

Public hearing: investments in coal and petroleum companies

– an investment industry view

We greatly appreciate the on-going ESG investing activities of Norway's Government Pension Fund Global (GPF) and are in general agreement with the recommendations of the expert group regarding the importance of active ownership in addressing the challenge related to fossil fuel companies. We were particularly impressed by the commitment of the expert group to the goal that the Fund should be “a forerunner when it comes to demonstrating how climate change issues can be integrated into the investment strategy”ⁱ and the commitment of the Fund itself to acting where there is good consensus on the scientific research in this area.ⁱⁱ It is in this context, and in response to the invitation for a “broad and open debate”, that we highlight three areas, which we feel the GPF risks failing to meet its stated ambitions.

1. GPF could invest far more in financially rewarding and environmentally beneficial investments.

Although this was not in the mandate given to the expert group, we consider it important to comment, from a financial perspective, on the Fund's exposure to investments aligned with a low carbon development path. The Fund's environmentally focused investments amount to NOK 31.4Bn i.e. 0.57 percent of total assets under management as at end of 2013.ⁱⁱⁱ Leading diversified asset owners that employ ESG strategies and that are being prudent about the risks and opportunities associated with climate change have allocations to investments in adaptation and mitigation well beyond this percentage.^{iv} Whilst not in any way ignoring the performance of equities in pure play renewable energy, there are good reasons – not least the Fund's time horizon – for investing more significantly in the transition to a low-carbon economy. For instance, given the Fund's significant fixed-income allocation of 37.3%,^v there is considerable scope to invest in Climate Bonds^{vi} and certified Green Bonds,^{vii} both of which have the same risk reward characteristics as traditional bonds. Investments in infrastructure present equally appealing opportunities in terms of GPF's risk return profile and ability to capture an “illiquidity premium”^{viii} as other large, long-term investors have done.^{ix} We note with interest that the Ministry has asked its Strategy Council to consider infrastructure^x and we look forward to finding out how the Fund thinks it can best use this asset class to deliver sound returns whilst also supporting a low carbon development path.^{xi}

Another action that GPF could take is to screen companies according to science-based emissions thresholds that comply with the carbon budget. Specifically, if the carbon budget is to be maintained in aggregate, companies across all sectors must restrict CO₂e emissions to their allocated tonnage and align with science-based de-carbonisation pathways. The Center for Sustainable Organizations' [Context-Based Carbon Metric](#) is an example of a tool that enables this level of evaluation. Such screening could be coupled with engagement provided targets, as described in section 2, are clearly set.

Comparable action can be taken at the portfolio level, across all sectors, using low carbon indices, such as those employed by AP4^{xii} and FRR^{xiii}. The market capitalisation weighted products typically in use, which are also widely criticized on pure financial grounds,^{xiv} force portfolio allocations to the fossil fuel sector that are significantly misaligned with the real economy.^{xv} To ensure diversification that more accurately represents the global economy, allocations must be aligned within an asset class or ‘counter-biased’ at the portfolio level.^{xvi xvii} It is worth noting that infrastructure investments, in particular those associated with low carbon development,^{xviii} e.g. clean energy, infrastructure, land use, resource efficiency and innovation, offer large, long-term investors the important collateral benefit of creating investment opportunities at a time when such investors have few good opportunities to gain competitive advantage.^{xix}

Allocating investments in this manner acts as a hedge against the almost inevitable portfolio losses that will be incurred should there be accelerated carbon re-pricing, for example as a result of reactive policy measures

in response to major environmental crises. Such events are typically described as “exogenous” even though many would consider them “predictable surprises”.^{xx} They would result in managers being unable to sell the wide range of high carbon exposures quickly enough to avoid significant losses. It is for this reason that we question the assertion that prevailing market price is necessarily an adequate compensation for investment risk.^{xxi} In this regard, we note that as a result of GPF’s fossil fuel holdings, the Norwegian public has triple exposure to fossil fuel risk in that they are: (1) its primary source of GDP; (2) the basis of the Fund itself; and (3) because three of the Fund’s ten largest equity holdings are oil and gas companies.^{xxii}

