Proskauer

Energy Transition:

A New Risk Climate for Investors

The Capital Commitment on **May 9, 2023**

Go to any private equity event in the last 12 months, and "energy transition" will have been discussed, meaning the shift in energy production away from fossil-based systems to low or zero carbon ones. As fund managers continue to raise funds focused on investments in this sector, we see no reason for this trend to change in 2023.

The ever-increasing web of ESG regulation is of course highly relevant for such funds and their investments, but the sector-relevant risks are much wider. There are four risks of which fund managers need to be aware.

1. Energy transition requires the development of new products and technologies. As with any innovation focused investment, such companies are more likely to become involved in disputes than established businesses. Prior experience of technology development suggests contractual disputes, delay claims and liquidity related disputes are the most common issues sector pioneers will encounter.
2. Energy transition projects are more likely to receive favorable tax treatment and other state subsidies. When these investment regimes are removed or altered, private investors may come into conflict with the state as seen in the €8 billion of investor-state claims brought against the Kingdom of Spain by solar venture investors when state incentives were withdrawn.
3. Climate change activism by civil society participants puts energy transition onto the agenda for all companies, even those not actively investing in the industry. Client Earth has recently claimed, as a shareholder, that the directors of Shell have failed to properly prepare for energy transition and meet long term climate goals. It is not hard to imagine similar arguments being made against any board, as part of the fiduciary duties to which directors are subject, especially where companies publicly commit to reduce carbon footprints.
4. As political pressures result in traditional sources of funds, including export credit agencies, withdrawing, or retiring from financing oil and gas projects, there is a marked shift to private capital funding models. The nature and type of disputes in relation to traditional energy assets will therefore also shift, given the different (usually shorter) investment timescales, funding models, risk approaches, and government liaison relationships.

These trends and developments must also be set against the existing and evolving regulatory background.

In the U.S., while the examination priorities for 2023 published earlier by the SEC did not significantly alter its position on ESG, the SEC did reiterate long held concerns as to whether advisers are employing the ESG strategies they are marketing to investors. The SEC, through its ESG Task Force made good on its promise to ramp up exam sweeps and enforcement actions for “greenwashing” in 2022

The SEC’s 2022 enforcement results focused on statements and omissions, with the SEC taking enforcement action against advisers and companies considered to have made materially misleading statements and/or omissions in disclosures about the incorporation of ESG factors in their investment processes as in the case of BNY Mellon Investment Adviser, Inc., or about the ESG impact of their underlying business operations as in the case of Vale SA, following the collapse of the Brumadinho dam in Brazil. We still expect proposals from the SEC that will codify disclosure obligations regarding ESG activities and facilitate oversight by SEC staff of ESG claims. Where exactly the SEC will come out in terms of the energy transition and climate change aspects of ESG is harder to predict, given the “anti-ESG” approach adopted by some states and the related pressure brought to bear on asset managers, including notably BlackRock.

In the EU, “financial market participants” are subject to both the Sustainable Finance Disclosure Regulation (the SFDR) and the Taxonomy Regulation. We have written before about the extent and effect of these regulations. However, new, and additional requirements continue to apply. From January 2023, SFDR in-scope firms must provide pre-contractual disclosures to investors in a prescribed template and, by June 2023, must provide SFDR annual reports for 2022 to investors (also in a prescribed template). These requirements are, however, already subject to amendment consultation which will likely give arise to amendments to these SFDR templates and these could be effective as early as next year. We expect that EU regulators are likely to be much more active in supervising and enforcing the SFDR disclosure and reporting requirements going forward.

The UK’s Financial Conduct Authority (FCA) recently closed its own consultation on the UK’s own ESG disclosure rules, with final rules now expected to be published by the end of 2023. The FCA has indicated that it will seek coherence with other international systems and is therefore likely to align with the EU regime, but the exact scope and application of the rules remain to be seen.

The opportunities for asset managers resulting from the geo-political focus on new energy systems are notable. With any developing sector, an awareness of the related challenges, both regulatory and from wider sectoral trends, will enable those opportunities to be fully unlocked, while mitigating downside risk.

Read more of our [Top Ten Regulatory and Litigation Risks for Private Funds in 2023](#).

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