

Calvert's Approach to Investing in the Energy Transition

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Key Takeaways

- Clean energy deployment is growing faster than many had forecast just a few years ago, but today fossil fuels still supply around 80% of global primary energy demand. We think that if clean energy investment can continue to attract ever more capital, the current period of 'peaceful co-existence' with fossil fuels will come to an end.
- The energy transition will be complex, but in our view it's this complexity that creates a rich opportunity set for investors intent on making a positive global impact, in addition to pursuing solid financial returns.
- The journey ahead contains high uncertainties, but we are seeing meaningful changes in how companies in the energy sector are approaching the transition – in terms of capital allocation, investing in technological innovation and improving information disclosure – and we are taking note. We are also now starting to see significant differentiations between oil and gas companies that previously wasn't the case in our view.
- At Calvert we see a need to be prepared for potential resilience of fossil fuel demand over time by selectively investing in oil and gas producers. Concurrently, as investors we think it's paramount to also provide capital to corporates that are accelerating clean tech deployment and seizing economic opportunities from the energy transition.

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—Calvert Research and Management

1 Calvert's Decades-Long Leadership in Climate Investing

Calvert has incorporated climate change considerations into its investment decisions for decades and few investment firms have our experience, depth of research and insight in navigating the energy transition. We see climate change as arguably the single largest global externality that continues to be mispriced by financial markets and advocating for progress on tackling climate change is a key part of our ethos.

A considerable part of our success in this area is derived from the Calvert Principles for Responsible Investment. The framework guides our research process and enables us to identify companies that we believe are capable of delivering value to shareholders as well as facilitating positive global change. Calvert's Principles for Responsible Investment do not rely on screens or exclusions, which allows our research approach to be flexible and adapt to events, information and circumstances. Our research process focusses on factors that are financially material to a company and that can yield real benefits by enabling better risk-adjusted stock returns, as well as better management of environmental and social impacts that affect a firm's value.

Calvert believes that the energy transition is about more than just the avoidance of high-emitting companies and industries. Avoiding these parts of the market based solely on current emissions or fossil fuel exposure may limit the impact and role that Responsible Investors can have in driving change. It could in fact impede progress on global emissions reductions by restricting capital to companies that may have high emissions today, but that are actively investing in decarbonisation.

The energy transition will take time and Responsible Investors must do more than focus exclusively on decarbonisation. To successfully navigate the transition, investors must also consider geopolitics, energy access and security, as well as economic development. We believe that Responsible Investors who want to successfully address climate change must adopt a broader capital allocation approach to drive positive global change and impact. The energy transition is complex, but its complexity is what creates a rich opportunity set for investors intent on making a positive global impact, in addition to generating solid financial returns.

2 Change in the Energy Sector

We believe a successful energy transition will take decades to fully unfold and that fossil fuels will have an ongoing role to play as societies and industries decarbonise. The energy industry is inextricably linked to the issue of rapidly accelerating climate change and, together, global oil & gas production and use contribute over 50% of global fossil-related greenhouse gas emissions. Their long-term use needs to be drastically cut to limit the most destructive impacts of climate change. However, at the same time, we cannot ignore the continued demand and necessity for fossil fuels¹ and the role these sources of energy play in powering today's global economy. The energy transition is moving quickly, and we think it is gathering pace; however, it is currently making progress that is too slow to meet global ambitions to meet 'net zero' greenhouse gas emissions by 2050.

¹ Global Oil Demand Hits Record and Prices May Climb, IEA Says (Bloomberg, 11 August 2023)

Political friction, geopolitical complexities and strained macroeconomic conditions are all contributors to slowing its momentum. This is highlighted by the fact that in 2022 the world spent more subsidising the current fossil-dominated energy system than investing in its transformation, whilst in 2023 average global surface temperatures broke new records.

As we embark on the decarbonisation journey, there are adjacent second- or third-order impacts that are beginning to emerge that need careful consideration – shown below. We believe that Responsible Investors must adopt a broader framework that encompasses these factors when considering the full breadth of the energy transition megatrend as it unfolds.

The last three years of COVID-19, geopolitical stress, energy price volatility, supply chain

approaching the transition – in terms of capital allocation, investing in technological innovation and improving information disclosure – and we are taking note. We are also now starting to see important and significant differentiations between oil & gas companies that previously wasn't the case in our view.

Against this backdrop of change in the industry and amongst corporates, we think oil & gas company involvement in the energy transition can be viewed through a broader lens than current carbon emissions or fossil fuel exposure alone. As such, our energy investment thesis aligns with 'on the ground' change based on market drivers and capital flows that are inherently forward-looking.

