Comments on the report to Bradford Overview and Scrutiny Committee: "West Yorkshire Pension Fund Divestment from the Fossil Fuel Industry"[i]

From West Yorkshire Divestment Campaigners, Oct 17th 2016

Overview

We welcome the Council's consideration of the financial risks to West Yorkshire Pension Fund (WYPF) from continued investment in fossil fuel corporations, and the ongoing efforts of WYPF to engage companies to change their business practices to be more in line with climate change goals.

However, we believe that the report does not fully assess or address the financial risks associated with continued fossil fuel investment. **We believe the recommended engagement-only approach carries with it overly-large financial risks to the fund.** We believe that a more risk-averse approach is necessary, **and suggest three additions to the engagement-only recommendation**, in order to reduce the financial risks to the fund and its members to more acceptable levels:

- **Partial divestment of coal, oil and gas stocks, to reduce risk.** "Stranded assets" are extremely likely in a world which takes robust action on climate change, which now seems far more likely given the ratification of the Paris Climate Agreement. Impax Asset Management say that "*there are strong indications that today's prices of energy stocks do not account for the risk*" of Government intervention to reduce fossil fuel pollution. We know that change can happen extremely rapidly, as seen by the almost total loss of value in coal stocks since 2011. We suggest that WYPF should divest over a three year period from companies involved in exploring for the most risky and polluting energy sources – namely coal mining and tar sands - and announce a partial shift of funds away from oil corporations into low carbon indices (these indices have been shown to outperform the FTSE100[ii]) also implemented over the next three years. **We note that partial divestment is entirely compatible with continued engagement.**

- **Set clear, timetabled engagement goals.** So far engagement is not working at the speed necessary (see page 4). Companies such as BP and Shell still have business models based on major exploration for new fossil fuels reserves, when the Governor of the Bank of England has said that the action needed to keep to a 2 degree goal "*would render the vast majority of [existing] reserves "stranded" – oil, gas and coal that will be literally unburnable*"[iii]. The Paris Agreement has tightened the goal further, to between 1.5 and 2 degrees. **Alongside partial divestment,** WYPF should set **an engagement goal that those companies must publish and implement a change to their business model so it becomes 2 degree compatible, by 2018 –** when the global stock-take of Paris Commitments is due. **If this goal is not met, then the fund would move the remaining fossil fuel stocks into a low-carbon index or other financially-robust alternative**[iv].

- **Conduct a full, independent climate change risk assessment**. We note that the report does not reference the examples of recent reports which advocate a stronger approach to climate change risk assessment, such as Mercer[v] and Impax. The report also does not note that in the last year a number of other local authority pension funds have taken steps to reduce the financial risks of their exposure to fossil fuel investments – namely South Yorkshire Pension Fund, Haringey Pension Fund, Waltham Forest Pension Fund, and the Environment Agency Pension Fund[vi]. We believe that WYPF should join these funds in a leadership role which will reduce risk – we note Impax Asset Management's conclusion that "*In time, it is likely that the market values of all stocks will incorporate carbon risk. However, investors who position themselves ahead of this change should out-perform*"[vii].

Finally, we set out below more detailed comments on the WYPF report, to back-up the above recommendations.

1) Performance of oil sector (Paragraphs 4.3-5.4)

We agree that the oil and gas sector has performed well over the last 30 years. However, what is important in this case is whether they will perform well in future. This reflects the standard investment industry disclaimer: "*Past performance does not guarantee future returns*".

The issue of whether the fossil-fuel sector will do well in future is connected to how the world reacts to the Paris Climate Change Agreement. This commits nations to keeping global warming to well below 2 degrees; to do this would require the large majority of existing proven fossil fuel reserves to stay in the ground[viii]. Fossil fuel corporations such as Shell have a business model based on not only exploiting existing proven reserves, but actively exploring for more. Shell's business model is not compatible with meeting the Paris Climate Change Agreement goals. If WYPF acts on the basis that the Paris Climate Change Agreement goals will be met[ix], then many of Shell's existing assets will diminish in value over time, and become stranded. It is possible that in such a situation there will be an orderly transition, but also it is possible that change will happen very rapidly – such as has been seen for coal company share values, with the file-for-bankruptcy of the world's largest coal company Peabody in April 2016. Can WYPF risk not being able to sell its oil corporation stocks without major loss?

