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Infrastructure ESG engagement: Know companies better

Research & Insights

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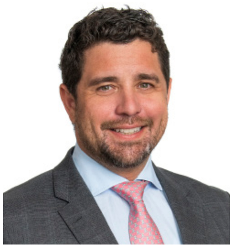
The highly regulated nature of most essential infrastructure assets means that they tend to have among the most developed ESG reporting and capabilities of listed companies. However, with more information and unique assets comes idiosyncrasies that make infrastructure ESG complicated, but beneficial for investors from a risk and opportunity perspective. Ausbil's Global Listed Infrastructure and ESG Research teams shed some light on this unique world.

Tim Humphreys
Head of Global Listed Infrastructure



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10 minute read

Key points

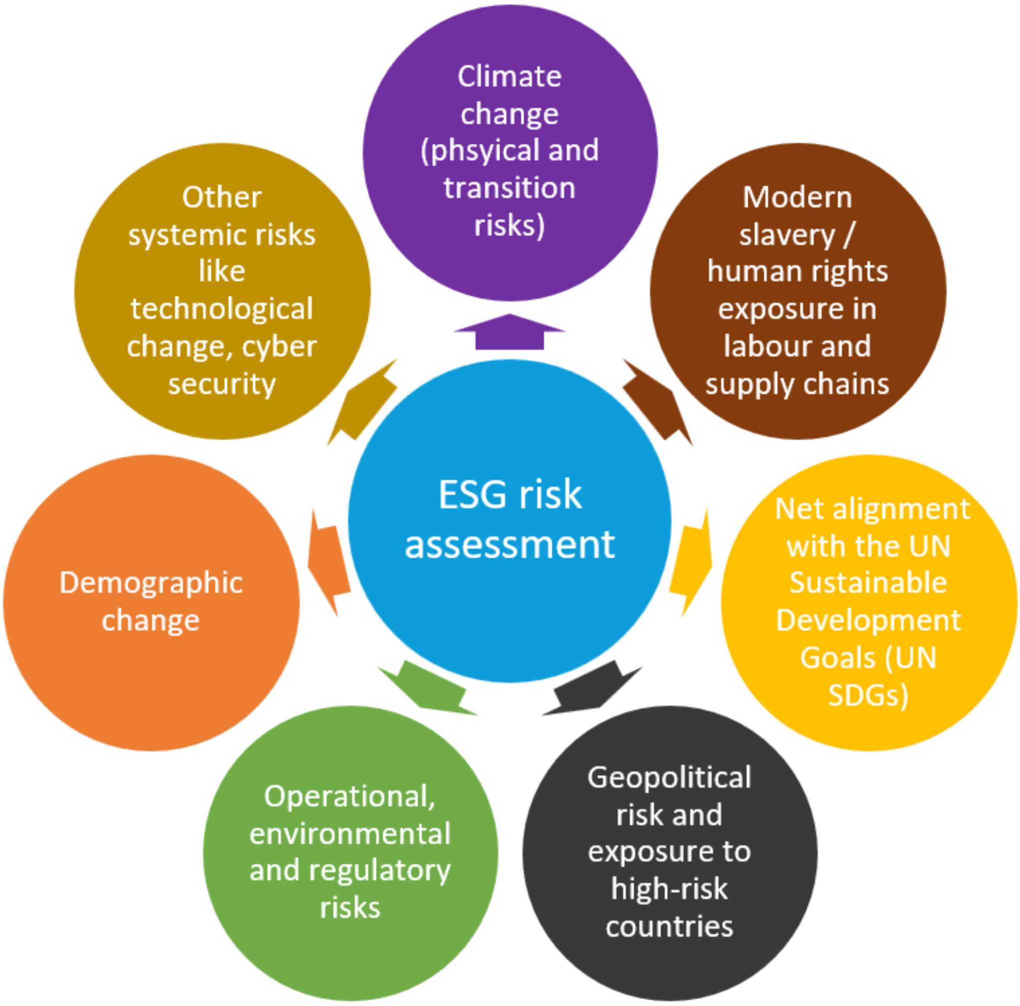
- ESG can bring the idiosyncrasies of infrastructure assets to life, highlighting opportunities, and helping to reduce risks.
- Essential infrastructure assets are among the most complex from an ESG perspective.
- While proxy advisers provide high-quality analysis and guidance on infrastructure assets, taking an ESG lens to analyse infrastructure companies can lead to different voting outcomes.
- Having a developed set of ESG engagements, backed by an in-house ESG research team, helps to assess the overall risk profile of the sector.

