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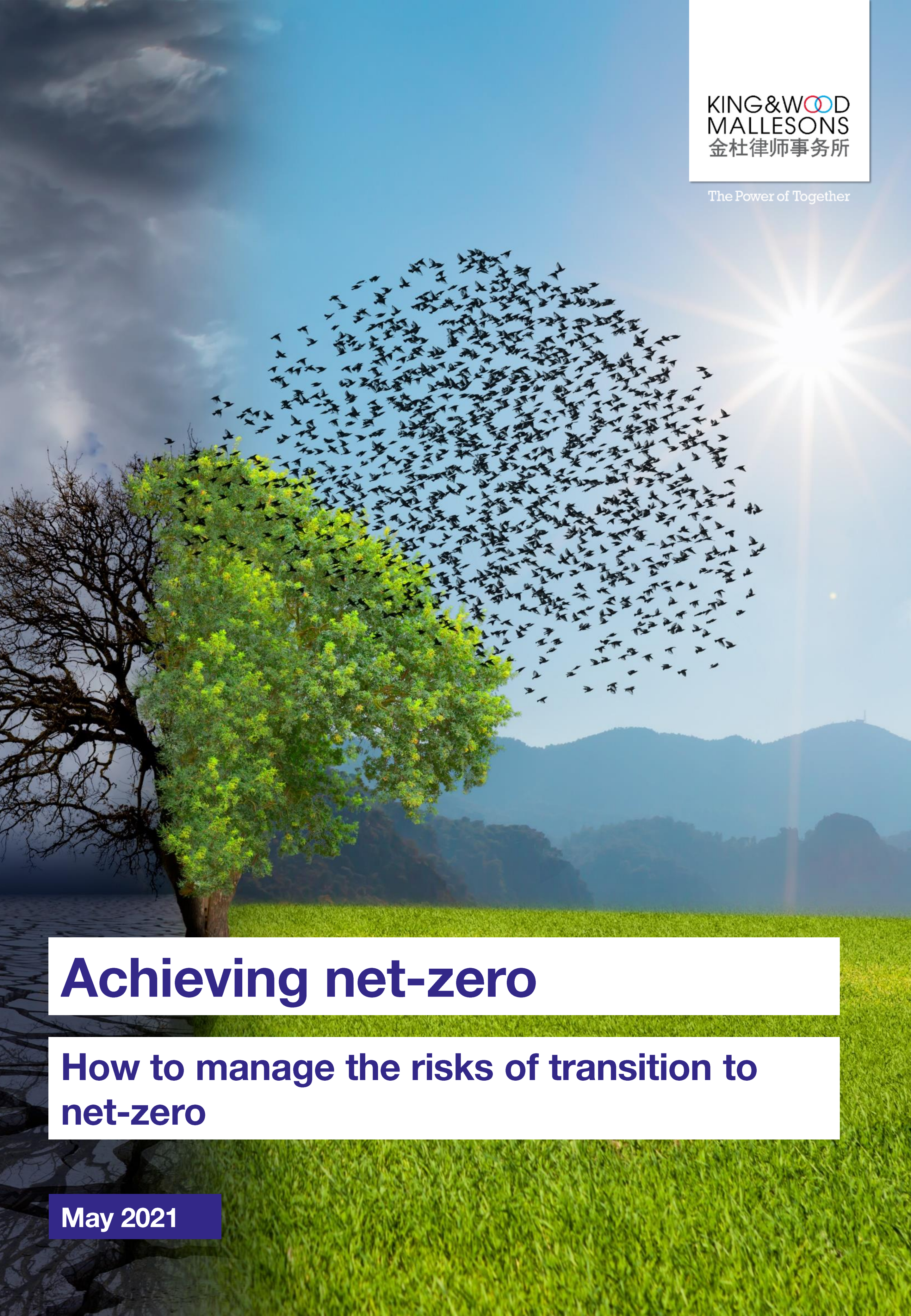


Achieving net-zero

How to manage the risks of transition to net-zero

May 2021

Achieving net-zero

China has set itself the ambitious target of net-zero carbon emissions by 2060 with emissions peaking by 2030.

