# Climate Change

## Overview

Climate change is at the forefront of social responsibility issues. In 2014, the Corporation Committee on Investor Responsibility (CCIR), which is supported by the Advisory Committee on Investor Responsibility (ACIR), announced its decision to address this issue through shareholder engagement rather than a policy of divestment, following the University's ethical investment policy. (See Appendix A for CCIR statement.) At the same time, Chief Investment Officer David Swensen sent a letter to Yale's Endowment managers encouraging them to account properly for the internal and external costs of greenhouse gas emissions and to avoid companies that refuse to acknowledge the social and financial costs of climate change. David Swensen updated the Yale community on the impact of the letter in 2016. (See Appendix B and Appendix C for Swensen's letters.) Both the initial statement and follow-up report were covered (here and here, respectively) by The New York Times.

Critics of fossil fuel investment seek to convince the University to divest from fossil fuel companies. They argue that divestment by Yale would influence public discourse and support "climate justice" through social and political change. According to these critics, Yale's ongoing investment in fossil fuels calls into question the University's commitment to combating climate change.

## Climate Change

Yale's guiding principles are predicated on the idea that consumption of fossil fuels, not production, is the root of the climate change problem. Targeting fossil fuel suppliers for divestment, while ignoring the damage caused by consumers, is misdirected. Given the world's current (and growing) energy needs, modern society could not exist without fossil fuel consumption. Life's basic necessities, including food and shelter, require petroleum-based products and services. Petroleum-based products are an integral part of everyday life, as they are used in transportation fuels, heating, electricity generation, and feedstocks for making chemicals, plastics, and synthetic materials found in many consumer products. Without demand from governments, businesses, and consumers, fossil fuel suppliers would not have a market for their products.

There is strong consensus that society must transition towards cleaner energy sources. Although public scrutiny has focused on investments in fossil fuel producers, the Investments Office approaches the issue more broadly by acknowledging that all investments are exposed to the risks of climate change. Under Yale's approach, which asks managers to incorporate costs of carbon emissions in investment decisions, investments with large greenhouse gas footprints are disadvantaged relative to investments with small greenhouse gas footprints. When taking into account the full costs of climate change, investment capital flows towards less carbon-intensive businesses and away from more carbon-intensive businesses. Until alternative energy technologies and infrastructures are more fully developed and more broadly implemented, fossil fuels will remain essential to support human endeavors.

## ACIR, CCIR and Investments Office

The University first addressed the issue of fossil fuel divestment in August 2014. After careful consideration of the issues, the CCIR decided not to recommend divestment from fossil fuel companies. The decision was guided by *The Ethical Investor*, which articulates the ethical principles of investing the University's Endowment.

At the same time the CCIR released its statement, Chief Investment Officer David Swensen sent a letter to Yale's external investment managers, which stated that greenhouse gas emissions "pose a grave threat to human existence" and asked the University's investment managers not to hold companies that refuse to acknowledge the social and financial costs of climate change and that fail to take economically sensible steps to reduce greenhouse gas footprints. Yale directed its partners to account properly for the internal and external costs of greenhouse gas emissions and examine investment returns assuming the adoption of sensible legislative or regulatory policies aimed at reducing greenhouse gas emissions. Each manager was subsequently engaged by Investments Office staff about the letter's content.

In 2016, David Swensen provided an update to the Yale community on the results of his 2014 letter, highlighting several examples of productive engagements. For example, Yale's letter prompted ARC Financial, one of Yale's energy private equity managers, to develop a universal framework for assessing, reporting, and comparing the greenhouse gas intensity of fossil fuel operations and to conduct a firm-wide audit on the carbon intensity of its portfolio. In addition, the update noted that Yale's managers had sold $10 million of holdings that were deemed inconsistent with the economic approach laid out by Yale.

