

Navigating ESG Complexities Through the Energy Transition

With Paul Yett, Director of ESG & Sustainability and Brent Burnett, Co-Head of Real Assets

ESG Considerations Within Infrastructure

PAUL YETT: As I think about it today, Brent, let's talk a little bit about ESG as it relates to infrastructure. When we think about that, that's an area that gets a lot of attention, perhaps most of the attention. Let's take the "G," the governance side. That's very important in the private markets. We're all focused on good governance structure. In many ways, governance is the given. I think we're not going to invest with a company or a manager that doesn't have a good governance structure or one that isn't fixable. That's pretty simple.

Then we think about the "E" side of it, the environment, as it relates to infrastructure, gets a lot of attention, a lot of focus on climate change, a lot of focus on greenhouse gas emissions, oil and gas, coal, all these things that are environmental. People think about that, talk about how to fix this problem. I'd say within the "E," how do you think about it? Are we missing anything? Is there an "S" side to this as well?

BRENT BURNETT: Yes, absolutely there is. And I think, to your point, Paul, we tend to sometimes myopically focus on the "E," and the reason that we do is because the "E" is somewhat measurable and quantifiable, and the "G" is

somewhat fixable, or at least you think that it is. So, when you have one element of ESG that's quantifiable and measurable, you have another element that's probably fixable. What gets most ignored, I think, in that conversation is the "S," the social element of infrastructure and the social element of an ESG policy. I think as institutions think about their ESG policies, trying to more comprehensively integrate the environmental, the governance, but not ignoring the social is going to be a critical part to that rollout.

PAUL: In ESG, the "S" sits in a different category typically around gender, racial diversity and ethnicity; things along those lines, and they don't usually conflate over necessary infrastructure. So, talk a little bit more about that. How does the "S" play into how we should think about infrastructure investing?

BRENT: Well, remember how this conversation came up, right? So you were, I think, railing about evil fossil fuels, and I asked you about how you liked the power prices in California?

PAUL: Yeah, yeah, yeah, and I cringed a little bit on that.

BRENT: And you weren't too happy about those, right?

PAUL: I don't like it. Yeah.

BRENT: So, let's talk a little bit about California. I'll pick on California because it's easy and because you're from there, right?

PAUL: My home state right now.

BRENT: California is a very interesting microcosm of some of the issues – environmental, social and governance issues – that can come up related to energy transition and how infrastructure impacts those things. I'll use a couple of examples specific to California. Kern County, I don't know if you're familiar with Kern County in California, a big agricultural area. It's also a very large oil and gas-producing area of California. It produces about 70% of California's oil, about 90% of its gas. It also happens to be a county where there's a lot of poverty in that county. Estimates of some 20% of the county that live below the poverty line. The oil and gas industry in Kern County generates about \$200 million of revenue per year for the county. About half of that goes to fund public schools in Kern County.

PAUL: So, that's good.

BRENT: So, that's good, that's a good social benefit in that you are funding some of your public education through an industry in Kern County, not to mention that employs about one in seven people in that county. So, you have an industry that is on a net basis that's a negative environmental industry, and yet it has a social benefit in that it funds a lot of your public education for the county. Now, Kern County also has produced about 25% of the state's renewable energy, so it's a large renewable energy producer. It is starting to transition away from an oil and gas economy potentially to a more renewable-oriented economy, but that renewable industry is nowhere near where it needs to be to offset the revenue declines that would happen if it shut down its oil and gas production. So, it's an example to me of where you're making trade-offs around, what are we willing to absorb from an environmental perspective? What is the consequence to that

though, from a social perspective? Because if you were to just shut that industry down completely today, how would you fund your public schools?

Don't get me wrong, there are social costs to oil and gas emissions, severe social costs, but it's an example to me where things are not always as cut and dry as we would like them to be when we're developing ESG policies. There are social consequences in terms of how we fund certain programs that have social benefits, the cost of electricity, particularly on poor communities, and these social elements, I think are the ones that often get ignored.

