Climate policy can drive decarbonization, but when poorly designed, it can create investment risk. We explore these risks and potential paths forward for policy to better incentivize decarbonization investments at attractive rates of return.

INTRODUCTION

The energy transition is a multidecadal reorientation of capital away from traditional fossil fuels toward lower-carbon alternatives. Industry decarbonization pathways and company net-zero commitments often depend, in large part, on climate policy. As long-term investors focused on sustainable earnings growth, we expect transition investments to be grounded in economic discipline, not only environmental ambition; however, in practice, this has proved challenging. While climate policy has shown it can reduce emissions in specific regions and sectors, these environmental gains have often come at the expense of attractive returns on investment. This tension can be exacerbated by how climate policy is designed and implemented.

We recently engaged some of the highest-emitting companies and industries across our portfolios, as well as some other market participants, to better understand this tension and identify potential paths forward. For the world to decarbonize at a rate that mitigates the worst effects of climate change, market incentives need to be better aligned with actions to reduce emissions. Our thinking on this topic continues to evolve through ongoing research and engagement; what follows is out current perspective.

CLIMATE POLICY CAN BECOME AN INVESTMENT RISK

Climate policy may translate into an investment risk when there is an inherent flaw in policy design. Some of the risks we have contended with in our research and investment diligence include three ways in which climate policy can "fail": when policy is too aggressive, when it is too abstract, and when an investment becomes overly reliant on it.

1. Climate policy is too aggressive
In cases where climate policy seeks to drastically bend the emissions curve over a short period of time, companies may not be able to make the investments required at an attractive rate of return. For example, the EU's carbon market via the Emissions Trading System (ETS) has been successful in cutting emissions from a variety of high-emitting sectors. However, imposing a direct carbon cost on EU industry, without ensuring a level playing field with importers, exposed domestic producers to a structural cost disadvantage. In globally traded sectors such as steel and chemicals, this ultimately pressured margins and earnings. Now that geopolitical considerations have refocused policymakers on domestic supply security, the EU is considering softening its climate policy. This includes potentially providing more free carbon allowances to higher-emitting sectors subject to the ETS and delaying the implementation of ETS2 (Emissions Trading System 2) from 2027 to 2028.

Part of the conviction in our investment in steel and mining company ArcelorMittal is that the management team has approached the challenges in the European regulatory environment in a sensible manner. Management has been vocal that ArcelorMittal will not continue to spend decarbonization capex in Europe without certain changes to the policy environment that would allow attractive rates of return on these investments. These changes include: (1) reform of the Carbon Border Adjustment Mechanism (CBAM) to close loopholes, (2) green capex subsidies, and (3) long-term cost-competitive electricity prices. For more information on how we think about ArcelorMittal's approach to decarbonization, please see p.16 in our recently published 2025 Stewardship Report.

2. Climate policy is too abstract
Investment risk can also arise when companies try to build markets without the specific combination of policy incentives required to support nascent technology and market development. Climate policy may exist as high-level targets, but markets for early-stage, lower-carbon technologies often require a complex combination of granular policy, supporting infrastructure, and customer adoption to scale into

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a self-sustaining, profitable industry. Today there remains a "green premium" for many lower-carbon solutions, such that customers are often not willing to pay the higher prices, absent any offsetting policy incentives. Typically, in these cases, returns suffer and investors penalize the decision-makers.

BP experienced this following the launch of "Reinvent BP" in 2020, which proposed an energy transition strategy at a pace well ahead of peers and out of step with market demand and policy support. As a part of that strategy, BP committed to rapid cuts to oil and gas production and an aggressive capital reallocation plan away from fossil fuels into renewables, electric vehicle (EV) charging, and hydrogen, where it lacked a structural competitive advantage. BP eventually pivoted back to a strategy more aligned with peers, but the share price has continued to reflect this strategic misstep.

We have preferred to be long-term shareholders of Shell because we think their approach to the energy transition has been more measured and therefore durable. While Shell has, at times, faced criticism for removing or refocusing discrete targets in its transition strategy, management has remained focused on areas of clear competitive advantage, where there is strong market demand. Shell's strategy has focused investment on Liquefied Natural Gas (LNG) as a lower-emissions bridge fuel and deployed smaller amounts of capital into longer-term solutions, such as carbon capture and storage (CCS).

3. Over-reliance on climate policy

Capital investments that are entirely reliant on climate policy can become just as value-destructive as those that lack policy support to begin with. Offshore wind, particularly in the U.S., has depended heavily on policy support—primarily in the form of tax credits—to generate attractive returns. Over the last several years, Orsted invested significantly in the development of a series of projects in the U.S. Investment risk emerged when the policy environment changed in 2025, and stop-work orders forced Orsted to take legal action to resume construction. The resultant project delays and inability to attract financing contributed to the need for an equity raise. There is now uncertainty about project economics longer-term and a hesitance to commit further investment.

