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STATE OF VERMONT
VERMONT PENSION INVESTMENT COMMITTEE

TO: Vermont Pension Investment Commission

FROM: Eric Henry

DATE: February 16, 2022

RE: Senate Bill 251

On February 4, 2022, the Commission's Environmental, Social, and Governance Committee met to consider, among other things, Senate Bill 251 regarding the prohibition of investing in the "largest fossil fuel reserve owners" and its potential impact on both investment performance and fossil fuel emissions. The Committee expressed its strong support for reducing global fossil fuel emissions but emphasized that a forced sale of these investment holdings would not actually reduce fossil fuel emissions. Further, the Committee expressed concern that divestment would create a drag on investment performance through increased investment management and consulting fees and a reduced investable opportunity set. The Committee did emphasize an alternative and more effective course in reducing fossil fuel emissions (i.e., the power of using proxy votes to engage with companies and their boards to affect positive change).

Divestment Does Not Change Corporate Behavior:

Divestment is simply selling shares of companies, and abdicating our voice in how they are run, to potentially less responsible shareholders. It does not reduce greenhouse gas emissions and is not a responsible investment. The reality is that reducing global fossil fuel emissions is much more complicated than some would have you believe. Larry Fink, Blackrock CEO and co-founder, in his 2022 annual letter to CEOs said the following:

"The transition to net zero is already uneven with different parts of the global economy moving at different speeds. It will not happen overnight. We need to pass through shades of brown to shades of green. For example, to ensure the continuity of affordable energy supplies during the transition, traditional fossil fuels like natural gas will play an important role both for power generation and heating in certain regions…As we pursue these ambitious goals—which will take time—governments and companies must ensure that people continue to have access to reliable and affordable energy sources. This is the only way we will create a green economy that is fair and just and avoid societal discord. And any plan that focuses solely on limiting supply and fails to

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address demand for hydrocarbons will drive up energy prices for those who can least afford it, resulting in greater polarization around climate change and eroding progress."

Indeed, as Russia's escalation on the Ukrainian border over the last several weeks threatens the flow of natural gas in Europe, we have seen a continued rise in energy prices at a time when the northern hemisphere is in the middle a very cold winter.

Much of the messaging around fossil fuel divestment comes from for-profit consulting firms, who stand to benefit from forced divestment. A private company prescribed by Senate Bill 251, for example, maintains a list of 200 publicly traded companies which it believes should be divested because of their fossil fuel emissions. Investment managers who use this list to remove companies from the investable universe not only have to contract with that company, but also incur higher costs in screening portfolios. These fees become a drag on investment performance. Perhaps a larger drag on performance comes from limiting the investable securities that investment managers can choose in optimizing portfolios.

As outlined above, none of this reduces fossil fuel emissions. In contrast, it actually reduces the pressure on these companies to do so as some public pension funds who would otherwise engage with these companies and their boards, are forced by legislative mandates to abdicate their voice and proxy votes in forced sales. Less responsible shareholders can exploit such forced divestment to buy shares at a discount and allow the boards and management teams to pursue earnings through irresponsible environmental, social, and governance policies.

Proxy Votes Do Change Corporate Behavior:

A more effective approach is using proxy votes to engage with these companies, their boards, and their management teams to reduce fossil fuel emissions and promote other responsible behaviors. This approach works, as highlighted by our recent proxy proposal at Hess Corporation. On December 22, 2020, VPIC filed a shareholder resolution with Hess Corporation to encourage the company to reduce its impact on climate change by requesting details on how the Company would reduce routine flaring and venting. We specifically requested: time-bound goals to reduce routine flaring and venting from operated and non-operated wells, and well completions; a commitment to the World Bank's "Zero Routine Flaring by 2030" initiative; and validation of flaring and venting data through a qualified third-party audit. Hess challenged our resolution at the SEC on February 9, 2021 and Staff subsequently met with Hess leadership alongside co-filer Minnesota State Investment Board, Segal Marco, and Ceres to discuss the request of the resolution. The Company indicated it was transitioning away from a flaring time-bound target and is instead recommending a greenhouse gas (GHG) and methane emissions reduction goal by 2025. Hess expressed concerns about our requested approach and clarified its process includes a qualified third-party to audit its GHG emissions results. As a result of our engagement efforts, Hess reported in an 8-K filing that it would link executive pay incentives to a flaring reduction target in the Bakken area, substantially below State guidelines. The Bakken region incorporates