China's recently published five year plan includes:

↓ **18% reduction of CO^2 emissions intensity**
From 2021 to 2025

↑ **Non-fossil fuel energy to make up to 20% of energy mix**

Detailed and ambitious plans are due from all parties to the Paris Agreement by November 2021 when the world is expected to unite to tackle climate change at the 26th UN Climate Change Conference of the Parties (known as "**COP26**").

The fundamental changes required mean transition by every facet of the global economy. Every company, bank, asset manager, fund, insurer and investor must look to adjust business models, commit to strategies to reduce or offset GHG emissions and commence the transition required to achieve those goals.

As with all significant change, initially there is risk, for governments, financiers, insurers, companies and investors.

The cost of meeting commitments under the Paris Agreement and the UN Sustainable Development Goals was estimated by the Organisation for Economic Co-operation and Development ("**OECD"**) to be USD6.9 trillion per annum from 2017 to 2030.

What is transition risk?

In essence, switching to a greener economy can significantly:

↑ increase the cost of business

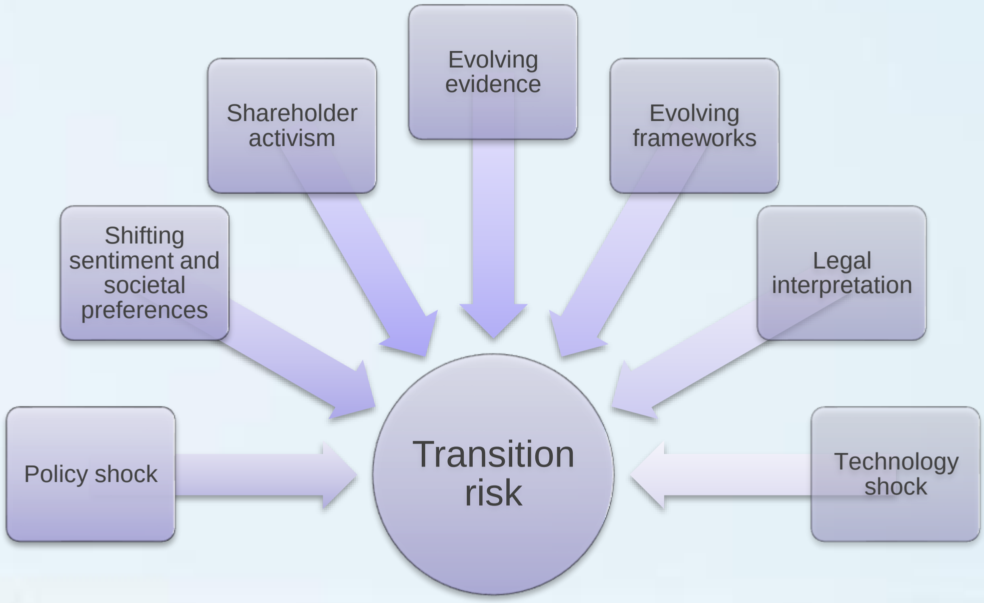
↓ reduce the value of assets

For certain industries, these risks are heightened and unavoidable. On the pages that follow, we examine the multiple types of transition risk, the industries most vulnerable to it and introduce the options for navigating the risks and turning the tide towards opportunity.

"By [COP26] the absence of a transition plan will likely be seen as either an intention to wind down a business over the coming decades, or an assertion that the company is separate or views itself as separate from society… the latter is unforgivable."
Mark Carney, former Bank of England governor and UN Special Envoy for Climate Change

Types of transition risk

There are multiple types of transition risk:



We explain certain of these examples in more detail below.