Ausbil's Global Essential Infrastructure Fund has codified a range of ESG exclusions in its investment policy in support of the ESG integration for the Fund. You can read our exclusions policy here: **Controversial Activity Exclusion Policy**.

Global essential infrastructure companies are large and complex. Infrastructure companies typically provide a service that is protected by regulation or by exclusive concessions or contracts. These companies have complex stakeholder relationships and typically operate in a heavily regulated environment that fundamentally impacts the environment (E), social (S) and governance (G) aspects of their operations.

Ausbil takes a sustainability approach to how we assess these ESG risks that incorporates our view on industries, individual sub-sectors, and each individual company, assessing risks on one or more of the factors illustrated in Figure 1.

Figure 1: The ESG risk spectrum



Source: Ausbil.

The heterogeneous nature of infrastructure means that our view on risk can vary significantly within an industry. In utilities, for example, the ESG risks will be different for companies with high exposure to fossil fuels compared to those operating in renewable energy.

Why do we engage infrastructure companies?

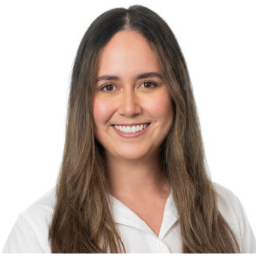
Ausbil engages with infrastructure companies for four key reasons. Firstly, we engage to ensure that the data we are using to make decisions is correct. There are multiple providers of ESG data, often with conflicting information on companies. Relying on one source of truth can sometimes be misleading.

Secondly, we believe we can have a more positive impact on companies that are in dialogue with us than if we simply exclude them. Company engagements help us make better-informed investment decisions.

Thirdly, we want all essential infrastructure companies to become more sustainable, potentially increasing the size of our investable universe.

And finally, we need to understand the full spectrum of a company's ESG behaviours and outcomes to form a complete picture. This will inform us of those companies we would never invest in, and those we believe are exemplary on an ESG basis.

Måns Carlsson, OAM
Head of ESG



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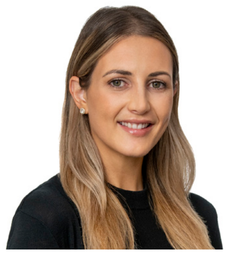

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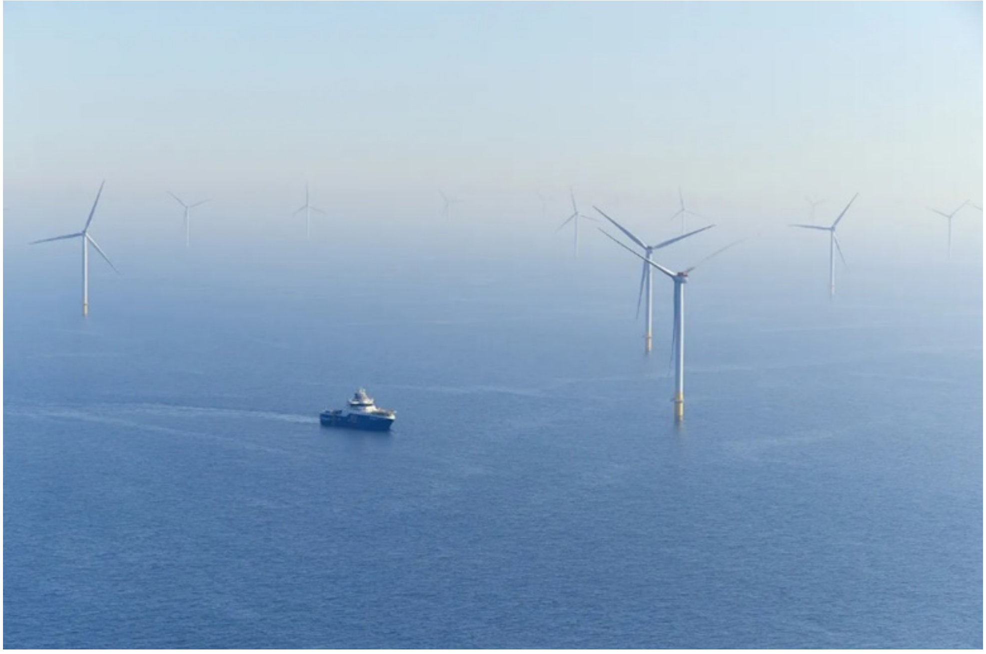
ESG Analyst