Calvert's Principles for Responsible Investment serve as the framework for our environmental,

Exhibit 1: The Energy Transition Is About More Than Decarbonisation

Responsible Investors Must Consider a Wider Range of Issues

RENEWABLE ECONOMICS	After a decade of declining costs due to economies of scale, maturing supply chains, and manufacturing as an industrial process, renewables are now cost competitive (without subsidies) against both coal and gas-fired generation
GOVERNMENT POLICIES	Climate policy is coming into focus as the US turbo-charges clean energy through the Inflation Reduction Act (IRA), which has kicked off a scramble by other countries to incentivize domestic supply chains, including Canada, the European Union, India, South Korea and the United Kingdom
GEOPOLITICAL BALANCES OF POWER	Today, green supply chains are dominated by China. Resource nationalism is rising as countries look to trade barriers like tariffs and export restrictions to maximize their economics and position their economies, including Chile (lithium), China (gallium and germanium) and Indonesia (nickel)
CRITICAL MINERALS	Forecasted demand will require massive calls on aluminum, copper, graphite, lithium, nickel, phosphorous, polysilicon and dozens more. Meeting this demand will require policy coordination and significant private capital formation
COMPETITION	The energy transition is seeing fierce competition, which in some cases has pushed returns below the cost of capital. The most compelling opportunities will be found in industries with healthy market structures

disruption and broader-based inflation have shown us that the shape and pace of the energy transition will be bumpy. The journey ahead contains high uncertainties, but we are seeing meaningful changes in how companies in the energy sector are

social and governance (ESG) research approach and describe the qualities of companies that we observe as successfully managing financially material ESG issues. The Principles support Calvert's goals of providing competitive investment performance and promoting positive global change

and impact by helping us identify and potentially invest in these companies. Calvert's approach does not rely on screens or exclusions and we are at liberty to invest in corporates across the global capital markets that meet Calvert's Principles.

Until recently, our research led us to understand that risks facing oil and gas producers due to direct fossil fuel exposure and pollution in the form of emissions made them unsuitable long-term investments. This conclusion was not the product of a top-down view of oil and gas companies, but instead was based on individual evaluations of companies within the energy sector. Research showed that these companies were poorly positioned to succeed as we move through the energy transition and, as such, were not aligned with Calvert's Principles. However, changes in recent years at oil & gas issuers are providing circumstances where Calvert feels confident to selectively invest in companies within the oil and gas industry. These companies may be significant carbon emitters today or hold fossil fuels reserves on their balance sheets, but we have come to believe they are charting an important role in the energy transition.

When considering the credentials of how individual issuers fit within the context of the Calvert Principles, we look for evidence of company action rather than rhetoric. We focus on forward-looking indicators that reflect how companies are allocating capital as our guide to underlying change. We treat some inherently backward-looking data points with caution and align our thinking with broader financial markets by homing in on sustainability issues that affect company performance, the scope for future strategic change and corporate capital allocation. We adopt this approach across a number of key sectors that are at the centre of the energy transition but have often been labelled as 'uninvestable' from an ESG perspective including oil & gas (energy), metals & mining and utilities.

With respect to oil & gas, we are selectively investing in companies that we think are set to benefit from the energy transition as they lean in to developing new businesses linked to global

decarbonisation. At the same time, these companies are supplying fuels today that keep the current economy moving.

Concurrently, as investors, we think an effective way to help drive a broader shift to a lower-carbon energy system is through stimulating changes in energy demand. One means of doing this is by supporting technology deployment to drive decarbonisation. For example, Calvert invests in companies rolling out EVs, investing in renewable electricity generation, manufacturing heat pumps, and developing low-carbon hydrogen projects. In these areas we look for issuers that we think have an advantaged position to benefit from opportunities from the secular growth trends of low-carbon energy technology deployment.

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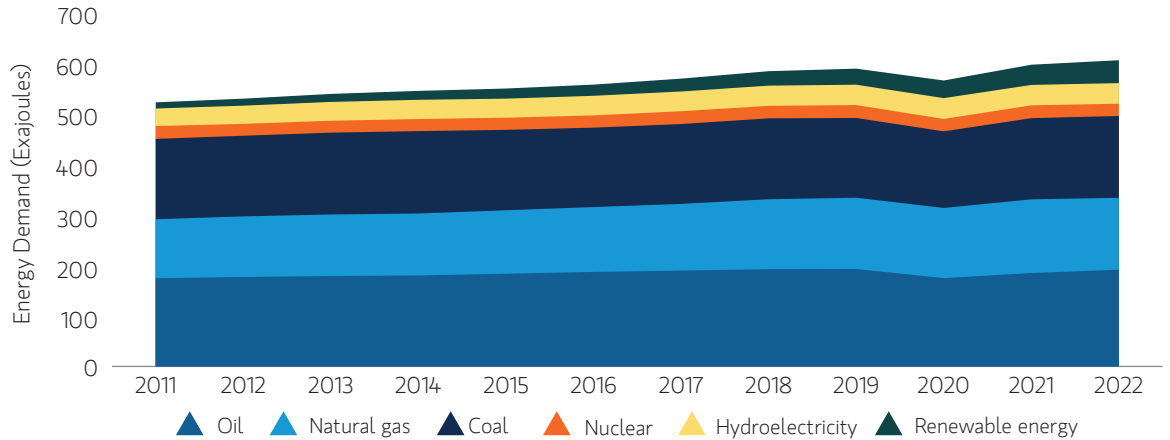
Calvert's Take on the 'Big Picture' on the Energy Transition

