The rise of the carbon-sensitive shareholder

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Summary

- The Carbon Tracker Initiative made a minor splash in the UK earlier this year by arguing that a large part of the value of the FTSE 500 was built on carbon reserves that the climate change agenda would ultimately render 'unburnable.'
- Although many of the Initiative's assumptions are debatable, the idea that the valuations of carbon assets and the companies that sell or use them on a large scale are contingent on political and regulatory change over the next two decades is clearly not.
- The main source of this regulatory change is not the top down Kyoto process, but a bottom up regulatory activism in both the emerging and developed worlds. This in turn is driven by changing social attitudes.
- The Carbon Tracker Initiative is itself a sign of a new form of investor activism driven by 'normative' environmental concerns. We label the driver of this activism 'the carbon-sensitive shareholder;' and we conclude that she is going to have to be taken increasingly seriously.

Earlier this year, a report by the Carbon Tracker Initiative raised the interesting question of whether the carbon reduction levels implied by international targets to limit climate change meant that large parts of Earth's current carbon reserves, and the asset values based on them were effectively valueless – that they would be 'stranded' by future constraints on carbon use.

This Global Counsel Insight looks at the case for stranded carbon assets and wonders if the more immediate risks to company valuations come not from long term assessments of the value of carbon stocks, but investors shifting perceptions of the social and environmental role and conduct of hydrocarbon producers. Since the Carbon Tracker Initiative itself is an example of a new form of investor activism, we also take a look at the rise of the carbon-sensitive shareholder, and ask where this trend might be taking us.

Contingent carbon

The Carbon Tracker Initiative's assessments hang on a number of debatable assumptions. Most obviously they are based on the assumption that the acceptable emissions levels identified by the UN Intergovernmental Panel on Climate Change can and will be achieved. Such a scenario certainly has far-reaching implications not just for companies whose value depends on the ability to sell hydrocarbons, but also for those who buy and consume them on large scales.

They also assume that market valuations of energy and mineral companies are fundamentally based on rational assessments of hydrocarbon reserves projected decades into the future, which is questionable to say the least. BP lost half of its market value after the Deepwater Horizon accident in 2010 without losing a grip on much of its reserves.

This does not mean the notion of 'stranded' carbon assets can simply be dismissed. However, it is better to think of the value implied by carbon reserves, and the value generated by burning them, as 'contingent', especially beyond a 2020 timeframe. What they are contingent on above all is regulation, political action and social change, and the technological change that these will drive.

The most high profile international political attempt to shape this consensus – the Kyoto process - is actually barely relevant to this. A successor to the Kyoto protocol was narrowly rescued in Durban in December 2011 where both emerging and developed agreed to agree "an outcome with legal force" by 2015 to be implemented in 2020. What this ambiguous phrase entails is, however, unclear (see Global Counsel Insight *Disagreement deferred at Durban*, 3 December 2011). A high level of scepticism about the likelihood of a seriously constraining framework on greenhouse gas emissions in 2015 is understandable and almost certainly justified.

However, it also misses the point. The key driver of constraints on carbon use, and thus the key destroyer of implied value in hydrocarbon businesses and processes and their underlying hydrocarbon assets, is going to come from the bottom up not the top down. As with trade liberalisation and the WTO, the role of multilateralism is much more likely to become that of binding unilateral commitments into international agreements, not agreeing 'concessions' in advance.

Not waiting for Kyoto

Conventional market wisdom is often that national and regional politicians in both the emerging economies and the developed world are likely to subordinate long-term environmental concerns to short term economic ones. There is actually plenty of evidence that this is not true. It is true that developing country policymakers have a strong bias towards economic growth and rising living standards. It is also true that a long period of subdued economic growth in the developed world, and Europe in particular, is likely to act as a political check on ambitious unilateral policymaking. But both of these things can be overstated.

Indian and Chinese obstructionism at the Kyoto level has much more to do with preserving policy space than any inherent resistance to greening their economies. India is the second-fastest growing market in the G20 for clean energy investment and, in July 2011, instituted a tax on coal, lignite and peat expected to raise half a billion dollars a year . In China, concerns over air quality standards in cities such as Beijing, Chongqing and Chengdu have helped ensure that binding environmental standards were written into the Twelfth Five Year Plan in 2011. In 2011, Indonesia promulgated a set of carbon emission reduction targets for 2025 that are the toughest in the world.