about 70% of Hess's flaring activity. We believe executive pay incentives are the most effective tools for incentivizing achievement of corporate goals. We continue to engage with Hess and commend its board and management team on progress made to date. Last month, the company announced its plans to eliminate routine flaring by 2025 and endorsement of the World Bank's "Zero Routine Flaring by 2030" initiative as part of its "overall strategy to proactively manage our carbon footprint and limit emissions of methane and other greenhouse gas emissions." We are pleased with Hess's progress on these stated goals and targets, which would not have happened had we simply divested our Hess holdings.

Recommendations:

1. Because divestment does not reduce fossil fuel emissions, but rather abdicates our voice in effecting positive change, increases investment costs, and lowers investment performance, we ask you to consider the ESG Committee's recommendation to formally oppose enactment of Senate Bill 251.
2. Because engagement with companies and their boards of directors has proven to be effective in changing corporate behavior, we ask you to consider referring the attached draft carbon reduction policy to the ESG Committee for analysis and consideration. As you can see, divestment is always an option where engagement efforts have failed to affect positive change and retention of the shares presents an unacceptable investment risk.

We look forward to discussing these issues with you next week. In the interim, please do not hesitate to reach out if you have question or would like to discuss.

Vermont Pension Investment Commission
Draft Carbon Reduction and Mitigation Policy

Section 523 of the Vermont Pension Investment Commission's enabling statute tasks VPIC with the responsibility "for the investment of the assets of the Vermont State Teachers' Retirement System, the Vermont State Employees' Retirement System, and the Vermont Municipal Employees' Retirement System." This section explicitly states VPIC "shall strive to maximize total return on investment, within acceptable levels of risk for public retirement systems, in accordance with the standards of care established by the prudent investor rule."

This policy sets forth VPIC's policy for responding to external or internal initiatives to divest of individual or groups of securities for purposes of achieving certain carbon reduction goals that do not appear to be primarily investment related. VPIC opposes any divestment effort that would either implicitly or explicitly attempt to direct or influence us to to engage in investment activities that violate and breach the Commissioners' fiduciary responsibility. Consistent with its fiduciary responsibility and the concepts of diversification and passive index investment, the Commission does not and will not systemically exclude or include any investments in companies, industries, countries or geographic areas, except in cases where it creates an economic risk to the fund or a potential for materials loss of revenue exists.

When pressured to divest, VPIC firmly believes that active and direct engagement is the best way to resolve issues. Face to face meetings with shareowners and senior management, or the Board of Directors, are essential to bring about change in a corporation. No further action will be taken until all efforts at engagement have been fully exhausted. Efforts at engagement include, but are not limited to, shareholder resolutions, media campaigns, and other efforts at engagement.

VPIC's commitment to engagement with companies rather than divestment is based on several considerations:

- Divestment would eliminate our standing and rights as a shareowner and foreclose further engagement.
- Divestment would be likely to have negligible impact on the portfolio or the market.
- Divestment could result in increased costs and short-term losses.
- Divestment could compromise VPIC's investment strategies and negatively impact investment performance, further increasing unfunded liabilities and funding requirements.

If engagement fails to resolve the risk factor sufficiently, the CIO will bring the issue before the Commission for consideration of divestment from the applicable securities. The Commission will receive input from its investment staff, investment managers, investment consultants, and other experts in the particular field or issue. If the Commission determines that the making of an investment or continuing to hold a security is imprudent and inconsistent with its fiduciary duty, it will instruct investment staff to remove the security from the portfolio.