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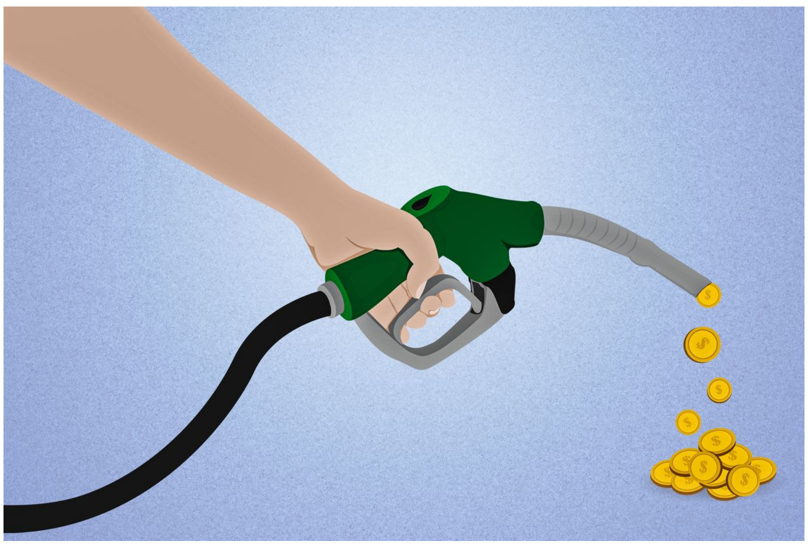
INDUSTRY NEWS

Energy-Focused Firms Defy Oil-and-Gas Divestments

A number of private-equity firms have been outspoken about their commitment to the oil-and-gas sector amid a capital flight from fossil fuel-related assets



Consultants and investors say that the capital flight from the oil-and-gas sector reflects not only environmental concerns but also a history of poor returns as well as uncertainty about the future value of traditional energy assets.

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By [*Luis Garcia*]

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Some private-equity firms that traditionally have backed oil-and-gas businesses are reaffirming their commitment to the sector even as many climate-concerned investors abandon fossil fuels.

These firms—which include ARC Financial, EIG Global Energy Partners, Quantum Energy Partners and Kimmeridge Energy Management—are betting that there are still profits to be made in the sector as oil and gas will continue to be critical to providing the world with the energy it needs before it can fully shift to renewable sources, maybe decades from now. They are going against numerous pension funds and university endowments that are partially or totally clearing their portfolios of fossil fuel-related assets, often in response to activist pressure.

The New York State Common Retirement Fund, with about $227.8 billion in assets, in December said it will seek to have net-zero greenhouse gas emissions in its portfolio by 2040 and divest of energy companies that don't meet its minimum carbon standards. Harvard University, meanwhile, in September announced that its $53.2 billion endowment, Harvard Management Co., will stop backing businesses that explore or develop fossil-fuel reserves, citing the threat of climate change. Another endowment, Brown University Investment Office, as of early last year had sold 90% of its investments in such businesses and said it didn't intend to make new ones. New York State, Harvard and Brown joined a growing list of institutional investors that have made similar pledges in the past two years.

"There's pressure from student groups on campuses pushing for endowments to divest from fossil fuels," said Christian Busken, director of real assets at consulting firm Fund Evaluation Group, which advises several endowments and foundations.

He added that those groups are part of an expanding activist movement that seeks to limit oil-and-gas producers' access to capital as a means of accelerating the shift to clean energy. Some energy-focused fund managers, however, say investors can better help the environment by continuing to invest in energy companies and pressing them to reduce carbon emissions.

"You've got a group of investors that want to be carbon free. That's a nice policy statement, but what does that really mean in practice?" said EIG Chief Executive Blair Thomas.

The majority of investors still believe that active engagement with oil-and-gas businesses on climate change with the aim of influencing business behavior is a more effective way than divestment to address the environmental challenges posed by fossil fuels. In a recent survey by RBC Global Asset Management of 800 investors worldwide, almost half, or 45%, of the respondents said engagement is more effective, compared with 10% that favored divestment.

