SUSTAINABLE RESOURCE INVESTMENT

SPECIAL BRIEFING | FOSSIL FUEL DIVESTMENT: THE FACTS

This is a special briefing from Sustainable Resource Investment. It reviews the campaign to pressure financial institutions and governments to divest fossil fuel holdings. Despite repeated claims there is a global divestment 'movement' by financial and government institutions, the facts paint a different picture.

KEY POINTS

- **The divestment campaign is fundamentally flawed**
- **Global demand for fossil fuels – including coal – remains high**
- **International commitments on climate will be modest**
- **Divestment imposes significant costs and risks on investors**
- **Campaigning will have no impact on investments – market fundamentals determine returns**
- **Much of the campaign relies on empty gestures and there have been significant rebuffs to the campaign**
- **The moral argument to the campaign relies on a faulty logic**
- **Changes to fiduciary rules have been rebuffed**

The divestment campaign is fundamentally flawed

Since 2012, a global campaign has been running to encourage investment funds to divest from their fossil fuel holdings, particularly coal. This campaign was developed in the US and brought Australia by international campaign groups. Pressure has been exerted on universities, banks, superannuation funds and local governments. It has had token results in Australia.

There are a number of threads to the argument made by divestment campaigners.

The first is that a combination of domestic regulation and technology will somehow stem demand for fossil fuels. The second is that a global agreement on climate change will impose a limit on the supply of fossil fuels, thus 'stranding assets'. Third, divestment from fossil fuel companies is a no-risk, no-cost strategy that will impact fossil fuel companies. Fourth, campaigners are stating that the divestment campaign has gained considerable momentum and a significant percentage of the world's capital markets have divested from fossil fuels. Finally, campaigners have resorted to a 'moral' argument on divestment, stating that continued emissions from fossil fuels pose a moral hazard to future generations. These points are addressed below.

Global demand for fossil fuels – including coal – remains high

Global coal demand has risen dramatically in the past decade. The International Energy Agency (IEA) predicts that the demand for coal is set to break the 9-billion-tonne level by 2019. China and India are often singled out

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as big consumers of coal, but investment in new coal assets is also occurring among a much wider set of countries, including ASEAN. It experts coal demand to continue to increase across and China and non-OECD countries by more than 30 per cent over the next 25 years.

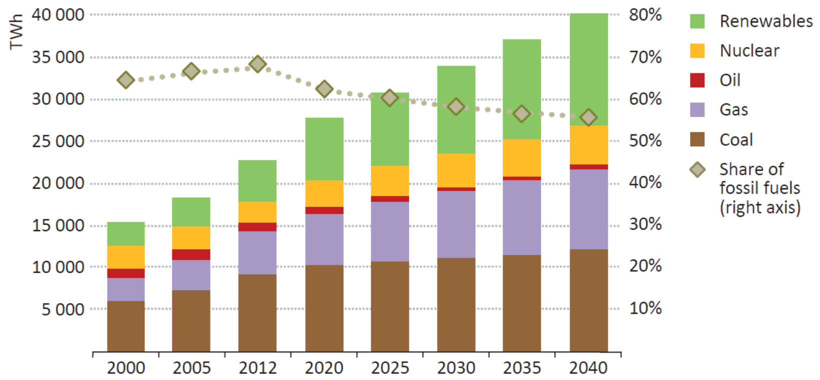

Figure 1. World electricity generation by source, 2000-2040 (IEA)

The World Resources Institute estimates that 1199 new coal plants are planned in 59 countries. The majority of these are in in developing countries such as China, India, Vietnam and Turkey. They are – for the most part – being backed by central governments rather than private interests in order to provide electricity to growing populations and the industrial sector.

It is clear that even if fossil fuel and coal divestments were sizeable, which they are not, they would not fundamentally reduce demand for fossil fuels in developing countries as they do not affect user demand, nor do they affect state financing.

International commitments on climate will be modest

A key component of the divestment campaign has been to imply that the UN climate change negotiations in Paris in December 2015 present a regulatory risk to investments in fossil fuel reserves, fossil fuel-based power generation and any associated infrastructure assets.