Recent energy market volatility has highlighted to us the extent to which the current global system relies on fossil fuels. Oil and gas provide over 50% of world primary energy; this rises to over 80% when including coal, forming the backbone of global supply. The energy system powers every corner of the modern economy from oil for transport and chemicals, to natural gas for heating and industry, to coal for electricity generation and steel production. Our ESG research spans the sector verticals in these areas to provide aligned thinking across the various value chains.

This system keeps the world moving and economies producing, but it is prone to geopolitical disruption and price volatility. Energy crises have knock-on effects on citizen living standards and require significant financial support to shield populations from the negative ramifications. According to the IMF², over USD7 trillion dollars were spent on implicit and explicit subsidies to fossil fuels in 2022 – over 5% of global GDP. Whilst this highlights the need to change how we power our economies,

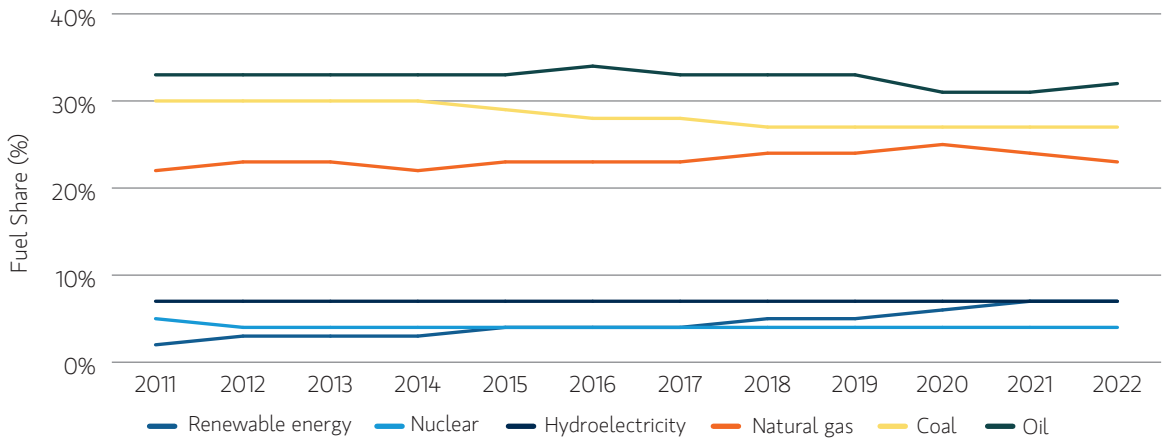
² IMF Fossil Fuel Subsidies Data: 2023 Update (International Monetary Fund, 24 August 2023)

Exhibit 2: Global Primary Energy Demand



Source: BP, Energy Institute as of 12/31/2022

Exhibit 3: Fuel Share of Primary Energy Demand



Source: BP, Energy Institute as of 12/31/2022

it also serves to remind us of the importance of minimising disruption as we do so.

Global energy demand has risen for decades and is expected to continue to do so, with Emerging Market nations set to be the main drivers of growth in coming years – countries for which topics such as domestic energy access tend to command more attention than decarbonisation. Energy efficiency is an important bulwark to this trend (and one we think requires more attention), but we think it will at best slow global growth rather than reverse the trend. More energy use over the years, mostly powered by using more

fossil fuels, has led to ever increasing annual greenhouse gas emissions which are now 6% higher than when the Paris Agreement was signed in 2015 and 50% higher than in 2000.

Its clear much more needs to be done, but we are also mindful of constraints.

Energy demand change is also not a constant picture geographically. India, now the world's most populous nation, consumes around a tenth of the primary energy per capita of the USA, but is growing fast. China's energy demand has increased rapidly since 2000 as it has industrialised; it is now both the biggest spender on clean energy globally

as well as the world's largest polluter, owing its high coal use. On the other hand, primary energy demand is in decline in Europe as efficiencies kick in and the nature of the economy shifts, and it has been broadly flat in the U.S. for several years². Coal use in both has shrunk as natural gas and renewables play larger roles.

Renewable energy in its various forms has exerted the highest growth in the last two decades. Increasing scale (e.g. larger wind turbines) and rapidly falling costs from 'learning by doing' have meant that clean energy is cost-competitive with fossil fuels in many regions. As a result, deployment levels are growing at an exponential rate – global renewable installations (in GWs) roughly doubled from 2018-2022 and are set to increase ~30% YoY in 2023.

