

2/11/16 Testimony of Al Boright

State Energy Policy and VPIC

I. THE DUTY TO PURSUE STATE ENERGY GOALS, UNDER VERMONT LAW

A. State energy policy

Under **3 VSA 2291**, titled State Agency Energy Plan, subsection (b) provides:

(b) "It is the **general policy of the state** of Vermont:

(1) to ensure to the greatest extent practicable, that state government can meet its energy needs and reduce greenhouse gas emissions in a manner that is adequate, reliable, secure, and sustainable; ... and that is environmentally sound."

Subsection (c) of that section requires the creation of a state agency plan for state government, and lists the objectives of the plan to include:

"(2) to consider State policies and operations that affect energy use."

B. **3 V.S.A.2291a**

§ 2291a. State agency planning and coordination

State agencies shall engage in a continuing planning process to assure that programs and actions are consistent with the goals established in the State Agency Energy Plan required by section 2291 of this title.

C. Diverging from the statutes for a moment for a brief discussion:

1. Applicability of the section. Representatives of the Treasurer's office most likely will refer you to the Public Service Department if you want to talk about energy planning issues. I expect they'll argue that these provisions apply to state operations, or utility matters, and not to the investment decisions of a retirement board. Certainly, the part of the Comprehensive Energy Plan that addresses the state agency energy plan does focus on the energy impacts of state operations, which is an important part of the entire picture. That may be a reasonable construction of the law. But maybe not. Looking deeper, one might notice that the provision is located in Title 3, the title that contains general government provisions like the APA, and not in Title 30, that establishes the role of the Public Service Department.

2. The plain meaning rule. And then, there's the old “plain meaning rule”, which Judge Wikipedia indicates is when a court determines that a statute means exactly what it says on its face, unless the result would be cruel or absurd. I don't have experience as a litigator, but as a law clerk at our Supreme Court, I learned that there is always a chance a court will construe a statute to mean exactly what it says. And if it did in this instance, what is the onerous duty involved here that the treasurer's office might want to avoid? To review and adjust your programs and actions so as to be consistent with the state's overriding energy and greenhouse gas reduction goals.

Absurd? Would it be absurd to require trustees of retirement funds to invest in a manner most likely to retain the habitability of the planet? That proposition is not a slam dunk. Particularly, in this case, where there is an expressed intent to “consider policies that affect energy use,” and where the overall goals address carbon-related performance by the society as a whole, and not just government operations. Contrary to the bias of myopic, ultra conservative financial advisers, these investment decisions do not play out in an isolated, finance-focused universe, with its own indestructible ecosystem, that is somehow exempt from climate change. In fact, this fund's continued investment in coal companies may allow a coal company to stay in business longer, thereby slowing the necessary demise of the industry. Is there a compelling argument to allow fund managers the unfettered and unquestioned ability to foster and be a collaborator in conduct that is inconsistent with the planet remaining habitable? I haven't heard it.

Not applicable to me? Perhaps, a representative of the retirement board might argue, “This couldn't possibly be intended to apply to us. That would be crazy.” That what some of my friends have always thought about the pot prohibition.

3. Legislative history. But it is an interesting legal question: do obligations to pursue these state goals carry over into retirement fund decisions by trustees? What is the legislative history likely to show us about legislative intent? Although I, most likely, did all the drafting on these energy planning sections, I can't remember this specific question coming up. But if anybody that wants to research the legislative transcripts on this, I'd bet that they will not find Curt McCormack, or David Deen, or whichever other legislators that were most deeply involved in

this at the time, certainly from the Natural Resources committees, saying: “let's make sure we draft it so as to be sure to preserve the power of a retirement board to act contrary to these goals by investing in coal companies or in oil companies who profit by dishonestly and dangerously impeding a general understanding of the climate-destroying impacts of our unchecked, carbon spewing conduct as a society.”

4. Comparison with utility regulation. It reminds me of the arguments from decades ago that the public service board should approve coal based electricity, because it was cheapest and the board had an obligation to keep electricity prices low, so as to benefit the ratepayers. Rich Cowart and other brilliant state employees like the late Bill Steinhurst, broke new ground, nationally, in making sure that the regulatory policy assigned appropriate costs to externalities like coal pollution. Sometimes, even an apparently substantial financial benefit is not justified, if you consider the issue in sufficient depth. Twenty years later, we face a similar issue, here, but with questionable financial benefit going forward.

