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IDEA

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BIG DEBATES 2025 | Europe

EMEA Sustainability - Directives, Decarbonisation, and (maybe) De-industrialisation?

European competitiveness, energy transition and geopolitical uncertainties will be front of mind for European policymakers in 2025. At the same time, Sustainable Finance will continue to evolve, with emphasis on stock selection within Energy Transition as well as increased focus on social investing.

Sustainability

While geopolitical uncertainty, global supply chain reconfiguring, tariffs, and the proliferation of AI loom large in the minds of European policymakers and investors, we continue to believe Europe can lead in driving Sustainability policy, fund inflows and pragmatic regulation.

We expect conversation on European policy to be dominated by a number of fundamental factors – **competitiveness**; **climate change**; **security**; **digitalisation**; **migration**; and **the cost of living**. Mario Draghi's "*The future of European competitiveness*" report pointed to three "transformations" Europe has to contend with – to become **more innovative and competitive**, to **complete its energy transition**, and to **adapt to a backdrop of** "**less stable geopolitics**, where dependencies are becoming vulnerabilities".

At the same time, we believe the world of Sustainable finance will continue its evolution, with a greater focus on selective components of the energy transition, as well as significant opportunities in social investing (including preventative healthcare, social infrastructure, AI Adopters and the just transition).

In a world of increasing "greenhushing", we still argue that Sustainable investment offers significant alpha opportunities across elements like "Rate of Change", social investing, and specific enabling technologies in decarbonisation, whether in electric grid transmission & distribution (including smart grid technology), energy modernisation or climate resilience. While significant upfront capex investment is required to deliver on energy transition goals, we note a number of technologies offer compelling economics and/or supply-demand imbalances as we head into 2025. We recommend focusing on companies with clear competitive moats (and avoiding commoditised markets), pricing power and mission-critical products or services for the energy transition.

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Sustainability

How will policies and regulation evolve against an uncertain geopolitical backdrop?

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Our View	Market View
We believe Europe can continue to lead in driving Sustainability policies, sustainable fund inflows & launches, and green tech innovations. We are closely watching a number of developments this year, including the EU Commission's agenda, reactions to Mario Draghi's report on Europe, and upcoming regulations (as well as potential adjustments or delays).	Investors are concerned about geopolitical & trade uncertainties, including debates around the outlook for Inflation Reduction Act tax credits & environmental policies in the US, possible tariffs, the outlook for the Ukraine conflict, and the "stickiness" of corporate sustainability commitments.

From an EU policy focus standpoint, the European Council in Brussels agreed on the 2024 to 2029 strategic agenda (see here) at end-June 2024. The areas of focus are broadly underpinned by three pillars – a free and democratic Europe; a strong and secure Europe; and a prosperous and competitive Europe. The priorities centre on boosting **EU competitiveness** (across components like a "deeper single market", more "ambitious… open and sustainable trade policy", "strategic supply chains" and increasing capacity in core technology areas such as AI & net zero), **climate change** (including the Clean Industrial Deal, a "sustainable and resilient agricultural sector", building a more resilient & secure EU energy system), **defence** (including continued support for Ukraine, cooperation with NATO and raised investment levels), **migration** (with a "comprehensive approach") and **digitalisation** (including investment in new technologies and training). These areas are further emphasised in President Von der Leyen's manifesto for the Commission, which details initiatives across components like critical raw materials, decarbonisation, a Social Climate Fund, AI and healthcare (see Exhibit 1).

