Briefing:

Pension Funds’ engagement with fossil fuel companies

March 2018

Introduction:

Pension funds are under increasing pressure from regulators, politicians, fund members, activists and their own sector to address the growing risks of climate change.

One of the main risks is from their holdings in fossil fuel exploration and production companies[i] such as BP and Shell. These companies are risky in two main ways:

- Their actions are fuelling faster climate change. Their business models are based upon a 3 degree plus world – even at 2 degrees the impacts of this would be severe on all sectors of the global economy[ii], damaging pension returns.
- Via the Paris Climate Agreement, governments intend to act to keep warming “well below 2 degrees” and aim to keep warming to 1.5 degrees; this transition has started and is accelerating. To do so the vast majority of the world’s fossil fuel reserves must remain unburned[iii]. Fossil fuel companies’ oil, coal and gas “assets” will become increasingly stranded[iv] as governments and industries take greater action, and as new technologies such as renewables and electric vehicles lower demand for fossil fuels.

Divestment is a moral and financial response to these risks. It increases the societal pressure on fossil fuel companies to change course, and on political actors to curb the industry’s influence and legislate against their activities. And it protects pension funds from risks that fossil fuel companies’ valuations will fall rapidly.

Consequently, over 800 institutions worldwide, with assets worth over $6 trillion[v], have taken actions to divest from fossil fuel companies, as one part of a climate change strategy. These institutions include New York City and the Rockefeller Brothers Fund, and some UK Local Government Pension Funds (LGPFs).

However many LGPFs are currently saying that they will not divest, and that they prefer to use their position as shareholders to engage with and attempt to influence fossil fuel companies instead.

Upholding the goals of the Paris Climate Agreement requires a net zero-emissions world by 2050[vi]. It requires no new fossil fuel exploration capital expenditure[vii] and a managed decline in production.

But current engagement strategies are focussed on inadequate goals, tend to have no deadlines, and have no clear escalation strategies.

This briefing addresses five main arguments these pension funds use in favour of engagement with fossil fuel companies, rather than divestment, and suggests how people could respond to them.

Five arguments used by funds:

- "Engagement is effective at achieving change"
- "If we divest we will lose power to engage with the relevant companies"
- "We work with fossil fuel companies to increase their positive investments"
- "It's financially risky to divest. We agree that these companies will devalue in future, but not now; we will have time to sell our shares later"
- "We need the money we get from Shell's annual dividend"

Questions to ask pension funds:

Engagement goals:

- *What are the current goals of your engagement with BP and Shell and other fossil fuel companies? What assessment have you made of these companies' progress towards those goals? What is your planned response if these goals are not met?*
- *What climate shareholder resolutions are you supporting? Have you assessed whether these motions if passed would constitute a Paris-compliant strategy from the company in question?*
- *We believe that a Paris-compliant strategy for a fossil fuel company would be to commit to no new fossil fuel capital expenditure by end 2019, a managed decline in production, and to reduce overall GHG footprint to zero by 2050 (scope 1,2,3), with compatible interim milestones for 2025, 2030 and 2040. Will you commit to strengthening your engagement strategy in line with these goals and deadlines, and divest if companies do not set these goals?*

Shifting engagement focus:

- *Has the fund conducted analysis of where it can most effectively use its limited capacity for engagement on climate change issues?*
- *Will the fund commit to setting a rapid "end-game" situation for its engagement with fossil fuel companies, and if these companies do not respond, divest and redirect its engagement resources into engaging with Government and companies in automotive, electricity and heavy energy-using sectors?*

Managing risks:

- *Is engagement being pursued by the fund as a risk-reduction strategy? If so, what specific measures are you asking for, what timeframes are you giving companies to have implemented them, and what will you do if they do not act?*
- *Are you in breach of your fiduciary duties if you hold fossil fuels stock knowing the financial risks?*

- *What advice have you sought on climate risks, and when? Do your mandates and contracts with advisors reflect the necessity to consider climate risks, and how often are you updating this advice?*
- *If you state that there are financial risks from divesting fossil fuel stocks, will you publish your analysis of what these risks are?*
- *Will the fund produce and implement an analysis of how it could meet its obligations without investments in risky fossil fuels?*
- *Has the fund assessed whether the fossil fuel majors' demand forecasts for future fossil fuel demand are accurate? What is the fund's view on these companies' consistent under-forecasting over the last decade of renewable energy growth?*
- *What is the fund's response to the March 2018 Carbon Tracker report*[viii] *that trillions of dollars of fossil fuel capital expenditure are at risk if the world moves onto a <2 degree trajectory, compared to the 3+ degree trajectory that Shell and BP use as their central planning scenario?*
- *We support efforts to increase the percentage of cleaner investments; we consider this to be an essential element of a comprehensive strategy to protect funds from climate change risks. Will the fund commit to producing an overarching climate change strategy for the fund, covering all risks?*

