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**State of Vermont
Office of the State Treasurer**

**VPIC Sub-Committee Meeting
Fiduciary Duties and Fossil Fuel Divestment
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Domini Social Investments is an SEC-registered investment adviser, based in New York, specializing exclusively in socially responsible investing. We manage a global family of mutual funds with \$1.5 billion under management for individual and institutional investors who wish to create positive social and environmental outcomes while seeking competitive financial returns.

We apply social, environmental and governance standards to all of our investments, believing they help identify opportunities to provide strong financial rewards to our fund shareholders while also helping to create a more just and sustainable economic system. We believe that our analysis helps us to identify opportunities and avoid certain risks that will generally not be reflected on the balance sheet—at least not in the short term—and, if our standards are to have integrity, there must be a point at which we will sell our shares. We use our ESG standards to include and exclude companies in every industry, and to exclude certain industries in their entirety, because their business models are fundamentally misaligned with our long-term objectives.

For many years, Domini has incorporated concerns about the environmental risks of fossil fuel production into our investment decisions. We have never held coal-mining companies, and have historically approved very few major integrated oil companies. We had historically favored companies focused on the production of natural gas because it burns more cleanly than oil. In recent years, however, as oil and gas companies moved to exploit riskier sources of energy, it became harder and harder to approve these companies for our portfolios. Ultimately, we adopted a policy to exclude all owners and producers of oil, natural gas or coal reserves from our funds.¹

We made these decisions in light of the financial, environmental and moral concerns associated with fossil fuels and in recognition that an increasing portion of the responsible investment community has found divestment a productive avenue to further debate on climate change, one of the most important and difficult issues of our time.

We believe that investors must use all of the tools at their disposal to effect a shift to a more just and sustainable financial system. The use of social and environmental standards to include and exclude securities from our funds in combination with a robust shareholder activism program has proven to be an effective combination.

Today, we would like to share some of our views on the unique nature of the threat of climate change, and why we believe divestment is an appropriate response by fiduciaries.

¹ <http://domini.com/responsible-investing/key-issues/our-position-fossil-fuel-owners-and-producers>

The last time atmospheric concentrations of CO₂ were this high was millions of years ago, long before *homo sapiens* appeared. This places us in an entirely new era of risk, for which we have no precedent or reliable benchmark. All companies carry some form of climate risk, and past performance is certainly not indicative of future results.

There is no one correct answer to this challenge – the most significant challenge humanity has ever faced. Fiduciary duty does not dictate an approach. It does not prescribe specific actions. Rather, it requires a thorough decision-making process, guided by prudence, care and loyalty. In our view, fiduciary duty does not require or preclude divestment.

I believe that fiduciaries are uniquely situated to address this risk, because we are bound by prudence, care and loyalty, which direct us to think beyond short-term market returns. I'd like to begin with a few observations I drew from some of the reports posted to the Vermont Pension Investment Committee website:

- I saw restated several times an assumption that fiduciary duty prevents the VPIC from holding a view that is contrary to the collective view of the market. To the contrary, prudence, care and loyalty require the VPIC to do its due diligence and to act upon a contrary view if it is sincerely held. There is no fiduciary duty to obey the market.
- There appears to be an implicit belief in both the efficient market hypothesis and the ability of your managers to effectively evaluate climate risk. Do not assume that your managers are implementing ESG strategies for your portfolio, merely because they have signed the UN Principles for Responsible Investment, or maintain ESG strategies. Do not assume that all ESG strategies are alike, or that the use of “negative screening” is impermissible or even uncommon among responsible investors.
- The benefits of divestment were cast in political, rather than financial or scientific terms. The very strong financial arguments underlying the call for fossil fuel divestment do not appear to have been considered.
- The potential costs of divestment did not appear to be balanced against the costs of maintaining these investments.

Climate change will translate into a variety of financial risks, including physical risks, carbon pricing risk, policy responses, transition risks, etc. When evaluating how these various scenarios may play out, we must keep in mind that the status quo – business as usual – is the greatest risk of all.

The VPIC ESG policy precludes ESG initiatives that “exceed a reasonable weighting in the Portfolio.” When viewed as an “ESG initiative,” divestment appears to fail this test.² Fossil fuel

² It should be noted in this context that the memorandum to the Vermont Pension Investment Committee, “Fossil-fuel Divestment Analysis” (July 28, 2015), stated that the energy sector represents approximately 11% of the S&P 500 and other World equity indexes. This overstates the case in two important respects: First, the divestment campaign is not directed to the entire energy sector, and second, energy currently represents just under 7% of the S&P 500. Its representation has halved since 2009. It represented 25% of the S&P 500 at the end of 1979 (<http://siblisresearch.com/data/sp-500-sector-weightings/>). Energy currently represents 6.4% of the MSCI World Index

divestment, however, is a reaction to a set of risks that are uniquely correlated to a specific set of companies. It isn't *divestment* that exceeds a reasonable weighting in your portfolio, it is *stranded assets risk* that exceeds this threshold and potentially threatens diversification. This is a new reality of the market that fiduciaries must contend with, whether or not they choose to divest.