Exhibit 1: Ursula Von der Leyen manifesto for Commission 2024-2029

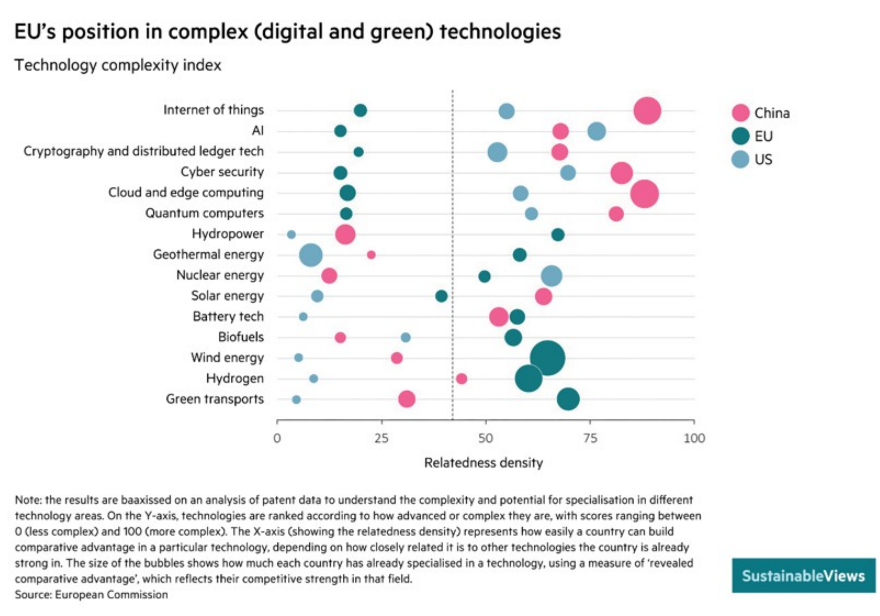
Proposal	Description
Clean Industrial Deal	Decarbonise and bring down energy prices - for competitive industries and quality jobs in first 100 days of the mandate - Industrial Decarbonisation Accelerator Act to support industries and companies through the transition. It will support European lead markets for the development, production and diffusion in industry of clean tech. It will also help to speed up related planning, tendering and permitting processes. - Bring down energy prices by prioritising investment in clean energy infrastructure - renewables and low-carbon technologies, grid infrastructure, storage capacity and transport infrastructure for captured CO2. We will also invest in energy efficiency measures, the digitalisation of our energy system and the deployment of a hydrogen network. - New Clean Trade and Investment Partnerships to help secure supply of raw materials, clean energy and clean tech from across the world.
Digital tech diffusion	Boost productivity
Skills and Labour gap	24 mn European SMEs create quality jobs anchored in local communities
Circular Economy Act	Create market demand for secondary materials and a single market for waste, notably in relation to critical raw materials.
Critical Medicines Act	Reduce dependencies relating to critical medicines and ingredients, particularly for products where there are only a few supplying manufacturers or countries.
Healthcare	European action plan on the cybersecurity of hospitals and healthcare providers in the first 100 days of the mandate
AI Factories Initiative	Ensure access to new, tailored supercomputing capacity for AI start ups and industry
European Biotech Act in 2025	To bring biotech from the lab to factory and then onto the market
European Defence Fund	Investing in high-end defence capabilities in critical areas such as naval, ground, air combat, space-based early warning and cyber.
Social Climate Fund	Help with renovations and access to affordable and energy-efficient housing
Vision for Agriculture and Food	Ensure long term competitiveness and sustainability of the farming sector and adjust EU budget and CAP to find the right balance between incentives, investments and regulation.

Source: Europa, Morgan Stanley Research

In September, former ECB President, Mario Draghi, published a report on **"The future of European competitiveness".** The report focused on four "pillars of prosperity" – sustainable competitiveness; economic security; open strategic autonomy; and fair competition. Draghi's work identifies three "transformations" Europe has to deal with: it needs to become more innovative and competitive, it needs to complete its energy transition, and it needs to adapt to a world of "less stable geopolitics, where dependencies are becoming vulnerabilities".

Our European Economics team highlights that beyond a "rather grim macroeconomic diagnosis", the report does offer some potential policy guidance (see note). On energy, for instance, suggestions include joint LNG procurement and a European-level electricity grid strategy. On innovation, the report notes that whilst Europe is one of the world's largest markets for clean technology and has historically been an early mover in clean tech development (Exhibit 2), competitive challenges have created barriers to scale. As a result, the EU is increasingly relying on imports to satisfy rising demand for clean tech. The report proposes EU action to promote locally-produced technologies, and to mobilise finance to ensure technologies are developed and scaled. Overall, the report identifies incremental investment needs for Europe of between €750 and €800 billion annually, equating to almost 5% of EU GDP, potentially shared between 20% public and 80% private sources.