We note too that in the WYPF graphs 5.3 and 5.4 - looking at the last ten years, the oil sector has not performed as well as the all share index. The conclusion that the UK oil sector has outperformed the "FT All Share" index is only accurate by careful selection of the start date at 30 years ago. If 2000, 2005 or 2010 had been chosen, the UK oil sector would have underperformed. In conclusion we disagree with the inference that not holding oil stocks would have damaged the fund, and we disagree that past performance is a good guide to future returns.

2) **Diverse portfolio (Paragraph 5.1)**

There is little evidence-base given for the assertion that even full divestment from fossil fuel corporations would introduce "undue risks" due to lack of balance. Impax's April 2016 report sets out how such balance issues can be managed[x]. The assertion of further risk of successful divestment from fossil fuel corporations leading to divestment on other issues is also not correct: the WYPF report rightly mentions in Section 6.3 that fiduciary duty allows ethical considerations to influence investment decisions only "*so long as that does not risk material financial detriment to the fund*". Only if this latter requirement were met could the fund divest, and if it is met then there is no problem.

3) **Costs of selling shares (Paragraphs 5.5-5.6)**

We agree that there are transaction costs of buying and selling shares. The fact that there are costs is not an argument not to buy and sell shares, otherwise the fund would always have the same portfolio. If there are financial risks to the fund, or holdings in particular companies are of financial concern, then it is understood that it would be the right action to take to sell those shares, rather than hold onto them to avoid transaction costs. The "forced seller" argument of section 5.6 does not apply: divestment campaigners are not calling for an immediate sale of stocks, but a phased-shift out of fossil fuel companies. It is interesting that the report mentions in section 5.6 that it believes that if other funds divest, share prices will fall: if this belief is correct it would be an argument to divest first, not to avoid divestment.

4) **Stranded assets (Paragraph 5.9)**

This section acknowledges the stranded assets argument that most oil reserves cannot be burned, but argues that because most oil reserves are owned by states not "investable" oil companies, the stranded assets arguments do not apply to investable oil companies. It is not clear on what grounds such an argument is based. We recommend that the fund conduct a thorough, independent assessment of stranded asset and other climate change risks.

5) **Engagement vs divestment (Paragraph 5.12-5.15)**

Although we welcome the engagement WYPF have made with the fossil fuel sector, the evidence shows that engagement alone has not worked – Exxon have yet to pass a shareholder resolution on climate change, in over 15 years. Shell and BP have passed resolutions, but these relate to monitoring. These companies still refuse to re-align their business models with a 2 degree world. The results of the 2016 AGM season were particularly disappointing, with analysis that "*Shell downplays the risks that a 1.5 – 2°C outlook poses to its business model and does not provide a clear pathway for strategic alignment with the target set by governments at COP21 in Paris*", and "*BP's reporting on resilience against low-carbon post-2035 scenarios lacks depth, with the company continuing to doubt the likelihood of a 2°C outcome and forecasting a 'base case' of fossil fuel demand consistent with 4 – 6°C warming*." [xi]. It is high-risk to assume that an engagement-only approach will have sufficient traction quickly enough. The WYPF report worries that "simply divesting" would take the pressure off management to respond positively on this issue. There is no evidence presented to support this assertion – the counter argument is that it

would pressure the company to change to prevent further share-selling by other entities concerned about climate change risks. In addition, it is possible to pursue a hybrid engagement-divestment approach, designed to strengthen the engagement aims.
For example, the WYPF could announce a 3 pronged risk management strategy:

- It would divest over a shorter three year period from companies involved in exploring for the most risky and polluting energy sources – namely coal mining and tar sands.
- Announce a partial shift of funds away from oil corporations into low carbon indices (these indices have been shown to outperform the FTSE100) implemented over the next three years
- Announce that it is continuing to engage with oil corporations, and that it will set an engagement goal that those companies must publish and implement a change to their business model so it becomes 2 degree compatible, by 2018 – when the global stock-take of Paris Commitments is due. If this goal is not met, then the fund would move the remaining fossil fuel stocks into a low-carbon index or other financially robust alternative[xii].