Cause	Explanation
Policy shock	Risk may arise from government policies relating to a range of areas including disclosure, classification, taxonomy, labels, risk management and corporate governance. For example: - Taxonomy regulation: a harmonised approach to establishing when activities or assets can be classed as sustainable. Previously "sustainable" assets might not cut it, for example China has recently excluded "clean coal" and secondary oil and gas extraction projects from a list of projects eligible for green bonds.* - Disclosure obligations: requiring financial institutions to disclose how they measure and mitigate ESG risk, how they incorporate sustainability into services and products with transparent sustainability objectives and how they achieve those objectives. Regulating against "greenwashing". This has the clear support from Hong Kong government, with a recent speech by the Securities and Futures Commission pushing for globally consistent, sustainability disclosure standards for corporates (and not just the adoption of EU standards).** - Financial benchmarks: that are made up of constituent investments which have a carbon intensity profile matching a particular climate transition pathway.
Shifting sentiment and shareholder activism	Institutional investors are focusing increasingly on ESG related issues, including board diversity and climate change. Listed companies find themselves faced with ESG related requisitioned resolutions. The targets are not just energy and mining companies, financial institutions have come under pressure too. For example, Barclays' institutional investors filed a resolution calling for it to phase out financing of energy sector and electric and gas utilities companies not aligned with the Paris Agreement. The resolution was dismissed at the 2020 AGM in favour of a climate change policy setting out the bank's transition commitments to becoming a "net-zero bank" by 2050. Likewise, HSBC's key investors had requisitioned a vote urging an end to climate harming finance. This was withdrawn after negotiation and HSBC put forward a resolution for actions to become net-zero, including a pledge to work with customers in all segments to support their transition journey.***

* http://www.pbc.gov.cn/en/3688110/3688172/4157443/4239595/index.html
** https://www.sfc.hk/-/media/EN/files/ER/CEO_Eurofi-Speech_15-Apr-2021.pdf
*** https://home.barclays/content/dam/home-barclays/documents/investor-relations/reports-and-events/AGM2019/AGM%202020%20Poll%20results%20RNS.pdf and file:///C:/Users/letear/Dropbox/My%20PC%20(L6BKJVT2)/Downloads/210322-agm-circular-en-2021.pdf

Key industries

Key industries face the highest transition risk:

Transport sector

- Burning fossil fuels for road vehicles, planes, trains and ships
- Primarily petroleum based (ie gasoline and diesel)

Energy sector

- Burning fossil fuels, mostly coal and natural gas

Property sector

-Electricity use
- Heating systems
- Airconditioning

Fossil fuel producers

- Combustion of carbon-based fuels
- Methane leaks, gas flaring and extraction methods
- Spills, leaks and contamination

Manufacturing

- Burning fuel for heat or to power industrial buildings and machinery

Agriculture

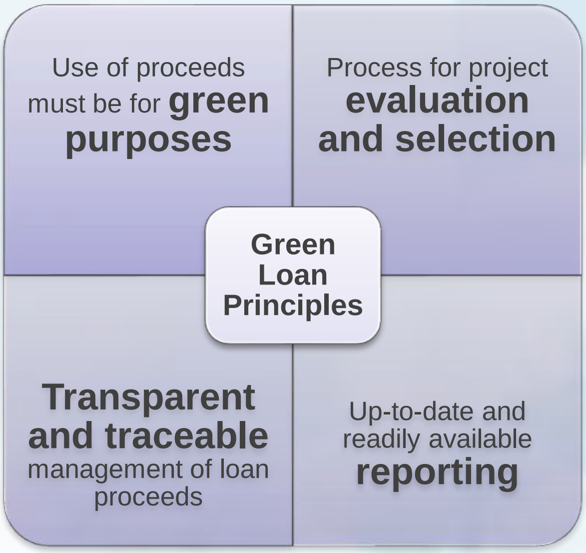
- Livestock emissions
- Rice production
- Palm oil
- Soy production

What's the solution?