In recognition of the seriousness of the climate crisis, the State of Vermont has engaged with other investors as members of INCR and Ceres, through proxy voting and shareholder activism. Domini is an active member of these networks as well, and we strongly endorse all of these activities. Shareholder activism is a powerful way to change corporate behavior and ultimately mitigate climate change. I have directed Domini's shareholder activism program for the past 18 years, so I understand that to gain a seat at the table, you must hold the shares, and I have seen the benefit in doing so. However, in my view, engagement is least effective when it seeks to change a company's core business model.

So why consider divestment?

The word "divestment" carries considerable political baggage. Despite its potential effectiveness if carried out on a broad scale, it is largely viewed as a political tactic, not a financial one. This muddies the conversation.

The debate about fossil fuel divestment is not about whether it is appropriate for a fiduciary to favor a social issue at the expense of financial returns. This is the wrong framing. The question today is whether the tactic of divestment is an appropriate response to the very real financial, social and environmental risks posed by the activities of fossil fuel production companies held by the State. These social, environmental and financial risks cannot be disentangled.

The VPIC investment process includes a monthly review of investments, including the removal of imprudent investments. The question today is whether continued investment in the largest owners of fossil fuel reserves is prudent or imprudent. Divestment, therefore, is an appropriate consideration, as part of your regular practice as fiduciaries.

Climate change is the ultimate systemic risk. All investments therefore carry some degree of climate risk. The companies targeted for divestment, however, face a unique and transformative risk – the so-called 'stranded assets' thesis.

A recent background paper prepared under the authority of the Chair of the Round Table on Sustainable Development at the OECD ("the OECD Paper") called divestment and stranded assets "two sides of the same coin," and noted that "stranded assets in the transition to a 2 °C compatible world are inevitable..."³

Limiting global temperature increases to an average of two degrees Celsius above pre-industrial levels is an imperative. It is the only outcome that is reasonably consistent with the State's

(https://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-index.pdf). Markets change, and the stranded assets thesis assumes the energy markets are in the midst of a very significant transition.

³ Richard Baron and David Fischer, *Divestment and Stranded Assets in the Low-carbon Transition* (Background paper for the 32nd Round Table on Sustainable Development, 28 October 2015, OECD Headquarters, Paris), available at <https://www.oecd.org/sd-roundtable/papersandpublications/Divestment%20and%20Stranded%20Assets%20in%20the%20Low-carbon%20Economy%2032nd%20OECD%20RTSD.pdf>

commitment to provide benefits over the long-term. To ensure we stay below two degrees, roughly 80% of current fossil fuel reserves must stay in the ground.

This thesis changes the fundamental nature of the oil and gas industry, the growth of which has historically been based on recycling revenues into the replacement of current reserves. According to Carbon Tracker, this business model is “no longer valid.” This insight will have profound implications for the oil and gas sector once it is widely accepted by the capital markets, and we believe this is inevitable, and is already happening.

In a recent speech, Spencer Dale, Group chief economist for BP, said that

“it is increasingly unlikely that the worlds’ reserves of oil will ever be exhausted. Existing reserves of fossil fuels – i.e. oil, gas and coal – if used in their entirety would generate somewhere in excess of 2.8 trillion tons of CO₂, well in excess of the 1 trillion tons or so the scientific community consider is consistent with limiting the rise in global mean temperatures of no more than 2 degrees Centigrade. And this takes no account of the new discoveries which are being made all the time or of the vast resources of fossil fuels not yet booked as reserves.”

As a result, he said “there is no longer a strong reason to expect the relative price of oil to increase over time.”⁴ He called for a new economics of oil.

The oil majors have told us that they are committed to an imprudent path. Both Exxon Mobil and Shell publicly rejected the stranded assets thesis in reports to their investors. In doing so, they also rejected the future, because the path they’ve outlined – a path that will lead to dangerous global temperature increases, is no future at all. Such a path takes us completely out of the realm of risk mitigation, into a chaotic environment for which there is no precedent.

According to Carbon Tracker, “Exxon have come clean that they are betting on 6 degrees of warming – but investors have no way of managing the risks associated with that trajectory”⁵ Fiduciary duty should dictate the rejection of such clearly imprudent strategies. Thankfully, Carbon Tracker has clearly articulated how this imprudent path is based on a series of unrealistic and implausible assumptions.⁶

In Paris, the world reached agreement to, in essence, ensure that the vast majority of fossil fuel reserves are not burned. In the wake of the Paris agreement, increasingly meaningful policy responses will happen, and they are critical. But the stranded asset thesis does not depend upon them. In a series of detailed reports, Carbon Tracker has demonstrated how a wide range of factors may affect future demand for fossil fuels, outside of the policy arena.