An international agreement on strategies to reduce greenhouse gas emissions is likely. However, these commitments will not be legally binding and they will be determined by national interest rather than international policy. Further, developing countries have it made clear their policies to manage emissions will not be at the expense of lower growth.

The most recent UN climate meeting in Germany provided a draft negotiating text, which provided a framework for countries to determine both their own levels of commitment, and the level of legal obligation associated with these commitments.

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Divestment imposes significant costs and risks on investors

Investors seeking to comply with the goals of fossil fuel divestiture potentially incur three key types of costs:

Trading costs. Investors seek the best returns through commingled funds. Commingled fund offer benefits of scale, access to premier investment managers, and broad portfolio diversification. However, investors in comingled funds cannot dictate the guidelines of the fund; they can only choose whether or not to invest under guidelines specified by the fund manager. The 'mechanics' of this 'in-or-out' choice mean that if any institution decided to 'divest', the process would necessitate the 'termination' of existing managers and significant changes to the portfolio far disproportionate to the fossil fuel holdings. In other words, divesting would require the institution to change its entire investment strategy.

Diversification costs. No single piece of financial advice is more widely accepted by academics and investors than portfolio diversification to increase returns and manage risk. Despite some assertions to the contrary, logic and experience indicate that barring investment in a major, integral sector of the global economy would -- especially for a large endowment reliant on sophisticated investment techniques, pooled funds and broad diversification -- comes at a substantial economic cost. It's hard to find managers who beat the market in general—all the more so when you are choosing from a small set of green funds.

Compliance costs. Management fees charged by mutual funds with an environmental focus appear to be, on average, greater than those funds without such a focus. Research by Professor Daniel Fischer (University of Chicago – see chart) indicates that the largest "green" funds have average expenses three times greater than those of the largest mutual funds that invest in energy firms.

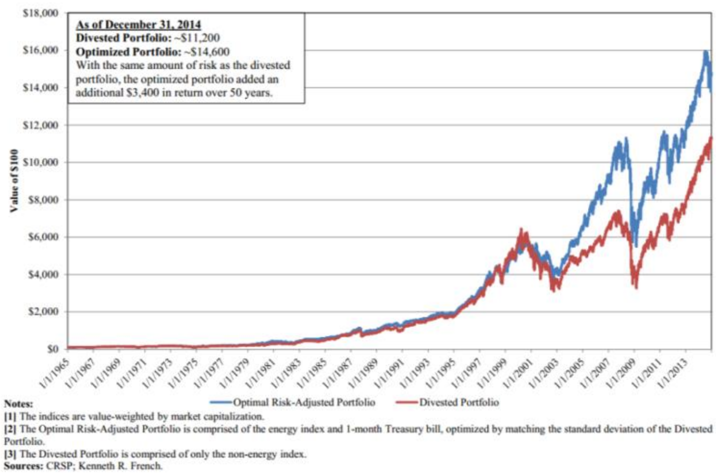

Figure 2: Optimal-Risk Adjusted Portfolio vs. Divested Portfolio (1965-2014) (Fisher)

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While each of the individual costs is meaningful in isolation, the cumulative costs have the potential to substantially impair the future value of investment funds - with virtually no discernible impact on the targeted companies. Fossil fuel divestiture is therefore unlikely to pass a cost-benefit test compared with alternative ways investors who so desire can promote environmental goals.

Examples of expected cost:

- Swarthmore College (largely considered the birthplace of the divestment movement) reported the cost of divesting would be about $200 million across 10 years;
- Pomona College California would face a ten-year impact of US$419 million;
- Harvard, Yale, MIT, Columbia, and NYU could collectively lose more than $195 million every year if they were to divest from fossil-fuel related equities.

Campaigning will have no impact on investments – market fundamentals determine returns

If Stanford's allocation percentages are used as a proxy for all university endowments, then the total financial muscle available to divest without leverage would be $55 billion. Even with all university endowments, $55 billion isn't enough to make a dent in the fossil fuel industry. In 2014, the aggregate market value of all fossil fuel companies approximately $4.9 trillion.