The power of voting

A critical part of our engagement process is how we assess key issues ahead of our engagement meetings, and how we exercise our voting rights. Annually, investors have a say on key governance and company proposals at either an annual general meeting (AGM) or an extraordinary general meeting (EGM). Proposed changes to the board of directors, auditor election, remuneration, and other issues are presented to shareholders for approval. This is where the weight of our capital, together with that of other shareholders, helps guide the governance of companies.

While a vote on a resolution can have one of three outcomes (for, against or abstain), management recommendations on how to vote are also valuable catalysts for meetings with boards, leaders and management. Whether our vote matters or not in the final count is balanced by the opportunity to understand the issues in more detail, make our case on ESG matters, and to help companies move towards best practices on ESG. Companies take votes very seriously, and in the lead-up to meetings, they are careful to listen to the thoughts and advice of shareholders.

Proving change is possible even for fossil fuel utilities



Up until 2017, Ørsted, previously known as Danish Oil and Gas was a state-owned company with 100% exposure to fossil fuels. Since 2017, Ørsted progressively exited all fossil-fuel based operations and transformed itself into a global renewable energy powerhouse. Pictured is an Ørsted offshore wind facility.

Current areas of engagement focus

E: Environmental issues

By their nature, infrastructure assets are heavily exposed to environmental issues. However, their large balance sheets and the complex stakeholder involvement that typically includes governments means that they are often more advanced on environmental issues.

Perhaps the largest issue for infrastructure assets is legacy. When many infrastructure assets were established, the world was a very different place. A classic example of this is a company called Ørsted. Ørsted is a Danish based global leader in renewable energy, but particularly offshore wind. Up until 2017, the company was called Danish Oil and Gas reflecting its origins as a state-owned company with 100% exposure to fossil fuels. Since 2017, Ørsted progressively exited all fossil-fuel-based operations and transformed itself into a global renewable energy powerhouse, which is why it became a member of our essential infrastructure universe.

In our engagement, Ausbil seeks to encourage companies to be similarly bold in becoming more sustainable. Examples of key areas of engagement on environmental issues are illustrated in Figure 2.

Figure 2: Key environmental issues we are engaging

Climate Change Clear plans for decarbonisation and de-risking

- Task Force on Climate-Related Financial Disclosures (TCFD) reporting adoption.
- Clear net zero goals, strategy and a plan.

Fossil Fuels Diversity must be satisfactory

- Plans for diversification away from fossil fuel reliance.
- Clear and actionable net zero goals.

Biodiversity Reporting in biodiversity alongside other environmental issues

- A clear biodiversity strategy.
- Reporting that meets the Taskforce on Nature-related Financial Disclosures (TFND) standards.
- Goals and targets for improvement.

Source: Ausbil.

Climate change and decarbonisation remain one of the peak issues of our time, and this informs a significant portion of engagement on essential infrastructure assets. The target of the Paris Agreement is to keep global temperatures less than 2 degrees Celsius above pre-industrial levels, and to pursue efforts to limit the temperature increase further to 1.5 degrees or less. In practice, this means countries have nationally determined contributions (NDCs), which are targets for mitigating greenhouse gas emissions.

Australia has legislated a target by 2030 to cut emissions by 43% on 2005 levels. However, the world is currently not on track for the 1.5 degrees Celsius global warming target. Sadly, the opposite is true, we are on track for a temperature rise far beyond agreed climate goals (UNEP, 2023).

In addressing climate change, our recent engagements have focused on targets for reducing Scope 1 and 2 Greenhouse Gas (GHG) emissions, as well as Scope 3[1], where companies can reliably track, record, and calculate emissions.

1. You can read more about Greenhouse Gas emissions and scope 1, 2 and 3 emissions here at Greenhouse Gas Protocol online at www.ghgprotocol.org

In our engagements, we aim to understand how both near-term reduction targets and long-term net-zero goals will be achieved. For companies without targets, we seek to know why. For example, the US energy infrastructure company Williams has committed to reducing the intensity of Scope 1 and Scope 2 GHG emissions by 30% on 2018 levels by 2028, and net-zero greenhouse gas emissions by 2050. However, Williams has not set this as an official target due to the lack of a feasible plan. In situations like this, our engagement focuses on helping Williams understand the importance of an actionable plan, and how it can be implemented.