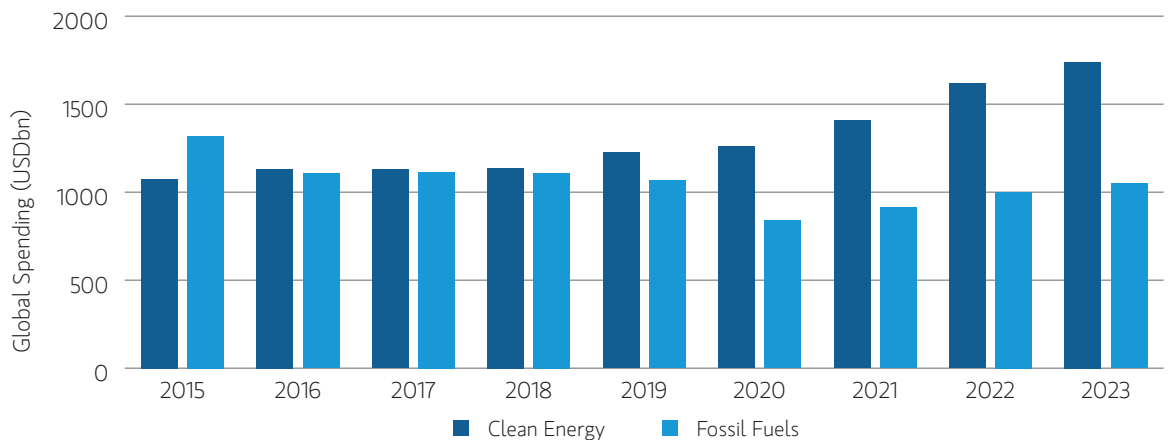
However, cost pressures are emerging, namely supply chain disruption, higher raw material costs as well as all-important interest rates.³ Furthermore, renewable energy penetration cannot continue at such rapid growth rates indefinitely without other facilitating changes happening. Electricity grids must expand and evolve, battery technology needs to improve, and the permitting of new projects needs to be streamlined. To decarbonise so-called 'hard-to-abate' sectors such as steel, cement, air travel or

heavy-transport, innovative low-carbon solutions need to scale up rapidly. Furthermore, the supply of key metals and mined materials – such as copper, lithium, cobalt and nickel – will need to keep pace with technology deployment.

To us at Calvert, this highlights the point that energy – in its various forms – carries a cost that may not be truly reflected in today's markets, be it the environmental/climate externalities of today's fossil-fuelled system, or the heavy capital requirements and labour-force changes needed to develop a future lower-carbon system. Energy is a key input cost for corporates, citizens and governments around the world and the true cost of a reliable, expansive (vis-à-vis energy access) and low-carbon system is not accurately captured in valuations – making energy inputs mispriced commodities in our view.

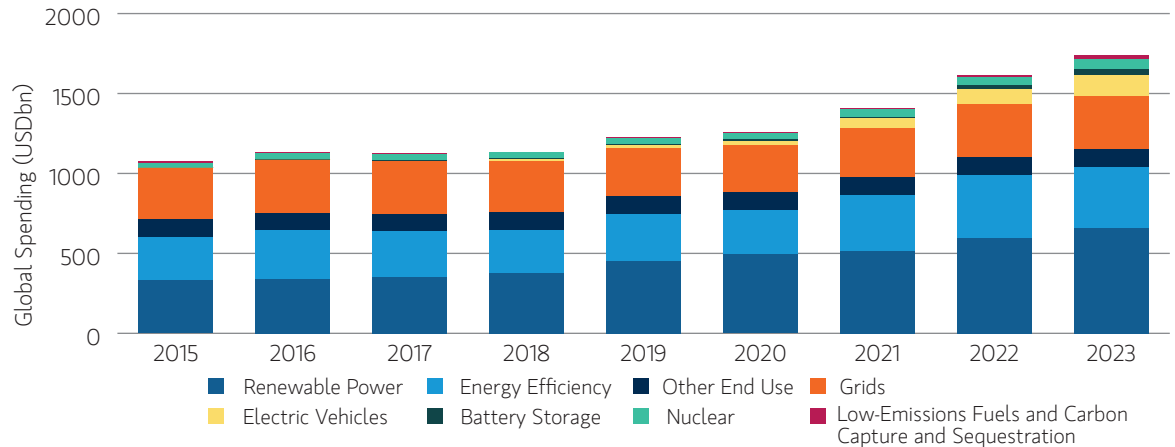
As investors, we look at capital flows as an indicator of direction of travel and we see trends pointing to increasing investment in a cleaner energy system, and in fact accelerating as shown below. Policy support – such as the U.S. Inflation Reduction Act – are also providing tangible tailwinds to clean-tech deployment. For example, in 2023 the IEA expects more capital to flow to solar PV projects (USD382bn) than upstream oil production (USD371bn) globally for the first time.

Exhibit 4: Global Spending on Clean Energy and Fossil Fuels



Source: IEA as of 12/31/2022. Forecasts/estimates are subject to change, and may not necessarily come to pass.