In the developed world, almost every major market now has some form of emissions, efficiency and/or renewables target written into law. Most operate forms of subsidy for renewable energy, either in the form of subsidised operating costs or subsidisation of installation, often through stimulus programmes (see Chart 1). Even in markets such as the US, Australia and Canada, where federal governments have yet to legislate in these areas, provincial and state governments are front-running environmental policy. Quebec and British Columbia have both instituted carbon taxes. California operates a cap and trade system and stringent renewables targets for 2020. A significant number of other US states have signed into law efficiency standards for building and infrastructure or incentives for renewable energy use. Global investments in renewable energy may have temporarily stalled in 2010, but they recovered in 2011 to more than $250bn globally.

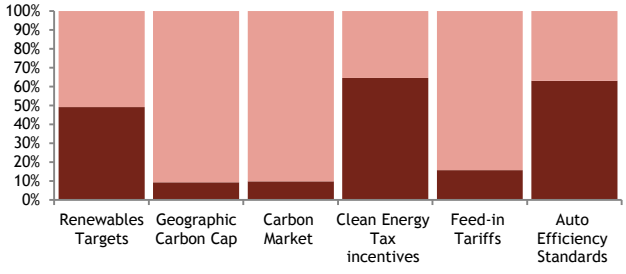

Chart 1: Percentage of emissions of top 20 global CO_2 emitters covered by various clean energy incentives in 2012. Does not include state and province-level initiatives in Canada, Australia and the US.

Source: Global Counsel research

Clear and credible legal jurisdiction over implementation make national and regional policy initiatives such as these much more direct in their impact on company valuations. As just one example, the 2011 announcement of a carbon tax plan by the Australian government wiped more than $7 billion from the market value of 25 of the biggest carbon emitters on the ASX Sydney stock exchange. In these cases the market is not reacting to revaluations of the underlying assets, but simple gut instincts on the impact on profitability of energy users and sellers.

Understanding what motivates this political action is key. It is partly practical, especially in China, where the environmental and public health impacts of carbon-intensive industrialisation are severe. But it is also normative: the result of voter and citizen support for, even demand for, change, even in the face of short term economic costs.

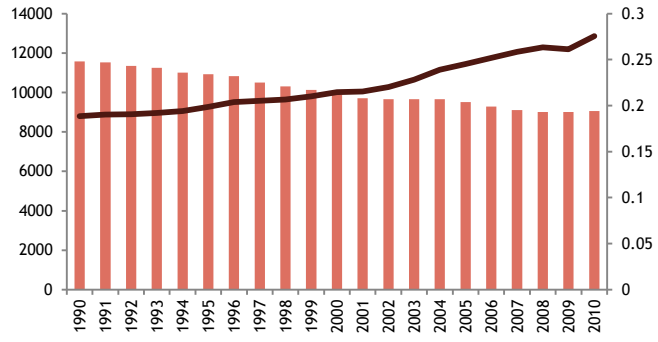

Chart 2: Energy consumption (LHS, MTOE) and energy intensity (RHS, KOE/$GDP 2005 prices) 1990-2010

Source: Enerdata 2012

The impact on carbon asset valuations of this pressure to reduce carbon use (as opposed to company valuations, which as the Australian and Deepwater Horizon examples show can be highly volatile) in the short and medium term is likely to be negligible. This is for the simple reason that the dynamic of economic growth and consumption growth in the emerging economies means that total energy use will continue to rise. The price advantage of natural gas and coal use over that of even the cheapest renewables such as wind power will contract as economies of scale for these new technologies become established, but not by much.

But the underlying political direction of travel is likely to reinforce a fall in carbon *intensity* by encouraging technological and cultural change (see Chart 2). Falling carbon intensity inevitably implies that total consumption will fall in turn as the industries and economies of the BRICs mature. In this scenario, the world's stocks of carbon assets are not stranded, as the Carbon Tracker Initiative suggests, but it must be assumed that they will be gradually revalued in the light of changing usage patterns. It is of course possible that a highly disruptive new technology could dramatically accelerate this process. But either scenario is likely to occur well beyond the current twelve year time frames of most energy companies and the analysts that value them.