This is not only a U.S. phenomenon. In the UK, Drax's BECCS (bioenergy with carbon capture and storage) project has faced a gradual erosion of a subsidy framework that underpinned the business model. Drax spent significant capex to convert an existing coal generation plant to a biomass generation platform, heavily incentivized by government subsidies. Under the new policy framework, these subsidies will disappear in 2027, to be replaced by new ones at half the level of output from 2027 to 2031. Drax also faces an uncertain path beyond 2031 after the current agreement with the government ends. This may delay the timeline for the implementation of carbon capture and storage and therefore for BECCS to become fully operational, which was originally planned for 2030.

Together, these examples highlight that policy can become a single point of failure for capital investments, whether the risk manifests as a sudden reversal or slow withdrawal of support. This risk is particularly acute when the technology in question also requires significant policy support to scale and achieve adequate returns on investment.

OPPORTUNITIES TO IMPROVE FUTURE CLIMATE POLICY

It may be impossible for climate policy to strike the perfect balance among all competing priorities, but we have identified a few potential opportunities for improvement:

1. Incentivize demand, not just supply, for low-carbon solutions

Incentivizing both demand and supply is important if climate policy seeks to scale lower-carbon solutions at attractive rates of return for the providers of capital. Supply-side climate policy has largely taken center stage, with a focus on the decarbonization of energy sources and production processes. Without demand-side incentives that work in tandem, companies find themselves without an attractive end market.

This is why we are intrigued by the work of Carbon Measures, an organization that intends to develop comparable product carbon footprints for the most carbon-intensive industries, covering approximately

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70% of global emissions. Carbon Measures builds on the e-liability methodology—highlighted in this newsletter in 2022—which applies cost accounting principles to carbon by tracking the actual emissions embedded in a product at each stage of the supply chain rather than relying on estimates. The goal would be product- and technology-agnostic climate policy, focused on simply regulating carbon intensity thresholds for end products and services. This would allow embedded carbon to be more directly reflected in pricing and procurement decisions. Transparent price signals could then incentivize the market to drive innovation and help close the "green premium". This work is in the early stages, but we think it has the potential to address market demand for low-carbon products and services.

2. Policy stability and consistency

Given that the capital cycle for many low-carbon investments is longer than any one political cycle, if policy is needed to help catalyze the market, companies need predictability and stability in the policy environment. For example, Dow has frequently pointed to the policy support via tax credits and long-term stability in the political environment in Canada as one of the key reasons why it was able to move forward with the capex required to build its first net-zero cracker in Alberta. Long-term political stability was cited by all the companies we engaged as a key precondition for any successful climate policy.

However, it is also important that policymakers can adapt quickly when newer technologies make prior regulations no longer fit for purpose. For example, nuclear small modular reactors (SMRs) do not necessarily have the same risk profile as legacy large-scale nuclear reactors, so nuclear regulations should be able to adapt as needed to reflect these differences. There is an inherent tension in policymaking between stability and the need for adaptability as new technologies emerge and evolve. Striking the right balance is critical as energy system needs change over time.

3. Cross-border collaboration

Finally, since climate policy is intended to address a global issue, it is important that policymakers do not operate in a silo and ignore the policy environment in other jurisdictions. While a global carbon price remains unlikely, the development of negotiated trade agreements which have started to price carbon—such as the Carbon Border Adjustment Mechanism (CBAM)—have started to prove effective. There are also examples of isolated successful cross-border projects, such as the Norwegian government's Northern Lights carbon capture and storage project, with investment from Equinor, Shell, and TotalEnergies. This project collects carbon dioxide from industrial sites in several European countries and transports it for storage. In August 2025, the first carbon dioxide volumes were injected and successfully stored in a reservoir beneath the Norwegian North Sea.

Part of the challenge remains that there is no single coordinating global body with the authority to regulate. The Conference of the Parties (COP) process remains the closest thing to this kind of entity, but it still relies on the commitment of individual member countries to implement and legislate. However, companies appear somewhat optimistic about isolated areas of success, made possible through the COP process. For example, the Oil & Gas Decarbonization Charter was an output from COP28. It marked the first time that many state-owned oil and gas companies publicly supported an ambition to reduce greenhouse gas emissions from their operations and achieve net zero by 2050. There may be more opportunities for successful collaboration during future COP convenings.

CONCLUSION

Climate policy directly shapes the return profiles for companies and influences capital allocation decisions. This is the first time we have tried to distill the insights from our bottom-up, fundamental company research into a point of view on the successes and failures of global climate policy. We will continue to assess how climate policy affects individual company investments, cost curves, and long-term returns. Ongoing engagement with the higher-emitters across our portfolios remains central to this work, as we track how policy frameworks can affect shareholder returns. As appropriate, we also hope to contribute to the conversation with regulators and other market participants by sharing our evolving perspective.

FURTHER INFORMATION

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