Fossil fuel divestment: the $5tn question

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Oil, gas and coal: Fossil fuels make up one of the world's largest liquid asset classes

PRESSURE is starting to build for institutional investors to cut their exposure to fossil fuel stocks. But can they find better places to park their cash and is it really at risk?

Divestment campaigners argue that continuing to extract oil, gas and coal is unsustainable if the world is to tackle climate change. Aside from rising environmental concerns, there are also worries that assets might become stranded as governments consider beefing up emissions regulations to help curb global warming.

While churches, universities and cities have signed up to starve fossil fuel companies of their cash over the past two years, there are limited viable alternatives for mainstream investors, new research from Bloomberg New Energy Finance (BNEF) shows.

With a combined stock market valuation of nearly $5 trillion, oil, gas and coal companies make up one of the world's largest liquid asset classes. The value of the 1,469 listed oil and gas companies is $4.65 trillion, while 275 coal companies are worth $233 billion.

Quitting coal would be relatively straightforward. But oil and gas companies are too large, and too widely held for large-scale divestment from fossil fuels to be easy or fast, BNEF finds.

The biggest shareholders in oil, gas and coal include the largest institutional funds in the world, alongside governments and strategic investors from within the sectors. The largest 25 holders of only the biggest 25 oil and gas companies – making up 61% of total market capitalisation for the sector – control more than $1 trillion worth of shares.

Divestment movements are less likely to hit the strategies of the Russian, Indian, Chinese, Colombian and Norwegian governments and their $250 billion of strategic holdings.

Any large-scale divestment movement beyond churches, campuses and municipalities will mean persuading firms such as BlackRock, Vanguard, State Street, and Capital Group – each with more than $1 trillion of assets under management – to reconsider their portfolios, Nathaniel Bullard, author of the report, said.

Preferred choice

Fossil fuels are investor favourites for a reason, said Bullard. Very few other investments offer the scale, liquidity, growth and yield of these century-old businesses with economy-wide demand for their products.

Still investors have started to seriously consider fossil fuel investment risk, including underperformance against benchmarks and asset stranding. The Carbon Tracker Initiative estimates that some 80% of proven fossil fuels must remain undeveloped if global warming is to be limited to a rise of 2° Celsius.

However a report from Energy Intelligence (EI) New Energy shows that the effect of shelved oil and gas developments would be small for most listed companies.

The direct effect of dropping high-cost undeveloped assets would be minimal for most companies, said Laszlo Varro, head of gas, coal and power at the International Energy Agency (IEA), as the vast majority of an oil company's valuation is associated with cash flows from existing assets, which would continue even under the strictest climate policies.

Projects at risk of being stranded only make up about 5-10% of European majors' total portfolios, an analysis by HSBC, a bank, has shown, and much less of future profits due to their high-cost, high-risk nature. Of course, incurred exploration cost would be wasted, but that typically makes up roughly 15% of a new field's costs, IEA data show.

In all, oil majors' stock market valuations would lose barely 5% because of stranded reserves, calculated EI New Energy.

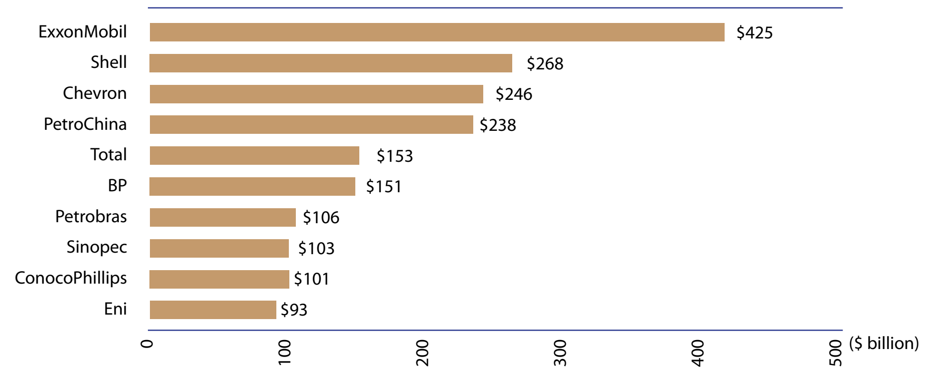
Climate policies that cut demand and cause oil prices to fall would be far more devastating as this would hit all production and reserves.

