Oil & Gas Divestment Considerations for PE

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Key Takeaways

- Divestment has continued to gain traction as a potential option for both GPs and LPs looking to limit climate exposure in their investments.
- While complete divestment is one strategy investors can take to decarbonize their portfolios, investors can also consider portfolio engagement as a strategy to avoid climate transition risks.
- Divestment may be an effective strategy for reducing climate change exposure for investors, but correlating divestment actions to real world emissions reduction is challenging and has led to little consensus over the broader effect of divestment strategies.

The Divestment Movement

In the early 2010s, when the movement to divest from fossil fuels started to accelerate in the U.S., it seemed that activists had hit upon a potentially important strategy to reduce reliance on planet-warming energy sources. Proponents of fossil fuel divestment argued that if enough entities pulled funding, the oil and gas industry would be starved of capital, making it less productive and less profitable, until the industry was ultimately replaced by renewables. Protests and other grassroots action – largely on college campuses – demanded financial institutions stop funding the fossil fuel industry. Eventually, a number of high-profile funds pledged to divest, with institutions like Harvard University pulling their endowments out of public oil and gas investments. By 2022, $22 trillion had been divested from fossil fuels across public and private markets, with over $40 trillion assets now committed to divestment, representing almost two thirds of the total global pension fund assets under management ($56 trillion).

While the divestment movement has pushed many large institutional investors towards divestment, it has not been the silver bullet that many were hoping for. Many firms, and in turn, substantial amounts of capital, remain invested in the oil and gas industry. For example, 80% of energy investments at the 10 largest private equity firms are in fossil fuel assets, as of 2022.

With the renewable energy transition becoming more urgent than ever, private equity funds are grappling with the question of whether to divest or hold fossil fuel assets. Many that chose divestment have also developed “exclusions lists,” as they have become known, which enumerate industries/geographies in which a firm will not invest, often including oil and gas among other sectors that harm public health and wellbeing (e.g., gambling, firearms). Major limited partners like ABP and the Norwegian Sovereign Wealth Fund have divested from the industry and are pushing general partners to do the same.

Asset Allocation Considerations

Investors use many strategies to reduce carbon emissions and hedge against climate risk in their portfolios, which may differ based on their underlying decarbonization goals. Investors looking to capitalize on the carbon transition can use divestment as a way to avoid potential stranded fossil fuel assets and free up capital to invest in energy transition opportunities (e.g., decarbonization technology, renewable energy). Other investors argue that divestment goes against fiduciary duties or limits the diversity of portfolios. Investor rationale for considering divestment may vary along a spectrum of climate transition risk avoidance to moral arguments, and such reasons for considering divestment are important to whether divestment is the best option for a particular investor as opposed to other decarbonization strategies. While divestment may be a strong outlet for transition risk avoidance, it is not the only decarbonization strategy available to investors aiming to influence real-world carbon reductions in the economy.

Divestment by large asset managers has the potential to influence normative change. As discussed previously, there have been successful divestment movements in the past, such as the 1970s campaign to eliminate investment from South African companies as a response to Apartheid. However, in this case it has been debated whether divestment achieved success through financial means or as further inspiration to social and governmental sanctions.

Given the complex drivers of oil and gas production, divestment rarely allows an investor to tally the actual, real-world emissions reductions achieved by their actions; the challenge of correlating divestment actions to real world emissions reduction has led to little consensus around the emissions reductions achieved by the divestment movement. When an investor decides to eliminate some carbon from their portfolio by selling their shares in the carbon-emitting company, those shares are transferred and the stock of equities in carbon-emitting companies does not change; carbon is simply moved from one portfolio to another. Skeptics of the divestment movement continue to argue that rather than starve the industry of capital, divesting actually shifts oil and gas assets into the hands of less responsible owners; As banks and investors have begun divesting from fossil fuels, private equity firms are taking their place, with fossil fuels representing 80% of energy investments made by the ten largest private equity firms by AUM. These acquiring firms are naturally inclined to increase their profits in new investments by expanding operations of these fossil fuel assets.