The Social Cost of Renewables vs. Fossil Fuels

PAUL: I think that people in its simplistic form think about good and evil, right? Renewables are good, that's where we want to be. We all want renewables, as we talk about wind and solar as being low emission, it's going to help save the planet. The evil being coal, oil and gas, the fossil fuel burning elements of it. So, in that context, it's just not as simple, there's the social element of it, the trade-off for it.

BRENT: Absolutely, and going back to high power prices in California, in California power prices are about 19 cents per kilowatt-hour, that's about 80% higher than the balance of the United States.

PAUL: I knew it, I knew it.

BRENT: So, you know this, right?

PAUL: I felt that, but now you put some numbers behind it.

BRENT: Now I've put a number to it, which makes it worse probably.

PAUL: Yeah, it makes it worse. It doesn't help.

BRENT: So, you're paying 80% more for your power than most other Americans. Now, there are some markets in the Northeast that are as high

as California, but generally speaking, it's a very expensive power market. And that may be okay for you, you may not internalize that as much as somebody who may be in a different socio-economic situation where their power bill makes up a much higher percentage of their monthly income, so there's a social cost to those high power prices in the sense that energy poverty, which is not having access or being able to afford energy, which is fundamental to our way of life is a very real concern for a lot of Californians.

The other issue, Paul, is that when you look at where that environmental policy typically gets set in California, it oftentimes comes from, at least at the front end, zip codes that are significantly wealthier than the average Californian, so there's an element of the well-to-do setting policies without internalizing the social costs on the less well-to-do, and California is a market where that's a real concern. There are lots of complexities to it. I'm totally over-simplifying here, but here's a very simple example. You work in private equity. Okay? So, you live in a nice house on a nice street in California. I work in infrastructure, so I rent a small apartment on that same street. Okay?

PAUL: Alright, fair enough, fair enough.

BRENT: So, we're going to overly simplify here, but let's assume that you and I get our electricity from the same utility. The utility has had to secure generation, they've had to put in a transmission and distribution, they've had to put in hook-ups to your home, to my apartment. That's established a rate base that allows them to charge us a certain amount for the electricity that we're going to buy from them. So right now, we're paying the same per kilowatt-hour, you might use a little more, I might use a little less.

PAUL: I have a little bit of a bigger house.

BRENT: Yeah, you have a little bit of a bigger house, so you might be paying a little bit more, but because you work in private equity and you can afford it, you decide that you're going to

upgrade your house, you're going to put in more efficient appliances, you're going to put in solar, you're going to take advantage of net metering so that you're selling back to the utility. You do all of these improvements, you reduce your electricity costs, and maybe in some case, you might even take yourself out of the system where you don't even need the electricity generated by the utility anymore.

PAUL: Which is good, right?

BRENT: Which is good.

PAUL: That's good for the environment. I'm being an environmentally responsible citizen with solar and other improvements on the house.

BRENT: Exactly. In our simple world though, that leaves me, the poor infrastructure guy, as the only rate payer now in that system, so those costs that the utility gets to pass through to the rate payers are disproportionately concentrated on me, so there's a social cost to this, and those environmental benefits that you're pursuing have potentially negative externalities on me as a renter who can't afford to do the same things.

PAUL: Exacerbating the inequities between the poor and others.

BRENT: That's exactly right. And there was some really interesting research, actually from Portland State and a professor from Vanderbilt that found that in developed economies that had higher degrees of renewable utilization, there was actually a wider inequality gap, which is interesting, right? Because that tells you that there's more than just an environmental cost to these policies. There is a social cost to these policies. In contrast, in developing nations, there was less inequality in nations that had higher degrees of renewable penetration. So, this gets back to my point around sometimes the better off in society are setting policies that may not fully reflect the social cost on those that are not as well off.

The Great Energy Transition

PAUL: I could see that there's a lot of complexity in terms of what people's desire is to focus on the environmental side of it, and there's a cost to that, and the cost may disadvantage certain populations more than others to get there, but there's still the need for that sort of transition, right? There's still the amount of environmental catastrophes that we're hitting every year, the climate change reality of it, we have to do something. How do we do that and how do we get from A, where we are today, to C, with a balance through that?