³ Renewable energy projects have high up-front capex that are more likely to be project financed, making them sensitive to interest rate changes.

Exhibit 5: Clean Energy Spending by Technology

Source: IEA World Energy Investment 2023. Note: 'Clean energy' includes renewables, power grids, energy storage, nuclear power, energy efficiency and electrification. 'Fossil fuels' includes upstream and midstream oil & gas, coal extraction and fossil-powered electricity generation.

We are reminded that long-dated energy markets predictions are almost always wrong; the demise of oil demand is too often called early and clean energy tech adoption is routinely under-forecast and repeatedly surprises to the upside. The path of the broader energy transition holds large uncertainties, and we think it will be non-linear and take decades. Nonetheless, in our view, the years to around 2035 are a key battleground for all energy sources across the spectrum to define their long-term roles and we do see a change in phase occurring in coming years.

In the last two decades, growing overall energy demand and clean-tech's relatively small starting point has meant that newer forms of energy have effectively been layered on top of the existing system on a global aggregate level, rather than actively displacing fossil fuels. We think that as clean energy deployment continues to accelerate and attract ever more capital, this period of what we like to call 'peaceful co-existence' will come to an end. In coming years, we see the various fuel sources and technologies coming into more direct competition with each other across uses in transport, electricity generation, industry and heating.

In the more immediate short-term, datapoints and trends around the shift to a lower-carbon energy system will continue to appear conflicting,

highlighting the complexity of the process. For example, in 2023 it is likely that the world will see record spending on clean energy technology, but also witness all-time high global greenhouse gas emissions that push the world even further away from achieving 'net zero' by mid-century.

4

Oil & Gas Outlook: Hope for Peak & Fall, Prepare for Peak & Plateau

Central to our view on the future of fossil fuels is that we see each passing year bringing the sector closer to going 'ex-growth', a phase that the industry needs to actively prepare for in coming years, given the long lead time of its investment cycles. Oil & gas demand will remain substantial for years to come, but we see the overall direction of incremental economic opportunities from global decarbonisation (and associated additional earnings streams) in coming decades as largely falling outside of the sector's core activities.

Much of the focus historically has been on the role of oil & gas supply⁴, but we think more attention should be paid to demand trends. Whilst still subject to large uncertainties (as seen in below charts), the prospect of a fall in global fossil fuel demand post 2030 will place

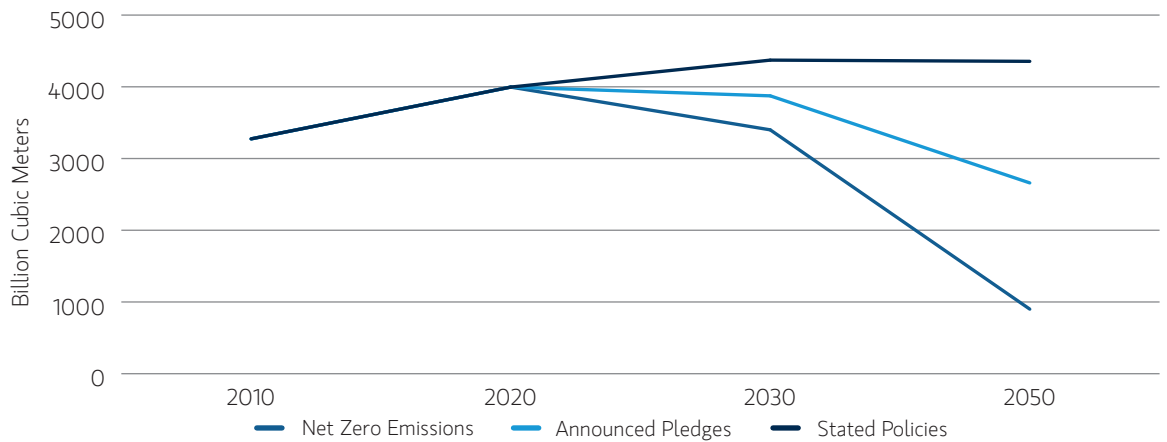
⁴ End new oil, gas and coal funding to reach net zero, says IEA (Reuters, 18 May 2021)

strains on the traditional energy industry. The notion of shrinking global demand is largely untested in a sector where business models to-date have centred on continued long-term production growth. We also think that demand change is where Calvert and other Responsible Investors can exert influence on the global oil & gas industry.

