Testimony Before the Vermont Senate Government Operations Committee Senate Bill 42, Divestment of Public Pension Funds, Plan and Report
By
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March 3, 2023

Senator Hardy thank you for allowing me to testify in support of S 42.

I am currently the Director of Financial Analysis for the Institute for Energy Economics and Financial Analysis (IEEFA.org). We are a global organization of energy and finance professionals working to support the energy transition from fossil fuels. I have been involved with energy and finance issues since 2007 and among other assignments have testified before state agencies and legislatures in Maine, California, Oregon, Washington, Maryland, Massachusetts and New York. My organization has written extensively on the topic of fossil free portfolios and particularly investment and shareholder mechanisms to achieve it.[1]

Prior to my work at IEEFA I spent 17 years in senior management positions in New York State and City finances including oversight of the City and State pension systems. My work included oversight of the State fund and various responsibilities at the City level including supervision of the city pension funds shareholder voting strategies.

Senate Bill S 42 calls for the creation of a plan that ultimately positions Vermont's pension assets to address climate change. The bill sets out a clear process for VPIC to follow: 1) identify the carbon exposure in the portfolio for each asset class; 2) develop a financially prudent plan to lower the amount of carbon risk in the portfolio moving toward a fossil free portfolio, and 3) report along the way to Vermont's legislature and oversight agencies. Like the divestment legislation Maine passed two years ago, S 42 requires that any divestment from fossil fuels be consistent with VPIC's fiduciary duty to make sound investments.

You should be in favor of this bill because: 1) it creates a plan – a roadmap to put it on track to protect Vermont's pension assets against further value loss from the oil and gas industry; 2) it provides time to review, analyze and develop a financially prudent strategy to meet a reasonable seven-year timetable for divestment --- assuming that there will be bumps; 3) it does not preclude the fund from addressing shareholder engagement with companies that have a track record of respect for their shareholders. In fact the bill actually will strengthen Vermont's hand as an active shareholder by giving it back its right to divest!

Practically, the bill is a response by the state legislature because VPIC has concluded that divestment is not a viable strategy. In this testimony, I will respond to the recent submission by the Vermont Pension Investment Commission regarding S 42.

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[1] https://ieefa.org/resources/two-economies-collide-competition-conflict-and-financial-case-fossil-fuel-divestment

The recent submission by VPIC [2] states:

> **Divestment would result in increased costs associated with transaction and management fees, as well as performance losses from the inability to allocate to top-tier private market investment strategies.**

The VPIC statement says that divestment will result in a -0.50% long term loss. Based on what? There is no citation, no explanation or rationale. The statement assumes what it should explain. From this baseless premise it then projects a series of future outcomes that impair Vermont's fiscal and balance actuarial.

The fossil fuel industry has been a poor performer for well over a decade. Absent the price spike from the invasion of Ukraine the industry has generally lagged the SP 500 and scores negatively when MSCI family fossil free funds are compared to All-World indexes. Over the long term since 1980 the oil gas industry once claimed 29% of the SP 500 today it is below 5%.

The industry faces historically unprecedented competitive pressures in the power, transport and petrochemical business. These are the principle offtaker industries from oil and gas producers. Also, the International Energy Agency tells us that there is no need for new oil and gas exploration and production if the world is to meet emissions goals.

The financial status of the coal, oil and gas industry and its outlook is covered extensively in a report issued by my organization.

I offer you more transparent information -- multiple instances where enacted divestment strategies with sufficient experience not result in losses.

Several examples of fossil fuel portfolios that have divested demonstrate that returns are either positive or neutral. A report prepared by BlackRock for the City of New York surveyed a number of funds that have divested. Fees were within existing budgetary ranges.

Recently moving forward with a net zero strategy the California State Teachers Retirement System (CALSTRS) assessed four indexes from the MSCI sustainable investments family of indexes.[3] Those funds – Paris Complaint, Low Carbon, Climate Change, excluding Fossil Fuels and a customized staff generated fund of the top 100 emitters met CALSTRS performance standards and moved the portfolio toward its net zero strategy. CALSTRS staff ultimately recommended to move over $20 billion in equities using one of these funds, confident in the ability of these indexes to absorb substantially larger capital allocations and to meet performance targets.

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[2] VPIC, Climate Change Analysis, January 2023.

[3] See: CalSTRS. Investment Committee Item Number 3a – Open Session. August 31, 2022 and CalSTRS, Item 3a CalSTRS Net Zero Strategy First Year Progress and Planning Update, August 31, 2022

There are many examples on the market these days that reflect different approaches to divestment that are profitable, reliable and growing. Ten to fifteen years ago, Vanguard, BlackRock, Fidelity, JP Morgan and a host of mainstream firms did not offer these products. Today they are quite prevalent, so much so that they are now rated. These funds are now capable of handling institutional clients.