Exhibit 2: EU's position in complex (digital and green) technologies



Source: Sustainable Views - https://www.sustainableviews.com/draghi-report-marries-decarbonisation-and-competitiveness-ab8fae3e/

A number of regulations are set to come into force in the next 12 months (see here for the latest edition of our EU & UK Regulation Tracker), including -

- **European Sustainability Reporting Standards (ESRS) under the Corporate Sustainability Reporting Directive (CSRD) -** the first undertakings will apply the new sector-agnostic & topical reporting standards across environmental, social & governance issues in the 2024 financial year, for reports published in 2025. The rules then continue to phase in from the 2025 financial year for large EU-incorporated undertakings (which meet at least two of the following criteria: >€25 million balance sheet, >€50 million net turnover or at least 250 employees during the year) and other large non-EU incorporated undertakings

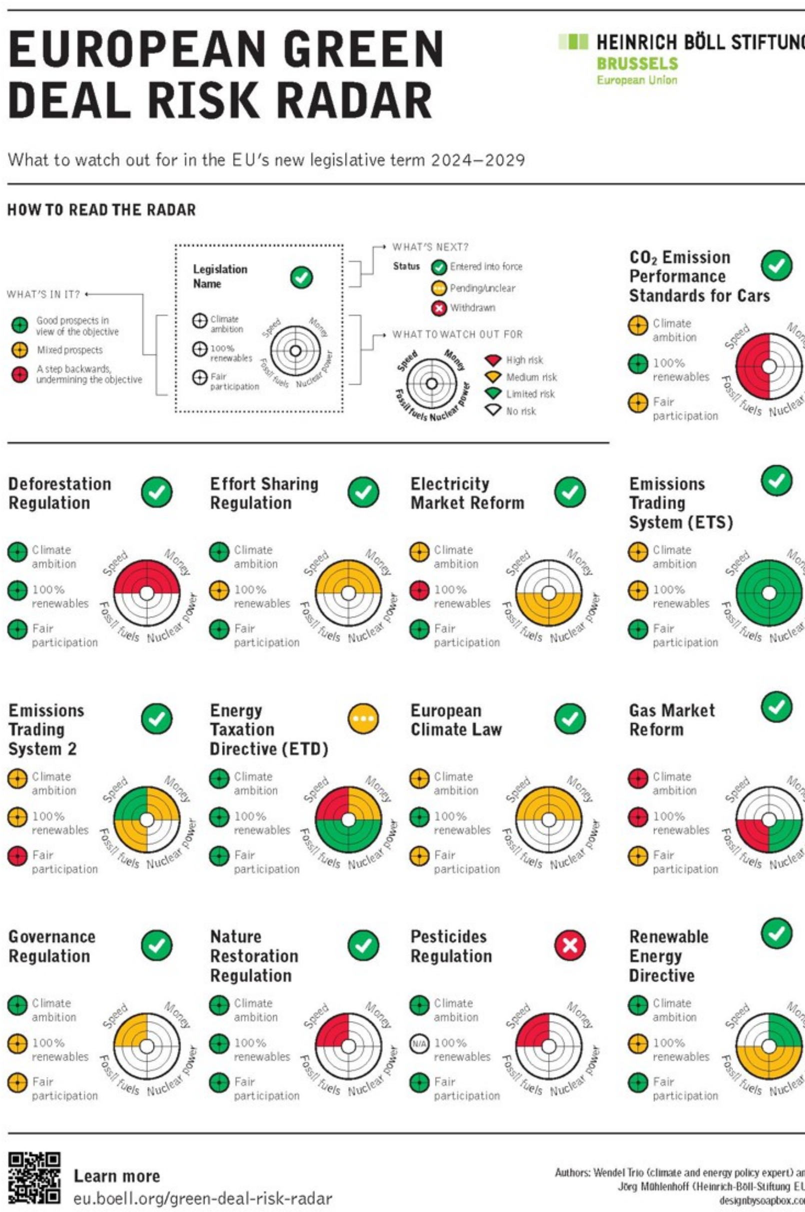
- **Deforestation Regulation -** implementation of this regulation has recently been delayed by one year (see further commentary) below and our note here
- **ESMA Guidelines** - from 21st May 2025, fund naming rules on ESG or Sustainability-related terms will be applicable for existing in-scope funds. Morningstar data shows 42 funds have dropped and 20 funds have swapped ESG-key terms in anticipation of the deadline. We have written extensively on the implications of the Guidelines, exclusion requirements, positioning & investor debates here, here, and here
- **Circular economy -** recycling targets are due to come into force for plastic, wood, ferrous metals, aluminium, glass, plastic packaging and management under the Packaging and Packaging Waste Regulation (here), alongside more ambitious objectives around recycling
- **Energy modernisation** - the end of subsidies to stand-alone boilers powered by fossil fuels from 1 January 2025, as part of the Energy Performance of Buildings Directive (EPBD). By end-2025, EU Member States are also due to submit their first national building renovation plans to the Commission
- **UK policies** - in 2025, we are expecting legislation on SAF mandates, the final Industrial Strategy (focused on clean energy and net zero goals), and potential endorsement of IFRS S1 & S2 for UK corporate disclosure, alongside continued evolution of fund labelling under SDR

