APPENDIX I. PRIVATE EQUITY & NET ZERO BEST PRACTICES

There are three categories of actions that private equity firms can adopt to ensure progress towards net zero:

1. Comprehensive reporting of climate transition risk,
2. Interim and long-term net zero goals aligned with climate science, and
3. A net zero strategy, which includes policies covering:
    a. Acquisition,
    b. Active ownership and engagement,
    c. Climate solutions investing, and
    d. Paris-aligned political and industry lobbying.

Each of these elements, and associated best practices are described in more detail below.

These best practices are geared towards traditional private equity investments, which involve general partner investments, board seats, and management control; however, the principles can also inform limited partners in selecting general partners, and also net zero planning for alternative private investments, like private credit.

REPORTING CLIMATE TRANSITION RISK

> *"PE firms that fail to [...] disclose fossil fuel investments and lending make themselves susceptible to risk of stranded assets and reputational damage."*
> —SBTi[78]

Climate transition risk is the financial risk associated with carbon-intensive assets that may lose value as a result of the economy's net zero transition whether as a result of climate regulation, low-carbon technology developments, or changing customer preference, among others. For financial institutions it is primarily reported in terms of absolute annual financed greenhouse gas emissions[79] that are not associated with legitimate net zero transition strategies, for example, those certified by the Science-Based Targets initiative.

KEY SOURCES OF BEST PRACTICES:

- IIGCC, Net Zero Investment Framework Component for the Private Equity Industry (May 2023)
- KPMG, TCFD Implementation Considerations for Private Equity (Oct. 2022)
- ICI, Greenhouse Gas Accounting and Reporting for the Private Equity Sector (May 2022)
- SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021)

[78] SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021) at 30.

[79] Reported based on the methodology set out by the Partnership for Carbon Accounting Financials, Financed Emissions, the Global GHG Accounting and Reporting Standard (Dec. 2022).

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Guidance for measuring financed emissions is provided by PCAF and the GHG Protocol. The latter outlines three ways to determine the boundaries of institutional GHG inventories: operational control, financial control, and equity share.

For private equity firms, the Science Based Targets initiative ('SBTi') recommends reporting financed emissions according to the operational or financial control methods.[80] Operational control involves reporting 100% of emissions where the firm holds "full authority to introduce and implement its operating policies,"[81] which may require approval of joint financial partners.[82] Financial control also involves reporting 100% of a portfolio company or an asset's emissions where the firm holds "the majority risks and rewards of ownership of the operation's assets."[83] The control approach requires that all portfolio companies also report based on the control method.[84]

Because the PCAF emissions accounting methodology is based on shifting company value, complementary metrics are also necessary to interpret the cause of increases or decreases, such as:

- Financial commitment: annual investments, direct project financing, and lending to fossil fuel projects and companies.[85]
- Physical emissions intensity: emissions per unit of physical output allows comparison within a sector.
- Share of renewables: for investment in energy companies, share of energy produced by renewable generation.[86]
- Dollar intensity: emissions per dollar of revenue or WACI (weighted average carbon intensity) helps compare emissions intensity across portfolios.[87]

According to the SBTi, financed emissions should be reported for scopes 1 to 3 where scope 3 represents 40% or more of emissions[88] for both investment and lending activities within managed funds. Some exclusions are permitted by SBTi, namely:

- Private companies acquired within 24 months or less and without validated science-based targets,[89] and
- Where the private equity firm does not have operational or financial control.

Using control as an emissions reporting boundary presents a potentially significant gap in climate risk disclosure, especially where private equity firms have major non-controlling investments in high-carbon assets. An example of an alternative and more ambitious boundary is provided by the Ontario Teachers' Pension Plan, which has set a target to align the portfolio companies in which it has significant stakes, either minority or control.[90]

Finally, even though private equity involves ownership and management control, SBTi recommends that associated emissions be reported as scope 3, category 15 financed emissions.[91]

80 SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021) at 34.

81 *Ibid.*

82 ICI, Greenhouse Gas Accounting & Reporting for the Private Equity Sector (May 2022) at 16.

83 SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021) at 34.

84 ICI, Greenhouse Gas Accounting & Reporting for the Private Equity Sector (May 2022) at 16.

85 SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021) at 30.

86 ESG Data Convergence Initiative, "Metrics" (n.d.).

87 KPMG, TCFD Implementation Considerations for Private Equity (Oct. 2022) at 80; See also: ESG Data Convergence Project, Metrics (accessed Sept. 2023).

88 SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021) at 28.

89 *Ibid*, at 28.