Meeting the Paris Agreement commitments requires expensive changes in technology and infrastructure. Public funding alone is not sufficient. Private funding is essential to assist vulnerable sectors to evolve, and it has emerged in a number of forms: green loans, green bonds, sustainability linked loans and securities.

Green loans

The Asia Pacific Loan Market Association ("**APLMA**"), the Loan Market Association ("**LMA**") and the Loan Syndications and Trading Association ("**LSTA**") have established the Green Loan Principles along with related guidance.



The Green Loan Principles establish that "green loans" are loans made available to exclusively finance, or re-finance, in whole or in part, green projects (eg renewable energy, green transportation etc). Core features are:

- consultant review (ie expert advice);
- verification;
- certification; and
- rating by a specialised rating agency.

The Green Loan Principles related guidance confirms that there are no template terms for green documentation.

Market participants are encouraged to be vigilant to "greenwashing" where claims as to the greenness of a project are false or misleading.

The LSTA has also established an ESG focused due diligence questionnaire for the borrower to complete.

We look at some examples of green loans in specific sectors on the following slides.

Energy transition loans

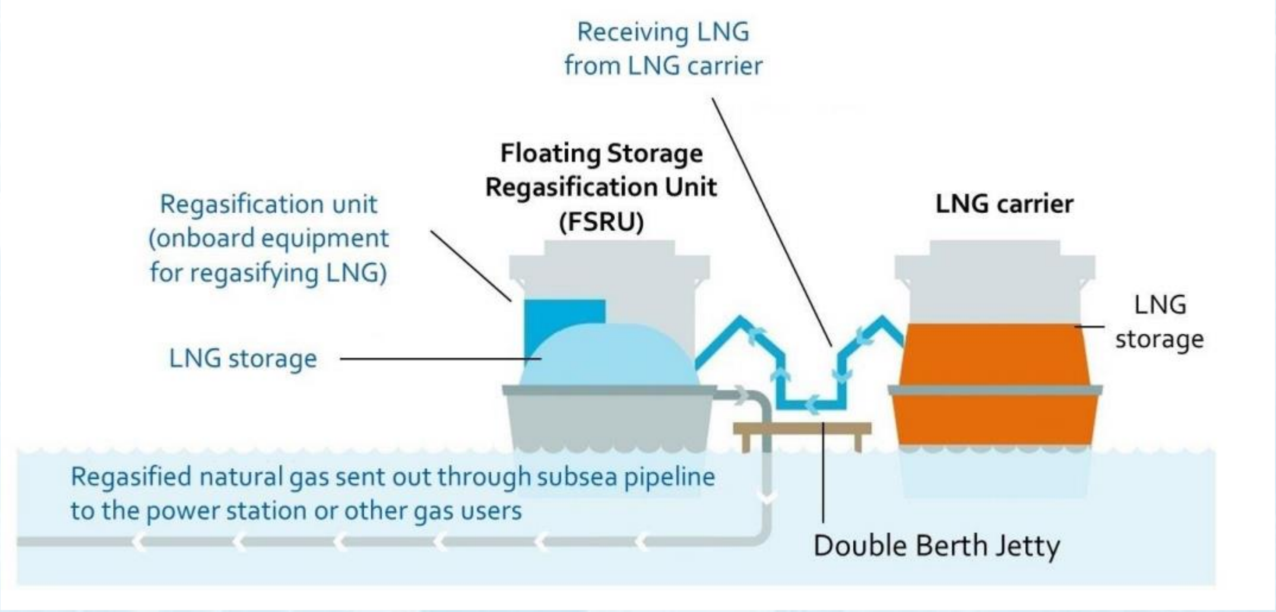
The energy sector is of critical importance to China's (for which purposes include Hong Kong SAR and Macau SAR) ability to meet the Paris Agreement emissions reduction targets. It is extremely encouraging that the two biggest energy companies in Hong Kong are both passionate and ambitious about their investment in, and promotion of, energy transition technology and clean energy solutions.

