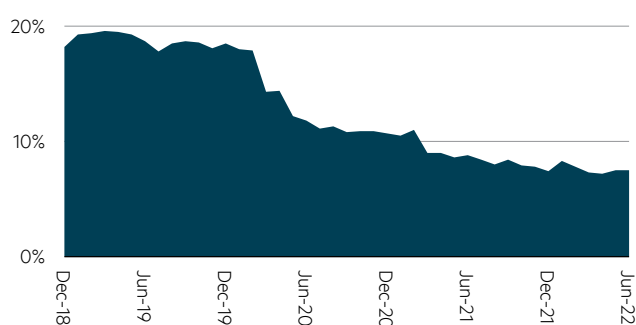


Conclusion

We adopt an integrated approach to managing ESG risks and opportunities across our investments. When it comes to the midstream infrastructure sector, we focus heavily on heightened long-term stranded risks owing to the pace of the energy transition and a resulting decline in the use of fossil fuels over the medium- to long-term. Our research and company engagements lead us to favour gas midstream assets with long-term strategic value, companies with strong governance arrangements and appropriate management and oversight of ESG risks. We believe these companies are most set to benefit from long-term opportunities associated with the three pillars of the energy trilemma, with relatively lower risk than perhaps some other midstream companies.

At the strategy level, we have materially reduced our exposure to North American midstream companies over the past few years (Figure 3). This reflects some of the structural changes to the sector over this period and a tempering of our view on the long-term outlook for the sector as a whole. Specifically, what we view as the investible listed opportunity has been shrinking over time. This is either due to acquisitions as Master Limited Partnerships (MLPs) have been rolled up and some companies have been acquired in direct transactions, or our increased focus on higher-quality midstream names as we incorporate our improved ESG capabilities. For instance, of the eight midstream companies on our Focus List only three currently have net zero targets – of which, we are invested in two.^{viii} The fuller valuation for some companies in the current favourable commodity price environment, combined with a potentially more challenged growth outlook, also contributes to our more limited midstream exposure.

Figure 3: Maple-Brown Abbott Global Listed Infrastructure midstream positioning – as at 30 June 2022



Source: Maple-Brown Abbott Global Listed Infrastructure

Appendix

Net Zero Asset Managers Initiative

In 2021, the Maple-Brown Abbott Global Listed Infrastructure (GLI) strategy became a signatory to the Net Zero Asset Managers Initiative (NZAMI).^{ix} In joining this initiative, we recognise that the infrastructure universe – most especially in the energy sector – is coalescing around a new ‘net zero’ norm with the vast majority of companies setting ambitious emissions reduction targets. As a reflection of this, and as part of our focus on ESG integration, we have made a commitment to align the GLI strategy with a pathway towards net zero scope 1 and 2 GHG emissions by 2050. To assist with this trajectory, we have set a target of a 50% reduction in the weighted average carbon intensity of the strategy by 2030 relative to a 2020 baseline. Further details about our net zero target and action plan are provided in our decarbonisation strategy.

Midstream infrastructure companies contribute to approximately 6% of the Strategy’s weighted average carbon intensity for scope 1 and 2 emissions.^x Direct and operational emissions for most midstream infrastructure companies typically come from gathering, processing, transmission and storage activities. We identify emissions management as a material risk and opportunity for midstream infrastructure companies, and for this reason, we monitor the emissions targets, progress and implementation plans closely. The level of ambition and quality of emissions reduction targets varies widely across the infrastructure universe. We actively prefer companies with ambitious and realistic decarbonisation targets supported by robust implementation plans. Where we identify deficiencies in a company’s decarbonisation strategy, we undertake targeted engagements to drive improvements.

viii The three Focus List companies with net zero targets are TC Energy, Enbridge Inc. and Williams Companies. See ‘A note on scope 3 emissions’ in the Appendix for comments on midstream companies’ net zero targets.

ix The NZAMI is an international group of asset managers committed to support the goal of net zero GHG emissions by 2050.

x Relates to scope 1 and 2 GHG emissions. A representative Maple-Brown Abbott Global Listed Infrastructure fund has been used as a proxy for this analysis. Data as at 30 June 2022.

Why methane matters



The emissions reduction benefits of switching from coal to gas can only be realised when fugitive emissions are actively managed to an absolute minimum.^{xi} We believe this methane 'break point' is often glossed over by companies and overlooked by investors researching companies in the energy sector. According to the IEA, methane emissions are estimated to be responsible for around 30% of the global rise in temperatures to date, and thus warrant specific attention in the midstream infrastructure space.⁴ Efforts to mitigate methane emissions over the next 10 years could mean the difference between a 2°C and 1.5°C world, with the energy sector offering the greatest potential for targeted mitigation by 2030.⁵ Indeed, to limit global average warming to at least 2°C, methane emissions will need to be ~70% lower than today's levels by 2030.^{xii}

Although less prevalent than CO₂, methane is a GHG eighty-six times more potent than CO₂ over a 20-year period and has a much shorter life span in the atmosphere.⁶ This creates a significant opportunity for the private sector because rapid methane emissions reduction offers one of the quickest ways to slow global warming.⁷ Aside from the environmental impacts and the need to comply with increasingly stringent regulations, managing fugitive emissions is also financially beneficial for companies. Indeed, the International Energy Agency (IEA) estimates that ~73% of oil and gas methane emissions can be mitigated with existing technology. Of this, ~40% can be achieved at no net cost.⁸ This is particularly true when natural gas prices are high.

We believe companies have an imperative to manage methane emissions to mitigate the warming effects of this highly potent GHG. Otherwise, from our perspective, the switch from coal to gas does not result in a net benefit.

Scope 3 emissions

As listed infrastructure companies increasingly set ambitious emissions reduction targets, the vast majority of these targets relate to scope 1 and 2 emissions, in other words, their operational emissions. This is to be expected as companies commence on a journey of decarbonisation. The most challenging and controversial part of a midstream company's emissions value chain relates to scope 3 emissions, which tend not to be included in such targets. Scope 3 emissions typically relate to upstream and downstream value chain activities including, for example, certain supplier emissions and the end use of a product, such as the burning of oil and gas. Defining and measuring scope 3 emissions is complex and the materiality threshold for a company depends on its sector and the nature of its operations and business model. The prevailing global standard for scope 1, 2 and 3 emissions reporting is the GHG Protocol, while the Science-based Targets Initiative (SBTi) is quickly emerging as the gold standard for target setting.

For midstream infrastructure, more recently, there has been a notable push among ESG-aware investors to encourage these companies to broaden their emissions targets to include aspects of scope 3 emissions. This is particularly important as scope 3 emissions tend to comprise the largest portion of overall emissions for midstream infrastructure companies, especially in relation to the end use of fossil fuels. However, at the time of writing, there is currently no emissions reporting and target setting standard for the midstream infrastructure sector on scope 3 emissions, making it difficult for these companies to clearly define what the path, if any, could look like. It is our understanding that the SBTi intends to release such a standard further into 2022. This will be a meaningful development for midstream infrastructure companies as they come under increasing scrutiny from bodies such as the CA100+ and by regulatory bodies such as the Securities and Exchange Commission (SEC), which has proposed a new rule requiring certain large companies to disclose material scope 3 emissions. We encourage companies to manage scope 3 emissions, but recognise the inherent challenges faced by certain sectors with tackling the first step, which is measurement.

xi Fugitive emissions are losses, leaks and other releases of methane to the atmosphere that are associated with industries producing natural gas, oil and coal. They also include CO₂ emissions associated with flaring of excess gas to the atmosphere.

xii According to the IEA Sustainable Development Scenario (2020).

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