90 Ontario Teachers' Pension Plan, 2022 Annual Responsible Investing and Climate Strategy Report, at 15.

91 Per the GHG Protocol (*Ibid*, at 23).

SETTING TARGETS

In order to reduce transition risk, financial institutions should set interim and longer-term financed emissions reduction targets across all financed emissions in line with the Paris Agreement. This means interim targets for 2030, consistent with a fair share of the 50% global reduction in scope 1 to 3 greenhouse gasses from a 2019 base year, identified as a requirement in the IPCC special report on global warming of 1.5°C.[92]

For private equity companies in the Net Zero Asset Managers initiative (NZAM), they are committed to ratchet up the amount of their AUM committed to net zero over time. This vague commitment can result in delayed action, so adding ambitious AUM coverage goals and timelines is required. For example, the Ontario Teachers' Pension Plan has committed 67% of portfolio emissions to be covered by 2025, and 90% of portfolio emissions to be covered by its interim target by 2030.[93]

For transparency, private equity firms should disclose the percentage of their total investment and lending activities covered by portfolio targets.[94]

These targets should be set at the group or parent company level for all subsidiaries and funds.[95] The SBTi recommends three different target-setting methods for private equity, depending on the asset class, the:

- Sectoral decarbonization approach (SDA),
- Science-based target coverage approach (SBT), and
- Temperature rating approach.

The SDA involves setting physical intensity targets that converge with established net emissions intensity pathways, e.g. the IEA net zero pathway.

The SBT approach requires investee company targets be reviewed through SBTi's validation process. SBTi recommends setting a target that "all current and future funds, starting from the base year selected by the firm, are on a linear path to 100% SBT coverage by 2040, at the latest."[96]

In cases where the SBT approach is too cumbersome, SBTi suggests the Temperature Rating method, which involves translating investee companies' emissions targets to an equivalent future temperature and where no target is set assuming a default of 3.2°C.

For Limited Partners, IIGCC recommends setting a target of private equity financing to General Partners aligned with net zero, e.g. 45% of private equity committed capital will be managed by General Partners in alignment with net zero by 2030.[97]

To ensure accountability, private equity firms should continuously report on their progress towards these targets.

[92] See for example: IIGCC, Net Zero Implementation Framework Implementation Guide (March 2021) at 28.

[93] Ontario Teachers' Pension Plan, 2022 Annual Report, at 40.

[94] IIGCC, Net Zero Implementation Framework Implementation Guide (March 2021) at 30.

[95] *Ibid*, at 22-23.

[96] *Ibid*, at 28.

[97] IIGCC, Net Zero Investment Framework Component for the Private Equity Industry (May 2023) at 21.

NET ZERO STRATEGY

A net zero plan also requires details on how the company will achieve its targets. GFANZ provides financial sector-wide support on developing net-zero transition plans.[98] For private equity in particular, there are four opportunities to ensure progress towards net zero:

- The preliminary decision to acquire an interest in a company,
- Engagement with the company throughout the holding period,
- The timing and structure of an exit, and,
- Ongoing broader net zero lobbying with industry and governments.

Best practices for each are provided below.

For Limited Partners, the following elements can form part of a filter when selecting General Partners in which to invest. They can also be used to engage with existing investments with General Partners to establish credible net zero plans. Limited Partners should report on these engagements.[99]

ACQUISITION

If committed to net zero, the initial decision of a private equity firm to invest or lend to a new company has a significant impact on its climate risk because it typically involves long-term holding periods and significant financial commitments.

In order to align with its net zero commitment, the decision to invest or lend should be based on the company or asset's realistic potential to align with a net zero future. This would involve a managed phaseout of high-emitting assets that are unable to align with net zero and the development of a net zero transition plan for remaining assets.[100] To be clear, this means no new or expansion of existing fossil fuel production.[101]

According to the SBTi, some companies are incompatible with a net zero future, and should be excluded from consideration, such as thermal coal companies.[102] There may be instances where thermal coal forms part of an acquisition, but would need to be the subject of a managed phaseout in accordance with Paris-aligned guidance.[103] The Powering Past Coal Alliance Declaration says that coal phase out is needed in OECD countries by 2030 and globally by 2040.[104]

To enable this assessment, investment committees need good data to assess current and future climate risks and opportunities. To ensure accountability, investors then require ongoing reporting against stated decarbonization plans over the hold period and upon exit.

A private equity net zero strategy requires an explicit net-zero aligned acquisition policy.

98 GFANZ, Recommendations and Guidance on Financial Institution Net-zero Transition Plans (November 2022).

99 SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021) at 19.

100 GFANZ, Defining Transition Finance and Considerations for Decarbonization Contribution Methodologies, Consultative Document (Sept 2023).

101 IEA, Net Zero by 2050: A roadmap for the global energy sector report (May 2021) at 99.

102 GFANZ, Defining Transition Finance and Considerations for Decarbonization Contribution Methodologies, Consultative Document (Sept 2023) at 29.

103 See for example: GFANZ, The Managed Phaseout of High-emitting Assets (June 2022).

104 Powering Past Coal Alliance Declaration (2017).

ACTIVE OWNERSHIP

During ownership, General Partners can use their influence over management to prioritize the development, implementation, and reporting on progress towards company net zero targets. SBTi recommends that private equity firms put in place company engagement strategies that prioritize:

1. Setting Paris-aligned targets across their portfolio within 12-months of acquisition;[105]
2. Publishing targets and transition plan in integrated financial reporting (per TCFD recommendations);
3. Ending capital expenditures in new high-carbon projects, increasing capital expenditures in low-carbon projects, and setting a clear timeline for the closure of existing high-carbon assets;
4. Reviewing and ratcheting up targets and transition plans in light of evolving climate science; and
5. Lobbying in support of net zero.