We note that Draghi's report also states that Europe's "larger regulatory flow" harms competitiveness compared to other regions around the world, pointing to the Corporate Sustainability Reporting Directive (CSRD), Due Diligence Directive (CSDDD), and EU Taxonomy Regulation as potentially costly and over-complicated. The report proposes specific measures to reduce the regulatory burden on SMEs. For energy-intensive industries, the report recommends monitoring and improving the design of CBAM during the transition phase, this includes simplifying the MRV process, addressing remaining loopholes, and revisiting the treatment of exports in CBAM.

At the same time, it's worth noting increased investor debate around risks of delay or dilution of some rules in this geopolitical environment, with the Heinrich-Böll-Stiftung's European Green Deal Risk Radar (see Exhibit 3) highlighting 13 of the key legislative components of the European Green Deal and potential risks of delay, defunding, undermining or withdrawal. It flags particular concerns around the **CO2 Emission Performance Standards for Cars**, the **Deforestation Regulation** (NB: this has already seen a delay in implementation as of November 2024 - see here), and the **Nature Restoration Regulation**, as well as an unclear path for the **Energy Taxation Directive**.

On emissions standards for cars, it suggests there is high risk of slowdown (around the 2035 targets) around the European Commission assessment in 2026, as well as potentially high risk of continued support for fossil fuels. In our view, the one-year delay to the compliance deadline for EUDR could potentially set a precedent for the EU's other 'global green reach policies', which include CSRD, CSDDD and CBAM (see note). The Radar also notes the Nature Restoration Regulation "was the subject of huge political divergences in both the Parliament and the Council and was adopted with the thinnest possible majorities", prompting concerns about the speed of implementation. Finally, on the Energy Taxation Directive, the Institute notes that public consultation is closed, but no agreement has been found in the EU Parliament or the EU Council. As a result, the Risk Radar points to risks of concessions, particularly around tax exemptions for areas like aviation & shipping use of fossil fuels, which may risk "undermining EU climate targets".

Exhibit 3: European Green Deal Risk Radar



Source: Heinrich-Böll-Stiftung - https://eu.boell.org/en/green-deal-risk-radar

Sustainability

As EU politicians prioritise competitiveness, how will they balance decarbonisation and de-industrialisation?