## 2014 Statement of the Yale Corporation Committee on Investor Responsibility

In the last year, the Yale Corporation Committee on Investor Responsibility (CCIR) has considered and discussed with the Advisory Committee on Investor Responsibility (ACIR) the proposal of some Yale students to divest from a number of publicly-traded fossil fuel-producing companies based on their holdings of carbon reserves in the ground. The student group "Fossil Free Yale," citing principles of *The Ethical Investor* (John Simon, et. al., Yale University Press, 1972), has urged the University to take steps to divest should engagement with targeted companies fail to result in fuller greenhouse gas emissions (GHG) reporting by them,[1] or if the companies' reports do not show improvement in the ratio of total GHG emissions per unit of energy produced. The Yale College Council also released the results of a referendum it held last November indicating substantial support among undergraduates for divestment of "fossil fuel companies contributing the most to climate change and associated social harms."

CCIR agrees that climate change is a grave threat to human welfare. We believe, however, that the actions Fossil Free Yale proposes Yale take as an institutional investor – divestment or shareholder engagement as a precondition to divestment – are neither the right means of addressing this serious threat nor would they be effective. Yale will have its greatest impact in meeting the climate challenge through its core mission: research, scholarship and education conducted by its faculty and students. Yale should undertake special efforts to increase holistic understanding of the problem and ways individuals and institutions can work effectively on solutions of all kinds, including effective governmental policies and technological innovation. Yale should continue to be a leader in sustainability and sound environmental practices, while helping students, faculty and staff behave in environmentally responsible ways. As an investor, Yale should emphasize that companies, as a matter of sound business practices, should take into account the effects of climate change and anticipate possible regulatory responses with actions that recognize the externalities produced by the combustion of fossil fuels. The Chief Investment Officer is communicating this position to Yale's external investment managers. And as an ethical investor, Yale should support well-constructed shareholder resolutions that call for company disclosures that address climate change issues, as we state below in policy guidance for ACIR.

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[1] The emissions data sought are based on the accounting framework developed by the Greenhouse Gas Protocol, specifically a reporting organization's Scope 1, Scope 2 and Scope 3 emissions. More detailed guidance can be found at http://www.ghgprotocol.org/, but the three categories are generally described as follows, according to the Greenhouse Gas Protocol FAQs (http://www.ghgprotocol.org/files/ghgp/public/FAQ.pdf):

Scope 1 –direct emissions from owned or controlled sources.

Scope 2 –indirect emissions from the generation of purchased energy.

Scope 3 –all indirect emissions (not included in Scope 2) that occur in the value chain of the reporting company, including both upstream and downstream. The 15 categories covered include purchased goods and services; capital goods; fuel- and energy-related activities (not included in scope 1 or scope 2); upstream transportation and distribution; waste generated in operations; business travel; employee commuting; upstream leased assets; downstream transportation and distribution; processing of sold products; use of sold products; end-of-life treatment of sold products; downstream leased assets; franchises; investments.

The Yale Corporation set *The Ethical Investor* as its policy guidepost for the University's approach to investor responsibility over 40 years ago, and the principles contained in it remain relevant and constructive in the many moral debates that could affect the manner in which the University invests its Endowment. A premise of *The Ethical Investor* is that Yale's Endowment supports the functioning and success of the University as an academic enterprise, and that an institution like Yale must prioritize its commitment to teaching and scholarly work. Taking into account non-economic factors is not a decision to be made lightly, and a decision to divest or refrain from certain investments should be taken only when justified by the presence of grave social injury[2] and broad moral consensus concerning that injury, and after carefully confirming it to be a measure of last resort that will not undermine Yale's most central mission.

Under principles of *The Ethical Investor*, in order to justify taking action against a company, Yale's policy requires that the targeted company be causing social injury, and, in the case of divestment, grave social injury, through its actions. The buildup of atmospheric GHG through fossil fuel use is caused by the *combustion* of fossil fuels, not by holding reserves of carbon in the ground for possible future extraction, or even by bringing fuel to market. The fossil fuel extractive industry is involved in combustion mainly as supplier, but carbon dioxide (CO2) emissions are produced by the energy industry and power companies, companies involved in transportation, and many if not most other industrial and commercial firms, as well as individuals and households. Targeting a segment of the fossil fuel extractive industry (the supply side) for potential divestment largely on account of emissions by other actors downstream from them, while ignoring the direct contribution by individuals, businesses, government agencies, non-profit and other organizations that emit CO2 by burning fossil fuels (the demand side), in our view is misdirected. [3] And it does nothing to improve public or private policies that are capable of addressing the problem, either in the United States or globally, including by incentivizing the substitution or development of technologies and behaviors that may ameliorate GHG buildup.

