THE RESPONSIBLE CAPITALISM NEWSLETTER

Big Change at Big Oil?

This quarter was an extraordinary period of social tipping points in relation to Big Oil, each of which is likely to have long-lasting ramifications. Legal and shareholder activism is on the rise and this quarter we witnessed what appears to be a turn in the tide. Royal Dutch Shell, ExxonMobil and, to a lesser extent BP, have found themselves in the crosshairs of action from an increasingly sophisticated group of climate change activists. A further surprise came from the International Energy Agency (IEA) which unveiled an industry framework for achieving net-zero green house gas (GHG) emissions by 2050. This was a departure from the IEA's previous stance, which was typically to align with the industry consensus. Whether the IEA's report will influence the industry is another matter. Its main conclusion, that investment in new fossil fuel supply has to cease immediately to achieve net zero, is unlikely to find unanimous support in boardrooms and raises the spectre of carbon leakage where disposals of highly polluting assets by listed integrated oil and gas companies end up in the hands of companies and jurisdictions subject to more lax policies[1]. This risk has come to pass in asset disposals by both Shell and BP in recent months. No-one should underestimate how extraordinarily challenging a smooth transition will be.

Carbon policies and human rights

Starting in the Netherlands: in May, the Hague District Court ordered Royal Dutch Shell to slash carbon emissions by at least 45% from 2019 levels by 2030. This was the first example of a court holding a major energy company to account for its role in global warming. The complaint was brought by Milieudefensie – Friends of the Earth Netherlands – and was supported by six other environmental groups and around 17,000 Dutch citizens. They alleged Shell's activities "endangered human rights and lives" by jeopardizing the goals of the Paris Agreement.

Royal Dutch Shell countered the claim by underscoring the merits of its own transition plan, which includes a net-zero 2050 target. By then, it aims to cut the carbon intensity of its energy products to zero, including "emissions associated with the production, processing, transport and end-use" of its energy product[2].

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There are two key points to highlight with this case. First, the Dutch court's ruling considered Shell's lack of a clear science-based alignment with the Paris climate goal a human rights violation. This is significant as it effectively means that there is now a legal precedent which links climate change policy to human rights[3]. Climate change cases are on the rise globally, so this interpretation could have significance. The UN Environment Programme's (UNEP) climate litigation report in January calculated there were 1,550 active cases of climate change litigation in 38 countries around the world, nearly double the 884 cases brought in 2017[4]. Many of these cases are in the US, with cities such as New York and San Francisco making claims against fossil fuel companies.

Second, the ruling also underscored a potential flaw in net-zero 2050 targets, which was highlighted in the UNEP Emissions Gap Report 2020. The report said that while country-level commitments to cutting emissions towards net zero by 2050 were encouraging, they lack essential targets for near term emissions cuts[5]. By 2030, GHG emissions need to come down by over 50% compared to the current policy trajectory to have a 66% chance of keeping temperatures below 1.5°C, and a 90% chance of sub-1.9°C, in 2100 (Figure 1). More recent analysis from Climate Action Tracker draws a similar conclusion: it suggests a slight narrowing of the gap due to recent government net-zero pledges, but also underscores a lack of clear path for making significant emissions cuts in the next decade[6].

The court ruling highlights a key tension in the Paris Agreement between the unanimous goal of limiting global warming to 2°C, with the more ambitious 1.5°C target, and the "pledge and review" approach to achieving that through nationally determined contributions (NDCs), which was an outcome of COP15 in Copenhagen 2009. Although more realistic and sensitive to different economic and social circumstances across countries, this bottom-up approach has resulted in a wide gap between policies, pledges and the underlying goal of limiting global warming to 1.5-2.0°C.

The court case in the Hague shows the potentially important role of litigation in seeking to narrow this gap. However, we are mindful of the point we raised above in relation to the IEA's report – the ruling may do little to avert carbon leakage, where oil companies from other countries make up for any cuts made by the likes of Royal Dutch Shell. Governments therefore need to step up to deal with that sort of leakage, which is part of the intention behind the EU's proposed carbon border tax. This would help neutralise the sort of policy arbitrage that is an inevitable risk associated with an uneven NDC-style approach to cutting global carbon emissions.

We are not naïve about the potential for a years-long legal challenge from Shell to

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the Hague ruling which will delay compliance. Nevertheless, we believe this case has raised the significance of litigation as a potential long-term material risk factor that must be considered as part of the investment process for highly polluting companies. It is one example of how the wider ecosystem of climate action is evolving and forcing more rapid change.