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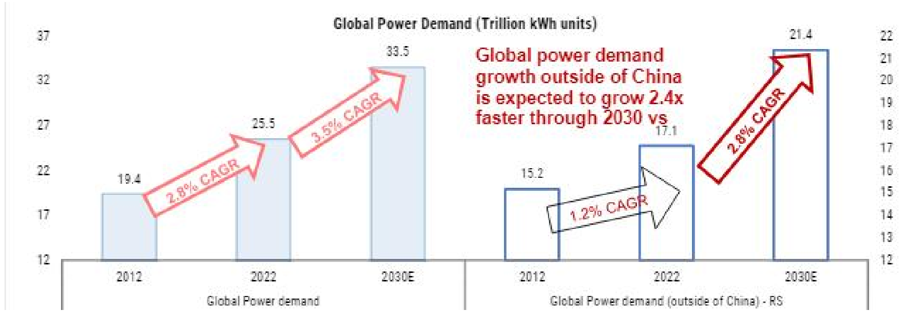
Our View	Market View
We argue Sustainable finance will continue to evolve, with increased focus on selective components of the energy transition (e.g. electric grids, energy modernisation, circular economy, climate resilience, CCUS), as well as significant opportunities in social investing (including preventative healthcare, social infrastructure, AI Adopters and the just transition).	With headlines pointing to (small) outflows from US sustainability funds, the potential withdrawal of the US from the Paris Agreement, and increased incidence of "greenhushing", some investors question whether companies may walk back or delay their sustainability ambitions, if decarbonisation is still a corporate priority, and whether the pace of the energy transition may slow in 2025.

As we suggested last year, "sustainable investment" is continuing to evolve, with significant alpha opportunities across both "Rate of Change" and specific enabling technologies in decarbonisation, whether in grid transmission & distribution, energy modernisation or climate resilience. While significant upfront capex investment is required to deliver on decarbonisation, we note a number of technologies offer compelling economics and/or supply-demand imbalances as we head into 2025.

At the same time, there is an ongoing debate in Europe about the level of ambition inherent in EU decarbonisation targets, combined with the stringency of its regulation, potentially disadvantaging European corporates. We note the recent announcements from ArcelorMittal and Norsk Hydro, which highlighted challenging market dynamics for some decarbonisation technologies in Europe as reasons for re-evaluating the focus of their European decarbonisation strategies (see ArcelorMittal note and Norsk Hydro note).

With global power demand inflecting materially higher (see Exhibit 4 below), the investment need in new power generation (across renewables, gas-fired power plants and nuclear power) and electrical equipment (is increasingly pressing, driven by datacenter proliferation, industrial electrification, and on-/friendly-shoring of manufacturing. In MS's Global Clean Power: At a Tipping Point note earlier this year, we estimated 2026 wholesale power prices will increase by 20-25% compared with 2019 levels, resulting in elevated returns for power producers globally to near-record highs. At the same time, we have seen continued equipment cost deflation in areas like solar modules & wafers.