In detail: five arguments for engagement used by funds - with responses and questions to ask funds:

1 "Engagement is effective at achieving change"[ix]

Main responses:

- **Engagement can work on non-core areas of a company's operations, but it is not successful with changing the core business model of companies, which is what is needed here.**
- **Many years of engagement with companies like Shell and BP has had very limited success – not leading to commitments from companies to alter their business model in line with the Paris Agreement**
- **Current engagement strategies with fossil fuel companies being pursued by LPGS funds and their proxies do not have clear goals, deadlines or escalation strategies that align with the Paris Agreement**

Engagement may be an effective strategy to pursue with companies where it is not the core business model of the company which is at stake. Engagement has had major successes – such as ShareAction's campaign persuading companies to pay a Living Wage[x].

But it has not proven successful in trying to get fossil fuel companies to change their core business model. After decades of attempts at AGMs, the limited successes achieved have been around monitoring and reporting.

Fleetingly rebranding themselves "*Beyond Petroleum"* back in 2000, BP have deprioritised their renewable businesses in recent years in favour of new investment in deep sea and arctic drilling, highly-polluting tar sands developments, and fracking.

ShareAction reported in 2017 that "*Shell's strategic priorities and capital allocation decisions have remained heavily tilted towards hydrocarbons*", and "*Shell's current business model and base case for planning is consistent with 3-5^{0}C + of global warming, an outcome which is unacceptable and highly risky for many of Shell's investors. Furthermore the company confirms that it has '*no immediate plans to move to a net-zero portfolio over our investment horizon of 10-20 years'"[xi]. Shell have since set themselves a greenhouse gas intensity target for 2050[xii], limiting the emissions they create per unit of energy consumed, but this still explicitly allows them to increase overall greenhouse gas emissions[xiii].

ShareAction's 2017 report on BP similarly concludes that their base case is consistent with 3-5^{0}C + warming[xiv].

Throughout 2017 and 2018 both BP and Shell[xv] have been aggressively pursuing many new oil projects globally.

Total and Statoil are often perceived to be better on climate change than BP and Shell, however:

- Total's chief executive said about its increased renewables investments: "we w*ill remain first and foremost an oil and gas company"* in the long term, with 20% of assets low-carbon by 2035.[xvi]
- Statoil published a climate strategy in 2016 that even by 2030, over 80% of its new investments would still be in fossil fuels[xvii].

Global investment managers Schroders have published a dashboard of global progress on climate change, across 12 sectors. Oil investment and production are by far the worst performing sectors – their ongoing actions are compatible with 4 and 8 degrees warming respectively[xviii]. This would cause immense damage to the economy as well as people and nature - in December 2017 global insurers AXA said that a 4 degree world is "uninsurable"[xix].

This is a rogue sector. Shareholder engagement is not working to rein it in; a new strategy is needed.

Even if engagement could deliver with them, the organisations pursuing engagement are not pushing for changes which would make fossil fuel companies sustainable.

Upholding the goals of the Paris Climate Agreement requires a net zero-emissions world by 2050[xx]. It requires no new fossil fuel exploration capital expenditure[xxi] and a managed decline in production. But current engagement strategies are focussed on inadequate goals, tend to have no deadlines, and have no clear escalation strategies.

The upcoming 2018 AGM season as yet sees no shareholder resolutions on climate aimed at BP. The 2018 AGM resolution aimed at Shell is weaker than the one submitted in 2017, which garnered just 6% of investor support, and it actively allows Shell's climate emissions to increase[xxii].

Time has run out for engagement with fossil fuel companies.

Questions for funds:

- *What are the current goals of your engagement with BP and Shell and other fossil fuel companies? What assessment have you made of these companies' progress towards those goals? What is your planned response if these goals are not met?*
- *What climate shareholder resolutions are you supporting? Have you assessed whether these motions if passed would constitute a Paris-compliant strategy from the company in question?*
- *We believe that a Paris-compliant strategy for a fossil-fuel company would be to commit to no new fossil fuel capital expenditure by end 2019, a managed decline in production, and to reduce overall GHG footprint to zero by 2050 (scope 1,2,3), with compatible interim milestones for 2025, 2030 and 2040. Will you commit to strengthening your engagement strategy in line with these goals and deadlines, and divest if companies do not set these goals?*

2 "If we divest we will lose power to engage with the relevant companies"[xxiii]

Main responses:

- **UK pension funds should refocus their engagement efforts on areas where there is a potential for meaningful progress**

Pension funds have a responsibility to beneficiaries to be leaders in preventing climate change.

But even the biggest pension funds have limited capacity for engagement, and only a fraction of that will be focussed on climate change.