Others argue that divestment itself does little to impact the operations of fossil fuel assets, given their large reserves of capital. According to a study published by Oxford University in 2013, "Sizeable withdrawals are likely to escape the attention of fossil fuel management since oil and gas stocks are some of the world's most liquid public equities." In short, some argue that divestment is not likely to financially impact fossil fuel companies in a material way. Therefore, broad stroke divestment would be unlikely to create a large enough impact on fossil fuel companies to halt their operations. Simultaneously, investors lose influence over these companies to decarbonize. While divestment has a place within certain strategies and goals, it is not necessarily the only option available to investors looking to decarbonize.

Investor Engagement

Divestment alone may not be the only responsible course of action for investors; firms can engage with portfolio companies, attend shareholder meetings, and support shareholder resolutions that promote sustainability and climate action. Additionally, whether holding or divesting from fossil fuels, firms should seek renewable investments where possible. As part of a balanced portfolio, firms can consider investing in renewable energy companies, energy efficiency projects, or sustainable infrastructure. This approach allows firms to support and take advantage of the transition to a low-carbon economy whether maintaining exposure to the oil and gas sector or not. Engagement allows investors to retain more control over the reporting and internal goal setting of oil and gas companies, aspects imperative to successfully aligning with a carbon transition. Not all current fossil fuel energy companies need to be left behind in the transition away from carbon. According to the International Energy Agency, recent movements in financial metrics suggest that Oil and Gas companies focused on energy transitions create more value for shareholders than other companies.

Engagement Considerations

If a firm chooses to hold its oil and gas investments, there are several ways to do so while aligning with a carbon transition, as outlined below. While some of the practices below are important to responsible stewardship regardless of industry, they are especially key for oil and gas investments.

1. **Push for progress where possible:** As shareholder, firms can actively engage with oil and gas assets, exercising voting rights and participating in shareholder meetings to advocate for more sustainable practices and better governance.
    a. **Support transition efforts:** Encourage oil and gas companies to diversify their energy portfolios and invest in renewable energy sources. For example, some oil and gas companies can be particularly well positioned to integrate offshore renewable project development, given experience in offshore operations. Further, fossil fuel companies can leverage technical expertise in pushing forward decarbonization solutions, including renewables generation, energy retail, batteries, and carbon capture, utilization, and storage. Firms can advocate for investments in such solutions to reduce environmental impact.
    b. **Encourage ESG integration:** Promote the adoption of Environmental, Social, and Governance (ESG) practices within oil and gas companies. Encourage portfolio companies to disclose their ESG performance, set targets for greenhouse gas emissions, and enhance their social and environmental responsibility efforts. In particular, firms can impose requirements on oil and gas portfolio companies around the reporting of KPIs, allowing firms to track performance in environmental management, worker health and safety, and other material areas. A firm may opt to sign up for an external reporting initiative, such as EDCI, to monitor safety metrics, environmental incidents, industry certifications (e.g., ISO 14001) for environmental management controls, and infrastructure audits.
2. **Monitor investor requirements:** While a firm can adjust its philosophy towards divestment and exclusions over time, so too can LP investors. It is important for firms who plan to hold oil and gas assets to ensure ongoing compliance with investor requirements, which may eventually necessitate certain disclosure or partial divestment practices.
3. **Stay informed:** To further support transition efforts, firms should be sure to stay up to date with industry trends, advancements in technology, and policy developments related to the oil and gas sector. Firms should remain abreast of emerging risks and market dynamics, including the potential impact of renewable energy growth and the evolving energy transition.

Maintaining investments in oil and gas assets may inevitably involve supporting an industry with significant environmental and social impacts. It's important for firms to balance investment decisions with their values and long-term sustainability goals. Diversifying investments and exploring other sectors that align with a firm's responsible investing principles can help achieve a well-rounded ESG portfolio.

