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DIVESTMENT FROM FOSSIL FUELS: IS IT ACCELERATING THE ENERGY TRANSITION?

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Evidence of a direct impact of the divestment from fossil fuels on greenhouse gas (GHG) emissions reduction is limited, but the divestment movement has contributed to raising awareness of the need for climate action, and increased support for climate policy.

Fossil fuel production and consumption is widely acknowledged as one of the key contributors to climate change, but money is still flowing at scale towards the fossil fuel sector. There has been a strong global call to action to divest from fossil fuels, but is divestment accelerating the energy transition?

WHAT IS THE DIVESTMENT MOVEMENT FROM FOSSIL FUELS?

About a decade ago, the fossil fuel divestment movement began to spread across college campuses in the US, triggered by an article by Bill McKibben in Rolling Stone magazine (McKibben, 2012). This rapidly growing social movement put pressure on universities, at first, to sell-off their shares in fossil fuel companies. After several universities committed to divest from fossil fuels, some high-profile organisations followed suit starting in 2014, such as the World Council of Churches and the Rockefeller Brothers Fund. The movement expanded to European universities, including the Netherlands. In the Netherlands, advocates of fossil fuel divestment put pressure on Dutch pension funds, in particular the pension fund for employees in the public and education sectors (ABP), to divest their assets from fossil fuel companies such as the British-Dutch Shell company. McKibben stated in his Rolling Stone article: *"We have five times as much oil and coal and gas on the books as climate scientists think is safe to burn. We'd have to keep 80 percent of those reserves locked away underground to avoid that fate."* Part of the value of fossil fuel companies is based upon these 'unburnable' reserves, which would become stranded assets due to increased climate action, in turn negatively impacting the share values and return on investment of these companies. The main arguments from the start of the movement were not only from a financial risk perspective, but also from an ethical and moral standpoint. The divestment movement has emphasised that divestment is the only moral choice for institutions that care about the economy, society and planet (Fossil Free, 2014); making references to previous divestment campaigns, such as divesting from South African companies under Apartheid, which was part of strong international pressure on the Apartheid government.

WHY IS THE DIVESTMENT MOVEMENT IMPORTANT?

Combustion of fossil fuels, combined with industrial processes, contributed about 78% of the total GHG emissions increase from 1970 to 2010 (IPCC, 2014). It is clear that unabated use of fossil fuels is incompatible with reaching the goals of the Paris Agreement, and needs to be significantly reduced, or even phased out entirely. Today, our society and economy still relies heavily upon fossil fuels, so it is no surprise that the global financial markets and the fossil fuel industry are closely intertwined. The fossil fuel sector had a market capitalisation of 4.9 trillion US$ in 2014 (BNEF 2014), which was more than five times the GDP of the Netherlands. The fossil fuel industry has offered reliable investment track records by generating consistent yields for investors such as Dutch pension funds with fiduciary responsibility towards their clients, including many individuals who want to enjoy a financially stable retirement. To what extent the consistent, stable yields from the fossil fuel industry continue is uncertain, due to climate risks such as stranded assets. Research has already shown, for example, that performance of investment portfolios that exclude fossil fuel production companies does not significantly differ in term of risk and return from unrestricted portfolios (a.o. Plantinga & Scholtens, 2020, Halcoussis et al. 2019, Henriques & Sadorsky 2018).

The current scale of divestment is only a small fraction of the total market capitalisation of all companies in the fossil fuel industry (HSBC, 2015). In the Netherlands, some banks and pension funds have pledged to step out or reduce their investment in coal over time, and 22 philanthropists have pledged to remove around 200 million euros of their personal wealth from fossil fuel companies (Fossielvrij, 2019). Most critics of the divestment movement argue that direct effects of divestment on the financial performance of fossil fuel companies or GHG emission reduction are very limited (Braungardt, 2019). For example, the large scale of the global financial system makes it easy to find alternative suppliers of capital, and although the sustainable energy sector has grown substantially over the last two decades, fossil fuels still play a crucial role in our society, and probably will for some time.

