Environment

Why engagement trumps divestment in the battle against climate change – The case for engagement with fossil fuel companies

As divestment from one or more types of fossil fuel company is becoming a more frequent occurrence, we believe that engagement can be a more effective tool in climate change mitigation efforts.

Setting the scene

As universal investors with interests across all sectors and asset classes, large-scale pension funds and endowments understand that the long-term returns on their investments are correlated to the long-term health of the economy. For this reason, they have long been genuine and vocal supporters of efforts to tackle climate change. This is based on the analysis that the cost of building a low-carbon economy, which may involve reduced returns on investment in the short term, will be well rewarded by the long-term gain of avoiding the harms of potentially catastrophic carbon levels and climate change.

Unfortunately, political and economic reality has not kept pace with investor ambition. Currently, the world's economy is on a de-facto trajectory of 4°C global warming, although national leaders have individually pledged to achieve a 3°C pathway and collectively still aspire to keep global warming to 2°C, the maximum limit judged safe by scientists to avoid catastrophic climate change. Limiting climate change to 2°C remains the goal of the UN climate talks in Paris in December 2015, although it is a challenging target, given the additional policy measures that will be required above and beyond those already pledged.

Fossil fuels will remain important in low-carbon scenarios

Investors support long-term policies that facilitate a smooth and cost-effective transition to a low-carbon economy. The International Energy Association has projected the most rational global demand response for fossil fuels in the case of the transition to each of the 4°C and 2°C pathways. In the 4°C pathway, demand for all fossil fuels would rise. However, in the 2°C pathway, demand for coal is projected to fall immediately, while oil demand peaks by 2020 before declining. Gas demand continues to increase, albeit at reduced rates.

In either scenario, continued investment is required in each of the coal, oil and gas industries, although the level of investment is naturally lower in the 2°C scenario. Reduced demand would have a significant impact on the price of fossil fuels and many current and planned projects may prove to be uneconomic and result in the destruction of shareholder value. Meanwhile, it is estimated that up to 80% of all fossil fuel reserves could never be exploited under a 2°C pathway, including 60-80% of the reserves of companies listed on the stock exchange.[2]

The pros and cons of engagement vs divestment

Some long-term investors have expressed concerns about the apparent inconsistency of supporting efforts to tackle climate change and holding investments in fossil fuel companies. Following pressure from beneficiaries, some funds have decided to divest entirely from either a particular class of fossil fuels, such as coal, or even from all fossil fuels.[3] In most cases, this position appears to be held on a point of principle instead of an economic appraisal of value. Other investors are decreasing their exposure to fossil fuels as a way to reduce risk

Investment approach	Pros	Cons	Conclusion
100% Divestment	■ Improved returns, if divestment based on an economic assessment of risk vs return ratio ■ Ethically defensible position, as can claim that fund does not invest in high-carbon activities associated with exacerbating carbon ■ Sends an easily interpretable signal to policy-makers of support of policies to tackle climate change	■ Reduced returns or increased risk if divestment is not based on economic assessment ■ Loss of ability to continue engagement ■ Will not succeed in reducing global supply of (or demand for) fossil fuels, as new owner will almost certainly have fewer concerns about climate change	**Appropriate if...** ■ Based on an economic analysis of long-term risk and value opportunity ■ Desire exists to take an ethically-driven position that can claim to not profit from high-carbon activities ■ Desire exists to send a clear message to policy-makers on climate change **Inappropriate if...** ■ Focus is on maintaining maximum risk-adjusted fund performance while improving chances of tackling climate change
Partial Divestment	■ Improved returns, if based on an economic assessment of risk vs return ratio ■ Maintains ability to continue engagement ■ Sends a positive signal to policy-makers of support of policies to tackle climate change	■ Loss of some engagement influence, as shareholding is smaller ■ Not obviously consistent with an ethically driven position	**Appropriate if...** ■ Based on an economic analysis of long-term risk and value opportunity **Inappropriate if...** ■ Desire exists to take an ethically-driven position
Engagement	■ Potential to gain greater disclosure of a company's risk of exposure to low-carbon scenarios ■ Potential to influence company to reconsider appropriate levels of capital investment, consider alternative business models and to cease lobbying against climate change policy	■ Unlikely to succeed in changing the nature of the fundamental activity of the company, especially if it is government-controlled	**Appropriate if...** ■ Engagement goals are SMART (specific, measurable, achievable, realistic and time-bound) and resource is effective **Inappropriate if...** ■ Company refuses to discuss the particular issues

and improve returns, although they have not excluded any category of fossil fuels entirely.[4] Most investors have yet to formulate a specific investment strategy for fossil fuels. But they are pursuing a strategy of active engagement, requesting companies to increase the level of analysis of the risks to asset portfolios from policies to tackle climate change. This approach has met with some success, with a number of fossil fuel companies now publicly accepting the science on climate change and committing to conducting and then publishing stress-tests of their asset portfolio resilience in the event of stronger policies to tackle climate change.[5] When weighing up whether to engage or divest, it is important to consider carefully the objective of the investor and the likelihood of success under each approach. In particular, it is important to distinguish between ethical objectives, such as avoiding association with activities that exacerbate climate change, and more pragmatic objectives, such as maximising risk-adjusted returns on investment and increasing the potential for companies to react more rapidly to policy signals.