The carbon-sensitive shareholder

A no less interesting question raised by initiatives like the Carbon Tracker is the extent to which normative attitudes to carbon use might impact on investor attitudes to hydrocarbon businesses, again, *irrespective of their underlying asset values*. Here the key is not how investors evaluate 'realisable' value, but how they think society should attribute social value. The cigarette industry is shunned by significant sectors of the investor community because of how they assess the social value of smoking, not because a question hangs over the value of the world's tobacco stocks.

It may seem a stretch to categorise the hydrocarbon industry in a similar way. However, it is not outlandish. For a decade the Carbon Disclosure Project (CDP) has been seeking to improve the ability of investors to make informed decisions by encouraging companies to disclose their carbon emissions. More recently the Asset Owner's Disclosure Project (the AODP, not related to the CDP), has sought to complement this by asking the 1,000 largest institutional investors to report on their efforts to manage their portfolios'

climate risk. We will have to wait until the release of their first survey at the end of the year to gauge the success of the AODP. Regardless, the project is likely to grow in step with the rise of the carbon-sensitive shareholder.

The AODP, the CDP and other investor sustainability movements like the Investor Network on Climate Risk (INCR) and various Socially Responsible Investment (SRI) approaches in the EU have expanded rapidly in the last decade. INCR asset managers now account for more than 12% of all assets under management globally, including alternative investments such as private equity. 'Dark Green' SRI funds that actively screen investments against sustainability criteria manage around the same proportion of funds under management in the EU (Charts 3 and 4).

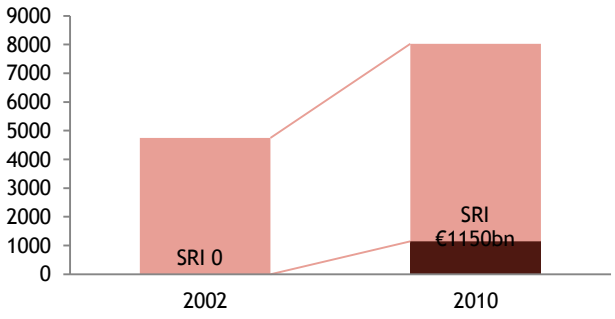

Chart 3: EU managed assets covered by 'core' SRI disciplines, as a share of total EU managed assets, 2002 and 2010 (€bn).

Source: Eurosif 2011

None of these funds currently exclude hydrocarbon producers for environmental reasons – although some do so for reasons linked to human rights abuse in their markets of extraction. But, reinforced by climate change arguments on one hand and perceptions of their conduct in extraction markets and environmental damage caused by accidents such as Deepwater Horizon on the other, these asset managers are placing an entirely new level of scrutiny on hydrocarbon producers and users.

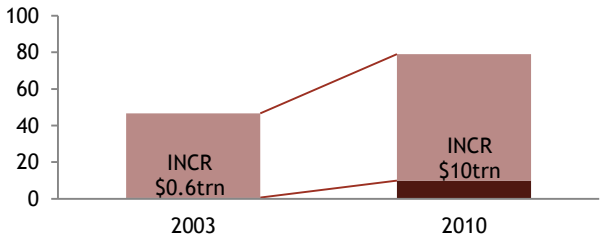

Chart 4: Global assets covered by Investor Network on Climate Risk, as a share of total global invested assets (US$tn)

Source: CERES 2012, City UK estimates 2012

The carbon-sensitive shareholder is in fact one voice in a wider debate about the relationship between big business and society. Al Gore and David Blood of Generation Investment Management have argued that investors concerned about environmental sustainability are part of a wider movement whose concerns include short-termism; executive pay; and corporate and social responsibility. They are probably right, although questions related to pay and performance are likely to be tied to the business cycle in a way that environmentalism is not. As the economy strengthens, the momentum behind carbon-sensitive shareholding is likely to strengthen, for the simple reason that society and corporates will be regarded as more able to bear the short term costs.

While hydrocarbon producers are still far from being categorised with tobacco companies and weapons manufacturers, there is little question that what might be called their social 'license to market' to western investors will be an increasingly relevant question. Large institutional investors such as churches and public sector pension funds are increasingly taking an active interest in gauging and reflecting their members' views on hydrocarbon investment. It is easy to dismiss this as peripheral risk. But it has implications across the board, from share liquidity and capital costs to investor and public relations. The carbon-sensitive shareholder is here to stay.

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