The University's past decisions to divest from certain oil companies doing business in Sudan, and from certain companies doing business in South Africa, were based on a well-identified set of injurious actors.[4] In contrast, the injury from GHG emissions is complex and the number of contributing actors spans the economy. Effective mechanisms to control the injury necessarily must include those who use fossil fuels as well as those who produce fossil fuels, and on a global scale. Of course, the burning of fossil fuels over the centuries has

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[2] As defined in *The Ethical Investor*, "social injury" means "the injurious impact which the activities of a company are found to have on consumers, employees, or other persons, particularly including activities which violate, or frustrate the enforcement of, rules of domestic or international law intended to protect individuals against deprivation of health, safety, or basic freedoms …"

[3] As described in more detail in Footnote 1 above, Scope 3 emissions attempt to capture all emissions in the company's "value chain" that occur from sources that are neither owned nor controlled by the company. Calculating Scope 3 emissions is extremely burdensome on companies, which would have to investigate, assess and monitor emissions from sources they neither own nor control, both up and down the value chain. The methodology and guidance for Scope 3 is very subjective, so when combined with the logistical challenges of measuring these indirect emissions, self-reported Scope 3 data are of questionable value for comparing the emissions of companies to identify "bad" actors.

[4] These companies were identified as providing substantial assistance to governments engaged in extreme injurious conduct (i.e., genocide and apartheid) that violated basic international human rights and freedoms.

enabled the development of economies and the betterment of human welfare around the world. And at least until alternative energy technologies and infrastructures can be developed and implemented, fossil fuels will remain essential to some degree. How one determines the net socially injurious impact of fossil fuel combustion by particular companies, and how one goes about identifying the companies responsible for the incremental emissions that cause injury (and thus who should be held accountable) are questions fraught with difficulty. We do not believe it a wise use of University resources to try to engage with an impracticably large number of companies, or to do so based on metrics that are not reliable for making the ethical judgment our policy deems necessary to justify consideration for divestment.

Yale's policy guide, *The Ethical Investor*, recognizes that there are some types of social injuries more appropriately corrected by government action, as opposed to company or industry-wide action. CCIR believes that the formidable problem of climate change, which rightly deserves the attention and involvement of all, is heavily dependent on government policy interventions, both nationally and internationally. The solution to this problem cannot be identified with a specific set of companies or even companies alone. Sensible and sound governmental policies are essential to reduce the threat of climate change.[5] Yale in exercising its voice as a shareholder should support such policies, and should vote proxies on shareholder resolutions that will demonstrate Yale's support of company behaviors that are consistent with the reality of climate change and the need for a multi-faceted coordinated response from all sectors of the government and the economy. Thus, CCIR has adopted the following policy guideline for implementation by ACIR:

CCIR Proxy Voting Guideline on Climate Change

> *Yale will generally support reasonable and well-constructed shareholder resolutions seeking company disclosure of greenhouse gas emissions, analyses of the impact of climate change on a company's business activities, strategies designed to reduce the company's long-term impact on the global climate, and company support of sound and effective governmental policies on climate change.*

CCIR invites ACIR to further consult with CCIR should it have questions about the positions presented in those shareholder resolutions on which it may be voting proxies.

CCIR appreciates the involvement by Yale students on this issue of paramount importance for all of us. The considerable devotion of students and members of ACIR to become educated and to educate others, and to engage members of this Committee on the matter of climate change and the role of institutional investors has contributed significantly to our deliberations and we offer our sincere thanks. We encourage continued dialogue between the students and the ACIR as the new guidance is implemented.