We are also engaging with companies on their GHG emission reduction targets via the Science-Based Target initiative (SBTi). The SBTi is a corporate climate action organisation that aims to coordinate the climate initiatives of companies and financial institutions worldwide.

Another focus has been the Ausbil Global Essential Infrastructure Fund's thermal coal exclusion. We actively engage with utilities to understand their coal exposure. We have found that information from ESG data providers is often incomplete or incorrectly represents the importance of the thermal coal operations in such companies. Ausbil's approach requires engagement at an individual company level to obtain the necessary data to make the appropriate exclusionary assessments. Where the data obtained is incomplete, Ausbil takes a conservative approach and would generally exclude such a company from the investible universe. You can read our exclusions policy here: **Controversial Activity Exclusion Policy**.

S: Social issues

Social issues, while important, are often not as obvious for infrastructure assets. Recent engagements have focused on a number of key issues (Figure 3).

Figure 3: Key social issues we are engaging

Human Rights — Labour rights and fairness.

- Adherence to labour rights across all aspects of the business.
- Focus on modern slavery risk and eradication.

Supply Chains — Knowledge of suppliers, and their suppliers.

- Focus on human rights in supply chain.
- Knowledge of supply chains to supply chains.
- Clearly documented expectations for suppliers and supplier due diligence.

Social Licence — Responsible community impact.

- Understanding the social licence to operate.
- Ensuring fairness and equity in pricing.
- Demonstrated responsible community action.

Indigenous Rights — Engaging communities positively and respecfully.

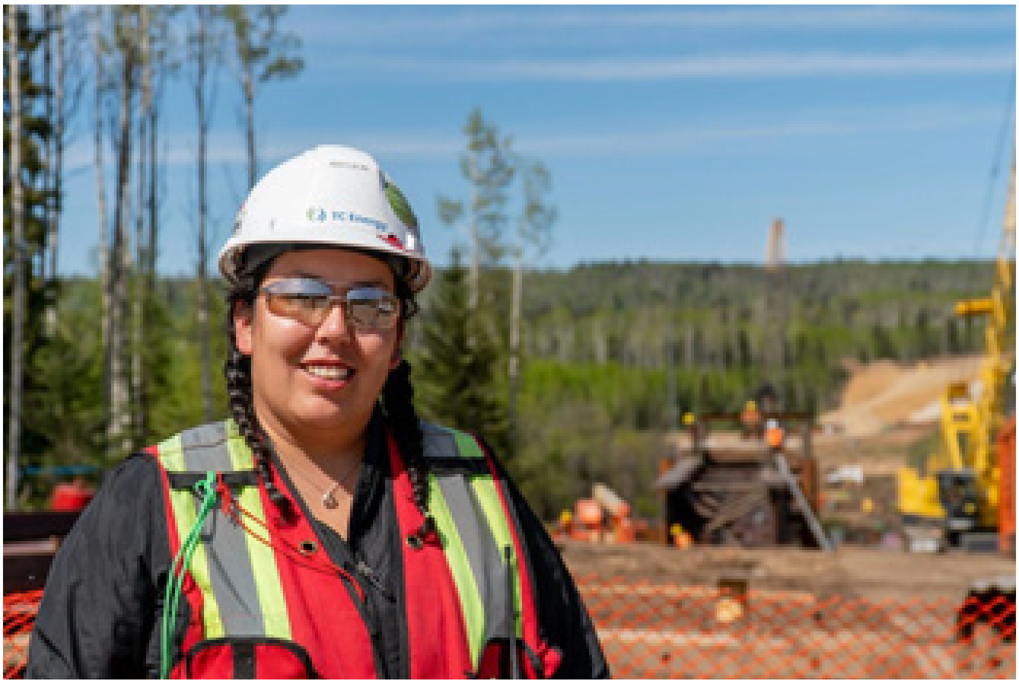
- Clear and documented policies on engaging with indigenous people.
- Positive inclusion of indigenous groups in key decisions.

Source: Ausbil.