5. Public employees in Vermont. But let me diverge again to express my high regard for Vermont's public employees, having just mentioned Bill Steinhurst and Rich Cowart. We have been blessed in Vermont with public employees of extraordinary quality and dedication. It always saddens me to see their legacy pop up mainly in the context of how much their retirement costs the state each year. In many ways, these people have dedicated their lives to serving the common good and many have actually risked their lives in this service. The last thing I want to do is decrease the retirement income and security of Vermont's public employees.

Although I, long ago, removed my personal retirement funds from the state system, and although I would not presume to speak for Vermont's diverse public sector retirees, I bet you Bill Steinhurst would have been appalled to have his retirement income tethered to investments in coal and petroleum, even more so as the value of those stocks inevitably plummet. I expect the same is true for many of us.

D. Back to the statutes:

SUGGESTION: Whether or not the board is legally bound by these provisions, for purposes of analysis, let's assume that the board chooses to evaluate its investments according to this energy policy that directs the actions of all other state agencies. I know that Treasurer Pearce and her staff share Governor Shumlin's concerns regarding the threat posed by climate change, and continue to take many actions on many fronts to address those ESG issues. Perhaps, those considerable efforts cover the policy waterfront, but let's see where the analysis and our statutes take us.

E. Goals of 2016 Comprehensive Energy Plan. State agencies are subject to these goals:

1. To **decrease per capita energy consumption** by 15 percent by 2025 and by one-third by 2050.
2. To **meet 25 percent of energy needs from renewable sources** by 2025; 40 percent by 2035; 90 percent by 2050
3. **End Sector goals** for 2025: Transportation: 10 percent renewable; Buildings 30 percent renewables ; Electric power: 67 percent
4. To **reduce Greenhouse Gas emissions** by 40 percent below 1990 levels by 2030; 80 – 95 percent below 1990 levels by 2050

F. 24 VSA 4302 (f)(1) meaning of the words: “Consistent with the goals”

“(f) Standard of review.

1. As used in this chapter, "consistent with the goals" **requires substantial progress toward attainment of the goals** established in this section, unless the planning body determines that a particular goal is not relevant or attainable. If such a determination is made, the planning body shall identify the goal in the plan and describe the situation, explain why the goal is not relevant or attainable, and indicate what measures should be taken to mitigate any adverse effects of not making substantial progress toward that goal.”

This is language developed as part of Act 200 of 1988. The purpose was to find words to use in the municipal planning context that would establish clear state growth management

goals, but that would give the towns flexibility to pursue those goals in a way that made sense, locally. Provided, there had to be substantial progress in the right direction. The same approach was then applied to state agency planning. I consider it is a flexible, widely useful, non burdensome, statutory tool. “You work out the details, but we expect substantial progress toward these specific common goals.”

Summary: all state agencies are required to engage in a continual planning process to assure their programs and actions make substantial progress toward attaining the goals specified above.

Is this inconsistent with other Vermont law? No.

II. THE POWER OF FIDUCIARIES TO CONSIDER ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) ISSUES UNDER VERMONT LAW

A. History.

1. Only the bottom line? According to Dr. Wikipedia, in the 1960's and 1970's Milton Friedman argued that the **value** of a company should be established almost **exclusively on the pure bottom line**, with the costs incurred by social responsibility being deemed non-essential.

2. You should look beyond bottom line. Let me pose a question to illustrate the problem the Friedman approach created: **does fiduciary duty really require a trustee to look at returns only, and to ignore the fact that a company, say ... creates and illegally dumps hazardous waste, destroys the climate, profits from slave labor and child labor, traffics in pornography, sells faulty products and those that may explode, advertises and sells tobacco, sells nuclear and other deadly weapons from a street stand, discriminates against minorities, fires whistleblowers, and pays its board members wages in the billions of dollars?**

Support for limiting fiduciary consideration of other than narrow financial factors started to decrease in 1989, reportedly, with the Exxon Valdez disaster in Alaska.

In 2005 the UN established the Principles for Responsible Investment (PRI) initiative to improve the analysis of ESG issues and to aid companies in the exercise of responsible ownership practices.

3. You better look beyond bottom line. Also, by 2005, a report to the UN indicated that not only was it acceptable to consider Environmental, Social, and Governance issues, but it was arguably part of fiduciary duties to do so. Asset owners and their agents should pay attention to long term factors (including ESG issues) in decision-making.

