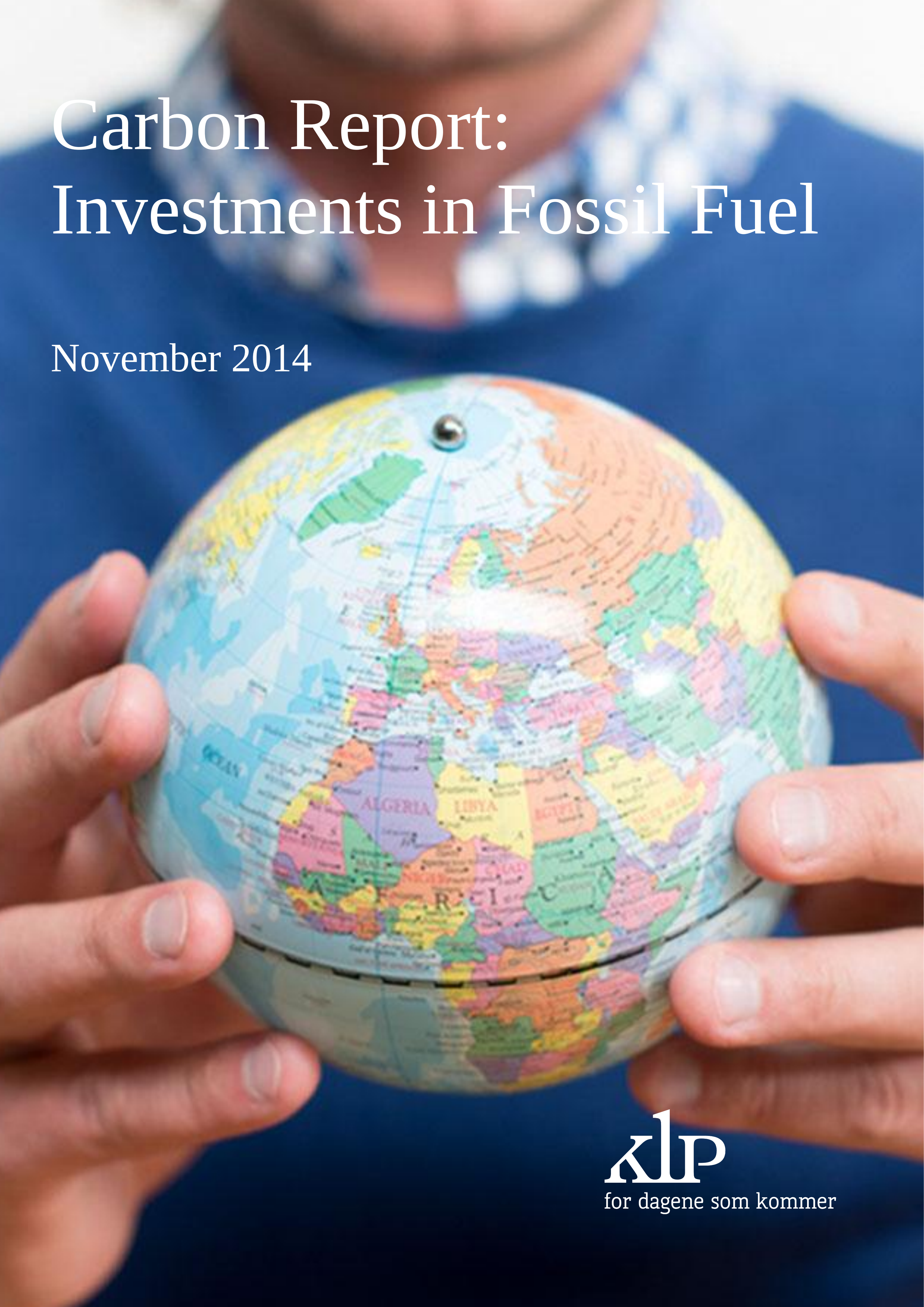
Carbon Report: Investments in Fossil Fuel

November 2014



for dagene som kommer

English Summary of the Norwegian Report

About the report

The consequences of climate change are serious, and there is broad scientific consensus that dramatic cuts in greenhouse gas emissions will be required if the two-degree target is to be achieved, ie that global warming should not exceed 2ºC. As a result of this, investment in fossil fuel companies has become controversial, with campaigns demanding divestment being mounted in Norway and abroad. Supporters of divestment argue that the exclusion of fossil fuel companies is a weapon in the battle against climate change and that investments in such companies represent a financial risk, because a portion of their reserves will have to remain in the ground if the two-degree target is to be achieved.

