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Divestment Alone Won't Beat Climate Change

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The fossil fuel divestment movement — an increasingly popular approach with environmentalists — primarily tries to convince pension funds, university endowments, and other asset holders that their investments in oil and coal are unethical because of impact of fossil fuel emissions on the world's climate. Proponents argue that divestment is a symbolic statement that can discourage fossil fuel consumption by stigmatizing the industry. Despite its recent successes, we believe this approach is limited.

Both of us have done work on sustainable development and are keen to see a transition away from fossil fuels in order to limit climate change. But divestment alone is not the answer.

The key argument for fossil fuel divestment is that the cost of carbon dioxide emissions and other pollutants are not being accurately priced by the market. Divestment can theoretically address this market failure by limiting investment by the fossil fuel industry by depressing company valuations and thereby increasing the cost of capital. The economics of that argument are valid, but it remains uncertain how large the impact of divestment would be. For many companies, most of the capital expenditures are financed from internal cash flows and bank financing. Therefore, for major oil and gas firms and big coal companies, divestment looks like less of a constraint. (For smaller companies it could well prove to be a bigger one.)

Divestment also runs the risk of unintended consequences which could thwart environmentalists' objectives. Markets have a fundamental correction mechanism for when a company's valuation falls significantly below its cash flow generating capacity: at some point a buyer steps in, often from private markets. Private equity funds do this best, buying up cash rich companies that are undervalued by public markets. Were divestment ever to succeed in lowering the valuations of fossil fuel companies, an unintended consequence could be a shift from public markets to private markets, if carbon tax regulations are not enforced fast enough. Such a shift could hurt transparency; companies that go private have minimal reporting obligations and they typically become very opaque. This could limit everyone's ability to engage the management of these companies in a discussion around climate change. In this case, divestment would clearly backfire.

Although divestment has sparked a needed debate, we feel it cannot exclude or replace parallel engagement efforts by shareholder and stakeholders.

Engagement calls for more transparency in the investment decisions of the fossil fuel industry. Shareholders could lobby management to consider climate impacts in all investment decisions, and push firms to avoid spending cash on high-cost, high-carbon capital expenditures. Instead, the firm could return the capital to shareholders as higher dividends or share buybacks, or diversify into other areas which might be less risky than fossil fuels.

If engagement works, then capital expenditures by fossil fuel firms are reduced, yielding lower carbon. Simultaneously, the risk profile of the company can be reduced and potentially share prices can even rise – a win-win.

The question is: will management be receptive to shareholders' pleas? It is impossible to know, and may vary on a case-by-case basis. However, management should be willing to listen, since an engagement strategy zeroes in on the most carbon-intensive projects rather than seeking to devalue a company's entire asset base (as divestment does).

None of this is to say divestment has no value. Right now, divestment is causing companies and investors alike to pay attention to the risks of climate change. In other words, if targeted engagement is the carrot, targeted divestment is the stick as the enforcement mechanism for those companies unwilling to engage. This mutually reinforcing process stands a better chance of reducing high cost new fossil fuel development than either approach on its own.

Fossil fuels will have to be part of the transition to a clean-energy future. Ultimately, the goal should be limiting new business development by fossil fuel companies. And rather than focusing only on ethics, the argument should focus on reducing risk to those companies themselves by pursuing a climate-secure global energy system.

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