Figure 1: Current policies are off course for a 1.5-2.0°C scenario

Table ES.1. Global total GHG emissions in 2030 under different scenarios (median and 10th to 90th percentile range), temperature implications, and the resulting emissions gap (based on the pre-COVID-19 current policies scenario)

Scenario (rounded to the nearest gigaton)	Number of scenarios in set	Global total emissions in 2030 [$GtCO_2e$]	Estimated temperature outcomes			Closest corresponding IPCC SR1.5 scenario class	Emissions Gap in 2030 [$GtCO_2e$]		
			50% probability	66% probability	90% probability		Below 2.0°C	Below 1.8°C	Below 1.5°C in 2100
2010 policies	6	64 (60–68)							
Current policies	8	59 (56–65)					17 (15–22)	24 (21–28)	34 (31–39)
Unconditional NDCs	11	56 (54–60)					15 (12–19)	21 (18–25)	32 (29–36)
Conditional NDCs	12	53 (51–56)					12 (9–15)	18 (15–21)	29 (26–31)
Below 2.0°C (66% probability)	29	41 (39–46)	Peak: 1.7–1.8°C In 2100: 1.6–1.7°C	**Peak: 1.9–2.1°C In 2100: 1.8–1.9°C**	Peak: 2.4–2.6°C In 2100: 2.3–2.5°C	Higher 2°C pathways			
Below 1.8°C (66% probability)	43	35 (31–41)	Peak: 1.6–1.7°C In 2100: 1.3–1.6°C	**Peak: 1.7–1.8°C In 2100: 1.5–1.7°C**	Peak: 2.1–2.3°C In 2100: 1.9–2.2°C	Lower 2°C pathways			
Below 1.5°C in 2100 and peak below 1.7°C (both with 66% probability)	13	25 (22–31)	Peak: 1.5–1.6°C In 2100: 1.2–1.3°C	**Peak: 1.6–1.7°C In 2100: 1.4–1.5°C**	Peak: 2.0–2.1°C In 2100: 1.8–1.9°C	1.5°C with no or limited overshoot			

Source: UNEP Emissions Gap Report 2020

The changing face of shareholder activism

Shareholder activism is another example of where disruptors are forcing change. This quarter has shown how fringe shareholders are punching above their weight by recruiting larger, mainstream allies on the share register. Again, for investors, this creates a unique form of materiality risk, in part due to an unusual form of asymmetric information created by those inside or outside of the action.

Prior to the court ruling in the Hague, Royal Dutch Shell's Annual General Meeting (AGM) highlighted the momentum behind activist shareholder group Follow This.

This organisation was the brainchild of Mark van Baal, who attempted activism via journalism for a decade, deciding to pursue the shareholder route when his career as a journalist failed to make an impact. Follow This has a beguilingly simple model. It recruits individual shareholders via an online investment platform who buy a single share in one or more of the oil majors it seeks to influence. It then represents the rights of those shareholders, bringing climate-related resolutions on their behalf to AGMs. The group's potency does not come from the aggregate weighting of the combined holding, which is minuscule, but the collective voice of the minority shareholders – and, importantly, how well Follow This can encourage larger shareholders on the register to vote for their resolution.

At Shell's AGM in May, Follow This was notably supported by Legal & General Investment Management (LGIM) on a resolution for Shell's policies to show greater alignment with the Paris goals.

By way of background, Shell's plan – which is embedded in the Key Performance Indicators of its leadership team and is one of the more robust plans among major oil companies – included a modest fall in oil production, partly due to the sale of oilfields and the natural decline in reserves. It plans to cut carbon intensity of its products by 20% by 2030, in part due to increased investment in renewable energy. It also plans to include nature-based carbon offsets and carbon capture and storage technology. Of concern, however, is the slow pace of emissions cuts, the reliance on offsetting and an increase in gas production and exports[7]. On balance, this strategy is likely to result in Shell producing more *absolute* carbon emissions – at least in the short term – even if it cuts the carbon intensity of its products. Moreover, Shell did not take into account the potential for fossil fuel demand to increase in the next decade, which will depend on the nature of the post-Covid recovery and speed of the transition to a lower carbon economy, rendering its net zero plans less effective. We have engaged with Shell on these points in recent months.