In Norway, the Ministry of Finance has appointed an expert group tasked with "*assessing whether exclusion of coal and petroleum companies [from the Government Pension Fund Global (GPFG)] is a more effective strategy for addressing climate issues and contributing to change in the time ahead than the exercise of shareholder power and influence*". In a letter dated 4 March 2014, the mayor of Eid, a local authority customer, asked KLP to consider withdrawing municipal pension funds from coal, oil and gas companies – if it could be achieved without lowering the requirements with respect to risk and return on investment. His views are probably representative of a fairly large number of politicians in local government.

Based on the letter to KLP from its customer, the Norwegian Storting's decision to evaluate the same move with respect to the GPFG, and the general climate of debate about the matter, KLP decided to perform its own assessment of the issue.

KLP uses the exercise of ownership rights, exclusions and investments for sustainable development as tools within its strategy of responsible investment. This analysis has assessed the expediency of various initiatives in response to the issue of climate change, including whether KLP should pull its investments out of coal and/or petroleum companies. The analysis has assessed the effect of the initiatives from various perspectives, ie ethical and social, environmental and financial.

KLP is already active in relation to climate change, as a CDP partner and through the exercise of its power as a shareholder to make companies *report* and *reduce* their emissions. In addition, KLP has invested approximately 19 billion Norwegian Crowns in renewable energy. Green bonds is naturally a part of the investment universe. The question for this assessment is whether KLP should do more. This report 1) assesses the potential effect of divestment from fossil fuel companies, 2) examines other steps KLP can take as part of its effort to protect the climate through its responsible investments strategy, and 3) presents KLP's decisions.

The report's findings in brief

The report finds no support for the "stranded assets" hypothesis, which posits that investments in companies with major fossil fuel reserves represent a greater financial risk than is normal for this type of undertaking. On the contrary, a divestment from all fossil fuel companies would significantly increase KLP's risk, particularly with respect to Norwegian shares. However, depending on the definition applied, divestment from coal companies alone would not represent any significant financial risk for KLP. Coal is deemed to pose the biggest threat to the climate, both in terms of carbon emissions per unit of energy and local pollution in the vicinity of coal-based facilities, even though there are substantial variations between different types of coal, oil and gas. Although the direct environmental impact of divestment from coal companies is expected to be moderate, it could nevertheless be an important contribution by KLP to the realisation of the world's two-degree target.

With regard to the ethical arguments, it is important to be clear about the purpose of divestment. Is it to avoid complicity ("clean hands") or to exert pressure? From a contributory liability perspective, the ethical arguments for pulling out of fossil fuel companies is not as weighty as for divestment from tobacco as a product class. Nor can the arguments be as strongly rooted in international norms as is the case with controversial weapons, even though the IPCC is clear about the necessity of increasing the proportion of the world's future energy supply deriving from renewable sources. Fossil fuel, despite its impact on the environment, is currently a cheap source of energy for major parts of the world's population. In the long term, the consequences of climate change will probably hit the most vulnerable people hardest, but in the short term, a shortage of energy also represents a significant burden on people's lives and health. In comparison, tobacco has no such positive sides. It is therefore difficult to conclude that fossil fuel is a fundamentally unethical product.

If the purpose is to exert pressure, there is no empirical evidence that a divestment would lead to reduced emissions. In terms of influence, the greatest impact that can be expected from divestment from one or more types of fossil fuel companies is to highlight KLP's engagement in the issue of climate change, and create some leeway for politicians and decision-makers. It would also be an important signal to companies about where future sources of revenue should come from.

KLP will achieve greatest environmental impact through investments in sustainable development. Expanding this to include more direct investments in renewable energy projects would be the best contribution it could make. KLP purchases green bonds when the returns and risks associated with such bonds fit in with KLP's portfolio, and the company expects to continue doing so in the future. KLP will always have limited influence and capacity to exercise ownership. On average shareholdings in the various companies are small, and cost-effective investment management does not allow the exercise of shareholder power to any great extent. The work currently being done on the climate through our partnership with CDP must be considered extremely effective when the objective is to influence companies. Nevertheless, bringing increased shareholder pressure to bear on the most carbon-intensive companies will be important, since reducing the emissions of a few companies with large emissions could produce significant environmental benefits.

Decisions

The report finds that the arguments for divestment are weaker than certain divestment campaigns have given to believe. Nevertheless, the global community, environmental movement and public opinion are growing steadily more united in their calls for action. KLP will use the tools it has at its disposal to help the world realise its two-degree target. We hope that will carry some weight in the public debate about the importance of concluding a global climate agreement, and will give politicians and decision-makers some freedom of movement. The expected costs of pulling out of coal companies will represent no significant financial risk for KLP. On this basis it has been decided that:

- *KLP shall exclude coal companies. Here, "coal companies" means coal mining companies and coal-fired power companies which derive a large proportion of their revenues from coal. At the very least, the threshold shall exclude those who derive 50 per cent or more of their revenues from coal-based business activities.*
- *KLP shall earmark an additional NOK 500 million for investment in new renewable energy production capacity.*
- *KLP shall measure and report its portfolios' carbon footprint.*
- *KLP shall exercise its power as a shareholder in carbon-intensive companies.*

Assessment

Divestments

KLP has assessed the potential effect of divestments from companies as part of our climate strategy from three different perspectives.