One investor, California Public Employees' Retirement System, the U.S.'s largest pension fund with $496.2 billion in assets in mid-November, separately has said engagement and advocacy are two pillars of its strategy to address both the risks and opportunities of climate change.

"The bigger part of the investor universe wants to use their capital to help force change in the industry," Mr. Thomas said. "They invest with firms like ours and then push us to invest responsibly, to measure and report carbon emissions, and so facilitate the energy transition."

Washington-based EIG, which also invests in renewable energy and has $22.6 billion under management, in August led a consortium that agreed to acquire a 49% stake in Aramco Oil Pipelines Co. in a $12.4 billion deal. The business earns tariffs on crude transported through the pipeline network of state oil giant Saudi Arabian Oil Co., or Aramco.

"How does that investment fit in the energy transition thesis? It's a logical question," Mr. Thomas said. He added that Aramco's carbon emissions per barrel of oil produced is one of the lowest in the world.

"Aramco, in our view, is going to be the last producer because they're the most efficient," he said. "As long as hydrocarbons are going to be here, that's the party you want to be producing."

Houston-based Quantum, one of the largest energy-focused private-equity firms in the U.S., also is seeking to reduce carbon emissions across its portfolio through actions such as curbing gas flaring and monitoring methane leaks, said CEO Wil VanLoh.

Starving the North American oil-and-gas sector from capital could shift production to parts of the world where environmental, social and governance standards are less strict, which would increase rather than reduce carbon emissions, he said.

"The world is going to use the same amount of hydrocarbons," Mr. VanLoh said. "It's just going to get them from countries that are much worse with ESG."

Quantum has looked at more than 10 energy-demand studies from reputable organizations and every one of them showed that oil and gas consumption will still be significant in the next 20 years as populations and middle classes grow in the developing world, Mr. VanLoh said.

In another study, consulting firm McKinsey & Co. estimated that global oil demand will continue to rise until 2029 and decline only by 10% from that peak in 2050. Natural gas demand, in turn, will be 5% higher in 2050 from today's levels.

The already fast pace of wind and solar development means that high oil-and-gas prices, as a result of suppressed investment in production, will do little to speed up the shift to renewable energy while increasing the cost of living, Mr. VanLoh said.

"You're going to put a large regressive tax increase on poor people, on middle-income people," he said.

EIG's Mr. Thomas said high commodity prices make it more difficult for governments to gather popular support for policies aimed at accelerating the shift to clean energy. He pointed to the recent spike in natural-gas prices in the U.K., which prompted complaints from businesses across the country.

“You have to strike a balance between decarbonization and reliability,” he said. “If people can’t have reliable electricity at a price that they can afford, you’re going to quickly lose support for the energy transition.”

Still, consultants and investors say that the capital flight from the oil-and-gas sector reflects not only environmental concerns but also a history of poor returns as well as uncertainty about the future value of traditional energy assets.

“As the world shifts increasingly to sustainable energy sources, investments in fossil fuels carry too much long-term financial risk,” Brian Clark, a Brown University’s spokesman, said in an email. “It is this escalating uncertainty, in conjunction with the long life and resulting illiquidity of such investments, that rendered traditional fossil fuels uninvestable in the opinion of our investment office leaders.”

The fewer endowments and pension plans still willing to invest in the oil-and-gas sector are demanding higher returns in order to justify these investments, said Rob Day, a partner at Spring Lane Capital, a private-equity firm in Boston that focuses on sustainable infrastructure. “Meanwhile, the cost of capital is falling for renewables.”

As oil-and-gas prices recovered sharply from the pandemic, returns in the sector are expected to improve, which could attract some investors back, said Jeff Eaton, a global co-head and managing director of Eaton Partners who also leads the placement agent’s real-assets practice.

However, he added that investment teams so far remain reluctant to propose any oil-and-gas deals to their boards.

“Some members of investment teams see some good investment opportunities in oil and gas,” Mr. Eaton said. “But they’re just not going to push it forward because they think there’s just too much friction to fight internally.”

Write to Luis Garcia at luis.garcia@wsj.com

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