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OUTLINE of TREASURER PEARCE Testimony on S.28:

Thank you for the opportunity to address you today on the issues of fossil fuels, and strategies to address the real, acute and detrimental impacts of climate change. Previous testimony by advocates of divestment spoke of the dangers of climate change and the issue of stranded assets and the carbon bubble theses. I will not repeat this. We agree on the problem. We agree on the need to take action. We are taking action. Where we differ is in the nature of that action. So my comments will address the risks associated with divestment, specifically to the investment of pension funds and the retirement security of over 48,000 members of the combined Vermont retirement plans. At the same time I hope we can find common ground on ways we can work together on these important issues and will make recommendations for joint action. I also want to thank 350.vermont for its efforts. It has raised awareness of the issue and informed citizens. But as noted by the carbon Tracker Initiative, not all funds can divest and there is another approach, that of engagement.

First I want to introduce our expert team that will be testifying today, in person or by phone: Matt Considine, Director of Investments at the treasurer's office, Timothy Smith from Walden, Julie Gorte from PAX, and Sister Pat Daly of tri State Coalition for Responsible Investment. I have handed out copies of their bios. Our experts today are going to speak to the deficiencies in the Aperio study, which was used to support divestment in earlier testimony, review our studies and detail the value of constructive engagement and shareholder activism. But first I am going to address some of the less exciting but important issues of fiduciary responsibility to the beneficiaries of the pension systems, and ultimately the taxpayers, as well as some of what I would characterize as serious misstatements of fact or misrepresentations you heard in previous testimony in support of divestment.

Jane Ambachtsheer, who participated as a United Nations consultant in the formation of United Nations Principles for Responsible Investment wrote in a 2013 article[1] that "Divestment is only one tool in the tool box. While divestment is not a new approach, divestment from fossil fuels is relatively untested and potentially difficult for investors for many reasons, such as:

- Fossil fuels represent a significant component of today's energy mix and they are used in a wide range of commercial and consumer uses beyond the energy sector (e.g. automotives, manufacturing);

[1] "Doing the Homework on fossil-fuel Divestment", Jane Ambachtsheer, Pensions & Investments

- Appropriate substitutes for fossil fuel companies may be fewer compared to other divestment campaigns, such as South Africa and Sudan;
- Divesting from such a large sector of equities markets might be considered a breach of fiduciary duty;
- Divestment eliminates a shareholder's ability to engage with companies and influence business strategy and companies may not be impacted by divestment on a relatively small scale, as a result;
- There is active debate over the ability of divestment to impact the value or behavior of companies, particularly in such a large and profitable sector; Divestment is likely to have up-front and recurring costs."

The bottom line is that there are issues with divestment.

I would like to address a serious misunderstanding of our fiduciary responsibly that was reflected in testimony earlier this month. A fiduciary is an individual, corporation or association holding assets for another party, often with the legal authority and duty to make decisions. VPIC members act in a fiduciary role and owe a duty to the members and beneficiaries of the participating retirement plans. In response to a question by Senator Bray, regarding how broad one may interpret their fiduciary responsibility, Mr. Becker stated that we have a fiduciary duty similar to that outlined by ERISA (Employee Retirement Income Security Act)**.** That is correct. Although we are not subject to ERISA, we are subject to IRS regulation and the Uniform Prudent Investor Act, or UPIA, which creates very similar requirements. In fact, while acknowledging the role of SRI funds, the 2013 Dartmouth College report unequivocally states that "As Vermont's laws currently stand; the pension board can only divest fossil fuel funds if there is a reasonable argument that returns will not be adversely affected" [2]

As noted in the VPIC's policy statements:

> The Committee is required by law to strive to maximize total return on investment, within acceptable levels of risk for public retirement systems, in accordance with the standards of care established by the prudent investor rule under 14A V.S.A. § 902 (the "prudent investor rule"). Further, the three State pension plans are qualified plans in accordance with Section 401(a) of the Internal Revenue Code. Federal and State law prohibit the use or diversion of any part of the corpus or income of the plans at any time prior to the satisfaction of all liabilities with respect to members and their beneficiaries for purposes other than the exclusive benefit of members and their beneficiaries."

But in earlier testimony by CleanYield, the Committee was advised that the DOL guidance in the 1990s, when Robert Reich was secretary of Labor, makes clear that nonfinancial factors are "certainly acceptable" in looking at the total impact to the beneficiaries of the fund" In further

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[2] Nelson A Rockefeller Center at Dartmouth College, "Divestment from Fossil Fuel Investments: An Analysis of Potential Impacts and Strategies", February 27, 2104.

testimony it was stated that "it's not just the financial, maximizing financial return and reducing risk but also the kind of world these beneficiaries are going to inherit. So there is room under federal guidance, under ERISA for non-financial criteria to be used in building portfolios."

This thesis is based on interpretive bulletins IB 94-1 and 94-2 that defined the term Economically Targeted Investments as "investments selected for the economic benefits they create apart from their return to the employee benefit plan. In issuing the bulletins, the DOL was addressing the "limited circumstances "under which fiduciaries may, in connection with investment decisions, take into account factors other than the economic interests of the plan. What was neglected in previous testimony was this was intended as a "limited" application. The 1994 guidance stated that in situations in which two or more investment alternatives <u>*are of equal economic value to a plan*</u>, that under these limited circumstances, fiduciaries can choose between the investment alternatives on the basis of a factor other than the economic interest of the plan. Furthermore in 2008 supplemental guidance was issued that stated:

> "The guidance provided in this document, Interpretive Bulletin Sec. 2509.08-1 clarifies, through explanation and examples, that fiduciary consideration of non-economic factors should be rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards. This guidance modifies and supersedes the guidance provided in interpretive bulletin 94-1."