2. Exclusion and engagement undertaken by GPF could significantly reduce the effects of climate change.

As one of the largest investors in the world, GPF cannot escape its leadership impact. This being the case, GPF’s actions will either: (a) help to perpetuate the very slow rate of response, namely “business as usual plus,” by most conventional investors^{xxiii} (and even some ESG investors^{xxiv}) to the growing scientific and economic understanding of the risks associated with uncontrolled climate change or (b) spur institutional investors, many of which are reluctant to be a first mover but would follow a leader, to take action that is actually “fit for purpose”, i.e. keeping global average temperature increases to 2 °C.

Corporations will take action to reduce their CO₂e emissions once they notice serious intent on the part of their long-term investor base. GPF could further demonstrate its leadership in this regard by publicly explaining the reasoning behind the 14 recent divestments from coal as well as any future such divestments and under-weightings.^{xxv} Such actions will make it easier for smaller, less well-resourced funds to act which in turn, will deliver value to the Fund for having taken a conviction approach.

Another suitable area for leadership, which could also help to ensure GPF’s ability to accurately evaluate issuers’ ESG performance, would be to support Ceres’ Investor Initiative for Sustainable Exchanges^{xxvi} and the UN’s Sustainable Stock Exchange Initiative.^{xxvii} Working in conjunction with one another, the ultimate goal of these efforts is to mobilise all exchanges to adopt an ESG disclosure requirement.

A more medium-term project would be to devise and publish a “road map” as well as progress updates for how the fund will be de-carbonised over the coming decades.

Finally, and reflecting the expert group’s recommendation that “the Fund’s ownership strategy be enhanced”, the Fund could lead the use of “forceful stewardship”^{xxviii} – instigating and voting on high benefit and low risk shareholder resolutions. Given that many fossil fuel issuers have strong business and personal incentives for delaying an energy transition for as long as possible, anything less than this engagement approach is unlikely to persuade them to develop and execute strategies aligned with a 2 °C warmer world. With other sectors that are more open to meaningful change in core business models, e.g. aviation, the Fund could support constructively disruptive market mechanisms.^{xxix}

3. The GPF is a unique and potentially very powerful tool to advance climate change policy and this is totally consistent with its fundamental purpose.

We see no contradiction between the financial goals of the fund and the objective of averting dangerous climate change. This is especially so given the intergenerational responsibility^{xxx} that was the impetus for the creation of the fund. Harnessing the influence of GPF in the pursuit of policies that are aligned with this intergenerational mission is completely consistent with its financial goals. Our assumption is that the Fund wishes to take a portfolio wide and long-term perspective and not simply consider short-term returns from fossil fuels at the expense of significantly increasing the climate risk to vast bulk of the portfolio.^{xxxi} In short, we assume the Fund aspires to operate as “fiduciary capitalists”.^{xxxii}

Moreover, whether or not other investors do so at the same time, publicly acknowledging scientific findings and investing accordingly signals to companies, markets, and legislators that GPF and other scientifically

informed long-term investors will not compromise their intergenerational principles especially when the consequences of our present path are of such great concern.^{xxxiii} As more funds show leadership with scientifically informed investment professionals taking a confident public role, the collective agency problem acknowledged by the expert group will be addressed, which will help to neutralise a debate that has become unhelpfully ideological^{xxxiv}, a seemingly intentional development.^{xxxv}

As market practitioners and researchers, we fully understand that commercial fund managers face market pressure to deliver short-term performance relative to peers in a way that causes them to discount risks such as climate change. We believe, however, that the nature of GPFG allows it to take a more joined up and longer-term approach to systemic risks like global warming.

Furthermore, we believe the insights so gained will have important knock-on benefits. For example, the results of analyses performed by GPFG to determine which investments are likely to outperform and which investments are most at risk (including possible stranded assets^{xxxvi}) as society moves to a low-carbon economy could be used to help policy-makers to devise legislation that will foster a market environment supportive of the identified winners.

