Environmental activism moves from the streets to the boardroom

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A landmark report released by ExxonMobil Corp. in March 2014 indicated that activist shareholders had struck a nerve in the debate over carbon asset liabilities. It's no longer just environmental activists who are challenging energy companies on their future production plans. Environmentally focused investment houses are flexing their significant muscle on an unprecedented scale, and refocusing part of the climate change debate on financial risk.

Projecting two billion more people on the planet by 2040, ExxonMobil expects to see a "130 per cent larger global economy and about 35 per cent greater demand for energy – which could have more than doubled without gains in efficiency."
ExxonMobil's report was prompted by a letter sent by Massachusetts-based Arjuna Capital last October asking the company to describe its plans to transition to a low-carbon business. Arjuna Capital, which together with its parent company represents $1 billion in assets, sent the letter as part of a larger investor inquiry to 45 large fossil fuel companies. The inquiry was co-ordinated by non-profit sustainability advocacy organization Ceres and the Carbon Tracker Institute (CTI).

As an initial response, ExxonMobil sought to block Arjuna's letter from appearing on its proxy through a no-action request with the Securities Exchange Commission. In March, the SEC ruled in

Arjuna Capital's favor, forcing the energy producer to put the letter in its proxy. However, the investment house withdrew its demand when ExxonMobil agreed that it would file a carbon asset liability report. Two weeks after the SEC ruling, ExxonMobil submitted *Energy and Carbon – Managing the Risks* and then a second report entitled *The Outlook for Energy: A View to 2040.*

"We were happy that Exxon wrote the report," says Natasha Lamb, director of equity research and shareholder engagement at Arjuna Capital. "However, they said they were not preparing for a low-carbon future. They believe it is highly unlikely that policy-makers will place a cap on the carbon we can burn, and that there will continue to be a high demand for oil." The action taken by Arjuna Capital and Exxon's response epitomize the two opposing narratives being advanced by industry and environmentally activist investors: the oil and gas industry assumes a high-while these investors assume a low-carbon future. Pressure from firms like Arjuna Capital, as well as a number of advocacy groups, has moved the debate between industry and environmentalists from the realm of public relations to investor relations.

ExxonMobil exemplifies the consensus view among oil and gas producers that demand for oil will go up – especially in China – due to population growth, economic expansion and the lack of a global strategy limiting carbon to reduce greenhouse gases. Investment in exploration and production is therefore expected to increase.

In its carbon asset liability report, ExxonMobil, lays out the assumptions underlying its approach to the future and its position on carbon asset risk. Projecting two billion more people on the planet by 2040, the company expects to see a "130 per cent larger global economy and about 35 per cent greater demand for energy – which could have more than doubled without gains in efficiency."

The company believes that by 2040, 60 per cent of energy demand will be supplied by oil and natural gas, with natural gas surpassing coal as the second-largest fuel source. It moreover believes electricity demand will grow by 90 per cent and energy-related CO_2 emissions will eventually plateau and then gradually decline. In the company's view, supply shortfall in future base energy demand will be met by unconventional sources such as deepwater, oil sands and tight oil.

On the other side of the debate, a growing number of investment firms (particularly those located in the northeastern U.S.) believe that demand for oil will and must decrease, due to additional regulations aimed at curbing greenhouse gas emissions. They claim that 80 per cent of the oil and gas reserves currently booked by energy companies must stay in the ground in order to limit the inevitable increase in global mean temperatures by 2 degrees celsius, and they are confident that regulation will be put in place to prevent these bubble reserves from being burnt.

The Carbon Tracker Institute released a report on May 8, 2014, indicating that around $1 trillion of planned oil projects are likely to be rendered uneconomic (or in the language of the institute, "stranded") if the world moves toward stricter limits on carbon emissions. The institute, which consults with pension funds, government assets, banks and institutional funds, says that "In contrast to industry outlooks that generally project continued growth in global oil demand through

2040, we find that vigorous action to address climate change is likely to begin reducing oil demand by 2020."