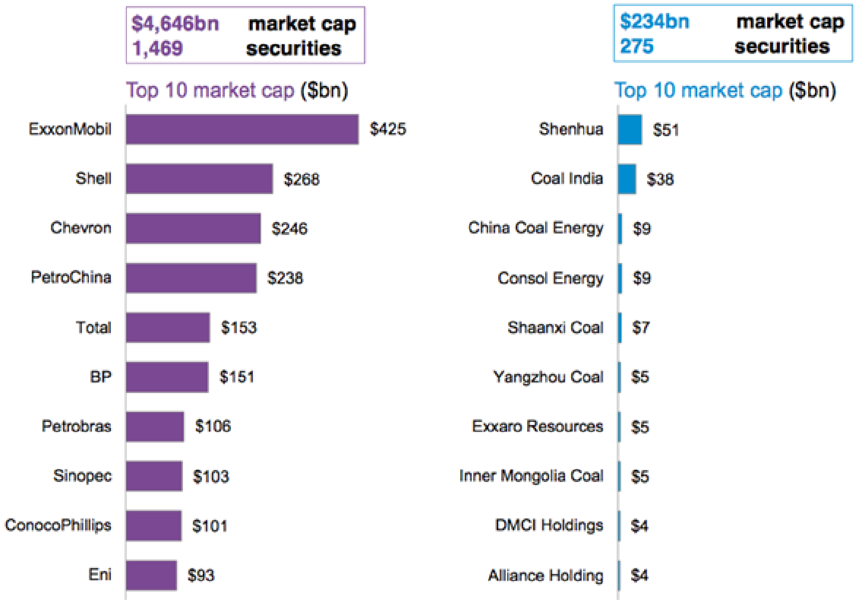

Figure 3: Summary of global oil and coal securities (Bloomberg)

Unless a worldwide quorum of investors including sovereign wealth funds, pension funds, mutual funds, hedge funds, governments, and universities find

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common ethical ground and divest together, the strategy is economically ineffective.

Further, because funds that divest are doing so on moral grounds rather than underlying business fundamentals, independent investors (with different environmental views) would likely purchase the divested shares (at a discount) and stabilize the market price. Stock prices are driven by fundamentals, not the decisions of particular investors to hold or sell.

The recent falls in commodity prices provide a particularly good example in this instance. The global fall in energy commodities has reduced the market value of many fossil fuel producers. Companies with stronger balance sheets and room for productivity gains have managed to weather the storm thus far. There have been some notable investor responses as a result. George Soros has taken a stake in two major US coal companies, Arch and Peabody. The Norwegian Sovereign Wealth Fund, which has been subject to the divestment campaign, has moved a noticeable portion of its investments into fossil fuel electricity generation from fossil fuel production – as generators are in a position to capitalise on low fossil fuel prices.

Much of the campaign relies on empty gestures

Most announcements to divest have been restricted to not increasing investments. Claims of divestment also frequently are made when the portion invested in coal is insubstantial or even non-existent in the funds of medium to large institutions. In other words, the reports of divestment are frequently empty gestures.

A few examples:

- Stanford University's commitment to divest from coal represents a "small fraction" of the $21.4 billion endowment managed by the university according to Lisa Lapin, a Stanford spokeswoman. Months after 'divesting' Stanford bought $26.6 million in oil and gas companies.
- Oxford University committed to avoid direct investments in coal and oil-sands companies in its $2.6 billion endowment. Oxford, in fact, held none.
- Georgetown University said it would purge its $1.5 billion endowment of direct coal holdings. The university later said the amount involved was "insubstantial;"
- The University of Otago in NZ used language that meant the trust did not have to move any of its fossil fuel holdings ;
- The University of California sold off $200 million in endowment and pension fund holdings -- which total around $100 billion -- in coal and oil sands companies, but the system still has some $10 billion of investments in fossil fuels and related industries;
- Not long after the Norwegian sovereign wealth fund made its fossil fuels divestment announcement, critics revealed that the fund had

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actually quietly increased its investments in coal. The report, Still Dirty, Still Dangerous, demonstrated that Norway had disinvested from coal mining to some extent but then increased its investments in fossil fuel-based energy generation, particularly in India and China.

Major investment holdings are not divesting their fossil-fuel holdings. This includes Harvard, Yale, the Bill and Melinda Gates Foundation, the Wellcome Trust.