Divestment Considerations

It is worth noting that the oil and gas industry encompasses a diverse array of companies, each playing a distinct role within the supply chain. Upstream companies are engaged in the exploration and extraction of oil and natural gas reserves. Midstream entities manage the transportation and storage of these resources through pipelines and infrastructure. Downstream companies refine crude oil into products like gasoline and petrochemicals, while distributing and marketing them. Oilfield services companies offer support for drilling, maintenance, and recovery efforts, and service and equipment providers contribute technology and support services to the sector. Firms looking to take a partial approach to divesting can consider prioritizing divestment from upstream and downstream oil and gas companies. If a firm chooses to divest from oil and gas assets, here are some responsible divestment considerations:

1. **Assess O&G exposure:** A firm should review its investment portfolio to identify the extent of exposure to oil and gas assets, including any upstream, midstream, downstream, or support companies. If not divesting from all, a firm can prioritize divesting its most climate-intensive assets. Consider seeking advice from ESG consultants to fully assess risks and opportunities.
2. **Seek alternative investment options:** Firms may redirect some capital from divested entities towards more sustainable energy options or other responsible investment alternatives. Consider investing in renewable energy firms or other companies developing green technology. Look for investment opportunities that align with ESG values.
3. **Monitor and evaluate progress:** Firms should regularly review and monitor their divestment strategy and assess the performance and impact of new investments.
4. **Communicate your divestment actions:** Firms should be sure to share divestment decisions and reasons with limited partners and other relevant stakeholders to maintain open dialogue on the subject.

Divestment Case Studies

Demonstrating the tenets of responsible divestment, The Rockefeller Brothers Fund (RBF) pursued a responsible divestment strategy by consciously and gradually divesting from fossil fuel investments. Announced in 2014, this strategic move was motivated by a commitment to addressing climate change and promoting sustainability. Over time, RBF systematically reduced its exposure to coal, oil, and gas investments while simultaneously redirecting its resources towards renewable energy, clean technology, and sustainable solutions. By engaging with companies and advocating for more responsible practices, the RBF demonstrated a holistic approach to aligning its investments with its values.

Another example of a fund that decided to approach divestment as an option is the Government Pension Fund Global (GPFG), which manages around $1 trillion worth of Norway's assets. As the world's largest sovereign wealth fund, it plans to shift almost $6.5 billion USD worth of assets away from oil and gas companies focused solely on exploration. However, the GPFG also plans to retain stakes in companies that have renewable energy divisions; for example, the fund is planning on retaining its shares in BP and Shell. The GPFG believes that these companies will play a strong role in developing green energy. Instead, it plans to use divested capital for more renewable energy investment. As explained above, the divestment itself will not necessarily limit the amount of carbon actually emitted in the world. Nonetheless, it may still be an effective strategy for the GPFG or GP investors, because divestment frees capital for investment in climate solutions, which can impact real-world carbon emissions and is an attractive new investment opportunity.

How Malk Can Help

To assess climate transition exposure and evaluate divestment options, firms need to thoroughly identify and assess risks of individual assets, monitor progress towards decarbonization goals, and effectively communicate climate strategy, which requires in depth due diligence and support to align with relevant reporting frameworks. Malk enables investors to identify climate risks through comprehensive diligence and can help investors evaluate progress towards decarbonization goals through carbon accounting and framework alignment.

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About Malk Partners

Malk Partners is the preeminent advisor to private market investors for creating and protecting value through environmental, social, and governance ("ESG") management and impact investing. Founded in 2009, Malk Partners advises many of the world's leading alternatives managers investing across private equity, growth equity, venture capital, and private credit by helping them define ESG goals, achieve ESG results, and guide their portfolio companies in driving value creation and mitigating risks. The firm is headquartered in La Jolla, California with a second office located in New York. For more information about Malk Partners, please visit www.malk.com.