Our view on the evolution of the oil & gas industry is several-fold:

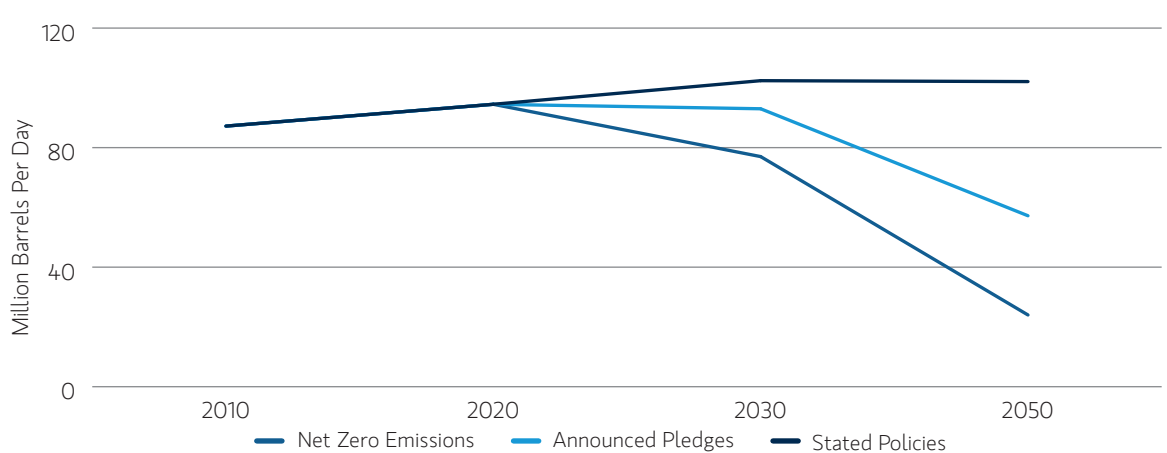
- Firstly, we think an effective way to influence the shape of the energy transition is through stimulating changes in fossil fuel demand. Calvert and other Responsible Investors can play a role in providing capital to energy-consuming corporates that are deploying clean energy technology to decarbonise.
- Secondly, oil & gas will feature in the energy system for many years to come, and in the event of demand following a 'peak & plateau' trend, we want to be invested in some of the companies that supply the needed fossil fuel to the world economy as a hedge to geopolitical disruption whilst it transitions.
- Thirdly, the oil & gas value chain itself is a large emitter (15% of global energy related GHG emissions) and must decarbonise its own fossil fuel production. Examples include curtailing methane leaks, installing carbon capture at its facilities, electrifying operations and cutting natural gas flaring. Most of these measures are actionable with readily available technology and some offer a net-positive payback over a short time period.

Exhibit 6: Demand Outlook Uncertainties for Natural Gas



Source: IEA as of 12/31/2022. Forecasts/estimates are subject to change, and may not necessarily come to pass.

Exhibit 7: Demand Outlook Uncertainties for Oil



Source: IEA as of 12/31/2022. Forecasts/estimates are subject to change, and may not necessarily come to pass.

At Calvert we see a need to be prepared for potential resilience of fossil fuel demand over time as the world gradually decarbonises by selectively investing in oil & gas producers that are evolving with the energy system. Concurrently, as investors, we think it's paramount to also provide capital to corporates outside of the oil & gas sector that are accelerating clean-tech deployment and seizing economic opportunities from the energy transition.

5 Selecting Companies: Looking Forward, Not Back

Due to the scale and nature of most oil companies, even the fastest changing firms will, in 5-10 years, still primarily be fossil fuel producers – highlighting the gradual pace of corporate transition. We also think that if meaningful business model evolution is to happen ahead of an ex-growth oil demand environment in the 2030s, it needs to have not only already started, but be currently gathering pace.

Accordingly, as part of our research into the energy industry, we look at where companies are heading and judge the credibility of their strategies by analysing their investment trends to 2030 to form our view. We take this approach rather than simply looking at current emissions trends – which largely reflect previous capital allocation decisions – or overly rely on corporate mid- and long-term carbon targets which may not be the consistent with company actions. Within recent years, we have seen broad-based efforts by the industry to cut operational emissions and engage more meaningfully on ESG topics in general. However, change of a greater scale at some corporates is now creating meaningful differentiation between issuers in our investment universe. As such, we now identify certain oil & gas companies that are actively changing with energy system and meet the criteria of the Calvert Principles.

We don't see producing oil & gas today and investing in the energy transition as mutually exclusive, but we are selective over which energy companies we feel meet the Calvert Principles (~90% of the energy sector remains ineligible).

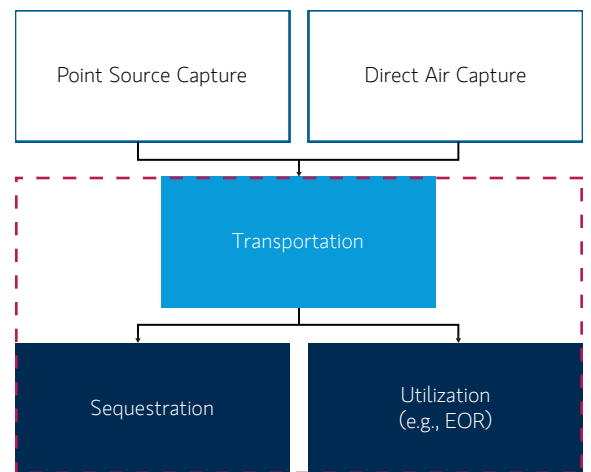
During this decade we want to see companies broadening their earnings drivers to align with wider decarbonisation trends, undertake material additive investment in energy transition, and curtail growth in fossil fuel production.