Frank Wolak, an economics professor who directs Stanford's energy and sustainable development program said that "These efforts are pure window dressing … And, much to my surprise, the student groups are complicit in this deception." He concluded the drivers for this activity were to generate PR for both campaigners and institutions; but to avoid reducing the market value of the fund which would follow from full divestment.

There have been significant rebuffs to the campaign

At a meeting in London between various campaign groups and the Sainsbury Family Charitable Trusts, activists gave a downbeat assessment of what is achievable through a divestment campaign.

The assessment was based on 'basic facts', 'simple arithmetic', and the continued confidence of the industry in the long-term viability of coal, oil and gas.

After the meeting, Mark Campanale of the Carbon Tracker Initiative said, "There are some signs of hope, but we're not seeing the City, as a group, changing its attitudes... And so, by default, they go back to business-as-usual, and Paris will not hit a home run."

Earlier this month, the London Pension Fund Authority (LPFA) rejected divestment despite pressure from campaigners and the London Assembly.

In a letter to its members, the LPFA wrote, '... we do not expect fund managers to specifically invest or divest in certain sectors, but they are expected to take a responsible investment approach instead.

"As a pension fund we have a fiduciary duty to make investments where we see the best return for our employers and members."

The LFPA's stance reflects that of a slew of other pension funds that includes California's two major pension funds systems and the World Bank, which has publically called on others to divest their holdings in fossil fuel.

The U.N. has also rejected divesting fossil fuels from its employee pension fund. As with the World Bank, the U.N.'s refusal to divest runs counter to its public stance on divestiture. The U.N. has endorsed "Global Divestment Day" and last year, U.N. Secretary General Ban Ki-moon urged companies to reduce or ditch fossil fuel investments.

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Vermont, the home state of 350.org founder, Bill McKibben, who was praised at the London meeting for "brilliantly unleashing the naive energy of a generation of students," has rejected fossil fuel divestment; as has his alma mater, Harvard, and the school where he currently teaches, Middlebury College.

The moral argument to the campaign relies on a faulty logic

Campaigners have more recently resorted to 'moral' arguments behind the divestment campaign, and specifically that carbon emissions pose a threat to future generations and sustainable development more broadly. There are two aspects to this that should be considered.

First is that technology is making considerable inroads into reducing emissions.

Coal can be used in a sustainable way through the use of modern technology, including high energy low emissions (HELE) and carbon capture and storage (CCS). HELE coal-fired generation emits 20 to 25 percent less CO_2. Moreover, HELE technology is a step on the pathway to the deployment of CCS technology. CCS technology at the Boundary Dam in Canada reduces the SO_2 emissions from the coal process by 100 per cent; the CO_2 by 90 per cent; and captures 1,000,000 tonnes of CO_2 every year, which is the same as taking 250,000 cars off roads.

Second is that there is still a large percentage of the global population that does not have access to electricity.

India, for example, has around a 20 per cent of its population – approximately 230 million people – living in extreme poverty according to World Bank definitions. Somewhere between 250 million and 300 million people do not have access to electricity. Per capita emissions in India are particularly low because of this poverty rate; the average Indian's greenhouse emissions are about one-tenth of the average US citizen.

Access to a reliable electricity network will provide energy for hospitals, schools, businesses and homes. Primary energy consumption in India is expected to more than double between now and 2040; this will be dominated by coal simply because it is the cheapest and most reliable form of electricity. In this case the 'moral' question posed by divestment campaigners is ambiguous: should impoverished people be denied access to low-cost electricity?

Changes to fiduciary rules have been rebuffed

Part of this moral argument is lobbying for a change to fiduciary rules such that fiduciaries must consider climate-related risks as part of their duty to investors, as well as maximising returns.

A recent speech by the Governor of the Bank of England about how to address the impacts of climate change attracted significant attention. The Bank has been lobbied by activists to alter fiduciary duty to allow financial advisors to

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recommend divestment in investment funds. Much was made of his statement about how the impact of climate change had to be addressed by government authorities. His remarks on fiduciary duty were more telling.

“Some have suggested we ought to accelerate the financing of a low-carbon economy by adjusting the capital regime for banks and insurers. That is flawed. History shows the danger of attempting to use such changes in prudential rules – designed to protect financial stability – for other ends.”

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