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Myths versus Facts in Socially Responsible Investing

The great enemy of the truth is very often not the lie – deliberate, contrived, and dishonest – but the myth – persistent, persuasive, and unrealistic.
– John F. Kennedy

The truth is often in short supply, and this is particularly true when looking at the environmental, social and governance (ESG) performance of companies. Given that this is important information when managing a socially responsible portfolio such as the Phillips, Hager & North Community Values Funds, this quandary – uncovering the truth from among many competing interests and perspectives – is of interest to our portfolio management team. More often than not, stakeholders and special interest groups say one thing and the company says the opposite, while the truth usually resides somewhere in the middle. It is the portfolio manager's job to wade through the rhetoric and understand what the issue is, how the company is managing it, and how the issue affects the company as an investment for the portfolio. Understanding the issues is an important part of this balancing act.

One notable example of differences of opinion that can occur between special interest groups and companies was the 1995 Brent Spar dispute. The Brent Spar was a large floating oil storage and loading facility, owned and operated by Shell in the North Sea oil fields. When the Brent Spar came to the end of its operational life, Shell determined that the best way to dispose of the facility was "deepwater disposal". This process involved towing the Brent Spar to a deep part of the Atlantic Ocean and sinking it. At the time, this was a common practice and Shell sought, and was given, approval for the disposal by the U.K. government, after meeting the environmental conditions that the government imposed on the disposal. Greenpeace viewed deepwater disposal as nothing more than the dumping of toxic waste in the oceans, and they believed that practice needed to be stopped. Shell said that the Brent Spar had about 75 tonnes of residual oil left – mainly in the pipes, and a small amount of heavy metals in the electrical system. Otherwise, they stated, it was just a metal shell. However, Greenpeace disagreed, stating that 5,500 tonnes of oil residue as well as toxic waste remained hidden on the Brent Spar (including radioactive waste). What ensued was a media frenzy and a public outcry resulting in Shell agreeing to use an alternative method of disposal, and the U.K. government reviewing the practice of deepwater disposal, and eventually prohibiting the practice.

In this case, an environmental group, Greenpeace, successfully took on a corporation and the U.K. government, and stopped an environmentally unsound practice. However, in the process, Greenpeace levelled a number of serious accusations against Shell. Accusations such as those, if they have substance, may result in a company being excluded from the PH&N Community Values portfolios because they contravene our ESG investment criteria. In the case of the Brent Spar, we had the benefit of an independent

review by a reputable third party that tested these accusations. What the review found was that there were about 100 tonnes of oil residue, trace amounts of heavy metals, and no "hidden" waste. In short, the accusations made by Greenpeace bore very little resemblance to the facts. The lesson here is that as investment managers, we must look beyond the face value of company and activist claims if we are to make an informed decision as to the ESG performance of a company.

The Brent Spar example is by no means unique. Let's take a look at two other areas where a deeper understanding of the issues is warranted.

Biofuels

Using biofuels is seen as a way to reduce carbon dioxide (CO_2) emissions by reducing the amount of gasoline and diesel that is derived from fossil fuels. The burning of fossil fuels emits atmospheric CO_2, considered by many scientists to be a contributor to global warming. Biofuels are the by-products of plants. The theory is that plants such as sugar cane and corn take in CO_2 during their growth; therefore, burning the fuels made from this plant matter should have no net effect on the amount of CO_2 in the atmosphere. However, theory does not always translate into practice.

In recent years, we have seen many governments around the world initiate biofuels programs. Some programs are well developed, such as in Brazil, and others, including the biofuel programs here in Canada, are just beginning to ramp up production. In Canada, proposed regulations will require that gasoline needs to have a 5% renewable resource content by the end of 2010. But does the use of biofuels really reduce greenhouse gases?

A number of factors could reduce the effectiveness of biofuels in reducing CO_2 emissions:

The manufacturing process for ethanol,[1] the most common biofuel worldwide, involves heating the feed stock mixture to induce fermentation. This heat is usually produced by burning fossil fuels.
Large amounts of fertilizer are required to grow the feedstocks for biofuels. A component of fertilizer is natural gas.
A by-product of fertilizer used in agriculture is nitrous oxide (N_2O). N_2O is almost 300 times more potent than CO_2 as a greenhouse gas and it persists for longer in the atmosphere. It has been estimated that N_2O released from farming some biofuel crops, such as corn, by itself negates the benefits of using biofuel as a means to reduce CO_2 emissions.
Land is often cleared to grow biofuel crops. The act of clearing the land will add CO_2 to the atmosphere, and when forests are cleared their ability to take CO_2 from the atmosphere is lost.