Broadly speaking, we are bearish on 'status quo' strategies that focus on aggressively growing long-term oil & gas production and instead want to see a credible route of evolution at companies as the global energy system changes. We see this as both managing longevity risks to a company's core business model, whilst also seizing on potentially additional high-growth earnings streams emerging from the energy transition.

We are not prescriptive over how energy companies should pursue economic opportunities from global energy system decarbonisation but support the notion that oil & gas companies should explore business ventures beyond fossil fuel production, processing and distribution (where sufficient returns can be generated) or prepare for a potentially shrinking oil & gas market by gradually rationalising production over time.

For example, we think upstream-orientated energy companies (Exploration & Production firms or Integrated Oil & Gas players) are potentially well-placed to benefit from the growing carbon capture

Exhibit 8: Carbon Capture Value Chain
Responsible Investors Must Consider a Wider Range of Issues



Source: Calvert Research and Management

and sequestration value chain (in red above) which is being helped by financial support from the U.S. Infrastructure Bill and Inflation Reduction Act. For other energy companies, it may make sense to explore opportunities in bioenergy, hydrogen, renewables or EV charging – e.g. some large integrated oil & gas companies are increasing the share of capex spend on non-oil & gas to up to 50% in coming years with the aim of growing their earnings from non-fossil activity several fold. Many of these technologies or markets are expected to experience multiyear double-digit growth rates compared to potentially weaker longer-term outlooks for oil & gas.

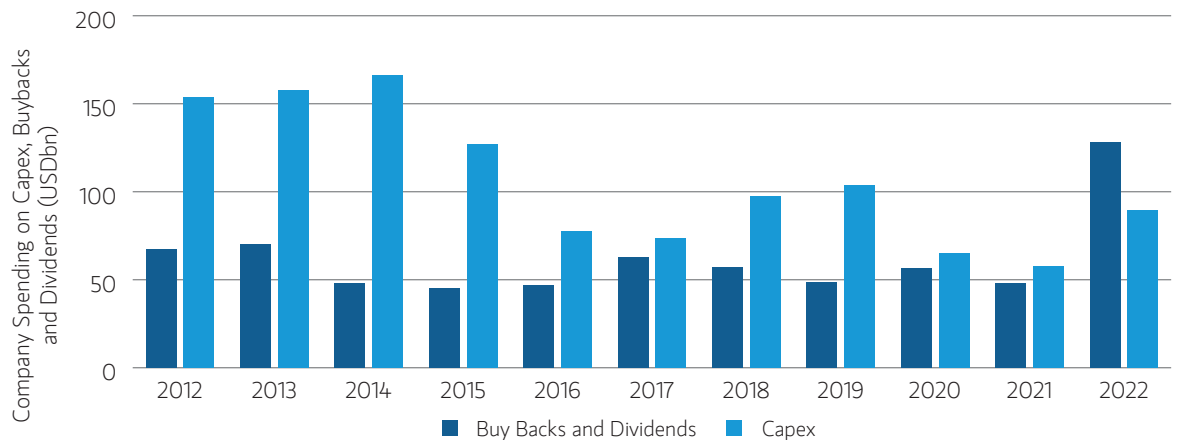
The oil & gas sector in general is trading below historical earnings multiples. We think this is partly due to the fact that we see the current backdrop as representing 'peak uncertainty' over the direction and pace in the energy transition. Nonetheless, we think the passage of time and evolving market attitudes to what the optimal business mix is for the energy transition may address this. We think issuers that are changing with the system and developing new earnings streams will ultimately benefit from a lower ESG risk profile and cost of capital. Finally, in the current context of elevated oil & gas prices resulting in high levels of cash generation at hydrocarbon-producing companies, we broadly think that capital that isn't reinvested in long-life oil projects, and is instead returned to the market as dividends or buybacks, can be argued as a broadly favourable outcome.

Energy companies, by their nature, take time to evolve and most oil corporate strategies involve long-dated plans that are still largely to be played out. With such uncertainty we anticipate there to be bumps in the road and as analysts we are carefully on the look for risks of so-called 'backsliding'. One of our tasks at Calvert is to continually judge the credibility and consistency of energy company strategies. For example, are energy companies targeting 'net zero' by 2050, but simultaneously growing oil & gas production? Similarly, some business model strategies lack a realistic path of execution. Others may plan to simply utilise questionable carbon offsets to drive emissions cuts.

“We think we are arguably at ‘peak uncertainty’ over the direction and pace in the energy transition.”