This is not an argument against engagement in general, **but a specific argument against continued engagement with fossil fuel exploration and production corporations**.

LGPF engagement activity on climate change should be focussed on other companies, where meaningful progress might be possible, and on the Government.

They should prioritise working with high-carbon firms in sectors where there are clear, credible low-carbon business model alternatives, for example, electric vehicles and renewable power for the automotive and power utility sectors. Ensuring those firms move more quickly has a double win of lowering physical risks, and lowering transition risks.

BMO Global Asset Management's "Responsible Funds"[xxiv] have adopted such an approach. They combine divestment with engagement: they have divested from fossil fuel companies, continue engagement with them through their ongoing membership of groups such as the Institutional Investors Group on Climate Change (IIGCC) and the Carbon Disclosure Project (CDP), and also engage on climate change with other sectors such as energy utilities and transportation. IIGCC and CDP will have more weight with fossil fuel companies if these companies see that IIGCC and CDP members are starting to divest: if fossil fuel companies don't make meaningful progress, more will follow.

The biggest long-term risks to pension funds finances are the systemic risks that come from escalating climate change impacts, and risks to the global economy which filter down to all parts of a pension fund portfolio. The LAPFF's November 2017 report[xxv] cites $2.5 trillion global financial assets at risk. It is stronger national, governmental policies which are required most. Pension funds' limited engagement activities should prioritise advocacy with national policy makers to put in place stronger mitigation policies to reduce these risks. This is a further argument to move away from engaging with fossil fuel production corporations such as Shell.

Questions for funds:

- *Has the fund conducted analysis of where it can most effectively use its limited capacity for engagement on climate change issues?*
- *Will the fund commit to setting a rapid "end-game" situation for its engagement with fossil fuel companies, and if these companies do not respond, divest and redirect its engagement resources into engaging with Government and companies in automotive, electricity and heavy energy-using sectors?*

3) "We work with fossil fuel companies to increase their positive investments"[xxvi]

Main response:

- **Clean energy projects are a tiny proportion of Shell, BP and other fossil fuel companies' capital expenditure**

Yes, some oil companies are increasing their cleaner energy investments, but it is clear that this is marginal – eg Shell's predicted to be $1-2 billion out of $25-30 billion in 2018-2020 [xxvii], and BP's $200million solar investment in November 2017 is stacked up against 7 major new oil and gas projects in 2017, delivering 800,000 barrels a day of new production by 2020 – which would emit 125 million tonnes of carbon dioxide a year[xxviii]. It is encouraging to see some pension funds supporting cleaner technologies – but this investment is not limited to projects run by fossil fuel companies, and it is also not an alternative to reducing exposure to fossil fuel exploration companies.

Questions for funds:

- *We support efforts to increase the percentage of cleaner investments; we consider this to be an essential element of a comprehensive strategy to protect funds from climate change risks. Will the fund commit to producing an overarching climate change strategy for the fund, covering all risks?*

4) "We need the money we get from Shell's annual dividend"[xxix]

Main response: There are plenty of alternatives to dividends from fossil fuel companies.

"We need the money" is not so much an argument for engagement, but an argument why funds don't want to sell their holdings. Companies like BP and Shell have paid a good dividend over the years. However, past performance is not a guarantee of future returns. Some oil companies have been maintaining their dividend through increasing debt[xxx], which is highly unsustainable. And there are many alternatives for pension funds – a share growth strategy; other dividends, other asset classes. West Yorkshire Pension Fund (WYPF) require £140 million of net income a year, from assets of £13.6 billion – that's a required return of just 1% a year. Property gave them 5.6% return in 2016-2017. This shows that the dividend from fossil fuels is far from essential to the running of the fund. Funds may argue that they have a long-term funding gap – however here the issue is ensuring long-term growth in the value of assets, for which the bigger concern is share drops in asset classes where they are highly exposed, such as oil and gas.

Questions for funds:

- *Will the fund produce and implement an analysis of how it could meet its short-term financial obligations without investments in risky fossil fuels?*

5) "It is financially risky to divest[xxxi]. We agree that these companies will devalue in future, but not now; we will have time to sell our shares later"[xxxii]

Main responses:

- **There is no evidence that it is financially risky to divest. Other funds have divested; fossil-free investments are performing as well or better[xxxiii].**
- **In contrast, it is financially risky to hold on to fossil fuel firms who are at risk of stranded assets**
- **If there are materially financial risks of holding stock in a company, it is likely a breach of fiduciary duty to hold onto that stock to try to manage those risks through investor engagement.**
- **Pension funds have been caught out before with sudden devaluations. It is very risky to rely on fossil fuel industry data to justify the claim that change will be slow in this sector.**

Funds have not set out evidence that there are financial risks from divesting. The reality is that the opposite is the case – continuing to hold stocks in the short-term in companies, whose actions they know will damage the fund in the long-term, goes against funds' long-term mandate.

