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Investors' new climate calculation: Engage or divest?

Robert Kropp | Jan. 20, 2015

Fossil fuel assets may have once seemed like a sure financial bet, but climate risks now undermine their economic value.

The concept of stranded fossil fuel assets, as described in a 2011 analysis by Carbon Tracker, is straightforward: If we are to avoid the worst effects of climate change by limiting global temperature increases to no more than 2°C, then as much as 80% of the reserves already counted as assets by fossil fuel companies will have to stay in the ground.

Setting aside the ethical imperative of ensuring a sustainable environment for future generations, the financial implications of the concept are momentous; that is, as James Cameron, the Chairman of Climate Change Capital, recently said, if "a significant regulatory or public policy change that will alter the market conditions for the use of this commodity" finally emerges.

Cameron was participating in a recent roundtable discussion on stranded assets, convened by Environmental Finance in London. In addition to representatives of sustainable investment organizations, environmental, social, and corporate governance (ESG) analysts and corporate executives participated as well.

James Leaton started the discussion by describing the financial analysis behind the concept. With fossil fuel exploration more and more often focused on controversial and markedly more expensive unconventional methods of extraction, the price per barrel of oil required for at least a 15% rate of return increases. However, with oil prices having dropped to new lows, the likelihood of profitability decreases.

"Some of the pure-play operators in the coal or unconventional oil sectors do not have the options that the diversified mining companies or the oil majors have," Leaton observed. "I also think they are underestimating the pace of development of alternative technologies, and how quickly the costs are coming down."

Cameron, however, observed, "The issue is not about the cost of the alternatives; the issue is about the cost of the transition; it is the infrastructure you have to build to make the alternatives really thrive, given the power of the incumbents."

"The view from companies is that we could be being over-optimistic on what can be done in the short term in terms of transitioning from fossil fuels into alternative energies, even though they accept that there is a need for such a transition," Miguel Santisteve of NASDAQ added. However, "Total, the French oil & gas producer, is now the second-largest producer of solar panels in the world through the acquisition of SunPower back in 2011," he added. "They are therefore getting ready for the transition."

"Regulations are very slow to emerge but companies have to anticipate the shift that will happen at some point," Schroders analyst Solange Le Jeune said. "If regulatory change comes more suddenly than they think, they would be in trouble."

Acknowledging the inevitability of a shift to a low-carbon economy, Tomas Gärdfors of the law firm Norton Rose Fulbright listed several recent European Union regulatory actions designed to accelerate the shift, and said, "European transmission infrastructure is a long-term asset which is well suited to pension funds." The financial returns on investment might be lower than those of equity holdings, at least until stranded fossil fuel assets have the expected impact on portfolios, but the returns will be much more stable as well.

But as Cameron pointed out, the question of who is to finance and operate the new infrastructure of a low-carbon economy is yet to be answered. "Who is going to supply the capital, operate those assets, deliver clean energy infrastructure and avoid stranded assets as a result?" he asked. " Who is going to come across and be both the financier and operator of clean energy infrastructure?"

If that calculation is indeed accurate, then investors would appear to be faced with two alternatives: divest, and move their assets into the renewable energy infrastructure that will replace current power generation; or engage, and somehow persuade fossil fuel companies to finance and operate that new infrastructure.

Addressing the problem of financing a clean energy infrastructure at a recent Environmental Finance event in London, James Cameron, the Chairman of Climate Change Capital, asked, "Who is going to do that work if it is not the European utilities?" Cameron noted that while financial institutions have taken the lead in acquiring clean energy assets, it seems unlikely that they will evolve into companies that will actually operate the infrastructure.

I previously wrote about the discussion, about the risk to investors of stranded assets, in the first part of this series. The roundtable continued as a debate over whether investors should engage or divest. During the second discussion, Cameron said, "I do not believe the answer is going to lie with the incumbents...No, you want solar companies out there that will absolutely cream them in the market."

The issue, host Peter Cripps said, comes down to this: "Is it a question of rebalancing your portfolio, or using your power as an investor in that company, or both?"

"If the company is in the indices, then, from a fiduciary perspective, if we are not mandated to divest on ethical or moral grounds we have to have a really strong conviction that these assets will become stranded," Cathrine de Coninck-Lopez, the sustainable and responsible investment officer at Threadneedle Investments, said. "So engagement is possibly the easier approach."

In the US thus far, the issue of stranded assets has received the most intention through the growing divestment movement, which has spread from college campuses to foundations and religious organizations. On the engagement side, ExxonMobil responded to a shareowner resolution co-filed by As You Sow by agreeing to produce what turned out to be an inadequate report on the risks of stranded assets.

Overall, however, according to Kate Brett of Mercer Investments, very few mainstream institutional investors are yet addressing the issue of stranded assets. At least in part, this may be due to what Cameron described as "the power of the incumbents."

"They dominate our psychology, they make us think there is no future without them, they make us think we will have to wait ten years, 20 years when we cannot," he said. "It is a fantasy, we cannot."

Fortunately for those who believe as Cameron does—that to delay for decades the transition to a low-carbon economy would be disastrous—the analysis provided by CTI in its 2011 report, as well as the series of analyses the organization has produced since then, focus on financial risks. Several of the roundtable participants noted that issues raised by CTI that once were discussed only in private conversations with select analysts have now become public information.

"Some of the companies we have spoken to are saying, 'A year ago we did not have to talk about break-even prices and capex allocation; that was a private debate we had with a few analysts. Now it is a public debate; we have to publish long reports, discuss it in the media or discuss it with shareholders,'" James Leaton of CTI said.

As formerly private information becomes mainstream knowledge, “I do see some people who have just become fund managers and they want to tweak their model with a range of different things, such as social and qualitative indicators,” Schroders analyst Solange Le Jeune said. “I mean that a new generation of analysts and investors is starting to look at valuation models differently.”

“You tend to think that the economy is always going to grow, the market is always right,” Miguel Santisteve of NASDAQ said. “Even though there are so many facts out there telling you otherwise, in terms of human population, arable land, access to water, scarcity of resources. It is obvious and in front of you: we need to change the economic model.”