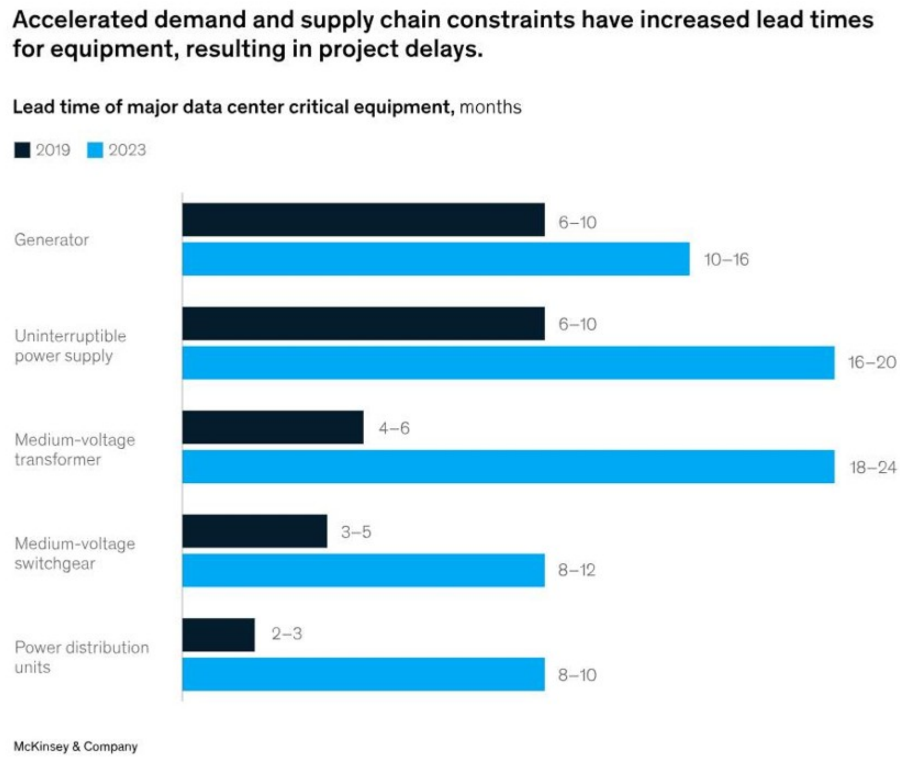
Exhibit 4: Global power demand Inflection: 25% faster growth vs the last decade and 2.5x quicker pace of growth outside China until 2030



Source: Statistical Review of World Energy, Morgan Stanley Research estimates

With this backdrop, we reiterate the need to be selective in decarbonisation stock selection. We recommend focusing on companies with clear competitive moats (and avoiding commoditised markets), pricing power and mission-critical products or services for the energy transition. We see continued focus on datacenter power drivers in 2025, with cooling technology increasingly a topic of investor interest (see here). At the same time, McKinsey analysis in September 2024 flagged that lead times for critical datacenter equipment have increased by a factor of 3-4x since 2019 across elements like transformers, switchgear and power distribution units. Electrical equipment providers, cabling companies, smart grid solutions, gas turbine offerings, and hybrid (i.e. renewable & gas) power generators continue to look attractive as the power landscape evolves in 2025. We also expect best-in-class renewable power generators to enjoy benefits from financing scale (i.e. preferential access to capital), superior supply chain infrastructure and operating excellence to deliver superior RoEs on solar & wind projects (combined with storage) through 2025.

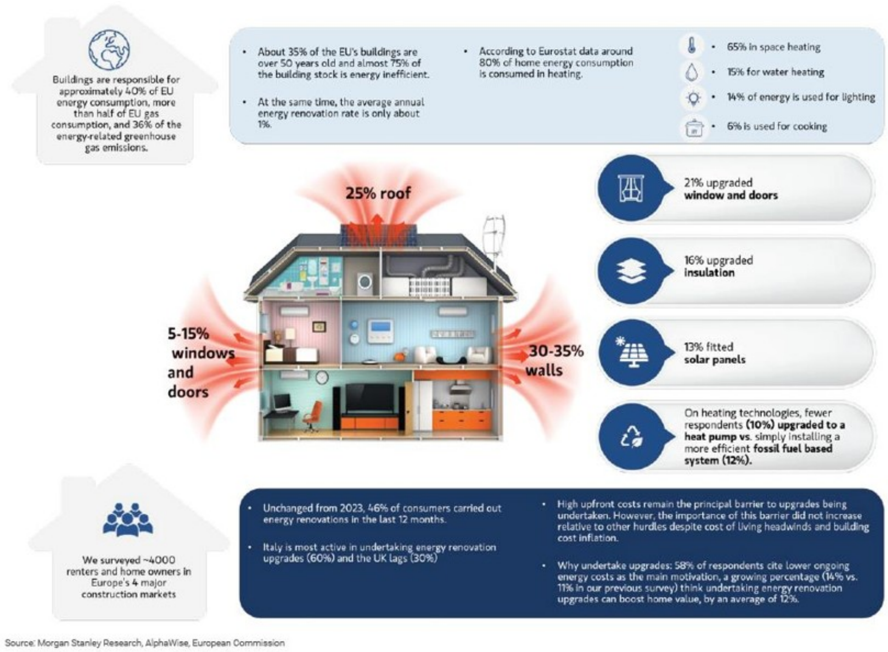
Exhibit 5: Datacenter critical power equipment lead times