Here are a few recent developments:

⁴ Spencer Dale, *New Economics of Oil* (Society of Business Economists Annual Conference, 13 October 2015, London), available at <http://www.bp.com/content/dam/bp/pdf/speeches/2015/new-economics-of-oil-spencer-dale.pdf>

⁵ *Exxon are not preparing for an energy transition to limit global warming* (Carbon Tracker), available at <http://www.carbontracker.org/news/exxon-are-not-preparing-for-an-energy-transition-to-limit-global-warming/>

⁶ *Responding to Shell: An Analytical Perspective* (Carbon Tracker, 9, July 2014), available at <http://www.carbontracker.org/report/responding-to-shell-an-analytical-perspective/>

- In February, for the first time in twenty-two years, ExxonMobil failed to fully replace its production, meaning that its reserve-replacement ratio — a key metric used by oil and gas analysts — fell to 67 percent. Anything less than 100 percent means that the company pumped more oil than it acquired or discovered. This tells us that even within the industry, it is understood that the business is changing dramatically.
- In October, Toyota, the world's best selling auto maker announced that by 2050, gas-electric hybrids, plug-in hybrids, fuel-cell cars and electric vehicles will account for most of its global vehicle sales, and that gasoline- and diesel-engine powered cars, currently accounting for roughly 85% of Toyota global vehicle sales, would be near zero.⁷
- The story for coal is even more dramatic. The Dow Jones U.S. Coal Index is down 90 percent over the last ten years. Peabody Energy, the world's largest publicly owned coal producer, with mines around the world, has declared bankruptcy.
- The cost of producing electricity from wind and solar has dropped significantly over the last five to ten years, and has started to reach price parity with the grid in various markets, including thirty countries and twenty U.S. states. Deutsche Bank predicts that by the end of 2017, solar energy will be at grid parity for most of the world.⁸
- India's energy minister now says that solar power is a more cost-effective option than coal. India has a national plan to generate more than 100 gigawatts of solar power by 2022, a twenty-fold increase over today.⁹

When will all of these developments conspire to dramatically alter the demand curve for fossil fuels? When will the market begin to react, in anticipation of this shift? At what point would it be prudent to avoid holding those stocks that are most sensitive to stranded assets?

According to a recent Goldman Sachs report,

“We believe mainstream emission scenarios underestimate the speed and scale at which fast-evolving, low-carbon technologies gain market share in carbon-intensive sectors, including power generation, lighting and autos. We estimate this could shift global emission pathways earlier and more significantly than is commonly expected, which could help global emissions to peak earlier than expected, possibly as early as 2020.”¹⁰

The OECD Paper cautions against relying solely on models that assume an orderly transition to a low-carbon economy: “Changes in the costs of low-carbon solutions and in international energy

⁷ Yoko Kubota, “Toyota Maps Out Decline of Conventionally Fueled Cars” (*Wall Street Journal*, Oct. 14, 2015), available at <http://www.wsj.com/articles/toyota-maps-out-decline-of-conventionally-fueled-cars-1444824804>

⁸ *Solar grid parity in a low oil price era* (Deutsche Bank, Mar. 20, 2015), available at <https://www.db.com/cr/en/concrete-deutsche-bank-report-solar-grid-parity-in-a-low-oil-price-era.htm>

⁹ Peter Dockrill, “India says the cost of solar power is now cheaper than coal” (*Science Alert*, Apr. 20, 2016), available at <http://www.sciencealert.com/india-says-the-cost-of-solar-power-is-now-cheaper-than-coal>

¹⁰ “*Low Carbon Economy*”, Goldman Sachs Global Investment Research (January 21, 2016).

prices can significantly affect the amount of stranded assets, as they could lead to a ‘disorderly’ transition and cause ‘runaway’ stranding.” It notes that “[a]n orderly transition may be the less likely of all scenarios....”¹¹

Conclusion

The unique nature of the climate change threat requires us to think differently. Traditionally, investors view stranded assets as a risk to be avoided. In this case, however, global financial stability requires that these fuels stay in the ground. The welfare of the State’s participants and beneficiaries depends upon that.

Ownership of shares in companies with significant oil, gas and coal reserves therefore puts the State in a difficult, if not untenable, position. The future success of these companies is directly correlated with potentially dire financial consequences for the portfolio, and dire consequences for society at large. Their continued growth is, simply put, imprudent.

Continued investment in the largest owners and producers of fossil fuel reserves aligns the Vermont pension fund with an inhospitable future that no prudent person would willingly accept, given the choice.

Investors are not simply passive actors in this system – we are playing a critical capital allocation role, and should be mindful of the implications of all of our investment decisions. We are not simply future takers, we are future makers, and we should invest accordingly.

¹¹ OECD Paper, at paragraphs 28 and 55, available at <https://www.oecd.org/sd-roundtable/papersandpublications/Divestment%20and%20Stranded%20Assets%20in%20the%20Low-carbon%20Economy%2032nd%20OECD%20RTSD.pdf>