Firstly, using the "stranded assets" hypothesis KLP has assessed the potential **financial effect** of a divestment from companies that extract fossil fuel. This theory states that companies which have substantial carbon reserves are overpriced because their reserves will have to remain in the ground if the world is to reach the two-degree target. In short, KLP's analysis showed little indication of any such systematic discrepancy in the pricing of these companies in the financial market. On the contrary, there was a high degree of probability of a negative effect on risk and returns, depending on how broadly applicable the divestment criteria were drawn up. The exclusion of companies engaged in the extraction of oil and gas would, in practice, bar KLP from investing in large parts of Norway's business sector, while a divestment from companies engaged primarily in the extraction of coal would involve relatively small changes in KLP's investment portfolio. All this suggests that if divestment were deemed appropriate, it would not be on financial grounds. On the other hand, it cannot be said that divestment from just a few coal and fossil fuel companies would involve any substantial risk of lost returns.

Secondly, KLP has assessed whether it is justifiable to invest in fossil fuel companies from an **ethical perspective**. Here it is important to define the purpose of divestment. The driving consideration behind KLP's present exclusion policy is *contributory liability*. In other words, companies are excluded to prevent KLP contributing to violations of our code of conduct through our investments. The possibility of exclusion can influence companies and, in many cases, acts as an implied "stick" to be wielded if dialogue is unsuccessful. However, KLP excludes companies regardless of whether we expect exclusion to alter their behaviour. In short, KLP for example, does not want to be invested in companies which contribute to gross or systematic human rights violations, or which cause serious environmental damage.

KLP has previously undertaken one exclusion on the basis of a company's carbon emissions, under the criterion covering companies which cause serious environmental damage. However, this criterion has proved difficult to operationalise because the causal relationship between an individual company's actions and changes in the climate involves processes that are considerably more complex than, for example, direct pollution of a nearby water source. In such cases it may be possible to achieve a "softening up" of the causality requirement by means of a simple rule for what KLP defines as operations which cause serious environmental damage. Nevertheless, the leap from the exclusion of the worst offenders to a recommendation to exclude an entire product class is not deemed justifiable from a contributory liability point of view. For there are no statutory or "soft law" instruments that are specific to the exclusion of fossil fuel companies, nor are there any that support the perception of e.g. coal as a fundamentally unethical product. If one compares fossil fuel to tobacco it is hard to find a positive application for tobacco, while fossil fuel – and coal in particular – is, despite its negative environmental impact, a cheap and major source of energy for the world.

The ethical assessment is thus highly dependent on timescale. In the long term, the world's most vulnerable will be the hardest hit by the negative environmental consequences of fossil fuel. But in the short term, reduced access to energy would have tangibly negative consequences on human life and health in vulnerable areas. If one examines the differences between the various fossil fuel sources it is possible to distinguish between coal, on the one side (with normally the highest emissions per unit of energy, in addition to harmful local pollution) and oil and gas on the other, even though gradations exist within each separate category. The Intergovernmental Panel on Climate Change (IPCC) points out that replacing coal with gas could form an important "bridge" over the next 50 years on the road to a renewable society. Consumption of oil is also reconcilable with the two-degree target, given strict limits on where and how much is extracted. Given the trade-off between the positive aspects of fossil energy and its clearly negative impact on the environment, it is therefore expedient to focus on coal at this juncture. *In other words, we cannot go so far as to say that it is fundamentally unethical to invest in coal, but it is an energy source which, in its present dimensions, does not fit in a world in which the two-degree target is reached.*

The third assessment criteria in this analysis is **the extent to which divestment would influence companies to reduce their emission levels**. Although this argument is bolstered by some rather weak anecdotal evidence deriving from the exclusion of cluster bomb manufacturers, experience from the tobacco industry shows no empirical support for it. It must also be considered that the opportunity to influence actual emission figures is probably greater in relation to *consumers* of fossil fuel than to its *producers*. For example, a company engaged solely in the extraction of coal has limited opportunities to switch to the production of something else, while a power company has greater freedom to alter its energy mix. This suggests that focusing solely on producers can probably be expected to have a fairly limited impact. To ensure that divestment has the desired environmental effect, companies' carbon intensity should also be assessed as part of the divestment strategy. *The conclusion of this part of the analysis is that KLP has modest expectations about the emission reductions it is possible to achieve through divestment from one or more fossil fuel* *sources. Nevertheless, exclusion may be an important move that can give politicians and other decision-makers the leeway they need to take action – and arrive at a global climate agreement.*

Operationalisation
If a divestment criterion is to be established, it should seek to encompass companies that probably have little ability or opportunity to change in a low-carbon society. This means that the bulk of the company's operations and revenues should derive from such a product area. Primarily, this will mean coal extraction and coal-fired power generation. Divestment from other industrial manufacturers which use coal as an input factor is not deemed expedient, since this may be difficult to operationalise using a clear rule, and the companies concerned may change with increasing frequency. In this respect, the exercise of active ownership, particularly through the reporting of emissions to the CDP and dialogue with the largest emitters, would be a more suitable approach.

