

EMISSIONS-INTENSIVE ASSET EXITS:

A Universal Owner Perspective
on Sales and Managed Closures



September 2023



Investor
Group on
Climate
Change

Acknowledgements

IGCC acknowledges Dr Ian Woods and Kate Donnelly as the lead authors of this report. IGCC would like to thank our members and broader management team for the generous insights they shared at the original roundtable discussion and throughout the development of this subsequent report.

About the Investor Group on Climate Change

The Investor Group on Climate Change (IGCC) is a collaboration of Australian and New Zealand institutional investors focused on the impact of climate change on investments. IGCC represents investors with total funds under management of more than \$3 trillion in Australia and New Zealand and \$30 trillion around the world. IGCC members' beneficiaries include more than 7.5 million people in Australia and Aotearoa New Zealand.

Contact

igcc.org.au

+61 2 8974 1160

secretariat@igcc.org.au

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1. Executive Summary

When companies sell their emissions-intensive assets, it may maintain or even increase the systemic risks that climate change poses to the overall financial returns of the institutional investors that part-own them.¹

Key contingency factors include whether the buyer has weaker environmental and social commitments than the seller, and has the capital required to fulfil these commitments.

In other words, will the asset be more, or less, responsibly managed on its way to eventual closure?

Regardless of the answer, a company or investor's fiduciary duties may still require them to divest so as to manage their exposure to asset- or stock-specific climate-related investment risks.

This discussion paper explores that tension.

It draws on discussions at an Investor Group on Climate Change (IGCC) member roundtable on 28 April 2023. Noting that a diverse range of views were expressed, this paper covers the majority of views expressed by the participants.

The initial roundtable discussion identified four broad areas in which investors can act to alleviate potential, unintended negative consequences from the sale of emissions-intensive assets.

Specifically, investors can:

1. Ensure that investment strategies consider the potential consequences of blanket fossil fuel exclusion policies and ensure that the role of 'managed decline' is considered as a climate risk-management strategy
2. Consider developing contingency factors that can be used to assess the relative merits and risks associated with emissions-intensive asset sales by investee companies
3. Engage with investee companies to encourage the buyer of an emissions-intensive asset to implement climate change commitments and strategies that are at least equivalent to those of the seller
4. Engage with regulators and government on a range of issues, including
 - a. the need to minimise the ability of asset buyers to arbitrage the climate change expectations that are placed on large, listed entities, and
 - b. ensuring the costs of a just transition and asset decommissioning and rehabilitation are appropriately provisioned for throughout the sale process.

¹ Environmental Defense Fund (EDF), 2022. 'Transferred Emissions: How Risks in Oil and Gas M&A Could Hamper the Energy Transition'. <https://business.edf.org/files/Transferred-Emissions-How-Oil-Gas-MA-Hamper-Energy-Transition.pdf>.

2. Background

Currently, most investors have exposure to companies with assets that cannot be operated for their entire economic or operational life if global warming is to be limited to 1.5°C. As noted in a recent Glasgow Financial Alliance for Net Zero (GFANZ) report on the managed phase out of high-emitting assets:²

The IPCC's most recent reports suggest that if historical operating patterns are maintained, CO₂ emissions from existing fossil fuel-based infrastructure (660 GTCO₂-e) would exceed the 1.5°C carbon budget (510 GTCO₂-e) by 30%, and by 66% when currently planned infrastructure is taken into account (850 GTCO₂-e).

The responsibility and associated financial costs of early asset retirements will materialise at some point in the economy and fall either to the company that owns the asset and the company's equity and debt holders, or to taxpayers if the asset's closure and decommissioning is not adequately provisioned. In both circumstances, early or under-provisioned asset closures may expose the fiduciaries of superannuation funds to financial risks. From this perspective, serving the best financial interests of fiduciaries could reasonably include strategies to minimise exposure to emissions-intensive assets in investors' portfolios and strategies to address systemic climate-related risks through a managed phase-out approach.

The managed phase out of emissions-intensive assets is an emerging area of consideration for institutional investors. However, investors have been engaging with companies about their exposure to climate transition risks for years. This engagement and associated fossil fuel exclusion policies have created an incentive for some companies to divest emissions-intensive assets.