Modern slavery and human rights in supply chains remains crucial in our engagements. The estimated incidence of modern slavery has been rising, not falling, with people living and working in modern slavery conditions increasing from estimates of around 40.3 million in 2016 to 49.6 million in 2021 (ILO/Walk Free/IOM, 2022). This represents a compound annual change of +4.2% across five years, which is a multiple of more than four times the annual world population growth for the same period of +1.0% per annum (World Bank, 2024). The UN Sustainable Development Goals have mandated a target for the eradication of forced labour worldwide by 2030.

The size of infrastructure assets makes the risk of exposure to abuses in supply changes very real. Advocacy, engagement and regulatory change can all contribute to combatting modern slavery and help reduce risks in supply chains. Ausbil has demonstrated experience in this area, having been a member of the Modern Slavery Experts Advisory Panel in Australia and made submissions in relation to regulatory change around modern slavery. Ausbil is also on the steering committee of Investors Against Slavery and Trafficking – Asia Pacific and chairs the Human Rights Working Group of RIAA (Responsible Investment Association Australasia). At the core of our engagement on modern slavery is a toolkit that Ausbil co-authored with RIAA, the *RIAA Investor Toolkit – Human Rights with a Focus on Supply Chains*.

Making sure people matter in infrastructure



TC Energy completed construction of the Coastal GasLink Pipeline in 2023 which crosses critical first nations lands. The company has been engaging with indigenous leaders since 2012, holding more than 26,000 engagements with indigenous groups. Our ESG engagement encourages positive interaction with first nations indigenous people in infrastructure, even when this is complicated. Outcomes that engage and accommodate the needs of indigenous groups have less risk and achieve better overall outcomes.

Another area of engagement has been indigenous rights. Leaders in this area are some of the Canadian energy infrastructure companies like Enbridge and TC Energy which have increasingly recognised the importance of improving relations with indigenous communities. One notable example is the Coastal GasLink project, where TC Energy signed agreements with all 20 elected indigenous bands along the pipeline route, offering them opportunities for equity ownership and economic participation. Ausbil engaged with TC Energy while the Coastal GasLink pipeline was under construction. Through our conversations with the company, we learnt about the complex governance structures within these specific indigenous communities which involves both an elected council and hereditary chiefs. In several cases, while an elected council had signed an agreement with Coastal GasLink, its hereditary chief had opposed the project. Such disputes within indigenous communities highlight the need for ongoing dialogue and reconciliation processes that respect indigenous sovereignty and adequately address environmental concerns.

G: Governance issues

Governance issues are quite idiosyncratic in essential infrastructure, with a number of key governance issues driving our engagement approaches (Figure 4).

Figure 4: Key governance issues we watch for

Board independence	A majority of directors should be independent

- Independent director tenure no longer then nine (UK) or ten (Australia) years of service.
- Directors cannot be independent if they were executives in the previous three years.

Diversity	Diversity should be satisfactory

- Gender, experience, age, ethnicity.
- Clear and documented diversity policies.

Experience	Governors should all be able to contribute positively

- A breadth of experience across the board, such as technical, financial or sector.

Remuneration	LTIs aligned with shareholders

- Remuneration must help align executive and governors with shareholder interests.

Auditors	Auditors should be rotated

- There are risks with long-tenured auditors.
- We look for auditor/ audit partner rotation at between 3-5 years for risk purposes.

Capital management	Capital raising, dividends, buybacks

- Limits on raising new capital.

Activist investors	Meeting rules.

- Limits on holding size to call a meeting of shareholders.
- Risk mitigation for critical infrastructure balance sheets.

Source: Ausbil.

On directors. We typically expect boards to have a significant proportion of independent directors. 'Independent' means directors who are not executives or have not been executives of the company for at least three years.

A complication of independent directorship is the issue of tenure. In the UK, a director who has served for nine years is no longer considered independent, in Australia, it is 10 years.

If an infrastructure board does not have a simple majority of independent directors, Ausbil's default position would be to vote against the appointment or reappointment of a director that ceases to be independent. Our engagement would continue with a focus on helping companies understand the importance of board composition to governance.

On diversity. At the board level, we also look for evidence and capacity with respect to diversity, not just of gender, but also age, with the aim of ensuring there are diverse viewpoints that can help these companies make more informed decisions.

According to consulting organisation Korn Ferry, nearly three-quarters of S&P 500 companies have instituted mandatory retirement age limits for board directors, typically at around 70 years of age. In 'older' boards, younger directors can bring new life, but also benefit themselves by learning from more experienced colleagues. In 'younger' boards, older directors can add significant experience, gleaned across cycles, and other businesses.