B. What are ESG issues, again?

Environmental factors include climate change, creation of hazardous waste, and sustainability in the face of depleted raw materials.

Social concerns include: human rights (slave labor, child labor, living wages); consumer protection (limiting co's. liability); sin stocks (alcohol, tobacco, pornography gambling, armaments, nuclear weapons); and animal welfare.

Governance concerns include management structure, employee relations (diversity, corporate behavior and values), and executive compensation.

C. In 2008 George W. Bush's Labor rules deterred considering ESG issues.

D. Obama administration changes to prudent investor rule allows consideration of ESGs.

Last October, the Department of Labor restated its guidance to prudent investors.

PRUDENT INVESTOR RULE: a prudent fiduciary **may not choose an investment with a lower rate of return** or a higher degree of risk, in order **to pursue collateral benefits**, but may consider them as tie breakers, other things being equal.

However, since ESG issues may have a direct relationship to the value of a particular investment, according to PRI, an investor is not prohibited from considering these factors to evaluate an investment's risk or return, or to choose among otherwise equivalent investments.

E. 14A V.S.A. § 902. Standard of care; portfolio strategy; risk and return objectives

“(a) A trustee shall invest and manage trust assets **as a prudent investor** would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be **evaluated** not in isolation but **in the context of the trust portfolio as a whole** and as a **part of an overall investment strategy having risk and return objectives** reasonably suited to the trust.

(c) Among circumstances that a trustee **shall consider** in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

1. **general economic conditions;**

8. an asset's **special relationship** or special value, if any, to the purposes of the trust or **to one or more of the beneficiaries.**”

F. Common definition of “Prudent”

“Prudent” is defined, on line:

1. **Sagacious** in adapting means to ends; **circumspect** in action, or in determining any line of conduct; careful, discreet, sensible; -- opposed to rash; **directed by ... wise forethought**; evincing prudence;
2. **Practically wise**, judicious, **shrewd**
His prudent career moves reliably brought him to the top.

G. Special relationship.

The prudent investor rule, in 14A VSA 902(b)(8) provides that "consideration shall be given to an asset's special relationship or special value ... to the purposes of the trust or to one or more of the beneficiaries."

One would expect the **prudent investor** to pay particular attention to the likely effects of unchecked climate change on the fund's sole beneficiaries: generations of retirees, and would avoid investments in activities that may endanger those retirees and invest instead in activities that help protect retirees. (As the Governor has pointed out, Vermonters are endangered when they breathe fumes from coal burned to our West, perhaps, thanks in part to VPIC investments helping coal companies stay afloat.) The beneficiaries of these funds, more than anything else, need a planet that is habitable into the distant future.

H. Assertions/facts that may be considered and should be considered by prudent investors:

A **prudent investor, exercising reasonable caution would be aware of** the Vermont statutory mandate cited above, and the underlying global threat posed by climate change, as well as **the following**, as a component of general economic conditions:

* scientific facts that show the rate at which global temperatures are increasing and **the need for immediate global action to reduce greenhouse gas emissions** if there is to be a chance for humans to help keep the earth's temperature rise below the 1.5 degrees Centigrade the world's leaders are now striving to avoid;

* the fact that, if unchecked, the **business plans of certain carbon industries would lead to dangerous temperatures** far above that level;

* the fact that certain fossil fuel **companies** have funded and continue to **fund propaganda that denies climate science** and opposes imposition of appropriate carbon pricing; and it's not just Exxon.

* the fact that fossil fuel companies may again invest hundreds of millions in **exploration for additional product**, although large percentages of **known reserves must be left in the ground**, if the world is to avoid disastrous temperature gains;

* the fact that since most reserves must be left in the ground, **investments in fossil fuels risk either massive loss in value, or destruction of the environment, or both;**

* the **US Congress is at political stalemate on climate science**, and with regard to the establishment of carbon pricing, or other climate change mitigation measures, and may actively oppose international efforts to address the issue, despite the fact that global "business as usual" may be leading to a devastating global temperature increase this century.

I. Example of decisionmaking, under this doom and gloom.

Assume for purposes of analysis, that the above dire assertions are facts.