The IIGCC guidance for private equity also provides clear engagement actions that are expected across various asset classes, at varying levels of control, with specific timelines, both for General Partners and Limited Partners.[106]

Additionally, where IEA's net zero roadmap cites no new oil and gas fields beyond existing approved developments, net zero by 2050 portfolio alignment necessitates the barring of oil and gas expansion by portfolio companies.

To track progress on private equity climate engagement strategies, investors need reporting on portfolio companies and asset decarbonization. Indeed, the ESG Data Convergence Initiative just announced that it will start collecting data for its private equity membership regarding portfolio company decarbonization and net zero commitments.[107]

EXIT

A private equity investor's exit from a portfolio company or asset can involve the company going public, being bought by another private investor, or filing for bankruptcy. Ideally, when a private equity firm exits an investment this supports the company's or assets' ongoing decarbonization. However, some investments may not have a realistic path to decarbonization, and will need to be wound down[108] to minimize the private equity investor climate risks, e.g. thermal coal and other non-transitioning fossil fuel assets.

Environmental Defense Fund Business recommends private equity firms commit, where possible,

> *[...] to sell assets only to companies with net zero commitments and transparent emissions reporting [and] for oil and gas, investors can ask buyers to address asset retirement, ensuring that wells and facilities are decommissioned appropriately.*[109]

105 SBTi, Private Equity Sector Science Based Target Setting Guidance (Nov. 2021) at 28.

106 IIGCC, Net Zero Investment Framework Component for the Private Equity Industry (May 2023) at Figure 7 for GPs, at Figure 8 for LPs.

107 EDCI, September Newsletter.

108 See winding down advice from US consulting firm BSR, Exit Strategies for Dirty Assets (n.d.).

109 EDF Business, Private equity enters the race to zero (Feb. 2022).

GFANZ provides some guidance in The Managed Phaseout of High-emitting Assets which includes:

- Ensuring that capacity for continued service remains following phaseout,
- Ensuring there is sufficient capital to execute the phaseout,
- Specification of escalation policy for failure to complete a phaseout,
- Designing a tailored local lobbying plan, and
- Setting targets and continually monitoring progress.

A comprehensive net zero strategy will include reporting on exits and how these align with economy-wide net zero transition.

INVESTING IN CLIMATE SOLUTIONS

A private equity net zero transition plan is not just about minimizing climate risks; it is also about maximizing climate-related opportunities, which include investing in the technologies that are necessary to enable the transition. Indeed, increased investment in this underfunded asset class is necessary to enable a sustainable transition. In its recently released consultation document, GFANZ defines climate solutions as follows:

> *Technologies, services, tools, or social and behavioral changes that directly contribute to the elimination, removal, or reduction of real-economy GHG emissions or that directly support the expansion of these solutions. These solutions include scaling up zero-carbon alternatives to high-emitting activities — a prerequisite to phasing out high-emitting assets — as well as nature-based solutions and carbon removal technologies.*[110]

The document also provides several additional attributes that ensure the investment is in fact a climate solution.[111] According to GFANZ, to ensure this financing is taking place, it's critical that signatories properly define the asset class, track their financing to this asset class, and quantify or approximate the expected real-world economy emissions reduction impacts of their capital allocations.[112]

Setting investment targets for this segment is also recommended.

[110] GFANZ, Defining Transition Finance and Considerations for Decarbonization Contribution Methodologies, Consultative Document (Sept 2023) at 15.

[111] *Ibid*, at 16.

[112] *Ibid*, at 15.

LOBBYING

In order to enable a net zero transition within their portfolios, private equity firms will need to lobby within the financial sector and beyond for supportive policies. Without such policies, private equity firms will not meet their net zero targets. Lobbying forms a key part of net zero commitments under the Glasgow Financial Alliance for Net Zero (GFANZ).[113]

To ensure net zero portfolio alignment, private equity investors need to ensure their portfolio companies are only engaged with political lobbying that supports the goals of the Paris Agreement. A UN expert group on net zero emissions commitments cites steps for net zero aligned industry lobbying practices.[114] Recommendations include:

- Advocating for climate action within industry associations,
- Developing an escalation strategy for when industry associations do not lobby in alignment with net zero, and
- Ceasing membership where the association fails to comply.

[113] See for example: Net Zero Asset Managers initiative, Commitment (n.d.) at 8 and 9.

[114] UN High-Level Expert Group on the Net Zero Emissions Commitments of Non-State Entities, Integrity Matters: Net Zero Commitments by Businesses, Financial Institutions, Cities and Regions (Nov. 2022) at 25.