Investor pressure may be only one of a few reasons that drives a company's decision to divest emissions-intensive assets. Other reasons may include a desire to:

- manage the climate-related financial risks associated with the asset/s
- maintain a broad shareholder base, including investors with fossil fuel exclusion policies
- use the proceeds of the sale to:
 - invest in higher returning assets
 - invest in low and zero carbon assets as part of a climate transition strategy
 - optimise the portfolio of assets (e.g., geographic or resource life-cycle exposure)
 - pay down debt
 - provide dividends to or buy back shares from investors.

² GFANZ, 2022. 'The Managed Phaseout of High-Emitting Assets: How to Facilitate the Early Retirement of High-emitting Assets as Part of a Just Transition to a Net-Zero World'. https://assets.bbhub.io/company/sites/63/2022/06/GFANZ_-_Managed-Phaseout-of-High-emitting-Assets_June2022.pdf.

As discussed above, divestment may also be in investors' interests.

Among other things, divestment may:

- reduce absolute and benchmark relative carbon exposure
- enable a better/clearer analysis of company risks, including climate-related transition and physical risks
- boost short-term returns.

However, as noted in a recent Environmental Defense Fund (EDF) report,³ a significant amount of merger and acquisition (M&A) activity in the oil and gas (O&G) industry between 2017 to 2021 led to:

- assets flowing at a significant rate from public to private markets, which typically have lower public transparency and accountability
- assets increasingly moving away from companies with environmental commitments (e.g., commitments to net-zero emissions, methane reductions or zero routine flaring) to those with a less rigorous approach to addressing climate and environmental issues.

Thus, while company-specific climate-related risks may have decreased in these cases, systemic climate-related risks may increase, which is not in the best long-term financial interests of investors and their fiduciaries.⁴

Additionally, there is a concern that some of the companies buying emissions-intensive assets at a discount from large listed companies are not adequately capitalised to provide for the decommissioning of these assets, environmental rehabilitation or a just transition for the workforce and broader community that will be affected by the asset closure. In these cases, the outcome will either be inadequate decommissioning and social protection or the transfer of these costs to taxpayers or others in the industry (see Box 1).

Against this background, the following question arises for investors: What, if anything, can be done to minimise these negative consequences, especially when investors are set to benefit, at least in the short term, from the divestment of emissions-intensive assets?

The Northern Endeavour and Laminaria and Corallina Decommissioning Cost Recovery Levy

In 2016, Australian O&G producer Woodside Petroleum sold the Laminaria and Corallina oilfields to Northern Oil and Gas Australia (NOGA), which went into liquidation in 2020 and left the decommissioning costs to the government.

In response, the government introduced an industry levy to cover the costs of the decommissioning, estimated at AU\$1 billion, and amended legislation that exposed past, present and potential future titleholders to a new 'trailing liability' for decommissioning costs.

These moves were contentious, as they make O&G mergers and acquisitions in Australia more complex. Some have argued that these changes set up a moral hazard. Further, some in the industry have argued that it was obvious that NOGA lacked the resources to run and decommission the rig at the time of the sale.

It has also been argued that the levy was an outcome inconsistent with the government's regulatory objectives and the expectations of industry in relation to appropriate stewardship.

The introduction of the Northern Endeavour decommissioning levy in Australia is an example of where the risk-management action of one company imposed a new financial risk on all companies in the industry.

³ EDF, 2022, above n 1.

⁴ United Nations Principles for Responsible Investment, 2017. 'Macro risks: Universal ownership' <https://www.unpri.org/sustainable-development-goals/the-sdgs-are-an-unavoidable-consideration-for-universal-owners/306.article>.

3. A Way Forward

The IGCC roundtable discussion highlighted that most investors do not currently appear to be applying hard-and-fast rules to incorporate climate-related systemic risks into their assessments of the risks or benefits of a particular asset sale. Individual investor approaches vary; however, based on the roundtable discussion, commercial implications still appear to be the primary or only consideration.