A. Moral decision. If a fossil fuel company, has a business plan inconsistent with a healthy planet, it is, in essence, declaring: "Try and stop my life threatening emissions," In my opinion, state trustees should refuse to remain a collaborator, a compensated partner, in a reckless enterprise that threatens life on earth. This risky behavior would make an enterprise an imprudent investment by retirement fund trustees. Such investments should be converted prudently, and quickly. Some argue that a failure to divest in such a situation would be a breach of fiduciary duty.

B. An economic decision. Let's also assume, contrary to recent trends, that fossil investments have a higher rate of return than the non-carbon alternatives, let's say Exxon returns X\$ and Fuzzy Non-Carbon returns X-1\$

Under the PRUDENT INVESTOR RULE a prudent fiduciary may not choose an investment with a lower rate of return or a higher degree of risk, in order to pursue collateral benefits.

Doesn't this mean that the trustee is bound to bypass Fuzzy Non Carbon because to pursue the collateral benefits is to suffer smaller returns?

NO.

PRI states: "Responsible investment requires investors to take a wider view, acknowledging the full spectrum of risks and opportunities... in order to allocate capital in a manner that is aligned with the long and short term interests of their beneficiaries."

C. Increased risk. As mentioned above, consideration of the ESG issues presented in this hypothetical is appropriate in determining the risk involved in a particular investment, and in this case, the assertions, if accepted, would justify a finding that the Exxon investment poses a much greater economic and environmental risk than perceived and previously allocated. Assume that when the actual risk posed by Exxon is identified, it is determined, that Exxon should be paying returns of X+5\$. What could be a riskier investment than one in a company that appears willing to destroy the climate for short term profits? Thus, in this instance, the green investment paying X-1\$ clearly becomes the prudent investment.

J. Updated Summary

1. Pursue decarbonization. VPIC has the duty and authority to pursue systemic decarbonization, without settling for less returns or more risk, for the benefit of retired state employees, like me.

2. But board powers are limited.

A. Recompute risk. VPIC could prudently sell its interests in Exxon, if it determines that Exxon's returns are not sufficient for the risks engendered, for example, by doing business with a company that knew its product led to dangerous levels of CO₂, but covered it up through a wide-ranging program of science-denying propaganda, which still has much effect within the Congress and the rest of the country.

B. Tie breaker. However, if the risks inherent in carbon investments are accurately identified, and the amount of the return accurately reflects the risk a fiduciary may only accept a lower return, in the pursuit of ESG goals, as a tie breaker. (An experienced correspondent suggested to me that, in practice, a trustee would be justified in selling Exxon upon simply concluding that its price is volatile and that it may be subject to a gas tax. Trustee's actions are vulnerable, in his experience, mainly when there is self serving involved.)

III. INVESTMENTS

A. Invest green. Literature suggests a great need for increased investment in companies that provide products or services that reduce climate change. As part of a portfolio readjustment, that would seem an easy way to help reduce climate related risks facing the beneficiaries.

And talk about jobs: one day during a recent energy system upgrade and renovation of my house, we counted 12 pickup trucks parked outside. Instead of paying for foreign oil, we were increasing the value of our home and shrinking our carbon footprint, while employing legions of our neighbors. The treasurer and people in her office know a lot about these matters.

B. Portfolio protection. PRI observes that it is permissible to make green investments to reduce risk faced by the portfolio as a whole.

Since 14A VSA 902 (b) requires consideration of the portfolio as a whole, including reasonable risk objectives, a particular green investment might be justified, even with smaller expected returns, if to do so would advance reasonable risk reduction objectives reasonably suited to the trust.

C. Low carbon index funds. A recent NY Times article highlighted passive, low carbon funds that feature broadly diversified investments, but of the lowest carbon producing companies in each category. As these holdings are periodically adjusted, companies have the ever present incentive to reduce their carbon footprint. Made possible by wise use of information developed thanks to the Carbon Disclosure Project, these funds parallel, but due to their lower management costs, generally outperform, the market. (Plain index funds on Feb. 4, 2016 charged net fees of .09%, low carbon funds charge net fees of .2%)(per Eric Becker)

D. Portfolio wide carbon reduction. As shown above, the trustees have the power to make decisions regarding individual assets, not in isolation, but “as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.” Vermont should establish and implement carbon reduction strategies for its entire portfolio, if it hasn't yet done so. Each individual portfolio decision should be made prudently, but with the goal of societal carbon reduction in mind. (This point was made at the UN conference two weeks ago, that Treasurer Pearce co-hosted.)