“MOST CRITICS OF THE DIVESTMENT MOVEMENT ARGUE THAT DIRECT EFFECTS OF DIVESTMENT ON THE FINANCIAL PERFORMANCE OF FOSSIL FUEL COMPANIES OR GHG EMISSION REDUCTION ARE LIMITED”

Theoretically, less demand for shares and bonds of fossil fuel companies can increase their cost of capital; an influential parameter in the shaping of the technology mix of future energy systems (Halstead et al. 2019). Proponents of the divestment from fossil fuels movement argue that these kinds of direct effects of divestment on the financial performance or GHG emission reduction of companies is not always the main aim of the divestment campaign. Proponents suggest that the movement has further highlighted the need for climate action and increased support from citizens and voters for climate policy (Braungardt, 2019). Focusing on ambitious climate policy and climate action makes sense when looking, for example, at the power sector transformation in Europe. Here, direct effects of divestment are not the main driver that are pushing out (development of new) coal-fired power plants. The driver is a combination of climate policy and action, and increased competition from renewable energy sources, due to their falling cost and the financial support from government. Even with a national government that aimed to revive the coal industry, coal plants are suffering in the US, and not because of divestment (EIA, 2020, the Guardian, 2020). However, outside of the power sector many low carbon alternatives to fossil fuels are often not mature enough yet to go through a similar transition.

TNO recently conducted a set of interviews with institutional investors about their clean energy investment and divestment from fossil fuel strategies. The main observations from these interviews underline the signalling effect suggested by the proponents of fossil fuel divestment (Donker, Halstead and Gavrilova, 2019). Investors in fossil fuel intensive companies seem to prefer to try to influence the strategy and vision of fossil fuel companies first, rather than trying to enforce change by divesting their holdings. In particular, larger investors can influence the direction that companies take by, for example, dialogue with the board of directors, exercising shareholder voting rights, and proposing shareholder resolutions. By divesting, investors relinquish their influence and voting rights, and thereby their influence over a company's strategy and decision-making. Stewardship and active engagement by investors can be powerful tools to steer the direction of the current key players in the energy sector towards a sustainable future. The question remains: will they use these tools effectively? One initiative that is worth mentioning here is the Dutch Investor advocacy group Follow This, which uses its shareholder position as a basis to enforce change. By buying enough shares of major fossil fuel companies, they file shareholder resolutions pressurising these companies to take action on climate change, while at the same time convincing other (more progressive), larger shareholders to join them. Clearly, by keeping 'skin in the game', this alternative approach to divestment could be a successful way of changing the behaviour of fossil fuel companies.

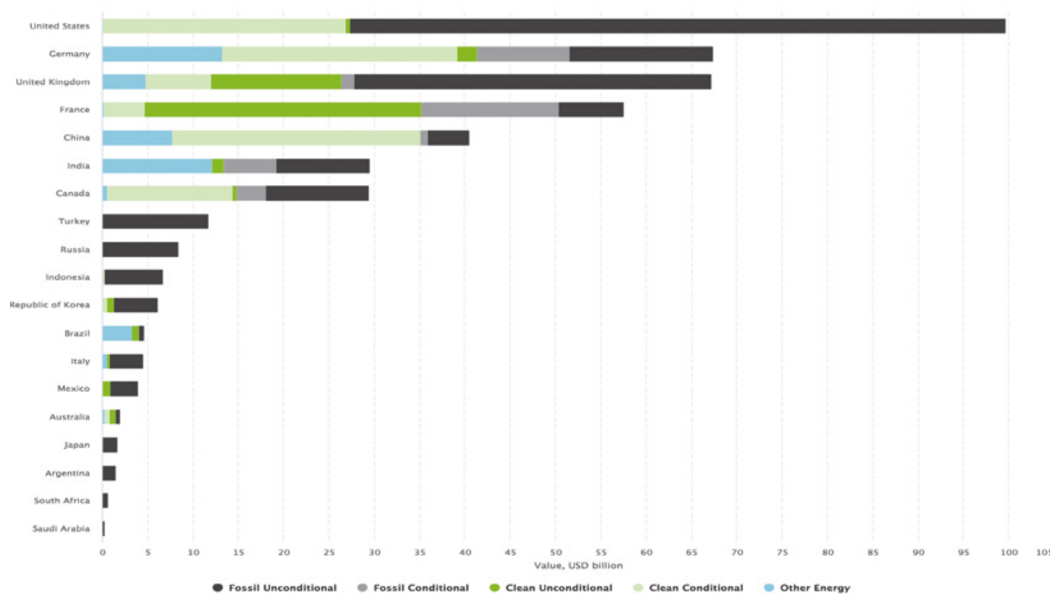

Figure 1 Overview of the distribution of funds in G20 corona recovery packages to various energy types (source: EnergyPolicyTracker)