The discussion revealed additional areas that investors could consider going forward, including:

1. **Supporting a managed phase-out approach.** This approach moves beyond a blanket exclusion of companies with emissions-intensive assets and instead, interrogates the company's asset and decommissioning expertise and the merits of corporate and asset-specific transition plans. Any such assessment should consider whether the transition plan is aligned with a 1.5°C pathway, is efficient from a timing and cost perspective and satisfies safety, environmental and just transition requirements.
2. **Encouraging 'good sellers' and 'good buyers'.** This involves engaging with the seller of an emissions-intensive asset, and the buyer if possible, to ensure that the characteristics of responsible ownership and managed phase out are considered in the transaction.
3. **Advocating for policy and regulation.** This approach seeks to minimise the opportunity for arbitraging different provisioning for the environmental and social liabilities associated with an asset.

3.1 The Case for the Managed Phase Out of High-Emitting Assets

Some investors adopt a blunt approach to managing climate-related financial risks (e.g., the exclusion of companies with more than a certain level of exposure to fossil fuel revenues). Such strategies may be legitimately used by investors as part of their risk-management approach, including as a reflection of their members'/clients' wishes; however, exclusion policies can financially marginalise companies with high-emitting assets and credible transition plans and/or remove an investor's sphere of influence over real-world emissions. In some cases, such an approach could also reduce the ability of a company to establish a best practice transition or decommissioning plan because they lack access to the capital and support needed to fund it.

Credible climate transition plans have been a core investor ask via initiatives like Climate Action 100+ (CA100+) and the GFANZ, as they promote an orderly energy transition and reduce the negative financial and social consequences of a sudden interventionist response to climate change.

The GFANZ has also proposed that managed phase out should be recognised as a credible, net-zero aligned strategy for managing and financing high-emitting assets. Critically, this approach requires clear commitments around the management and retirement of assets.⁵ It is argued that managed phase out can:

- support an orderly transition
- mitigate financial marginalisation for companies with high-emitting assets but credible transition plans
- allow financial institutions to stay engaged with companies in high-emitting sectors and support them through their transition to net-zero emissions
- draw in broader stakeholder support of a just transition and continuity of critical services.

The GFANZ recognised that investors need support in implementing this approach, which can be achieved through the steps detailed in the table on the following page.

⁵ GFANZ, 2022, above n 2.

Reproduced from GFANZ, 'The Managed Phaseout of High-emitting Assets', June 2022, p.6.

A CREDIBILITY AND INCENTIVES	1 Establish expectations of a Managed Phaseout approach.
	2 Capture Managed Phaseout in transition planning guidance and pathway development for financial institutions and corporates.
	3 Ensure there are metrics and targets for Managed Phaseout that support reduction in GHG emissions.
B DEVELOPING FINANCING	4 Develop guidance on financing mechanisms .
	5 Innovate beyond existing financing mechanisms.
C IDENTIFYING RELEVANT ASSETS	6 Develop framework to identify assets relevant for Managed Phaseout.
	7 Support development of tools to identify assets relevant for Managed Phaseout.
D MOBILIZING HIGH-IMPACT PROJECTS	8 Incorporate Managed Phaseout in country platforms to catalyze private finance to support climate objectives in emerging markets and developing economies.
	9 Set out public-policy actions that can support Managed Phaseout as part of economy-wide decarbonization.

3.2 Encourage ‘Good Sellers’ and ‘Good Buyers’

The management of climate-related financial risks may only be one factor that drives a company to divest an emissions-intensive asset. Similarly, multiple reasons may also drive a buyer.

From a climate change perspective, other key considerations for investors may include:

- a) that the climate change commitments of the buyer are no worse than the seller’s
- b) that the proceeds of the sale are used consistently with the seller’s climate change strategy (e.g., reinvested into emissions-neutral sectors or climate solutions).

Investors are rarely in a position to enforce sale conditions on the management of companies selling an asset; however, investors can engage with the seller and potentially the buyer to understand and influence the consideration of climate-related risks in transaction decisions. Investors can also hold the board and management accountable for any decisions made.