E. Substantial progress to meet state goals should be required. If Vermont planning law is deemed to apply or is followed for guidance: Existing investments and activities should be examined at least twice a year to see whether they make substantial progress toward the state energy and greenhouse gas reduction goals, and if they don't, they should be prime candidates to be sold and prudently reinvested so as to better comply with state law.

F. Huge generation investment by society is needed. At the recent meeting at the UN, co-hosted by Treasurer Pearce it was stated that there is a great need for investment in green technologies (a perfect use for proceeds from the sales of carbon stocks.) If global temperature rise is to be kept below 2 degrees C, global investors need to increase green investments, according to CERES, by 1 trillion dollars per year. Just saying.

G. Please come together, Vermonters. It may be a challenge for Vermont to install an appropriate share of new, non-carbon electricity sources here in Vermont, given how contentious solar and wind development currently are. But Vermonters don't have the luxury of arguing over this for ten years, the **investments made during the next five years will determine** global climate outcomes for the **next 30** years. We've got to come together, somehow, to preserve our natural environment and our priceless scenery the best we can, while still making rapid overall progress moving away from carbon.

H. Double green investments within 5 years. To protect generations of retiree beneficiaries, and to profit from the carbon reduction evolution, at a minimum, **trust investments, overall**, should mirror the conduct of leading responsible investors and should attempt, prudently, to **double its green investments by 2020**. Carbon stocks would seem to be prime candidates for sale, in order to fund other necessary investments.

IV. WHERE TO GO FROM HERE

A. How should the board perform the tasks required, here?

1. Green Financial Consultant. First, in selecting financial consultants, the board should seek those who have **demonstrated skills** and interest in establishing profitable portfolios while giving due consideration to **ESG** issues, and who are able to guide the board in making continued and substantial progress toward achieving the state's energy goals, as required or suggested by Vermont law, while also fulfilling its duties to beneficiaries. Advisers that are inclined to continue business as usual become a risky investment that should be avoided.

B. What about divestment?

1. Moral imperative. Although this memo has focused mainly on the statutes, in my personal view, there is a moral imperative to divest from the Carbon 200.
2. Statutory Support.. Decarbonization of the trust fund is supported by the whole thrust of Vermont statutes, as explained above.
3. Carbon is a bad investment. Carbon divestment makes sense because of the long term financial outlook. To quote a correspondent: “Risk and reward are highly asymmetric: the foreseeable rewards are grossly unequal to the foreseeable risks.” Some believe that

imbalance might even support a successful claim that it is an imprudent violation of fiduciary duties to fail to divest.

C. What about losing the value of engagement, if the state sells carbon stock?

Treat the value of engagement as if it were an ESG: don't hang around engaging, if the returns are less or the risks are more, get rid of most of it, and exercise engagement as non-owner, or as holder of a tiny position.

D. Should financial experts be making financial decisions, and not the legislature?

In general, I agree that investment details ought to be worked out by a specialist board with expert advisers. However, if the legislature wants a **major change** in direction, in a **short time**, as a matter of state policy, it is best for it to **act**. Furthermore, in this instance, as shown above, the **trustees may be limited by their fiduciary duties** in the speed and the extent to which they pursue ESG goals.

IF THE LEGISLATURE WANTS A CHANGE MORE RAPIDLY OR MORE BROADLY THAN THE BOARD IS LIKELY TO PRODUCE, CONSISTENT WITH ITS FIDUCIARY DUTIES, THE GENERAL ASSEMBLY SHOULD MAKE THE CHANGES..

Here, I believe the legislature ought to act, because of the urgency of the environmental situation posed by greenhouse gases, the long term risk posed by carbon investments, and the likely profitability of green investments over the long term. Even if the trustees agreed with the assertions above, at some future point in time, and revised their program of objectives, which included efforts to reduce the risk of the portfolio as a whole, after appropriate adjustments, they still can only prefer investments that pursue ESG goals in the case of tie breakers. The major shift required by this necessary change in course will more certainly and more quickly transpire at the direction of the legislature.

LEGISLATIVE QUESTION: Should you hope to empty your tubful of carbon investments, sooner or later, removing it cup by cup, by board action, or should you pull the plug right now by act of legislation, and rely upon the careful work of the board to adjust investments as required by law, while furthering the interests of the beneficiaries?