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Fossil divestment and engagement

By Dr Quintin Rayer | May 2, 2019

Introduction

Many investors are acutely aware of the risks from global warming [1], [2], including sea-level rise, storm surges, droughts, wildfires, extreme heat and extreme weather events [3], [4], [5]. Consequently, many ethical and sustainably-orientated investors have focused on reduction in industrial carbon emissions among other measures to hasten progress to a carbon-neutral economy. Fossil divestment is one approach [6], although some investors argue that engagement with fossil companies is more effective in promoting essential change.

This article outlines divestment and explores what engagement with fossil firms should involve, suggesting limits to the length of time spent talking with companies if there are no meaningful signs of progress.

What is Fossil Divestment?

Fossil divestment involves severing ties with firms that extract fossil fuel reserves, selling or refusing to own stock in fossil extractors and producers, and was backed by the UNFCCC in 2015 [7]. 2012 estimates suggested that to keep global warming below 2°C no more than around 565 gigatons of additional carbon dioxide could be released by mid-century; yet proven underground coal, oil and gas reserves amount to 2,795 gigatons [6]. Far more than the climate can tolerate to stay below 2°C warming. More recent estimates indicate that at

least two-thirds of known fossil fuel reserves must remain unburned [8]. The logic is simple – the vast majority of this carbon needs to stay locked in unused fossil reserves underground.

At the 2018 IPCC meeting in South Korea the world's scientific community re-emphasised the need to keep global warming contained, making it clear that to avoid the worst consequences, it must be kept below 1.5°C above pre-industrial levels [9]. Current warming is currently estimated at 1.074°C [10] and on track for 3.3°C or more by 2100 [11].

Why Not Fossil Divest?

Some investors fear that restricting investment may reduce diversification and impact performance, although many ethical investors disagree (see, e.g. [12], [13], [14], [15]). However, others accept the need to reduce CO2 emissions but feel engagement with fossil extractors and producers is more likely to achieve that goal [16]. They point out that a shareholding is needed to influence a firm, so divestment removes the possibility of company engagement [17]. Critics suggest that engagement is most effective when backed up with a credible threat to divest [18]. These investors have the same goal – a low carbon or carbon-neutral future – but differ whether engagement or divestment is a more effective tool.

Rules of Engagement

Given the climate risks that fossil fuels pose, engagement must be robust. It could lack teeth unless backed by a realistic likelihood of divestment if targets are not met [18]. An end is required to deliberate climate science obstructionism and continued fossil expansion.

The resulting minimum engagement criteria might include:

» Commitment to divest if minimum engagement targets are not met within defined timescales, perhaps two or five years.

» Major oil and gas companies must cease funding trade associations or activities that lobby against climate action [18]. If membership of trade associations is to continue, the companies must ensure those bodies do not work to obstruct climate action.

» Executive remuneration packages and bonuses must no longer be based on fossil production volumes. Ideally, they should be based around increases in renewable energy volumes [18], or emissions reduction. Royal Dutch Shell has recently agreed to set carbon emissions intensity targets, tying them to executive pay [19], although they still permit them to expand fossil production providing renewables are increased more.

» Exploration for new fossil fuel reserves should be stopped with no further capital allocated [17].

Other engagement measures are possible, but the points above would seem a useful starting point.

The second point addresses one of the fossil companies' most perverse actions – to invest in renewable energy and headline 'green' initiatives while still financially supporting global warming deniers, or other activities that obstruct climate action appears deeply hypocritical and cynical.

How this helps Advisers

Ethical and sustainable investors can either divest or ensure their engagement policies are as robust as possible. By taking early action, wealth managers can show leadership and accrue reputation with their clients. Advisers and fund selectors can identify those fund managers taking active steps in this area and guide their clients accordingly. The science is clear, decisive action to prevent dangerous climate change needs to be taken quickly.

Media commentary shows that many sections of the public understand this message, even if the finance sector has been slower to adjust. Clients increasingly wish to invest ethically; the Investment Association reports £16.8 billion assets in the UK ethical funds sector in February 2019, a yearly increase of £1.4 billion [20]. Advisers need to know how to best help clients by selecting the most appropriate ethical funds and accessing the skills of wealth managers who can support them in this crucial area.

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