On this last bullet we note section 5.14 which says:

"*As part of its engagement through the Local Authority Pension Fund Forum (LAPFF) WYPF continues to seek action from the companies with which it engages. To this end on 21 July the LAPFF and the Carbon Tracker Initiative (CTI) are launched a new report 'Engaging for a Low Carbon Transition' which sets out why a 2°C business model for Oil and Gas companies can be less risky than 'business-as usual'. By putting this report, backed up by professional research, in front of the boards of the major oil companies WYPF expects to achieve real change."*

This LAPFF/CTI report sets out a checklist of questions for engagement around a 2 degree transition, and concludes: "*the answers to such questions should put shareholders in a position to gauge the risk profile of their investment. There is a financial argument that those that can't reassure investors could be considered as divestment candidates*"[our highlighting].

We believe that the WYPF could implement this LAPFF/CTI approach by setting a deadline for this reassurance, as per bullet three above.

Finally, we note that paragraph 5.10 cites an April 2016 Impax Asset Management report as an argument to pursue an engagement-only policy. However, this Impax Report[xiii] explicitly states that it recommends "*a reallocation of 30% the holdings of a typical portfolio in oil and coal producers*" and states that "i*nvestors who wish to engage with management teams of fossil fuel asset owners can still do so if they opt for partial re-allocation*".

REFERENCES:

---

[i] For meeting on 19th October 2016. https://bradford.moderngov.co.uk/ieListDocuments.aspx?CId=139&MId=6522&Ver=4

[ii] For example www.ftse.com/products/indices/ex-fossil-fuels and FTSE Developed ex Fossil Fuel Index Series www.ftse.com/products/downloads/FTSE_stranded_Assets.pdf , and MSCI, December 2013. Responding to the Call for Fossil-fuel Free Portfolios

[iii] Mark Carney, 29th September 2015. Breaking the Tragedy of the Horizon – climate change and financial stability

[iv] Aviva has announced that it is taking such an approach – engagement, but divestment if engagement has not delivered results by a given date.

[v] Mercer www.mercer.com/insights/focus/invest-in-climate-change-study-2015.html.

[vi] Environment Agency, 2015. Policy to address the impacts of climate change. https://www.eapf.org.uk/~/media/document-libraries/eapf2/climate-change/policy-to-address-the-impactsof-climate-change.pdf?la=en . October

[vii] Impax Asset Management, 2016. Carbon risk for investors: Building a "Smart Carbon" portfolio. http://www.impaxam.com/sites/default/files/Smart%20carbon%20WP%20final%20global%20_0.pdf . April

[viii] Mark Carney, 29th September 2015. Breaking the Tragedy of the Horizon – climate change and financial stability. "*Take, for example, the IPCC's estimate of a carbon budget that would likely limit global temperature rises to 2 degrees above pre-industrial levels That budget amounts to between 1/5th and 1/3rd world's proven reserves of oil, gas and coal. If that estimate is even approximately correct it would render the vast majority of reserves "stranded" – oil, gas and coal that will be literally unburnable without expensive carbon capture technology, which itself alters fossil fuel economics*."

[ix] Conversely if WYPF acts on the basis that the goals will not be met, the fund is effectively betting on a future in which all sectors will be heavily damaged by climate impacts, and the fund's financial performance will be far more heavily negatively affected. In reality the WYPF is actively working to the basis that the Paris goals should be met – the fund's engagement policy is trying to shift company behaviour in line with global climate goals.

[x] The report refers to "undue risks against the index" – "undue", "the index" are undefined. Also, it is not solely "the index" balance should be judged against, but the whole fund portfolio, which goes well beyond holdings in equities or indices (eg property, bonds etc etc). Impax suggest that redeploying fossil fuel exploration and production stocks into energy efficiency stocks can "maintain..energy factor exposure", stocks which are typically correlated to retail energy prices, which are likely to rise when carbon prices are imposed.

[xi] Shareaction, 2016. Shell: https://shareaction.org/wp-content/uploads/2016/05/Analysis-ShellClimateReporting2016.pdf;
and BP: https://shareaction.org/wp-content/uploads/2016/04/Ananlysis-BPClimateReporting2016.pdf

[xii] Aviva has announced that it is taking such an approach – engagement, but divestment if engagement has not delivered results by a given date.

[xiii] Impax Asset Management, 2016. Op.cit.