On expertise. A balanced board requires some diversity in experience. In our experience, a balance of business, technical, financial, legal and governance expertise helps resolve for a more diverse set of challenges and is a less risky option to boards skewed towards one type of expert.

On auditors. Recently, the tenure of auditors has been an area of our focus for engagements. Regular audit firm rotation is not widely adopted in the US and Canada. For example, two US utilities we looked at have had an auditor in place since 1932, audit firms appointed before World War II. While this offers continuity and retains corporate knowledge, it is also important that auditors remain critical and at a certain distance from management to help companies comply and manage risk around their finances and operations.

Of the 30 US infrastructure firms where Ausbil voted in recent meetings, 12 companies (40%) had auditors in place for over 20 years, four of these for over 50 years. Only one of these firms conducted a solicitation process in the last 10 years in line with what is considered good practice.

In 2002, the Sarbanes-Oxley Act in the US shortened the audit partner rotation period from seven to five years and expanded the cooling-off period from two to five years. In 2014, the European Union passed regulations mandating audit firm rotation after ten years. We have taken action by engaging with companies with audit tenure of over 10 years to put plans in place to change this policy.

On remuneration. Another key area of focus is remuneration. Infrastructure assets by their sheer size and age are unlikely to be founder-led, and their equity registers are loaded with pension funds, institutional investors and government equity holders. For this reason, it is crucial that executive leaders and decision-makers are remunerated with structures that align them closely with shareholder outcomes over both the short and long term.

We look for a balance between short (STIs) and long-term incentives (LTIs). Long-term incentive structures should have clawback provisions, performance hurdles that align with shareholder wealth creation, and partly deferred equity rewards.

On capital management. While capital management is a financial decision, for a large essential infrastructure asset it carries ESG implications that need to be understood. By their nature, infrastructure companies are typically very long-term concerns. Cashflows and financing for assets can roll over multiple decades. Typically, this means that shareholders seeking returns from essential infrastructure investments are committed to long-term investing.

However, the nature of listed equity and financial markets is that short-term sentiment and issues can attract opportunistic or 'activist' investors who hold smaller stakes and are driven by short-term gains. As a result, their focus on the short-term quick fix can be at odds with the overall long-term plans and performance of a company. Some shareholders have attempted to make it easier for agitation, with Exelon and American Tower seeing activists attempt to reduce the minimum shareholding required to call a special meeting. While this can significantly empower shareholders, enhance accountability, and influence corporate governance, it also comes with potential costs, increased activism, and the risk of operational disruption.

On political donations. Engaging with political parties is common practice in infrastructure. Lobbying can be beneficial for stakeholders in that companies can share proactive, pragmatic and constructive feedback regarding policy design that can benefit all stakeholders. However, this means that political risk for infrastructure assets is higher. For example, there have been number of high-profile legal cases involving bribery in the US utilities sector. While we are seeing improved disclosure in this area, donations and lobbying remain key risks that we focus on in our engagement with all infrastructure companies, and utilities in particular.

Active ESG engagement drives better outcomes

Active ESG engagement deepens our knowledge of companies, allowing us to make better-informed investment decisions. Through active engagement, we are naturally assessing a larger pool of risks, threats and weaknesses and, importantly, identifying opportunities for improvement.

We believe ESG factors can perfect a long-term investment approach as it helps us make investment decisions that look at a kaleidoscope of risks that traditional analysis misses. Genuine engagement maintains an ongoing conversation with all companies in the potential investment universe, even when we deem them to be un-investable.

Through engagement we can actively improve the ESG credentials of our investment universe, and help reduce the systemic and non-systemic risks, and ultimately, expand our investable universe.

However, the inherent complexity of infrastructure assets requires intimate and experienced knowledge of their workings. We believe that as an active investment manager it is necessary to look through an ESG lens to identify risks which other investors may miss, offering a broader risk and reward outlook that can benefit investment outcomes.

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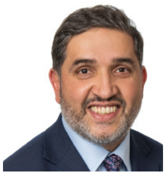

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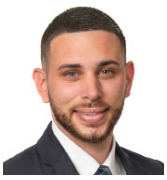

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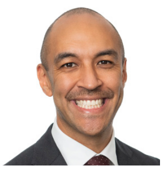

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