Any transaction needs to be considered on its own merits; however, some of the suggested characteristics of a ‘good seller’ and a ‘good buyer’ from a climate change perspective are outlined in the tables below. These characteristics can be used by investors as high-level guiding principles to assist in any engagement with sellers and buyers of emissions-intensive assets.



Potential Characteristics of a ‘Good Seller’

Characteristic	Detail
Strong climate change commitments	The seller should have published a Climate Transition Action Plan in line with international best practice. ⁶
Appropriate provisioning for end-of-asset life costs, including a just transition for the workers and community affected by the closure	The seller should be transparent with investors and potential buyers about the liabilities associated with the end of the asset’s life, including decommissioning, environmental rehabilitation and facilitating a just transition. ⁷ This should include detailed disclosure about how any such liabilities have been calculated.
Not undertaking actions, including obtaining approvals, to extend or expand the asset beyond a timeframe that is consistent with a 1.5°C pathway, as part of the asset sale process	Sellers should act consistently with any commitment they have made to meet the objectives of the Paris Agreement. Accordingly, sellers should not try to secure approvals or other arrangements that expand the capacity or extend the operating life of an asset beyond that required in a 1.5°C scenario, which would increase economy-wide systemic climate risks.
Undertaking climate-related due diligence on potential buyers	Consistent with the principles of good stewardship, sellers should ensure that buyers have the resources necessary to run and decommission the emissions-intensive asset at the time of the sale. This should include capital to cover asset decommissioning, environmental rehabilitation and the fulfilment of outstanding social commitments underpinning a just transition.
Using proceeds consistent with a strong climate change commitment	Proceeds from the sale of an emissions-intensive asset should not be used to acquire or expand operations that are not aligned to a 1.5°C pathway. For example, sellers could use proceeds to return capital to investors, pay down debt, maintain or transition other emissions-intensive assets or invest in climate solutions.

Potential Characteristics of a ‘Good Buyer’

Characteristic	Detail
Strong climate change commitments linked to an asset-level transition plan	Buyers should have published a Climate Transition Action Plan in line with international best practice. At minimum, buyers’ climate change commitments should be as strong as the sellers’.
Appropriate provisioning for end-of-asset life costs, including a just transition for workers and the community affected by the closure	The commitments of buyers to undertake appropriate decommissioning, environmental rehabilitation and ensure a just transition for workers and the community that would be affected by the asset’s closure should be at least equivalent to those of sellers.
Purchase better aligns the buyer to net-zero emissions	Companies will have different strategies to achieve net-zero emissions, and the acquisition of an emissions-intensive asset should not be inconsistent with a buyer’s strategy (e.g., via managed phase out).
Being subject to public disclosure obligations or committing to such disclosures about the company’s progress against the asset’s transition plan	As a general rule, listed companies are required to have greater transparency than private companies; however, some high-emitting assets may be subject to public disclosure obligations under mechanisms. In Australia, this may include the National Greenhouse and Energy Reporting (NGER) Scheme and the proposed disclosure requirements of the Task Force on Climate-Related Financial Disclosures. In general, a sale to a listed company may be preferable, as this maintains the ability of investors to engage with and hold accountable the new owner of the asset.

It may not be possible to ensure both parties demonstrate all these characteristics, especially if the negotiations of the sale are confidential. However, these characteristics seek to provide high-level guiding principles to assist investors in their engagement around emissions-intensive asset sales.

It is also recognised that guidelines for the appropriate provisioning for a just transition are yet to be developed. This is an area for further consideration pending the publication of guidance from the Australian government or regulators.

6 See, for example, IGCC, 2021. ‘Corporate Climate Transition Plans: A Guide to Investor Expectations’. <https://igcc.org.au/wp-content/uploads/2022/03/IGCC-corporate-transition-plan-investor-expectations.pdf>.