Kevin Bourne, managing director of London-based stock market indices provider FTSE described the divestment movement as one of the fastest-moving debates he's seen in his 30 years in the markets.

But divestment calls are not enough to pull the plug on trillions of dollars of investment in fossil fuels just yet.

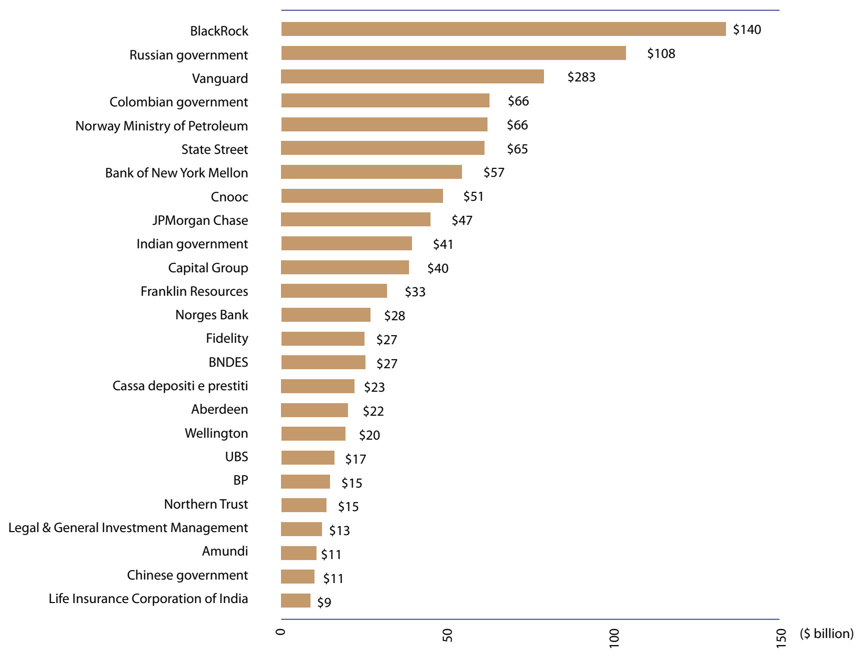
"It's easy for an individual to move assets out of one index fund and into another, but it is much harder for an institution to move billions of dollars

Figure 1: Oil, gas and coal equities



Source: Bloomberg (data correct as of 31 July 2014)

Figure 2: Top 25 investors in the oil and gas sector



Source: Bloomberg (data correct as of 31 July 2014)

(and the growth and yield that they have enjoyed) out of one company and into another," said Bullard.

The divestment debate has provided an opportunity to convince institutional investors that alternatives to fossil fuels are equally worthy investments.

Nevertheless, divesting from fossil fuels would not equate to directly investing in renewable energy generation, which is predicted to net $5.5 trillion in investment by 2030, half of which will happen over the next decade, argues BNEF.

To attract trillions of reinvested institutional dollars, clean energy would need a vast expansion of its YieldCos – publicly traded corporations that own operational assets – and green bond structures, or indeed, the creation of new instruments to recycle capital.

Of course, clean-energy equities offer growth potential and sufficient liquidity for institutional investors. But as an asset class, they are a fraction of the size of oil and gas equities. Clean-energy equities, as measured by the WilderHill New Energy Global Innovation Index, amount to 106 companies, with a total value of $220 billion.

Green growth

Clean energy as an asset class is simply not large enough to absorb substantial amounts of capital divested from fossil fuels yet, said Bullard. There are, however, a number of trillion dollar-plus sectors that could absorb divested dollars, including information technology and real estate investment trusts. While all have similar liquidity, they have different growth profiles and yield. Every sector is larger than clean energy, but no single sector has oil and gas's combination of scale, growth, and yield, data from BNEF show.

Still, when all of clean energy's assets and growth are factored in, it could be a trillion-dollar sector. It has positive long-term fundamentals and in many parts of the world is a first-best option for new power generation capacity. As it scales up it could attract hundreds of billions of dollars of investment from a single institutional investor. More investment vehicles would help too.

Above all, perception could shift capital investment patterns, reckons Bullard. "People choose portfolios, and people assess risk. Clear-headed investors may look at fossil fuel equities and weigh them not just against historical return and yield, but also future prospects given new technologies, consumption patterns, regulations, and finally, public perception".

Bullard concluded that fossil fuel divestment is neither imminent nor inevitable. But, neither is it impossible for motivated investors. ●