Sustainable finance transactions, in support of keystone transition projects, is a thriving area in Hong Kong and one that is set to catapult with China's drive towards net-zero.

Examples of energy transition loans that King & Wood Mallesons has worked on include:

CLP controlled JV vehicle ("**CAPCO"**) undertook the financing of an additional gas-fired generation unit at Black Point power station in Hong Kong. Black Point is one of the world's largest gas-fired combined-cycle power stations with ultra low-sulphur diesel as a backup fuel source. The use of natural gas has enabled CLP to reduce total emissions at a time when its systems witnessed 80% growth in electricity demand. The additional unit lifted efficiency of electricity production by approximately one-fifth. The project was approved by the Hong Kong government in support of its target of increasing the percentage of local gas generation by 2020.

CAPCO undertook the financing of the construction and procurement of an offshore liquefied natural gas ("**LNG"**) terminal, jetty and subsea transportation pipeline to a regasified LNG receiving station at Black Point power station in Hong Kong. The Floating Storage and Regasification Unit vessel will be used for receiving, storing, and regasifying LNG for the supply of natural gas to CAPCO and HK Electric for power generation through two separate subsea gas pipelines.



Source: CLP media release https://www.clp.com.hk/en/Current%20Releases/20160507_en.pdf

Green loans in the property sector

Advances in technology and building materials, along with enhanced awareness of environmental damage means buildings being constructed now can incorporate environmentally conscious design, construction and operations factors. But what about existing properties, built long before ESG was a permanent agenda item? The inefficiencies of such older buildings means significantly increased carbon emissions.

This has been recognised in Hong Kong's Climate Action Plan 2030+:

Buildings account for **90%** of Hong Kong's **electricity usage**

Over **60%** of Hong Kong's **carbon emissions** are attributable to generating that electricity

source: Hong Kong's Climate Action Plan 2030+

Private property owners will look to lenders to assist with financing the retrofit of properties to a greener standard.

At the end of 2020, the LMA published guidance on the application of the Green Loan Principles for real estate finance investment lending for retrofit projects. Retrofit of existing buildings involves taking measures to make verifiable improvements in the energy efficiency, carbon emissions and/or climate resiliency of the property. The guidance confirms that there is no single standard for determining which retrofit activities should qualify for funding under a green loan. However, to avoid greenwashing, there should be a material improvement in energy efficiency of, and results in a material reduction in the carbon emissions associated with, the building, or portfolio of buildings, being funded.

Ensuring properties reach a high green standard is already understood in Hong Kong. Its tallest skyscraper, the International Commerce Centre, is recognised in the top 3% of green buildings around the globe.* The 118 floor building uses the "Internet of Things" to collect data that enables real-time energy saving in equipment including lights, elevators and air conditioning units. Energy performance is measured and assessed across the various building zones to optimise efficiency and prioritise maintenance. The Internet of Things allows the management team to control air distribution throughout all 118 storeys. Future planned improvements include the installation of solar panels on the glass exterior, wind turbines on the cloud level roof and a battery system to store renewable power.**

Hong Kong has the Climate Action Plan, the technology and the innovative finance providers to significantly reduce building related carbon emissions by 2030. We anticipate a surge in project financing of this nature, starting now, in 2021.

What constitutes a green loan breach?

There is no established market standard in relation to what will constitute a "green" breach. This should be clearly documented in the facility agreement in respect of each transaction.

"*The use of proceeds is a key determinant of a green loan. Consequently, any breach of the use of proceeds provisions should be taken seriously and the loan should not be considered green from the date of occurrence of such event, subject to any cure rights. Parties should give due consideration as to whether or not a failure to apply the proceeds of a green loan towards a Green Project will trigger an event of default, and a subsequent cross-default across outstanding loans*." [LMA]

"Impact investing can turn what can appear at first to be insurmountable problems into tremendous commercial opportunities" Mark Carney, former Bank of England governor and UN Special Envoy for Climate Change