7 This would be consistent with International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets that state that a company should provide for a liability that may be a legal obligation or a constructive obligation. A constructive obligation arises from the entity’s actions, through which it has indicated to others that it will accept certain responsibilities and as a result, has created an expectation that it will discharge those responsibilities. International Industry Standards, such as those of the International Council on Mining and Metals (ICMM), are increasingly recognising that companies have a broad responsibility to their workforces, the environment and communities (see ICMM, 2018. Integrated Mine Closure. Good Practice Guide, 2nd Edition. https://www.icmm.com/website/publications/pdfs/environmental-stewardship/2019/guidance_integrated-mine-closure.pdf?cb=56219). Explicit provisioning for a ‘just transition’ is an expectation consistent with these principles.

3.3 Advocating for Regulation and Policy

Many of the potential problems identified with the divestment of emissions-intensive assets are mitigated in jurisdictions with comprehensive climate policies and regulations in place. Effective policies and regulatory frameworks help ensure that responsibility is clearly assigned for the provisioning of asset-specific emissions reductions and just transition plans.

For example, Safeguard Mechanism regulations in Australia operate at the facility level. This means that the responsibility to decarbonise affected assets over time is retained throughout the asset sale process.

In early 2023, the Safeguard Mechanism was amended to ensure that the emissions baselines of safeguard facilities will be reduced by 4.9% annually. This reform, paired with the addition of Safeguard Mechanism Credits for facilities that implement transformative projects that reduce emissions beyond 'business as usual', provide the architecture for the genuine abatement of emissions by Australia's heaviest emitters.

The Safeguard Mechanism is now much closer to being a rigorous, forward-looking tool for the decarbonisation of Australian industry.

Conversely, and as noted by the EDF,⁸ a substantial number of buyers in recent global oil and gas M&A transactions were not signatories to voluntary industry initiatives, such as the Oil and Gas Methane Partnership. This reveals the potential systemic climate-related risks that can arise where there are no regulations in place to govern the climate-related commitments of the buyer.

Investors have been engaging with governments on climate change for many years. The potential for negative effects to arise from the divestment of emissions-intensive assets reinforces the need for continued investor engagement with government to promote comprehensive climate change policy. Reflecting on the key questions raised during the IGCC roundtable, two key areas appear to require greater action from government.

It may be appropriate for investors to engage with government on these issues, which comprise of:

- The clear allocation of responsibilities, including appropriate and ongoing provisioning, to deliver a just transition for the workers and communities affected by asset closures. Provisioning for asset decommissioning and environmental rehabilitation, including discussions with key stakeholders about how these obligations can be integrated with regional transition plans, are key and related issues. The recently announced national Net Zero Authority and regional Transition Authorities are well positioned to lead on these issues.
- The need to mitigate the risk of transactions involving emissions-intensive assets to under-capitalised companies, which do not have the capital to cover decommissioning, rehabilitation and just transition costs. Such measures would reduce the risks of poor social and environmental outcomes or the transfer of significant decommissioning and transition costs to taxpayers.

These issues should also be considered within the context of Australia's overarching climate policy framework, including:

- mandatory climate disclosures for reporting entities (i.e., ensuring that just transition obligations and transferred emission and decommissioning risks are considered in corporate climate transition plans)
- timeframes for facility closures under national sector climate pathways
- the ambition of Australia's targets and policy framework. This would include the national 2035 emission reduction target, the Safeguard Mechanism and Australia's commitment to the Global Methane Pledge.

8 EDF, 2022, above n 1.

4. Next Steps for Investors

The question of how to mitigate transferred emissions risks in Australia remains nascent; however, the IGCC roundtable identified several areas for further consideration by policymakers and the institutional investor community.

Several areas of practice for investors to further consider have emerged through the development of this report, including:

- considering how managed phase out may fit within investors' climate strategies
 - developing a set of contingency factors that integrate systemic climate-related risks to draw on when assessing the risks and merits of emissions-intensive asset sales by investee companies
 - communicating clear expectations to investee companies that promote 'good seller' and 'good buyer' characteristics
 - engaging with policymakers, individually and through industry forums, to support the development of new regulations that will mitigate the systemic risks associated with the transferred emissions problem.
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Contact

+61 2 8974 1160

secretariat@igcc.org.au

igcc.org.au

[linkedin.com/company/investor-group-on-climate-change-igcc](https://www.linkedin.com/company/investor-group-on-climate-change-igcc)

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