Building on this scenario, by heightening GPFG's level of contact with government agencies (including mainstream financial regulators), and key information intermediaries (including sell side and credit rating analysts, investment consultants and auditors) a more climate-aware policy framework could be devised. That is to say, if climate-aware policies and regulations, which all investors had to adhere to, were implemented, the degree to which commercial fund managers face market pressure to deliver short-term performance and enable the externalisation of environmental costs would be decreased. In turn, this would make it easier for GPFG to do what is best for the citizens of Norway.

An area where GPFG can play a major role alongside other concerned long-term investors, is to urge investee companies to stop lobbying against climate change measures, both directly and via trade associations and think tanks or as Christiana Figueres, Executive Secretary of the UN Framework Convention on Climate Change said, when speaking at the 2014 PRI conference in Canada, corporate lobbying should be "scrubbed".^{xxxvii} Specifically, since corporate political capture is arguably the biggest factor contributing to policy failures we currently experience^{xxxviii}, GPFG could use its ownership status to help insure issuer transparency around lobbying and political contributions. As described by the former head of corporate governance at Norges Bank Investment Management (NBIM) in his personal submission to this consultation.^{xxxix}

"There is a real problem -- indeed, what economists would call a principal-agent problem -- involved in the fact that several such companies continue to lobby hard against the exact sorts of policies that their owners – the principals – truly need and wish for. Not least in the US, we have seen how effective such lobbying has been, and how much the results of such lobbying often have gone against the interests of the principals. Investors, including the GPFG, should challenge companies within their portfolios on this exact issue through their active ownership, and press for more transparency and long-term responsibility vis-à-vis one's principals when it comes to lobbying strategies."

Such disclosures will enhance the ability of GPFG and its asset managers to identify and evaluate issuers' contribution to solutions or conversely, their maintenance of political gridlock, thus building upon the aforementioned ability to accurately evaluate issuers' ESG performance. Such an approach is fully consistent with the expert group's recommendation that the Fund should take a "conduct based approach" to its assessments and use engagement and exclusion in an integrated manner to focus most assertively on companies that are "severely harmful" to the global climate.^{xl} Whilst the expert group focused on physical impact, there is a strong case for arguing that public policy impact is a much bigger problem and that indeed, some of the most harmful companies may not be brown energy producers or heavy energy users.^{xli} We hope

the Council of Ethics, having been charged with implementing this more robust approach, will consider these arguments seriously.^{xlii}

In a similar vein, GPFG could contribute to Norwegians' awareness of the implications climate change has on the value of the investments that will fund their retirement as well as the purchasing power of the income so attained in a climate damaged world. By explaining the reasoning behind reductions in the fund's carbon exposure, public understanding and concern of the issues at play will be increased. Done professionally, such outreach efforts will enhance public support for more proactive corporate, investor, and government action to lead Norway, as well as the international community, to a successful energy transition.

In summary, given GPFG's eternal horizon and intergenerational perspective, the scale of its investment, and the scope of its wider responsibilities across Norwegian society, it has a strong rationale for taking a proactive stance to avoid long-term risks associated with climate change, such as mis-pricings in the market, and an educational approach towards its external communications so as to encourage industry-wide risk mitigation.

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ⁱ Norwegian Government, “Press release from the expert group on the Norwegian Government Pension Fund Global’s investments in coal and petroleum companies”, 8.12.2014 <https://www.regjeringen.no/en/whatsnew/Ministries/fin/press-releases/2014/Report->

ⁱⁱ Norwegian Government, “Report from the expert group on investments in coal and petroleum companies”, 3.12.2014 <https://www.regjeringen.no/en/aktuelt/Report-from-the-Expert-Group-on-investments-in-coal-and-petroleum-companies1/id2342780/>

ⁱⁱⁱ Norges Bank Investment Management, 2013 Government Pension Fund Global Annual Report, 2014 http://www.nbim.no/globalassets/reports/2013/annual-report/annual-report_2013_web.pdf