The position of these investment firms and non-profit advocacy organizations stand in sharp contrast to the perspective in ExxonMobil's report, and the debate between the two sides continues to intensify. Consider that groups like the Carbon Tracker Institute, the Institutional Investors Group on Climate Change (IIGCC), and Ceres's Investor Network on Climate Risk represent 100 institutional investors and provides information to investors on climate change risks. These investor organizations are ramping up pressure on oil and gas companies to become more transparent about their how carbon assets may be at risk. For example, the IIGCC with its 80 members from nine countries, and $7.5 trillion in assets, together with Ceres have produced a Global Climate Disclosure Framework for the oil and gas sector.

In a similar vein, the International Energy Association, which represents a broad membership of developed, oil-consuming countries, has written that around two-thirds of fossil fuel reserves cannot be burned if we are to limit carbon dioxide emissions to a level that gives a reasonable chance of restricting global warming to 2 degrees. BP PLC acknowledges that global hydrocarbon reserves exceed a carbon budget for limiting global warming to 2 degrees in its latest sustainability report, but does not state clearly how the company intends to adjust its operational planning to mitigate the risks.

In January 2014, Ceres co-hosted its second Investor Summit on Climate Risk and Energy Solutions, along with the United Nations Foundation and the United Nations Office for Partnerships. More than 500 leaders from financial institutions, governments, energy and technology companies attended to examine how public pension funds, labor funds, investment portfolios and governments can work together to mitigate climate change risks with informed investment decisions.

"The cost per barrel is the crux of our argument," says Logan. "The industry is betting on a future of increasingly high priced oil, and has projects which will only succeed if oil stays high or goes higher." One of the summit speakers was an elected official, Thomas DiNapoli, the comptroller of the state of New York, who oversees the large state employee pension fund. "Over the last seven years, our fund has filed several climate risk shareholder resolutions at 20 of our portfolio companies and we actually achieved agreements with 13 of those companies," DiNapoli told attendees of the summit. His fund has long held stocks in fossil fuel companies but is increasingly putting funds into renewable energy infrastructure and clean technology.

DiNapoli believes that policy action at all levels of government has the potential to make large portions of hydrocarbon reserves stranded assets, threatening to dramatically lessen these companies' valuations and diminish returns to investors.

Andrew Logan, director of the oil and gas program at Ceres, says one key issue in the dueling narratives is the price of oil and the breakeven point for future projects to be profitable. "The cost per barrel is the crux of our argument," says Logan. "The industry is betting on a future of increasingly high-priced oil, and has projects which will only succeed if oil stays high or goes higher."

Meanwhile, Royal Dutch Shell plc, BP and Chevron Corp. have reduced their investment in alternative sources over the past few years, which Logan believes increases their exposure to carbon asset risk.

Logan's certainty about increasing global climate regulation, however, also meets with widespread skepticism. Andrew Leach, an economics professor at the University of Alberta, says there is a timescale problem with valuing reserves. Some investors have 30 to 50 year time horizons. In Canada at least, both provincial and federal governments use three to five year time horizons, and this approach has a bearing on how policy sometimes fits short-term political goals, not long-term investor goals. For this reason, it is unlikely changes in government policy on climate will affect energy companies' reserve figures. Many in the Canadian oil patch believe the same logic applies in other democracies.

For oil and gas industry executives, the heightened carbon bubble debate may seem like the result of environmentalists decamping from the streets and occupying the boardroom. A more accurate assessment would be, however, that it is not the environmentalists themselves that are moving into the boardroom but their worldview.

"The investors are seeing the broad shift in what is happening. We don't care about the volume of reserves," Arjuna Capital's Natasha Lamb says. "We care about value for the shareholders. We would rather [energy companies] spend shareholder capital on alternative energy or as shareholder dividends, but not pouring more capital into funding more oil [development]. Exxon's outlook says that demand is not going to go down. The IEA's 2035 demand curve projects that demand is going down."

The climate change debate has entered a new chapter and has expanded boldly from the sphere of science and ethics into a new realm of questioning: namely, does investing in oil and gas exploration and production make financial sense as the world enters into a regulatory environment increasingly hostile to carbon? How you choose to answer this question as an investor really depends on whether you believe oil and gas demand will grow or shrink. The energy industry has long assumed investors were firmly sympathetic to its view. Firms like Arjuna Capital are calling that assumption into question.

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