In our view, divestment is unlikely to succeed in changing global levels of either supply or demand of fossil fuel production. Firstly, the new owner of the divested stock wants to see his or her investment pay a return and will almost certainly have fewer concerns about climate change risks. Even if all third-party investors were to shun a particular investment, ultimately the company's management team could buy the asset at minimal value or it would likely be nationalised. In addition, the vast majority of coal consumption and production is controlled directly or indirectly by national authorities. It is therefore difficult for private investors to alter coal supply or demand in the face of opposition from national policy-makers. Even countries that are ardently committed to the transition to a low-carbon economy, such as the UK and Germany, remain committed to some coal usage over the next decade and potentially longer.

It is also difficult to build an ethically purist position against any particular class of fossil fuel, given that all will remain in use at large scales for at least the next four decades under any foreseeable and orderly transition to a low-carbon economy. Fossil fuels therefore cannot be classed as morally repugnant per se. The challenge is the total quantity of global supply and demand, which is a function of the complex structure and incentives of national economies.

A differentiated engagement strategy

Hermes EOS has recently reviewed the nature of its engagement objectives with fossil fuel companies to ensure they are genuinely achievable. Below we set out a potential range of engagement targets depending on the nature of the fossil fuel company. It is important to note that this is a framework approach and that the appropriate engagement objectives for any particular company always vary based on their particular circumstances and history of engagement.

[2] Unburnable Carbon 2013: Wasted capital and stranded assets published by Carbon Tracker.

[3] For example, Stanford University will not invest in any publicly traded companies whose principal business is the mining of coal (May 2014), the Rockefeller Brothers Fund is divesting from coal and tar sands investments (Sep 2014) and the Church of Sweden and University of Glasgow agreed to divestment from all fossil fuel companies (Sep/Oct 2014). The Church of England announced exclusion of companies with over 90% of revenues from coal or tar sands in April 2015.

[4] Norwegian financial services company Storebrand announced reduced exposure to fossil fuel companies to "ensure long-term stable returns" in July 2013.

[5] Exxon Mobil has shifted position to accept the science of climate change and to stress-test its investments against different potential costs of carbon. BP and Shell have committed to disclosing their assessment of asset portfolio risk arising from a move to a low-carbon economy (2015).

[6] It may be possible to encourage diversified mining companies to invest in carbon capture and storage technologies. However, they generally do not have the skills or necessary experience to achieve this and so would need to invest in other ventures or collaborate at a wider industry level.

Engagement goal	Mining: Majority Coal >50%	Mining: Minority Coal <50%	Oil & Gas
Risk appraisal of portfolio resilience to low-carbon economy and appropriate level of capital expenditure across the portfolio	✔	✔	✔
Public policy position: avoid lobbying against climate change policies that limit use of fossil fuels; support global efforts to tackle climate change	✘	✔	✔
Investigate alternative business opportunities, including investing in low-carbon solutions (eg carbon capture and storage, renewables)	✘	✘[6]	✔

The result is a differentiated engagement programme with realistic and achievable goals. In the case of a majority coal producing company, it is still realistic to expect that it will carefully appraise the risks to its portfolio and future investment profile arising from low-carbon scenarios and to adjust its capital expenditure accordingly. This analysis should be published to investors so that they are fully aware of the financial risks involved in continuing to invest.

For a minority coal mining company, in addition to conducting the risk assessment above, it is also realistic to aim for the company to cease any lobbying against policies that tackle climate change and to publicly support achievement of policies to tackle climate change.

A typical oil and gas company can take an even more progressive stance on climate change. This is because with a sufficient advance policy signal, it can benefit from the opportunity to sell increasing amounts of gas to displace coal as a low-carbon fuel, while only seeing modestly reduced oil consumption over the next two decades. It would also potentially have the skills and expertise to invest in alternative business lines, such as carbon capture and storage, biofuels and renewables requiring significant engineering, such as geothermal power and offshore wind.

Conclusion

Divestment on the grounds of a hard-headed financial analysis of risks and opportunities is entirely justified. However, it is likely that this will lead to only partial divestment, as certain fossil fuel companies could still be well placed to thrive even in reduced demand scenarios. Divestment for any other reason may be justified on ethical grounds. While it can send a signal to policy-makers of investors' frustration at the lack of progress towards tackling climate change, divestment is very unlikely to contribute to the objective of reduced supply or demand of any class of fossil fuels.

Corporate engagement can help to improve the prospects of tackling climate change at the same time as reducing the investment risk and improving the returns of investments in the fossil fuel industry. However, it is important that the engagement approach is tailored to the nature of the fossil fuel company, with a different approach taken to pure play coal companies, diversified mining companies and oil and gas companies.

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