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[5] Some governmental policies, to be effective, will necessarily require better metrics than currently exist for measuring emissions "generated" by each actor. Valuable work is continuing in this area, including here at Yale; however, this problem cannot be the responsibility of the Investments Office, which must focus on its core function of maximizing stable, long-term returns for the benefit of the Yale's students and programs.

# Chief Investment Officer Letter to Managers

August 27, 2014

I write to discuss climate change and Yale's investment program. The Investments Office bases its approach to global warming on the conclusion that greenhouse gas emissions pose a grave threat to human existence. Climate change (caused by deforestation and emissions of carbon dioxide, methane and other gases) creates a substantial risk of significant changes to the world's ecosystem and from actions to address those changes, making consideration of the impact of climate change essential when evaluating investment opportunities.

Yale asks that when making investment decisions on the University's behalf, you assess the greenhouse gas footprint of prospective investments, the direct costs of the consequences of climate change on expected returns, and the costs of policies aimed at reducing greenhouse gas emissions on expected returns. Simply put, those investments with relatively small greenhouse gas footprints will be advantaged relative to those investments with relatively large greenhouse gas footprints.

A full accounting of the internal and external costs of greenhouse gas emissions will call into question the business models of some investments, which will require especially careful consideration. Today, examples include thermal coal producers, tar sands operations, companies that rely on cheap power from coal and low lying coastal real estate. Of course, the list of investments requiring special consideration will change along with changes in the population of investments with business models that rely on mispriced externalities.

Conversely, fully pricing the externalities created by greenhouse gas emissions will create opportunities for profit. Examples include companies that produce renewable energy and products that facilitate demand shifting or otherwise promote efficient use of energy.

With respect to the particular case of investments in corporate entities, as you consider the implications of climate change, Yale expects you to discuss with company managements the financial risks of climate change and the financial implications of current and prospective government policies to reduce greenhouse gas emissions. You should encourage managements to mitigate financial risks and to increase financial returns by reducing greenhouse gas emissions. Yale asks you to avoid companies that refuse to acknowledge the social and financial costs of climate change and that fail to take economically sensible steps to reduce greenhouse gas emissions.

Government policies addressing climate change will impose costs on many investments, especially those with relatively high greenhouse gas footprints. If countries around the world implement pricing schemes that reflect the true costs of greenhouse gas emissions and if in your investment decisions you properly account for the costs and risks

of greenhouse gas emissions, Yale's investments will be well positioned to deal with a more enlightened regulatory environment. On the other hand, even if governments adopt imperfect policies to control greenhouse gas emissions, the University's position will be protected by accounting for the financial impact of these policies on portfolio investments. Even in the absence of effective government policies to mitigate greenhouse gas emissions, your consideration of the costs and risks of climate change should lead you to better investment decisions.

Analyzing the greenhouse gas emissions associated with investments is far from simple and fraught with challenges. As in all aspects of investment analysis, decisions will be based on incomplete, imperfect information. That said, consideration of the risks associated with climate change should produce higher quality portfolios.

Please contact me with any questions or comments.

Sincerely,

David Swensen
Chief Investment Officer

# Chief Investment Officer Letter to the Yale Community

April 12, 2016

To: The Yale Community

From: David F. Swensen, Chief Investment Officer

Re: Impact of Investments Office Climate Change Letter

On August 27, 2014, President Salovey announced a number of university sustainability initiatives to address the existential issue of global climate change and its consequences. The President's statement was issued following a decision by the Yale Corporation Committee on Investor Responsibility to refrain from divestment of the University's holdings in fossil fuel companies. The President's message, which emphasized Yale's role as an academic institution and a leader in sustainability, referred to a letter I would be sending to Yale's external investment managers on the issue of climate change. I am writing to let you know about the impact that letter has had on Yale's portfolio, on the University's managers and on the Investment Office's investment process.