Even though the coal being extracted and burned produces varying levels of pollution and carbon intensity – with the cleanest coal having a lower carbon intensity than the most polluting oil (eg oil sand) – it may be difficult to take this into account in the operationalisation of a divestment criterion. With limited access to information about companies' coal mix and carbon intensity, this would be a difficult task. It has therefore been decided to define coal as coal, and base a divestment criterion on this product class.

On this basis, it has been decided that:

- *KLP shall exclude coal companies. Here, "coal companies" means coal mining companies and coal-fired power companies which derive a large proportion of their revenues from coal. At the very least, the threshold shall exclude those who derive 50 per cent or more of their revenues from coal-based business activities.*

Active ownership

KLP will always have limited influence and capacity to exercise shareholder rights. On average shareholdings in the various companies are small, and cost-effective investment management does not allow the exercise of shareholder rights to any great extent. The work currently being done on climate change through our partnership with CDP[1] must be considered effective when the objective is to influence companies. In recent years this work has produced significant positive effects, both in Norway and internationally. As recently as 2009 KLP performed its own analysis of KLP Global Index's carbon footprint, compared with MSCI Global Index, the Oslo Stock Exchange's Main Index and the Nordic Index. Behind the analysis at that time was a desire to influence Norwegian companies which had high emission levels but which provided only partial or no disclosure at all.

Such an objective for the exercise of ownership rights remains relevant. Lower emissions from the largest polluters would make an important contribution to reducing the world's carbon footprint and to the achievement of the two-degree target. Such an objective for the exercise of ownership rights may also be combined with the measurement and reporting of the KLP portfolios' carbon footprint. Measuring and reporting the portfolios' carbon footprint is an excellent initiative, but has its weaknesses. Even though many companies have gradually become good at reporting, there is no agreement on standardisation. Furthermore, many companies still do not disclose emission figures. These figures must therefore either be recalculated or, in other cases, approximated on the basis of estimation models. So far, however, this is the best available, and represents a starting point for efforts to further standardise and improve disclosure. On this basis, it is decided that:

- *KLP shall measure and report its portfolios' carbon footprint.*
- *KLP shall exercise its power as a shareholder in carbon-intensive companies.*

Investment in renewable energy and green bonds

The most effective way KLP can contribute to the achievement of the two-degree target is to invest more in renewable energy. This would reduce KLP's overall carbon footprint, contribute to significant environmental benefits and for achieving the 2-degree target. It would have a positive diversification effect on the portfolio,

[1] CDP website. URL: https://www.cdp.net/en-US/Pages/HomePage.aspx

and could potentially provide good returns on investment. This may be done in a variety of ways, but cooperation with Norwegian partners in markets other than the area covered by our partnership with Norfund may be an interesting solution. Increasing our commitment to cooperation with Norfund may also be relevant. The bulk of the growth in demand for energy will come in less developed countries, so it is natural that investments in renewable energy should be aimed at this type of market.

Direct investment in renewable projects carries a higher financial risk, but may potentially also bring higher returns than investments in more mature sectors. Furthermore, these are often long-term investments where the money goes in its entirety to the desired purpose. One alternative could also be to invest in renewable energy funds, if the requirements with respect to risk, returns and costs are acceptable. Another alternative could be to increase exposure to listed renewable energy shares and/or bonds, although here the selection is relatively limited, and the shares – more frequently than tangible projects – will correlate with existing investments and markets. Green bonds, on the other hand, are constructed precisely to meet this kind of demand and objective. In preference to traditional, general bonds, investors wish to earmark their funding contribution. Green bonds enable KLP to highlight the fact that we are financing projects that are important to our stakeholders, without such investments leading to increased risk or lower returns. KLP buys green bonds when the risk and returns on such bonds conform to its portfolio requirements, and expects to continue doing so in the future.

KLP is already a major investor in renewable energy, primarily in Norway. In addition, KLP sees opportunities for increased investment in renewable energy outside of Norway. One way to do this is through partnerships with Norwegian businesses. In any event, KLP will immediately earmark a one-off sum for investment in new renewable energy production capacity. On this basis, it is decided that:

- *KLP shall earmark an additional NOK 500 million for investment in new renewable energy production capacity.*