BRENT: Absolutely. We have to do something. The latest climate studies that were published fairly recently have painted this as a catastrophic picture that we're looking at if we don't change something. Going back to your analogy of, or your question around good versus bad, as it relates to fossil fuels and renewable generation, we would like to draw clear distinctions between those fuels that we use that are environmentally negative and fossil fuels and those fuels for energy generation that we may use that are environmentally more friendly, like renewable generation as being good versus bad. We like things to be black and white.

PAUL: Wind power.

BRENT: Exactly.

PAUL: Everyone loves wind power.

BRENT: Everybody loves wind power, everybody loves solar, everybody loves electric vehicles for their environmental benefit, but I think that's the wrong way to think about it, because even those transportation technologies do have some negative environmental consequence to them. Wind generation, for example, these huge wind blades generate a lot of global waste, they can't be recycled, they're oftentimes retired in 10 years because there's a new design that comes out that might be better, more efficient, but

those typically have 25-to-30-year useful lives, they're pulled down in 10 and they go sit in some specialized landfill somewhere.

So, when blade waste is a real problem, we're generating a lot more wind power globally, what do we do to with these old wind blades? On the solar side, there was a good Wall Street Journal article a couple of weeks ago about how most of the solar panel manufacturing which comes from China is done using coal-fired generation. Globally, coal is still the single largest energy source. We still have net capacity additions globally in coal-fired generation, and part of that coal-fired generation is going to build a new renewable industry. There are some embedded conflicts even in the environmental piece for some of these technologies that are being pursued.

PAUL: How should I feel about that? The block you and I now live on together, I have all my solar panels, I feel really good about that. I come home, plug in my electric vehicle and think this is awesome, and you're telling me that it's coal-generated, at least in some part.

BRENT: I'm not saying it's not better, right? What I'm saying is we can't let the perfect be the enemy of the good. Part of this energy transition is recognizing that it's going to take a very long time, and that we have to be willing to make some trade-offs in how we get there. You like to plug in your electric vehicle... Electric vehicles have a great potential to reduce emissions, electric vehicles require a lot of lithium, cobalt for the battery infrastructure, copper for the wiring. These are still very environmentally intensive things to mine, sometimes these things are mined in locals that have a poor history of human rights.

So even that, there's a social element to those that I think we need to be aware of, and we need to recognize in this transition that we have to comprehensively identify what are the environmental consequences, what is the right

governance structure, what are the social costs in the short term and in the long-term as we move through the adoption of these types of technologies.

Private Capital's Role in the Energy Transition

PAUL: Brent, as investors in the private markets, when we have the conversations again – and a lot of the conversations are all around improving the environment. It sounds like there's a lot of complexity, there has to be a distinct discussion as it relates to the "S" in ESG as well. The framework for ESG is prolific today. It's ESG questionnaires, ESG screens – ESG risk framework for everything we do is kind of the price of admission, and as we think about that for private equity investors, what role do we have to play in this?

BRENT: I would actually ask you a question, Paul, like what you just described today, was that true five years ago, 10 years ago?

PAUL: It absolutely wasn't. So, if I think back to Hamilton Lane, we've been issuing an ESG questionnaire for over a decade, and it wasn't unheard of 10 years ago to get a response that said something like this from a General Partner, "We think about the environment and social and of course governance, but we don't really have any policies or a team." Today, the responses are not only if we have fully dedicated resources to think about ESG, but also if we have policies and procedures in place and manuals written on them. So, the increase over that last decade has been incredible. There's also the notion that ESG, as part of the investment decision framework, has become so specific around it, so there might be a due diligence track on the performance, the financial metrics, but there's also one very much in private equity today that's increasing in its complexity and its number of questions. So, the growth is incredible.

BRENT: It is incredible, and it tells me that you asked about what the role of private equity, private capital, and this energy transition is. In many ways, we're already seeing it. You're seeing ESG become a fundamental component to how institutions and private equity managers operate. As you said, it's not just nice to have, it's the price of admission today. You have to have a comprehensive ESG policy. So, I think there's a leadership element of private capital in terms of setting the standards for how we're going to engage with investments in an environmentally responsible, socially responsible way.