WHAT DOES THE FUTURE HOLD?

COVID 19 is having a major impact on the global economy and the energy sector. Governments of many countries have operationalised public stimulus packages to survive and recover from the crisis. There is a clear opportunity to stimulate a green recovery, and governments have an important role to play in providing a signal to the market that fossil fuels are not the future. Thus far, G20+ countries have pledged US$233 billion to fossil fuels, including to large fossil fuel consumers in transport and industry, in their recovery packages. This equates to 53% of all public money that has been committed to the energy sector in these recovery packages. Environmental conditions are only included in 20% of the loans, loan guarantees, and other bailouts to fossil fuel-based companies in the energy sector (EnergyPolicyTracker, 2020). The Dutch government committed at least €3.5 billion of direct support to individual companies, €3.4 billion of which to airline KLM alone. The government also launched a National Growth fund consisting of €20 billion, and initiated Invest-NL[1].

1 *Invest-NL focuses on "financing projects and businesses that drive the energy transition and accelerate the growth of innovative, fast-growing companies" (Invest-NL, 2020)*

Both initiatives aim for change in the Dutch economy, particularly referring to the energy transition and alignment with the Dutch climate agreement. Pledges, targets, policies, subsidies, shareholder rights and redirecting the focus of government-owned enterprises such as EBN from natural gas towards geothermal energy, are other examples of efforts by the Dutch government to send signals to the market to move away from fossil and towards sustainable alternatives. Governmental support to fossil fuels thus sends a mixed signal to the private sector and puts the achievement of climate and energy targets under further pressure.

The direct impact of divestment from fossil fuel companies appears to be limited so far, but insurance companies could play a significant role in altering this. The insurance sector is concentrated, with a few large market players, and fulfils an essential function with its underwriting of investment activities (Halstead et al, 2019). Major insurance companies like Allianz, Aviva and Zurich are concerned about climate change as it would impact their business in various ways (Bank of England 2015; DNB 2018), and have begun to act on that by shifting assets away from fossil fuel companies and refusing to underwrite their operations (Unfriend Coal 2017). Fossil fuel companies will become much less attractive if insurers stop covering the (non-climate) risks of fossil fuel projects or charge higher insurance premiums due to perceived higher risks associated with climate change (Halstead et al, 2019).

“THE DIVESTMENT CAMPAIGN HELPS RAISE AWARENESS OF THE TOPIC OF CLIMATE CHANGE, AND WHO IS STILL INVESTING HEAVILY IN THE FOSSIL FUEL INDUSTRY”

The divestment campaign helps raise awareness of the topic of climate change, and who is investing in the fossil fuel industry, but the movement has, perhaps surprisingly, not paid much attention to the (re)investment of capital into low-carbon sustainable energy alternatives. It is important to understand that divestment from fossil fuels does not necessarily mean a reinvestment of the divested capital into sustainable alternatives such as renewable energy occurs. Research has shown that money divested from fossil fuel companies (primary sector) and reinvested in banks (tertiary sector) will very likely end up funding fossil fuel companies again (Ritchie & Dowlatabadi, 2015).

More efforts on the investment challenges of low-carbon sustainable development and deployment could be very beneficial to accelerate the energy transition. For example, regulation could be made that helps immature markets and sustainable energy technologies to develop, and improves the transparency, common language and standardisation in sustainable finance. In conclusion, when sustainable energy alternatives thrive and start to push fossil fuels out of the market - as we are seeing in the power sector today in Europe and the US - capital will be redirected away from the fossil fuel industry towards sustainable energy investments, making the energy transition a success.

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