^{iv} Examples include: California State Teachers Retirement System (CalSTRS), PensionDenmark, Environment Agency Pension Fund, Fonds de Reserve pour les Retraites (FRR) and Universities Superannuation Scheme (USS)

^v Norges Bank Investment Management's website, <http://www.nbim.no/en/investments/>

^{vi} ClimateBonds’ website, <http://www.climatebonds.net/>

^{vii} International Capital Market Association website: <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/>

- ^{viii} Mercer, “Capturing the Illiquidity Premium in Your Investment Portfolio”, 2014
<http://www.mercer.com/insights/point/2014/capturing-illiquidity-premium-in-investment-portfolios.html>
- ^{ix} Inderst, G. and Della Croce, R. “Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada”, OECD Working Papers on Finance, Insurance and Private Pensions, No. 32., 1.7.2013
<http://www.oecd.org/pensions/pensionfundinfrastructureaustraliacanada2013.pdf>
- ^x Government Pension Fund Global website: <https://www.regjeringen.no/en/aktuelt/Evaluation-of-infrastructure-investment-in-the-Government-Pension-Fund-Global/id2342720/>
- ^{xi} OECD website: http://www.oecd-ilibrary.org/environment/mobilising-investment-in-low-carbon-climate-resilient-infrastructure_5k8zm3gxxmnq-en
- ^{xii} Rundel, S. “AP4 Retreats from Carbon,” top1000funds.com, 10.11.2013
<http://www.top1000funds.com/profile/2013/10/11/ap4-retreats-from-carbon/>
- ^{xiii} FRR Press Release, 9.16.2014 <http://www.fondsdereserve.fr/documents/press-release-low-carbon-index.pdf>
- ^{xiv} Thoma, J., Dupre, S., Gorius, A., Coeslier, M., Guyatt, D. “Optimal Diversification and the Energy Transition: Impact of Equity Benchmarks on Portfolio Diversification and Climate Finance” 2° Investing Initiative, 11.2014
- ^{xv} As NBIM is aware, market-cap weighted benchmarks create bias towards conventional valuations of issuers rather than being based on their creation of economic value. In connection with this concept, restricting investments to large cap stocks reduces active managers’ ability to maximize returns. The allocations suggested will address the bias created towards 'investing as usual' in large-cap fossil fuel companies, which have begun to see declining market returns.
<http://www.nbim.no/en/transparency/discussion-notes/2014/benchmark-design-for-an-active-investment-process/>
- ^{xvi} Ibid, Thoma, J.
- ^{xvii} Henderson, H. “Fossilized Asset Allocation Still Mis-Pricing Energy And Risk,” Seeking Alpha, 1.22.2015 <http://seekingalpha.com/article/2840336-fossilized-asset-allocation-still-mis-pricing-energy-and-risk#comment-46898926>
- ^{xviii} Global Commission on the Economy and the Climate, “New Climate Economy Project. Better Growth Better Climate”, 2014
- ^{xix} Rajan, A. “The Alpha behind Alpha: Rebooting the pension business models” Amundi Asset Management/CREATE Research, 2014
- ^{xx} Bazerman M & Watkins M, “Predictable Surprises: The Disasters You Should Have Seen Coming and How to Prevent Them”, Harvard Business School Press, 2008
- ^{xxi} Williams, J. “Norwegian oil fund should divest firms 'harmful' to global climate – report”, Investments and Pension Europe, 3.12.2014, <http://www.ipe.com/news/esg/norwegian-oil-fund-should-divest-firms-harmful-to-global-climate-report/10005429.fullarticle>
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- ^{xxiii} 85% of delegates indicated that they were badly or very badly prepared for the risks associated with global average temperature increases of 4 °C.
Preesman, L. “IPE Awards: Investors ill-prepared for climate change, poll shows”, Investments and Pension Europe, 21.11.2014
<http://www.ipe.com/news/esg/ipe-awards-investors-ill-prepared-for-climate-change-poll-shows/10004882.fullarticle>
- ^{xxiv} For the views of ESG analysts when they answer anonymously on how well the sector is doing, see: https://www.responsible-investor.com/images/uploads/articles/RI_Divestment_Survey_.pdf
- ^{xxv} Milne, R. “Norway oil fund reveals divestments and resolution rejections”, The Financial Times, 5.2.2015
<http://www.ft.com/cms/s/0/cef444fe-ad1a-11e4-bfcf-00144feab7de.html#axzz3QybzPtcX>
- ^{xxvi} Ceres’ website: <http://www.ceres.org/investor-network/incr/sustainable-stock-exchanges/sustainable-stock-exchanges>