There are increasing risks to pension funds from continuing to hold fossil fuel corporation stocks because they may be overvalued, and subject to sudden drops in valuation. These "transition" risks have been highlighted repeatedly, for example by the Governor of the Bank of England[xxxiv]. They include the potential for fossil fuel companies' assets (such as oil and gas reserves) to become stranded – the "unburnable carbon" argument.

Some asset owners believe that they will be able to see any possible future devaluations coming in advance , and therefore don't need to act now. The experience of the very rapid devaluations in the coal sector in 2015, and the major losses to many pension funds, suggest that this is a highly risky assumption.

Some pension funds have argued that "*the world will continue to use oil for a long time, we will have time to adjust*". However it does not take a great drop in oil demand to see a large drop in oil prices. The examples of Kodak bankruptcy due to its slow reaction to digital photography innovation, and the financial crash in 2008 also show that change can happen extremely rapidly. For example, if it takes 7 years for a new technology to go from 1 to 10% market share, the same rate of expansion will see 100% market share within the next 7 years. As Chris Goodall at Carbon Commentary sets out, an old technology may still have 90% market share, and still be growing in absolute terms, and appear to be healthy, but in reality it is on its way out. By the time a new player gets to 10%, it is already too late for incumbents to change business model[xxxv].

There is also growing evidence that fossil fuel corporations are seriously underestimating the scale and speed of change in the global energy sector. They have repeatedly underestimated the speed of solar and wind growth[xxxvi]. Their estimates of the level of growth of electric vehicles, and its consequent impact on global oil demand, look like gross underestimates compared with analysis from more independent analysts, or other sectors, such as the car makers themselves[xxxvii].

In July 2016, the Local Authority Pension Fund Forum and Carbon Tracker wrote that shareholders needed to engage with oil and gas corporations to be able to gauge the risk profile of their investments. They concluded that "*There is a financial argument that those that can't reassure investors could be considered as divestment candidates*"[xxxviii].

We are now almost two years on – increasingly, engagement as a risk-management strategy looks highly suspect. If a fund believes that such a corporation poses growing financial risks, why is the strategy not to reduce exposure to that stock, rather than continue holding it in the hope that engagement activities will cause the company to change its strategy?

Questions for funds:

- *Is engagement being pursued by the fund as a risk-reduction strategy? If so, what specific measures are you asking for, what timeframes are you giving companies to have implemented them, and what will you do if they do not act?*
- *Are you in breach of your fiduciary duties if you hold fossil fuels stock knowing the financial risks?*
- *What advice have you sought on climate risks, and when? Do your mandates and contracts with advisors reflect the necessity to consider climate risks, and how often are you updating this advice?*

- *If you state that there are financial risks from divesting fossil fuel stocks, will you publish your analysis of what these risks are?*
- *Has the fund assessed whether the fossil fuel majors' demand forecasts for future fossil fuel demand are accurate? What is the fund's view on these companies' consistent under-forecasting over the last decade of renewable energy growth?*
- *What is the fund's response to the March 2018 Carbon Tracker report[xxxix] that trillions of dollars of fossil fuel capital expenditure are at risk if the world moves onto a <2 degree trajectory, compared to the 3+ degree trajectory that Shell and BP use as their central planning scenario .*

Conclusion:

Former deputy comptroller of New York State Tom Sanzillo wrote in the Financial Times on 8th March 2018 that:

"*The shareholder engagement process increasingly looks like a cynical exercise through which shareholders and fossil fuel companies talk instead of act, the urgency of climate change is denied and real questions of fossil fuel profitability are ignored.*

But there is an alternative. Divestment is increasing in popularity both in boardrooms and society, not just because it is the clear ethical choice, but because it is financially smart and consistent with fiduciary duty in an era of growing climate risks.

The time to reason with the oil companies has passed."[xl]

Local authority pensions should divest their holdings in fossil fuel exploration and production companies, for financial and moral reasons. Engagement should be refocussed on fossil fuel consuming companies and governments. For pension funds who will not yet countenance refocussing their engagement strategies away from the likes of BP and Shell, activists should ask what the goals and deadlines of such strategies are, how they will strengthen them to ensure they are Paris-compliant, how the pension funds believe their current strategy adequately protects them from growing risks, and when the funds will call time on this engagement if these goals and deadlines are not met.

Funds should not risk hardworking pension-holders money trying to engage companies which no sign of acting, who are being sued for billions of dollars by local authorities in the USA, and whose investors are all watching one another as they wait to sell.

Investor engagement is a high-risk strategy better off played by those who can afford to lose significant sums. It shouldn't be public money that needlessly carries the financial and legal risk.

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