Testimony regarding S.28 before the Vermont Senate Committee on Government Operations May 2015

Submitted by:
Maeve McBride
350 Vermont
255 S. Champlain Street, Suite 11
Burlington, VT 05401
Maeve@350vt.org
802-999-2820

Introduction:

Consistent with the passing of Senate Resolution 7, "Senate resolution relating to climate change," and the state's energy goals outlined in the Comprehensive Energy Plan, the Vermont legislature is obligated to enact policies to reduce Vermont's carbon footprint and invest in an emerging green economy. Divesting from the largest fossil fuel companies offers the legislature the opportunity to protect pension beneficiaries from risky carbon-intensive investments and to join a host of institutions, foundations, and organizations that are affecting the investment market. There are several options for the legislature to encourage or enact divestment of the pension funds. While 350Vermont recommends that the Senate Committee on Government Operations pass S.28 as written (Option 4 below), thereby divesting the pension funds from the largest 200 fossil fuel companies, we have identified several other options for reducing carbon risk for pension beneficiaries.

Why divest?

Divestment is a smart environmental and financial policy. To avoid the worst effects of climate change, the planet's climate cannot warm by more than 2*C. To accomplish this necessary limit, 70-80% of identified fossil fuel reserves need to be left underground. If we continue on our current track of consumption, we risk a 5-6*C increase in global temperatures and catastrophic consequences (Carrington 2015, Leave Fossil Fuels). Publicly divesting from fossil fuel companies would send a strong message: Vermont will not be complicit in the destruction of our planet. As fossil fuel companies face rising social and regulatory pressure and ever-increasing extraction costs, companies may soon be forced to keep fossil fuels in the ground. Stockholders in fossil fuel companies will then be left with *stranded assets* – overvalued reserves of coal, oil, and gas that are on these companies' balance sheets but will be rendered valueless. When these assets become stranded, conservative estimates indicate that our economy will lose $20-27 trillion (Humphreys & Electris 2013).

The world's major financial institutions are taking stranded assets seriously. The following is a snapshot of recent divestment success stories:

- In an April 2015 internal report entitled "Stranded Assets: What's Next?," global banking giant HSBC warned investors that carbon-intensive investments will likely become "economically non-viable" and advised investors to invest elsewhere (Hurst 2015).
- The Bank of England just launched an inquiry into the long-term viability of fossil fuel assets in the face of climate change and an expanding carbon bubble (Carrington 2015, England).
- In March, the City of Oslo, Norway committed to divest its pension fund from coal.
- This month, the Church of England announced that it will divest approximately $18.3 million from fossil fuel companies (Martin 2015).
- Three groups of Danish pension-holders voted to divest their pensions from coal, oil, and gas in the past two weeks (Carrington 2015, Danish).
- World leaders are slated to make far-reaching greenhouse gas emissions regulations at the United Nations Climate Change Conference (COP21), which would further decrease the economic viability of fossil fuel companies.
- On May 14, 2015, the University of Washington's Board of Regents committed to divest from thermal coal, making UW the largest university to divest yet.

Options for Divestment

We recognize that the asset management of Vermont's pension funds is a complicated task, with over $4 billion in assets, over 3,000 different holdings, and 39 investment managers. Several options for divestment are presented below, along a gradient from a non-binding resolution to full fossil fuel divestment, from simple to complex. To decrease the exposure of the pension funds to carbon risk, divestment should begin at once, but proceed over several years. S.28 currently calls for divestment over a 5 year period.

Option 1: Resolution

A resolution encouraging divestment has been proposed this session. Joint House Resolution 6: Joint resolution urging the Vermont Pension Investment Committee to divest the State's three public employee retirement funds of all fossil fuel assets by January 1, 2020 was introduced. The bill is co-sponsored by 36 representatives.

****Excluded this option from final version****

Option 2: ESG Mandate

VPIC currently abides by an Environmental, Social, and Governance (ESG) Policy, such that VPIC is able to "make or divest from certain investments for the purpose of achieving ESG

goals that do not appear to be primarily investment-related." (Pearce 2013) However, only 16 of VPIC's 39 investment managers are signatories to the UN Principles for Responsible Investment (UN PRI). The UN PRI is an international initiative that requires a pledge to uphold six principles for responsible investing, including the incorporation of ESG issues into investment analysis and decision-making. The legislature could mandate that all investment managers selected by VPIC are held to the UN PRI.