* https://www.shkp.com/en-US/media/press-releases/icc-sets-an-outstanding-environmental-standard-as-the-first-building-in-hong
** https://www.bbc.com/future/article/20210209-hong-kong-the-worlds-greenest-skyscrapers

Sustainability linked loans

Unlike green loans, sustainability linked loans are not linked to sustainable projects or assets. Rather they incentivise a borrower to achieve predetermined performance objectives**,** for example through a margin adjustment incentive linked to achieving sustainability targets. The APLMA, LMA and LSTA have also established the following principles:

Securities lending

In December 2020, the International Securities Lending Association ("**ISLA**") created an ESG steering group made up of buy and sell side members, market vendors and tri-party collateral managers. The steering group's mission for 2021 is the development of an ESG framework for securities lending around four pillars:

- industry advocacy;
- creation of best practices
- regulatory analysis and product application; and
- thought leadership.

This will include working to develop a common understanding of ESG objectives in the context of securities lending arrangements, updating best practices for recalling securities, creating standards for voting in line with good governance principles, increasing transparency to ensure lenders know the purposes for which securities are being borrowed (ie preventing voting in a way that is not aligned with the lender's ESG strategy) and standardisation of collateral selection or ensuring cash is reinvested consistently with ESG objectives.

*The estimated value of the global sustainability lending market in 2020 rose to **$199.4 billion*** Full Year 2020 – Refinitiv Deals Intelligence

Is there a global solution?

We have described above examples of specific ESG finance products and industry application. There are many more financial products, services and solutions available to assist financing the transition to a low carbon economy.

A plethora of benchmarks, certifications and taxonomies exist to accompany the various solutions, many being sector specific. As yet, no unified, agreed, global approach to transitioning to net-zero exists, but we are getting closer.

Globally, it has been recognised that delay in change is not an option. As we approach COP26 in November this year, governments and industry bodies are expected to release new laws, more regulation and stricter standards, ie “policy shock”.

Whilst companies will look to transition to carbon neutral (or carbon negative) projects, legacy assets will remain to be managed. Certain industries will take time to reduce carbon emissions. That is where the next level of solution emerges – **carbon trading**, where companies look to offset the carbon emissions they cannot reduce.

Formal “cap and trade” markets already exist and more are being created, including plans for a nationwide carbon trading market to be launched in Shanghai in June 2021. Voluntary markets are also burgeoning, spear headed by the Taskforce on Scaling Voluntary Carbon Markets, a private sector-led initiative working to scale an effective and efficient voluntary carbon market to help meet the goals of the Paris Agreement. We will delve into carbon trading in detail in the next in our series of ESG insights, leaving for now the words of Bill Gates:

“A robust voluntary carbon market is one important tool the private sector can use to address climate change and reach net-zero emissions by 2050. While this market is important for a number of reasons, I am most excited because I believe it has the potential to drive early investment in green technologies, especially those that are difficult to commercialize…if we don’t start financing innovation now, it will be impossible to reach our decarbonization goals before we run out of time…those who have the courage to take these steps now will not only help the world avoid a climate disaster, they will position themselves for success by being the best equipped to finance, produce, and buy the clean solutions that will underpin our future economy.

Next steps …

King & Wood Mallesons has a long track record in advising on green loans, sustainability linked loans and green bonds. We help clients to develop and implement ESG policies and to launch successful ESG financial products, including private equity funds, green bonds and social impact bonds.

Please contact us if you have any questions.

We would be delighted to help.

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Any references to "China" shall be construed to be a reference to "The People's Republic of China.

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As a leading international law firm headquartered in Asia, we help clients to open doors and unlock opportunities as they look to Asian markets to unleash their full potential. Combining an unrivalled depth of expertise and breadth of relationships in our core markets, we are connecting Asia to the world, and the world to Asia.

We take a partnership approach in working with clients, focusing not just on what they want, but how they want it. Always pushing the boundaries of what can be achieved, we are reshaping the legal market and challenging our clients to think differently about what a law firm can be.