My letter was delivered to all of Yale's active external investment managers on August 27, 2014. Over the course of the following weeks, my staff followed up with each manager to discuss the letter. In general, Yale's managers supported the approach of the letter and appreciated the admonition to consider the economic impact of climate change on investments, without placing definitive restrictions on portfolio decisions. Many expressed enthusiastic support and highlighted actions their organizations planned to undertake to support Yale's objectives. A few expressed confusion or uncertainty and the Investments Office addressed both through additional conversations and clarification of Yale's expectations.

At the time of the distribution of the letter, a few managers held positions we felt were inconsistent with our principles. Thermal coal miners and oil sands producers are two of the obvious industries that would suffer if regulation imposed the social cost of carbon emissions on producers. As of June 30, 2015, the Endowment had *de minimis* exposure to those industries. One manager held a small position in a publicly-traded company that engaged in the production and sale of coal. Another manager held interests on Yale's behalf in two publicly-traded oil sands producers. Combined, these investments represented less than $10 million of exposure to Yale. Since that time, the first manager exited its coal position. The firm's founder agreed climate change and carbon pricing represented unknowable risks and fossil fuel producers with significant carbon footprints were declining businesses, a profile the firm preferred to avoid. The second manager sold both positions and stated it would not initiate similar positions in the future. This manager had already begun to think about the impact of climate change on its portfolio when it received my letter and subsequently expressed support for the principles outlined in it.

Since the distribution of my August 27, 2014 letter, new investments made by the University's investment partners have been in keeping with the spirit of the approach outlined in the letter. We believe the lack of new investment in greenhouse gas intensive energy companies confirms a common understanding between Yale and its external managers.

In addition, the Investments Office has incorporated into its investment process pointed engagement with Yale's external managers on the topic of climate change. Although public scrutiny has focused on investments in fossil fuel producers, the Investments Office approaches the climate change issue more broadly by considering any exposure with risk related to climate change and potential regulations aimed at reducing emissions. That consideration includes, for example, asking managers about the implications of climate change when evaluating farmland acquisitions in southern locations or pushing our partners to consider the risks of owning low-lying coastal real estate.

In an example of productive engagement with our managers, my letter precipitated a significant effort by one of Yale's energy-focused private equity managers to develop a broadly applicable framework for energy investing in a carbon-constrained world. Leveraging its strong in-house research team, the firm developed a framework for assessing, reporting, and comparing the greenhouse gas ("GHG") intensity of fossil fuel operations on an apples-to-apples basis. The firm conducted carbon audits of its portfolio companies and assessed the exposure of each to more stringent emissions regulation. The firm led a symposium of investors to discuss the approach and shared a white paper with other industry participants. The firm hopes that by gathering data and modeling the GHG intensity of an operation, investors can build greater awareness of the characteristics that lead to lower GHG intensity and ultimately make better decisions on future investments, either by avoiding more challenged assets or by improving a project's design.

The Investments Office plans to continue its engagement with managers on the issue of climate change. Since the distribution of my letter in 2014, Yale initiated a number of new investment relationships with external partners and provided each of them a copy of the letter. The Investments Office engaged in conversations with each manager about the University's objectives in considering climate change. A number of managers called attention to the alignment that exists between Yale's policy and their current investment processes, highlighting specific actions their organizations had undertaken to address climate change. For example, Yale's new real estate managers noted that reduced energy consumption benefits their bottom lines as well as the environment. In one instance, Yale had traveled very far down the path of hiring a new energy manager. Discussions with the manager about the contents of the letter revealed a divergence of views and attitude between Yale and that manager towards the risk of climate change, including whether and how to incorporate those risks in its investment process. In part as a result of those conversations, the Investments Office decided not to pursue that investment relationship.

The Investments Office believes the risks of climate change, like any risks, should be incorporated in the evaluation of investment opportunities. This is not an easy, straightforward task. However, initiating and continuing a dialogue with our managers about those risks result in more thoughtful consideration of investment opportunities, higher quality and lower risk portfolios for Yale, and better environmental outcomes.