Additionally, the Legislature could declare certain practices inconsistent with the VPIC ESG policy, such as hydraulic fracturing. According to VPIC's Domestic Proxy Voting Policy, investment managers are instructed to: 1) support proposals that require companies that utilize hydraulic fracturing to report on the environmental impact of the practice, to report on the risks associated with community concerns with the practice, and to disclose policies aimed at reducing risks and hazards associated with the process; and 2) support proposals that encourage the use of alternative approaches to extracting natural gas in lieu of the use of harmful chemicals (VPIC 2014). Given these guidelines and Act 152 that bans hydraulic fracturing, divestment from companies practicing hydraulic fracturing is a logical next step.
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Option 3: Coal Divestment
According to a study by investment management firm Aperio Group, divesting from coal offers virtually no risk penalty (Geddes 2013). In their multi-factor study, divesting from the largest 15 coal companies resulted in 0.0006% penalty risk for portfolios. Currently, approximately $7,879,995 (0.2%) of Vermont's pension funds are invested in coal. As both Eric Becker of Clean Yield Asset Management and Matthew Patsky of Trillium Asset Management noted in testimony earlier this session, coal investments are on the long-term decline and have not been profitable in the last 25 years. Consider this graph of coal stocks:

Source: Yahoo! Finance

Many entities are choosing to begin their fossil fuel divestment with a divestment from coal companies. This would be a manageable first step for Vermont because this level of

divestment would require divestment from just 13 companies, managed by only 7 of the 39 investment managers.

Option 4: Carbon Tracker 200

S. 28 calls for the divestment of the top 200 coal, oil, and gas companies, ranked by the potential carbon emissions content of their reported reserves, over a modest 5 year time frame. “A fossil free approach to investing could result in a more resilient portfolio that is more likely to avoid the risks and cover the commitments made to city pensioners and beneficiaries in the coming years” (HIP 2013). Currently, Vermont is invested in over 60 of the “top 200” with a total asset value of approximately $100 million.

Option 5: Low Carbon Investment

In the recent report, “Beyond Divestment: Using Low Carbon Indices,” a new framework is presented for “evaluating ways to reduce two dimensions of carbon exposure – current carbon emissions and potential future emissions embedded in fossil fuel reserves” (Briand 2015). This option can be seen as a more holistic approach whereby VPIC would be directed to make low carbon investments, support the creation of low carbon funds, and reduce exposure to fossil fuel and carbon intensive companies both in and out of the energy sector. In this option, VPIC could also retain small holdings in the “top 200” in order to continue their shareholder engagement activities.

Option 6: Full Divestment from the Energy Sector

In February 2013, NEPC, LLC, the investment consultant for VPIC, issued an analysis on divestment from the *entire* energy sector. In 2013, the VPIC holdings in the energy sector were valued at over $140 million. We do not recommend this option.

Shareholder Engagement

While shareholder engagement has an admirable track record, it is not an effective strategy to mitigate our climate crisis. Allow us to outline a few points to this end:

- Fossil fuel companies have not responded to decades of calls by shareholders to reduce greenhouse gas emissions or invest in renewable energy. Not only do fossil fuel companies have little incentive to change their core model, but there also exist few viable alternatives to their carbon-intensive business model. Little progress has been made in urging fossil fuel companies to reduce emissions largely because little *can* be done: the search, extraction, refining, and burning of fossil fuels produces greenhouse gases (Alpern 2015). Innovation in energy is being led by renewable energy companies, not the fossil fuel industry.

- The Vermont Treasurer’s Office Sustainability Report released in April outlines several shareholder engagement issues that the Treasurer’s Office and the VPIC are working on. While their efforts are admirable and important in many ways, none of the examples listed in the Treasurer’s Report directly confront our climate crisis.

- In order to retain a “seat at the table” but minimize their exposure to risky carbon-intensive investments, some investors have chosen to retain the minimum number of shares in fossil fuel companies needed to file shareholder resolutions. The Unitarian Universalist Association (UUA) is one such investor (Unitarian Universalist Association 2015).

Finally, we understand that transaction costs are of concern to the legislature and VPIC following the release of New England Pension Consultants’ (NEPC) 2013 report on pension divestment in Vermont. Eric Becker, CIO of Clean Yield Asset Management, and Matthew Patsky, CEO of Trillium Asset Management, have refuted NEPC’s figures during testimony many times. To avoid large transaction costs and sudden charges, S.28 calls for divestment over a period of five years - ample time to divest responsibly (Brecha 2015). Additionally, many colleges divested without incurring any transaction fees including Hampshire College, Sterling College, Green Mountain College, Unity College, College of the Atlantic, and Goddard College (personal communication, Catherine Lowther, 5/15/15).

Works Cited:

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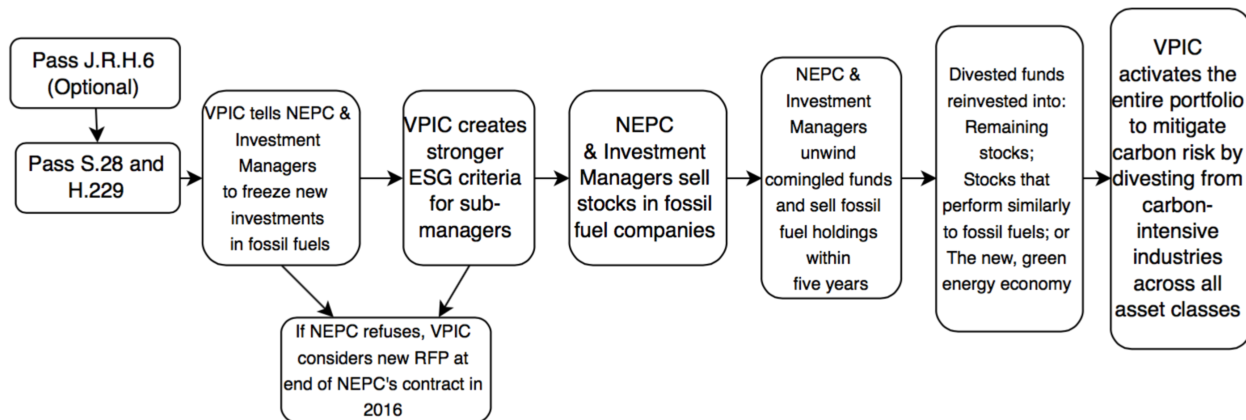
Past version of testimony:

Levels of Divestment:

1. Pass Joint House Resolution 6, recommending that VPIC divest
2. Divest from coal
3. Divest from the Carbon Tracker 200
4. Fully divest from all companies that have holdings or operations in coal, oil, or gas

The following diagram details how Vermont's pension funds will be divested if the legislature passes S.28 and H.229:



As this Committee has already heard in past testimony, most scientists, research groups, and intergovernmental bodies agree that to avoid the worst effects of climate change, the world's climate cannot warm by more than 2*C. Fossil fuel companies have five times enough carbon in their reserves to reach that 2* tipping point. By now, the science is clear: we have to leave 80% of the carbon reserves underground to avoid the most devastating effects of climate change.

Because fossil fuel companies have already incorporated these reserves into their net value and stock prices, they have a vested interest in ensuring these reserves are extracted, refined, and burned. Keeping reserves underground is bad news for fossil fuel companies, but good news for the rest of us. These companies are already scraping the bottom of the metaphorical barrel, as plentiful sources of coal, oil, and gas become harder to find – evidenced by the millions of dollars spent on tar sands, marine drilling, hydraulic fracking, and mountaintop removal for coal. However, as fossil fuels become more difficult to extract, these companies' operating costs increase. Couple this with increasing social pressure on carbon-intensive business (like Vermont's proposed carbon pollution tax), and companies may soon be *forced* to keep some reserves underground. Eventually, these inflated fossil

fuel stock prices plummet, the “carbon bubble” bursts, and investors like Vermont will be left with $20-27 TRIL in “stranded assets” – fossil fuels, and money, left under our feet (Humphreys & Electris 2013). It is our informed opinion that fossil fuel investments are a sinking ship, and Vermont should extract itself while it can – for the environmental and fiscal security of Vermonters.

We understand that transaction costs are of concern to the legislature and VPIC following the release of New England Pension Consultants’ (NEPC) 2013 report on pension divestment in Vermont. Eric Becker, CIO of Clean Yield Asset Management, and Matthew Patsky, CEO of Trillium Asset Management, have refuted NEPC’s figures during testimony many times. To avoid large transaction costs and sudden charges, S.28 calls for divestment over a period of five years - ample time to divest responsibly (Brecha 2015).

While 350 Vermont strongly recommends that this legislature pass bill S.28 that calls for divestment from the 200 fossil fuel companies with the largest proven reserves of fossil fuels within five years, we understand that this may seem like a big leap. Pension divestment is a long, tricky process, and we at 350 Vermont know that the Treasurer and legislature have many factors to consider. As a logistically simpler first step – and one that presents an approximately 0.0006% increased risk to the portfolio – 350 Vermont would like the legislature to consider divesting from coal first (Geddes 2013). As Matthew Patsky, CEO of Trillium Asset Management, noted in testimony earlier this session, coal investments are on the long-term decline.

Consider this graph of coal stocks:

Source: Yahoo! Finance

According to a 2014 study by Aperio Group, divesting from coal offers “virtually no risk penalty”. In their multi-factor study, divesting from the largest 15 coal companies resulted in 0.0006% penalty risk for portfolios. That equates to less than one one-thousandth of a percent of theoretical return penalty (0.0002%). Currently, approximately 0.2% of Vermont’s $4.01 BIL pension funds is invested in coal. Should the legislature choose to mandate that the Vermont Pension Investment Committee (VPIC) divest its $7,879,995.75 of coal holdings, the above flow-chart illuminates that process. With its investment managers and consultants, VPIC would freeze new investments in coal, sell its sixteen current coal holdings, and unwind and divest comingled funds.

A legislative mandate to divest at any level would force VPIC to incorporate stricter environmental, social, and corporate governance (ESG) criteria for money managers. ESG criteria screen potential investments for environmentally and socially responsible business practices, and has a positive effect on long-term financial performance.

When choosing to reinvest divested funds, VPIC has three options: distribute divested funds among remaining asset classes, allow money managers to reinvest in industries/sectors that perform similarly to fossil fuels, or reinvest in the new, green energy economy. 350 Vermont does not at this time make recommendations for reinvestment, but encourages the legislature to think long-term. Climate change and financial instability of the fossil fuel industry threatens Vermonters, and fiduciaries should consider these risks. Continuing to invest in fossil fuel companies exposes Vermont’s pension funds and pension holders to more risk than divesting does.

Works Cited:

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