I think that's a positive, but I think the other reality is that private capital is very uniquely positioned to fund this energy transition. If you think about what's going to be required for an energy transition, there are certain stages of development that things have to go through. There's an incubation of an idea, there is the R&D and development of that idea, then there's the wide-scale commercialization and adoption and infrastructure that's required to support that. Private capital can play a role in each of those stages of development, and there's capital with different risk and return profiles that can come in and really be a driving force to funding this energy transition. I think governments will play a very substantial role at the federal, state and the local level in terms of setting a regulatory framework that's predictable around the adoption of some of these technologies, but by and large, this transition can be funded by private capital.

PAUL: That's great, that's very encouraging. Where is the low-hanging fruit today? Are there areas that you would focus on that you see today that moves us towards that, as we have a need to continue to deploy capital, make good returns for our clients, for the beneficiaries, but also do it in a responsible way?

BRENT: I think there are. I think the industries, the fossil fuel industries in particular, have become

much better about incorporating environmental stewardship into some of their activities, which is a low-hanging fruit, right? This is, as I mentioned, an energy source that we need today and will continue to need at least in the short to medium term, so focusing on some of the low-hanging fruit in terms of ensuring that we don't have methane leaks in natural gas pipelines, that plug and abandonment responsibilities are taken seriously. Potentially increasing some regulation around how we source water, how we treat water, how we store water used in the drilling and extraction process. So, there are lots of, I think, environmental low-hanging fruit that's already being adopted today by some of those industries, and I think that's a positive.

I think on the private capital side, some of the things that you mentioned around setting the right policies for engagement with GPs is going to be critical to moving this forward. I do think we have to embrace natural gas as a transition fuel in many ways, as I mentioned, the world is still very hooked on coal, which is a terrible environmental fuel, natural gas has about 50% less emissions than coal. So, over this transition period, until we reach a point where we can source 80% of the world's energy supply from renewable energy sources, we need to adopt some transition fuel that's cleaner.

PAUL: Globally, is coal still the largest source of energy?

BRENT: I believe it is. Yes, and I think the other thing that's interesting, Paul, is that there continues to be net additions to coal. So, it's not just that it's the largest and it's dying. It used to be about 50% of the world's energy supply, it's been hovering in the mid-30s for a very long time, so you think about coal as an example of energy transition of a fuel that shouldn't be phasing out, and it's been roughly stagnant for a very long time. Natural gas could be very similar and that we know eventually we need to get off of it, but it could have a long transition period, and it

is a much cleaner burning fuel than coal. Don't get me wrong, it's not without environmental consequence. It is, and it's not without social consequence, but right now, I think there are still better options for transitioning to gas as a fuel source away from coal-fired generation.

Balancing the Social Impact During the Energy Transition

PAUL: I like to think of it as doing it in a responsible way, so if that is true, 50% of the private dollars are responsibly investing in renewables, that's a really responsible way of putting capital, but I think, back to the earlier part of our conversation, the "S" side needs to be factored into that too. So, what does that mean for lower marginalized people, lower income people in terms of this transition period? Hopefully, we're being responsible in thinking about that as well, and these conversations are important.

BRENT: Absolutely, especially in the short to mid-term. You have to have some backstop to those marginalized and lower income communities. You can't just automatically raise their prices, right? So, we have to internalize what the social costs are and be able to remedy the social situation, just like we do the environmental situation.

PAUL: The conversations need to be had together.

BRENT: Exactly, and it can't be a policy that's dictated to communities by people who are not in the same situation. You have to have community buy-in into these, and you have to have some backstop to account for the social cost that this transition period may impose on certain groups.

PAUL: Great. Well, this is encouraging in that: One, we're having a dialogue. It's not just about the "E" and the "G," the "S" is a really important component as we think about energy transition, as we think about climate change and how to improve upon it. I'm also encouraged by

the dollars that are going in, the investable opportunities, the opportunity to make good returns while also being responsible with the capital going up. So, thank you as always. Every time I speak with you, I learn something new, and I get enlightened on new things. I'm not sure that I feel any better about the house we live in or the neighborhood we're in together, but we can at least have a beer in the backyard.

BRENT: Sounds good.

PAUL: Great. Thank you.

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