

ENERGY: A SPECIAL REPORT

New Pressure for Energy Over Environment?

BY MARGARET PELOSO, LEONARD WOOD AND CORINNE SNOW

A WELL-WORN STEREOTYPE PORTRAYS

American corporations and particularly the energy industry as ambivalent at best about the environment. However, increasingly, major asset managers and investors have been asserting their views on the relationship between the well-being of the environment and the strength of their returns.

Some institutional investors are now emphasizing links between environmental protection and long-term shareholder value in the aim of strengthening the value of their investments. Climate-related aspects of environmental protection and the carbon footprint of energy companies are receiving heightened attention.

An indicator of shifting attitudes is found in BlackRock Inc.'s September 2016 white paper "Adapting Portfolios to Climate Change," which urges "all investors" to "incorporate climate change awareness into their investment processes." The white paper urges asset managers and investors to prioritize environmental criteria in their investment decisions and engagements with portfolio companies as a means to optimize investors' market exposure risks and bolster returns.

Corporate boards should keep watch as institutional investors articulate financial rationales for environmentally protective policies in their portfolio companies. This will be especially true in the



energy industry, which is under scrutiny from environmentally minded investors.

This spring's proxy statements of energy companies and companies in other industries demonstrate how shareholders with environmental agendas are availing themselves of powers afforded to shareholders by corporate legal machinery and securities regulations to impose their changing preferences on the companies in which they invest.

A FOCUS ON CLIMATE CHANGE

BlackRock's assertion of a connection between climate change and market

value may be old news to environmentalists and economists but it is likely to spark newfound interest among investors. Expressing environmental issues in financial terms, BlackRock's white paper claims that "the world is rapidly using up its carbon budget" and that the "sums at risk are enormous."

Similar ideas appeared in a February 2016 letter written by Larry Fink, BlackRock's CEO, to S&P 500 companies, claiming that, "Over the long-term, environmental, social and governance (ESG) issues ... have quantifiable financial impacts."

The white paper argues that climate factors have been “underpriced,” meaning that the market has yet to realize the risks climate change poses to long-term value of companies, and investors have yet to appreciate the potential upsides of investing in new technology that mitigates environmental harm.

BlackRock cautions that even short-term investors can be negatively affected by sudden regulatory developments, rapid technological change and extreme weather events.

The white paper recommends that investors prepare for a future in which governments impose a price on carbon emissions.

This white paper is just one of a number of recent moves to encourage asset owners and managers to take advantage of a growing array of climate-related investment strategies.

As part of the white paper, BlackRock created a “rulebook” for making a corporate bond portfolio more climate-friendly, which discourages investment in coal, fossil fuel reserves, and industries with high carbon or toxic emissions. In 2014, BlackRock teamed up with London’s FTSE Group to create stock indices that exclude oil and gas companies. In 2015, it launched a social impact mutual fund that “aims to invest in measurable social and environmental outcomes while seeking to generate competitive financial returns.” BlackRock is looking to invest in energy companies that will reduce their climate impact, energy innovators that will produce more environmentally efficient technologies and other companies that implement environmentally efficient technologies.

The message from BlackRock and similarly minded institutional investors is clear: Companies should take

proactive steps to improve their environmental policies and protect asset value. BlackRock encourages companies to adopt benchmarks to evaluate and improve their climate impact.

Companies with such benchmarks in place, the white paper argues, “have the potential to perform in line with or better than regular counterparts.” Investors, for their part, can push companies toward these policies by seeking lower carbon portfolios and considering divestment.

THE LEGAL PLAYING FIELD

Corporate boards will need to pay close attention to these developments as this form of shareholder engagement and activism plays out through the machinery of corporate and securities law. Public companies are already preparing to face investors that are increasingly studying environmental aspects of operations beyond the bottom line.

But companies with significant carbon footprints need to make not only business decisions but legal decisions about how they will publicly report under the Securities Exchange Act.

BlackRock is only one of several institutions to have suggested in recent years that companies voluntarily undertake more robust environmental disclosures in their public filings.

Public energy companies need to be prepared, meanwhile, for an intensified wave of shareholder proposals in light of the specter of alignment between top institutional investors and smaller shareholders that regularly put environment-related proposals on corporations’ annual proxy statements through the Rule 14a-8 process.

Energy companies in particular are receiving more and new kinds of environment-related proposals from

smaller shareholders. Such proposals have historically failed at annual meetings of public corporations by significant margins, in large part because the proposals do not receive sufficient support from institutional investors.

This pattern shifted in 2016 as energy companies in the Fortune 500 saw “for” votes on individual environmental proposals reaching, in some cases, above 40 percent of the votes cast or eligible to be cast at shareholder meetings.

If more asset managers assert linkages between climate change and long-term company value, shareholder proposals submitted to companies under Rule 14a-8, including those put forth by small shareholders, will almost inevitably have greater chances of success.

It can also be fairly expected that certain institutional investors will eventually bring more of these environmental proposals to shareholder meetings themselves. If this happens, public companies, especially energy companies, can expect higher levels of shareholder pressure on environmental issues.

Margaret Peloso is a counsel based in Vinson & Elkins’ Washington office and Leonard Wood and Corinne Snow are associates in the firm’s Houston and New York offices.