A key criticism by Follow This is that Shell was not using an absolute carbon number but a carbon intensity number, which averages carbon emissions across products; hence the resolution from Follow This at Shell's AGM for a strategy that cuts absolute emissions by 25-45% across scope 1, 2 and 3 emissions by 2030. With LGIM on board, among others, the resolution was supported by over 30% of shareholders, which was twice as many votes as a similar Follow This resolution received last year. Meanwhile, 89% of shareholders voted in favour of Shell's existing plan (including ourselves). The court in the Hague has obviously stepped in since with similar requirements. Momentum is behind the actions of groups like Follow This, which are basing their efforts on climate science rather than behind-the-curve government policies. Its platform currently offers single shares in Shell, Total, BP and Chevron.

Before wrapping up, a few words on Exxon and the small impact hedge fund Engine No.1, a company which reputedly had a modest $240m under management before its recent activity and was non-existent until December last year[8]. Its strategy bears some similarities to that of Follow This, although its first strike suggests it is a more powerful force in creating change. Run by hedge fund veteran Chris James, the firm is tapping into the zeitgeist among similarly minded institutional investors. With the backing of Calstrs, the $300bn US pension fund with a history of voting against Exxon's board, Engine No.1 succeeded in unseating three Exxon directors and replacing them with two former oil refinery executives and a venture capital investor – and it managed to do this holding a mere 0.02% of Exxon's stock. One of the new directors is Kaisa Hietala, who was instrumental in the transformation of Neste, the Finnish energy group, into a highly profitable renewable diesel and aviation fuel business. Engine No.1's success is an extraordinary act of disruptive shareholder activism. Its modus operandi is to create value through a positive social and environmental impact strategy. Time will tell whether these changes have a material bearing on the group's strategy.

What does this mean for our clients?

There are several things to take away from this activity, but the overall message for investors is that this form of activism needs to be considered as part of our wider checks and balances when it comes to assessing material risks and opportunities. Follow This is transparent about the four oil majors it is seeking to influence. Engine No.1 is likely to be more opaque, working closely with small groups of major shareholders that it knows will back its agenda. This is a potentially clever strategy as it creates uncertainty and pressure on highly polluting companies to introduce carbon transition policies based on the science behind the Paris Agreement. And within the Hague, it is now considered a matter of human rights, although with the obvious acknowledgement that it won't be a view shared in many parts of the oil producing world. The key point here is that there are many pressure points that investors need to factor into their analysis of a company's resiliency. We also need to work with groups such as ISS to ensure voting recommendations are done in a way that fully reflect the intention behind Paris-aligned motions.

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Investors increasingly understand the need for immediate emissions cuts and we ourselves have an important role in understanding the risks and opportunities posed by the climate transition for our clients, especially as signatories of the Net Zero Asset Managers initiative. The next five years will be crucial for determining the future trajectory of how hot our planet gets and we need oil giants to be part of the solution. Hence, these groups need to be open and honest with investors about what they're doing. At our recent Active Owners webcast, Professor Will Steffen spoke about social tipping points where it will no longer be socially acceptable not to have robust, science-based emissions reduction goals in place. From the activity of the last quarter, we suspect we are reaching that point.

Endnotes

1 https://www.iea.org/news/pathway-to-critical-and-formidable-goal-of-net-zero-emissions-by-2050-is-narrow-but-brings-huge-benefits
2 https://www.shell.com/energy-and-innovation/the-energy-future/our-climate-target.html#iframe=L3dlYmFwcHMvY2xpbWF0ZV9hbWJpdGlvbi8
3 https://theconversation.com/shell-ordered-to-cut-its-emissions-why-this-ruling-could-affect-almost-any-major-company-in-the-world-161754
4 https://www.unep.org/resources/report/global-climate-litigation-report-2020-status-review
5 https://wedocs.unep.org/bitstream/handle/20.500.11822/34438/EGR20ESE.pdf?sequence=255
6 https://climateactiontracker.org/press/global-update-projected-warming-from-paris-pledges-drops-to-two-point-four-degrees/
7 https://www.theguardian.com/business/2021/feb/11/shell-grow-gas-business-energy-net-zero-carbon
8 https://www.ft.com/content/ebfdf67d-cbce-40a5-bb29-d361377dea7a

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Important Information

Majedie Asset Management, established in 2002, is an independent, employee-owned investment boutique that actively manages equities for institutional investors, wealth managers and endowments across a range of UK, US, Global and International strategies.

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