Source: McKinsey & Company - https://www.mckinsey.com/industries/private-capital/our-insights/how-data-centers-and-the-energy-sector-can-sate-ais-hunger-for-power?stcr=1E319107D8BB42D8AE607618512129C0&cid=other-eml-alt-mip-mck&hlkid=02a77434434c4a0ca5278603b914b958&hctky=14843896&hdpid=f02ffaa1-b3d3-4ba8-b91f-fc2d077ff5a1#/

Beyond the power sphere, we expect continued European focus on other components of the just transition like energy modernisation of buildings, green metals (see here, here and here), and circular economy. As Morgan Stanley highlighted earlier in 2024, energy renovation spend is a potential >€2.8 trillion investment opportunity to 2030, across energy efficiency solutions like upgraded insulation, improved roofing, better glazing and HVAC systems. Additionally, given 40% of datacenter emissions come from embodied carbon (Scope 3), green materials like low-/zero-carbon cement & concrete, steel, copper and aluminium will be necessary to decarbonise AI deployment.

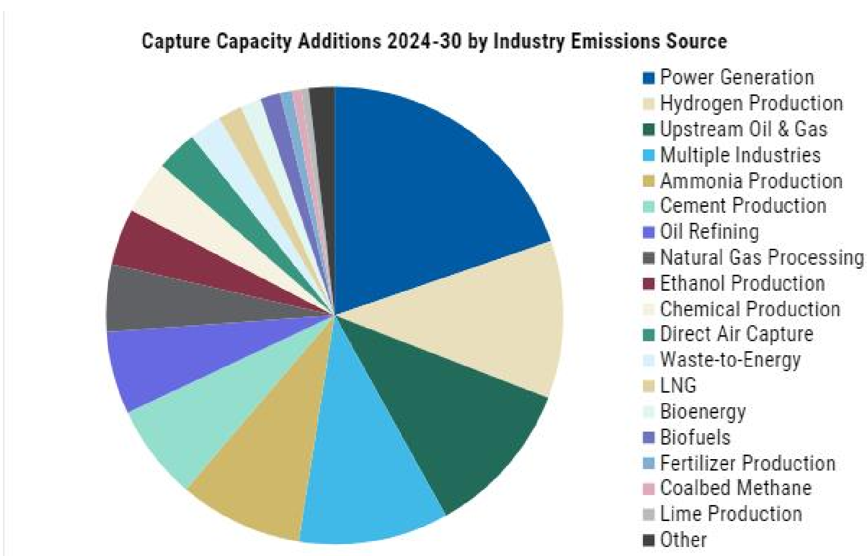
Exhibit 6: How are we upgrading our homes?



Source: Morgan Stanley Research, AlphaWise, European Commission

We note that CCUS could play an important role in decarbonising datacenters, across scope 1, 2 and 3 emissions. The pipeline of carbon capture projects continues to grow, with ~530 Mtpa of capture capacity expected to start up by 2030, according to Wood Mackenzie estimates, vs 53 Mtpa in operation as of end-2023. The US has the largest expected volume of 2024-30 capacity additions by country (188 Mtpa), followed by the UK (55 Mtpa). We are closely watching the commissioning and start-up of a number of large storage facilities.

Exhibit 7: Carbon capture capacity additions 2024-30 by industry emissions source



Source: Wood Mackenzie, Morgan Stanley Research

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Equal-weight/Hold	1731	46%	367	46%	21%	819	48%
Not-Rated/Hold	5	0%	0	0%	0%	1	0%
Underweight/Sell	593	16%	73	9%	12%	228	13%
Total	3,749		796			1694	

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