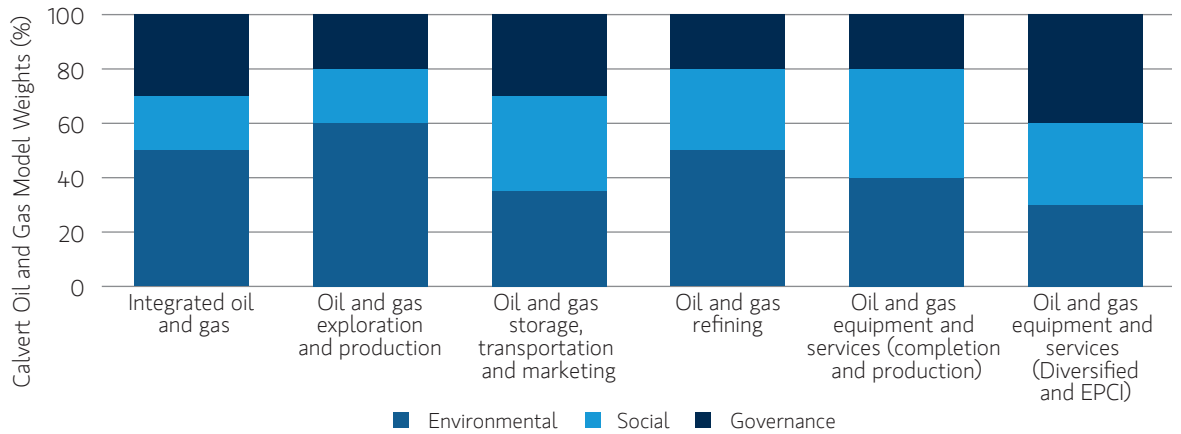
Each individual corporate journey needs both shareholders and management to be on board with its strategy, which itself needs to be backed up by a clear capital allocation framework and conviction to execute it over the peaks and troughs of a business cycle.

Exhibit 9: S&P500 Oil & Gas Company Capex vs. Buybacks and Dividends



Source: Bloomberg as of 12/31/2022

Exhibit 10: Our Approach: One Size Doesn't Fit All



Source: Calvert Research and Management as of 06/2023

Calvert’s company evaluation models reflect our thinking – we seek to identify forward-looking indicators that point to the financially material factors for each respective peer group. Whilst there is a natural commonality of importance in ‘E’ factors across the six energy value chain peer groups (such as emissions performance), there is also an important role for ‘S’ and ‘G’ to play in our assessment. Earnings drivers and capital allocation decisions vary materially between the peer groups, and we therefore seek to identify the most relevant factors for a given issuer within an industry grouping.

“Calvert’s company evaluation models reflect our thinking – we seek to identify forward-looking indicators that point to the financially material factors for each respective peer group.”

We shape our assessment of each peer group by using custom indicators (developed by Calvert) to assess the underlying trends at play at each issuer. These include:

- For large integrated oil and gas companies, we examine the direction of upstream oil & gas portfolio to 2030 and capex spending on non-fossil fuel activities.xs

- For E&Ps, we look at whether companies are responsibly managing their existing oil & gas operations and allocating capital to emerging carbon capture businesses.
- For refining companies, we measure the proportion of throughput that is oriented to sustainable fuels such as biodiesel or sustainable aviation fuel.

In addition, we must consider Social factors and align with the Just Transition Principles⁶ – that a healthy economy and a clean environment can and should coexist. The process for achieving this vision should be a fair one that should not cost workers or community residents their health, environment, jobs or economic assets.

6 Calvert’s Role and Conclusion

Our role at Calvert is to allocate capital to generate returns, drive positive global change, and manage ESG risk effectively. Our approach to the energy transition, spurred on by change we are seeing at the issuer level, seeks to achieve this across a number of key strands.

Firstly, we are keenly focused on driving change in the energy system and see the most effective way to deliver positive change is through helping companies decarbonise.

⁵ U.S. places \$1.2bn climate bet on tech pulling carbon from air (Financial Times, 11 August 2023)

⁶ The concept of “Just Transition” acknowledges that the move from traditional fossil fuels to renewable energy requires consideration of the impact on vulnerable workers and other affected communities when addressing the challenge of stranded assets and ensuring that the substantial public and private investments in low-carbon strategies and technologies create an inclusive, sustainable economy. For more information, see the Just Transition Alliance at <https://jtalliance.org/>

Rather than avoidance, we will look to work with certain issuers that may have high emissions or produce fossil fuels today but are changing their business. We will also continue to provide capital to corporates that are themselves deploying low-carbon technology to help energy users decarbonise.

Secondly, we think Responsible Investors should broaden their view of climate change investing and Impact. We are widening our scope to include considerations of the energy transition to include geopolitics, energy access and social impacts.

Thirdly, we remain attuned to limitations or constraints of the current momentum behind the transition, and we want to be dynamic in our thinking; as such, we are prepared to adapt our thinking as the energy landscape changes. We want our approach to be grounded in the ideas of taking a realistic approach that is actively engaging with companies and observing changes in capital allocation and evolution of markets.

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