xxvii Sustainable Stock Exchange Initiative website: <http://www.sseinitiative.org/sseinvestors/>

xxviii Covington, Howard and Thamotheram, Raj, The Case for Forceful Stewardship (Part 2): Managing Climate Risk (January 19, 2015). Available at SSRN: <http://ssrn.com/abstract=2551485> and <http://dx.doi.org/10.2139/ssrn.2551485>

xxix This market-based initiative seeks to reduce emissions in aviation by proactive use of incentives to reflect the externality associated with emissions.
<http://ensia.com/voices/aviation-is-the-key-to-reducing-climate-emissions/>

xxx Government Pension Fund Global website: <https://www.regjeringen.no/en/topics/the-economy/the-government-pension-fund/id1441/>

xxxi Covington and Thamotheram estimate that a typically diversified fund will have about 8% in fossil fuels and 92% in non fossil fuels.

xxxii John Rogers, the recent President of the CFA Institute, has used the term “fiduciary capitalism” for capitalism in which “long-term-oriented institutional investors shape behaviour in the financial markets and the broader economy” through actions that, “seek to minimise negative externalities and reward positive ones.”

<http://blogs.cfainstitute.org/investor/2014/04/28/a-new-era-of-fiduciary-capitalism-lets-hope-so/>

xxxiii World Bank. 2012. “Turn Down the Heat. Why a 4°C World Must be Avoided.” A report for the World Bank by the Potsdam Institute for Climate Impact Research and Climate Analytics. 2012. Washington, DC: The World Bank.

xxxiv For data showing how the views of Republican and Democrat voters on climate change have diverged over recent decades see: <http://www.environmentmagazine.org/Archives/Back%20Issues/September-October%202008/dunlap-full.html>

xxxv Oreskes N and Conway E. 2012. “Merchants of Doubt: How a Handful of Scientists Obscured the Truth on Issues from Tobacco Smoke to Global Warming”. Bloomsbury Paperbacks.

xxxvi Towers Watson website: <http://www.towerswatson.com/en/Insights/IC-Types/Ad-hoc-Point-of-View/2015/01/Fossil-fuels-Exploring-the-stranded-assets-debate>

xxxvii PRI website: <http://www.unpri.org/whatsnew/investors-take-montreal-carbon-pledge-to-footprint-portfolios/>

xxxviii Lipton, E. “Energy Firms in Secretive Alliance with Attorneys General,” The New York Times, 6.12.2014
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xli For example, Prof Jeffrey Sachs made a robust case against the Wall Street Journal under Rupert Murdoch’s ownership. http://www.huffingtonpost.com/jeffrey-sachs/the-wall-street-journal-p_b_5776558.html A similar case has been made against the Australian, also owned by News Corp, by Prof Robert Manne: <http://www.theguardian.com/commentisfree/2014/jul/16/history-will-condemn-climate-change-denialists>

xlii Martin Skancke, Elroy Dimson, Michael Hoel, Magdalena Kettis, Gro Nystuen and Laura Starks, “Fossil-Fuel Investments in the Norwegian Government Pension Fund Global: Addressing Climate Issues Through Exclusion and Active Ownership, A Report by the Expert Group Appointed by the Norwegian Ministry of Finance, 3.12.2014
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