There are also other unintended consequences of biofuel crop production. These include fertilizer run-off, which can contaminate rivers and oceans, disrupt the ecosystem and ultimately add greater demands on water resources. Perhaps most importantly, however, the production of biofuels can divert land and resources from food production to energy production. In recent food and agriculture commodity price spikes, biofuel production was seen by some analysts and market theorists as one of the significant contributing factors.[2]

While biofuels are not as "green" as we may think at first, do they help or hinder when it comes to global

warming? On balance, biofuels may have actually contributed to global warming, but this does not mean that all biofuels are a bad idea. In a recent United Nations report, ethanol from cane sugar was found to have zero net CO_2 emissions, while ethanol from corn could have marginal benefits if properly planted and processed. If not, then these practices would have a negative effect. Biodiesel derived from palm oil grown on cleared tropical forest has a significant negative effect. In the case of biofuels, it is important to look past the blanket preconceptions to understand what the benefits and risks actually are.

Oil sands

The resource-intensive extraction of bitumen from Alberta's oil sand reserves is the most talked about socially responsible investing issue in Canada. We have already discussed why we think it is appropriate to include oil sands producers in the PH&N Community Values Funds ("Socially Responsible Investing (SRI) and the Alberta Oil Sands", Fourth Quarter Report, December 31, 2008). Now, let us look at two shareholder proposals that will be on the ballot at the annual meetings of Royal Dutch Shell and BP. These proposals ask the companies to report on the risks associated with their respective investments in the Canadian oil sands. The proposals are reasonable as they are asking for enhanced reporting on each company's rationale for engagement in oil sands production projects, addressing issues that represent a real risk to the companies and their shareholders. The PH&N Community Values Funds intend to support these proposals when we come to vote our shares for Shell and BP. Both companies have reasonable disclosure practices and much of the information being requested is already publicly available; however, bringing the information together in one report will give shareholders better clarity on the risks associated with the companies' investments in the oil sands.

Below is a look at some of the assertions made by the promoters of these shareholder proposals, all common criticisms of oil sands production.

Extraction of oil from the oil sands is a major contributor to global climate change.
Oil sands development is a large emitter of CO_2, but in the global context they are insignificant. The oil sands produce about 5% of total CO_2 emissions for Canada, and Canada produces about 2% of the total global emissions. If we shut down the oil sands tomorrow, it would reduce global emissions by about 0.1%.[3]
A barrel of oil sands oil produces three times the amount of CO_2 emissions that a conventional barrel of oil does.
It is true that the extraction and processing of oil sands oil is more carbon-intensive than conventional oil. However, if we look at the total carbon content of a barrel of oil sands oil (the so called "wells to wheels" carbon), it is, on average, only 10% higher than a conventional barrel.[4]
Huge amounts of water are used to extract and process oil sands oil.
Water use and water quality are a very real concern for oil sands production because large quantities of water are required to process oil sands bitumen. For every litre of oil produced, about three litres of water are required. Due to the limited availability of water, oil sands companies are now recycling much of the water they use (for example Syncrude now recycles 80% of the water it uses) so that they can stay within their current water-use licences.[5] As such, we have seen significant improvements in overall consumption and efficiency with regard to water use.

There is little doubt that the production of the oil sands has an impact on the environment in the communities of northern Alberta. However, as responsible investors we want to ensure that we are investing in companies that understand this impact and manage these risks. We start to do this by understanding what the risks actually are, which these new proxy proposals will help to facilitate.

Summary

It is often the case that myths are based on some kernel of truth. Unfortunately, it is not always easy to make a distinction between truth and myth. As responsible investment managers, it is important not to take information at face value, whether it is coming from inside or outside of a company. Our obligation stands with our clients to make sure we understand the issues and make informed investment decisions based on available facts and good research.

[1]An alcohol-based fuel produced by fermenting plant materials. It is commonly made from sugar dervied from wheat, corn, potatoes, sugar cane and beets.

[2]This assertion is based on the argument that a significant supply of corn and maize normally consumed as food would need to be diverted to the production of ethanol, driving prices up.

[3]Government of Albert, "Facts about Greenhouse Gas Emissions and the Oil Sands", December 2009.

[4]Alberta Energy Research Institute, "Emissions from oil sands comparable to other crude oils", Press release, July 23, 2009.

[5]Water-use licenses are issued by the provincial government as a means of conserving water and ensuring that there are sustainable yields for all users, including stakeholders outside of the oil and gas industry.

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