I was surprised at the sweeping nature of the VPIC statement regarding losses because VPIC itself holds the Champlain mid cap index. This fund does not have any fossil fuel companies in the portfolio. According to VPIC's November 2022 quarterly report Champlain's financial returns exceed benchmarks since its inception in 2009 and its fee structure is in line with other funds used by VPIC.

The VPIC statement states that the bill creates an impediment to access top tier private market investments. If this is a reference to private equity I would suggest to you that top tier private market investments are not in fossil fuels. Since 2009, action in the private equity industry has been in healthcare (+14.4% compound annual growth rate or CAGR) and information technology (+13.3% CAGR). McKinsey reports that energy is a last-in-class private equity performer. Since 2009, energy has decreased from 12% of the market to 7% of the private equity market by deal volume. Its negative 1.9% annual growth rate pales against industry leaders.

At best the VPIC review of the document submitted to the legislature is incomplete in its assessment of how a divested fund could perform. It fails to disclose its assumptions. It does not identify or explain contrary information on the market as part of its rationale in opposition to the bill. And it ignores the Champlain index fund. Champlain mid cap is producing benefits for the Vermont system and its retirees. Champlain is fossil free, exceeds investment targets and charges fees within current budgetary constraints. VPIC's earlier 2017 study makes clear that the shift toward sustainable investment while slow is firmly rooted.

The bill puts the fund on a trajectory to capture the value creation from the shift in capital from a fossil fuel economy to a sustainable one. The pace of change seems reasonable. The bill requires frequent reporting to the public and legislature. This adds to the certainty that problems encountered can be identified early and addressed appropriately.

2. The VPIC statement says that divestment is ineffective because it does not result in reduced share value of divested companies and does not reduce emissions.

Divestment is first and foremost an action to protect the value of the pension funds from losses. The divestment action must meet the fiduciary test of serving members interests first. Climate risk is a financial risk. Financial risks require financial actions to mitigate them. By reducing and ultimately eliminating fossil fuels from the portfolio the risk has been eliminated from the portfolio. This is fundamental.

Second, whether or not the single actions of VPIC can reduce the share price of a company is difficult to tell. Stock prices are a market judgement based on the sum total of factors that drive a specific company. Companies like Peabody Energy – the world's leading private coal company -- carries as a material risk to the company the impact of the divestment movement. Moodys[4] and Standard and Poors have both identified the impact of movements on credit assessments. These are formal, third party entities that are publicly and financially accountable for their views. VPIC's use of academic sources that are unaccountable to markets is helpful to clarify academic debate – but in the end fiduciaries and investors must make money. This is not an academic debate.

Third, the CALSTRS example mentioned above provides a very good example of the interactive effects of how capital movement can result in low or no fossil holdings. CALSTRS made its recommendation of where to invest based first on financial standards and then on the portfolio performance of the index in relation to emissions reductions.

Finally, there have been several positive initiatives related to shareholder engagement and fossil fuels. Engagement with fossil fuel companies however is not one of them. It simply does not work. Most notably shareholders went to great lengths to replace three ExxonMobil board members. They were successful but the company's climate policies remain fundamentally unchanged. The company remains wedded to exploration and production of oil and gas. At its most recent earning calls last month CEO made clear that Exxon "leans in when others lean out." One of the most active shareholder funds has been the NYS Common Retirement Fund. In December 2020 the sole trustee of the fund NYS Comptroller Tom DiNapoli announced his intentions to divest due, in large measure to the recalcitrance of many oil and gas companies. The Comptroller led the shareholder engagement movement at ExxonMobil for almost a decade.

The International Association of Insurance Superintendents has made it clear that an engagement policy is undermined if funds publicly state that they will not divest. To the fossil fuel companies involved taking divestment off the table basically means that investors are not resolute in their commitment to climate change. Their shareholder engagement overtures lack credibility.

> "In order to be effective, an engagement strategy with the investee company may include exercising voting rights as a shareholder, sending letters or attending meetings with the management of investee companies, setting up documented and time-bound engagement in actions or shareholder dialogue with specific sustainability objectives, planning escalation measures in case those objectives are not achieved, including reductions of investments or exclusion decisions."

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[4] Moodys, Shifting Environmental Agendas, September 2020. (Proprietary – available upon request)

In 1991 I worked with the New York City Comptroller to file a shareholder resolution with ExxonMobil. ExxonMobil opposed that resolution and has remained steadfast in its contempt for shareholders specifically and external oversight in general. Your engagement strategy will not change that company.

Overall VPIC would do better if it asked consultants and advisors the right question. Here, the right question to an investment professional is this: the State of Vermont is desirous of removing fossil fuels from its investment portfolio. The plan should detail: how this can be achieved while maintaining compliance with investment return targets?

Vermont needs S 42 to direct VPIC toward proper goals, to establish and maintain accountability during a difficult time and most importantly, to protect VPIC from losses in fossil fuel investments.

Thank you for allowing me to address the Committee today. I am available for questions.