Quattro Pensions
CONSULTING ACTUARIES

news bulletin

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Stranded Assets -
Is Your Scheme At Risk?

A "stranded asset" is an asset that has suffered a large, premature and unexpected write down. It may even have become a liability. This can happen for a variety of reasons. For example:

- Technology: The demand for public telephone boxes has collapsed to zero. Will the yellow pages and street maps be next?
- Legislation: The global response to CFCs in products like fridges, freezers and some aerosols led to stockpiles of CFC becoming a liability rather than an asset.

There are numerous such examples from asbestos to the tape cassettes for your Sony Walkman. However, the purpose of this Briefing Note is to highlight the possibility that shares in carbon-intensive energy firms – particularly the oil majors – are now being talked of as potentially the next Stranded Asset.

What is the risk?

Put simply, there is a risk that markets are systematically mispricing carbon-intensive energy stocks, particularly oil. The thesis is as follows:

1. The International Energy Agency itself said in its World Energy Outlook 2012 that "no more than one-third of proven reserves of fossil fuels can be consumed prior to 2050 if the world is to achieve the 2 °C goal, unless carbon capture and storage technology is widely deployed".

Abolition of short-service Refunds:

Changes to DC schemes from October 2015

Currently, a member of an occupational pension scheme who leaves having completed more than 3 months but less than 2 years' qualifying service may be entitled to a short service refund.

The government intends to abolish such refunds, to ensure that money saved into a pension scheme stays there.

The move is likely to be followed by further Legislation to introduce automatic transfer arrangements for people who change employer during the course of their career.

Subject to finalising the Legislation, from October 2015, occupational DC schemes will only be able to make refunds within the first 30 days of membership.

2. However, share prices of oil companies are based partly on proven reserves, and fluctuate with the price of a barrel of oil.
3. Share prices have not taken any sort of hit that could be attributed to the risk that two thirds of their product might be unusable.
4. Therefore, there must be a risk of a significant price correction.

We are not saying that oil stocks are overpriced. We are however saying that there is a real risk that this might be the case. Efficient market theory has been laid to rest both by a large number of mainstream economists and by events – for example – the collapse caused by mispricing of subprime. So markets can be wrong, and there is a non-zero risk that they may be wrong in this instance.

A mainstream view

This view, that oil may be the next stranded asset, is not a flaky view held by a few sandal-wearing teepee dwellers. This is rapidly gaining mainstream traction:

- In mid-October Mark Carney told a World Bank seminar that the "vast majority of reserves are unburnable" if global temperature rises are to be limited to below 2C and issued a warning that the lack of long-term thinking by governments and businesses, was a "tragedy of horizons" that could lead to market failure.
- The Rockefeller Foundation is amongst the 800 global investors that have started to "decarbonise" their asset portfolio, to the collective tune of $50BN. Others include a large number of universities, cities, and religious organisations. The disinvestment movement is a blunt instrument, but it is a powerful one.

Risk Factors

Some of the factors that contribute to the risk to oil stock prices are:

- The threat of litigation relating to damage caused by global warming.
- Shareholders demanding reductions to exploration budgets (why bother searching for more if you can't use what you already have?).
- Public / political pressure to reduce high-risk, high-cost extraction (for example shale oil, tar sands, arctic drilling).
- Increasing competition from renewable energy sources.
- Legislation. Governments could put in place laws and taxes and disincentive systems in order to meet their 2 degree warming promises.
- Political support. The IMF and others have called for the ending of fuel subsidies.

Can Trustees make investment decisions for ethical reasons?

A recent report from the Law Commission, which itself stemmed from the Kay Review into UK equity markets and long-term decision making, says:

"…We clarify that pension fund trustees do not have to "maximise returns" in the short-term at the expense of risks over the longer term.

We conclude that trustees should take into account factors which are financially material to the performance of an investment. Where trustees think ethical, environmental, social, or governance (ESG) issues are financially material they should take them into account.

We also conclude that, whilst the pursuit of a financial return should be the predominant concern of pension trustees, the law is sufficiently flexible to allow other, subordinate, concerns to be taken into account. The law permits trustees to make investment decisions that are based on non-financial factors, provided that:

- *They have good reason to think that scheme members share the concern, and*
- *There is no risk of significant financial detriment to the fund."*

In other words, the law does not appear to be an obstacle to taking a well-considered position having thought through the arguments and the facts.

Conclusion

This is NOT a call for immediate disinvestment or other knee-jerk reaction. This briefing note is simply to bring a potentially significant risk to your attention.

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