Moreover the 2008 interpretive bulletin provides examples of issues, one of which bears on the current discussion that would cause a breach of that fiduciary duty."[3]

> "A plan sponsor adopts an investment policy that favors plan investment in companies meeting certain environmental criteria (so-called ``green'' companies). In carrying out the policy, the plan's fiduciaries may not simply consider investments only in green companies. They must consider all investments that meet the plan's prudent financial criteria. The fiduciaries may apply the investment policy to eliminate a company from consideration only if they appropriately determine that other available investments provide equal or better returns at the same or lower risks, and would play the same role in the plan's portfolio."

This is precisely why, as integral to our fiduciary responsibilities VPIC has adopted an ESG policy for evaluating opportunities to either make or divest from investments for the purpose of achieving certain environmental, social or governance ("ESG") goals that do not appear to be primarily investment-related. We did the requisite studies to determine the impact and determined that substantial harm would come to the fund under a fossil fuel divestment strategy.

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[3] http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=21631&AgencyId=8&DocumentType=2

In testimony by divestment advocates it was stated that "VPIC used the NEPC report to estimate forgone returns." That is inaccurate. The Treasurer's report (referred to as VPIC) was completed prior to the NEPC study and independent of it. They evaluated the same portfolio but were completed by separate staff- staff from the Treasurer's Office and NEPC. We also noted that NEPC is an independent fiduciary that does not invest funds of any kind, therefore not creating a conflict or marketing advantage by articulating a brand of investment or any other such conflict.

The NEPC and Treasurer's office studies are the **only** studies that directly address the VPIC portfolio. The Aperio study does not analyze VPIC's specific holdings. Mr. Becker states that "the Aperio study showed the "return penalty a myth". That is a characterization that even the Aperio study authors would not make. Matt Consodine will provide testimony that the Aperio study uses a hypothetical historical optimization and by its own admission states that "there is no definitive answer" and results "do not provide a consensus on whether there has been a return penalty or benefit from carbon screening". Matt will also go over the transaction costs which we believe CleanYield, in its testimony did not capture. By the way, in making its analysis CleanYield cited its selling of some of its shares of ExxonMobil. As of the 12/31/2014 report filed with the SEC, it still holds over 9,000 shares of ExxonMobil.

Our reports, which Matt will describe, point to significant cost to the VPIC portfolio, a portfolio funded by taxpayers and employee members for the exclusive benefit if some 48,000 active, vested, terminated and retired members of the state, teachers and municipal system.

I also wish to point out that the Vermont State Employees Union adopted a resolution on December 11, 2014 stating:

> "That Members of the Vermont State Employees' Association, Inc. Retirees' Chapter recommend to the members of the VSEA Board of Trustees and VSEA Council that they do all in their power to prevent the passage of legislation that would enable members of the Vermont Legislature to be involved in the decision of how or where the monies in the Vermont State Employees' Pension Fund be invested."

This resolution was adopted by the VSEA Retirees' Chapter Board of Trustees, the VSEA Board of Trustees, and the VSEA Council in December 2014.

Divestment is not a strategy appropriate to the Vermont pension plans and is direct conflict with its fiduciary duties and its responsibilities to both taxpayers and employees. As I stated last year, this Senate Committee in its role as oversight to Government Operations shares a duty both to the taxpayer and the employees.

The Dartmouth report states in its summary, "despite its adaptability, divestment has limits when applied to fossil fuel shares in pensions. …the decision on whether or not to divest needs to be framed through a financial lens before social arguments can even be taken into consideration". Further, the Carbon Tracker Initiative recognizes the same limitation. In a paper entitled "To

Divest or Not to Divest", one of the key movers in the fossil fuel and carbon bubble movement states "For those investors who are constrained by the structure of the investment process, or indeed are not mandated to make ethical investment choices, they need an alternative way of approaching the problem. The majority of institutional investors are likely to fall into these categories" The carbon tracker initiative paper goes on to identify ways to proceed for investors who do not have divestment as an option. I am pleased to state that we are making progress on all four of their recommended actions. Much of our efforts are detailed in a "Sustainability and ESG Activity Report" prepared by the Treasurer's Office and submitted for your review I would be pleased to come back and report on these activities. These include local investments in energy efficiency and renewable energy, a project that Senators Pollina and White of this committee assisted by sponsoring the 10% in Vermont legislation, a project to engage with regulators at the SEC on environmental disclosure, active participation in the carbon Disclosure Project, voting our proxies, shareholder engagement through letters, and co-filing shareholder resolutions.

- In 2014, the Vermont State Teacher's Retirement Board of Trustees and the Vermont State Employees' Retirement System Board of Trustees approved the addition of a fossil fuel-free mutual fund investment option for the 403(b) plan. As of February 17, 2015, the Deferred Compensation, PAX Fund had 45 participants with $434,491 in assets.

Contrary to the testimony you heard last week, we have recently filed shareholder resolutions. The Vermont Pension Investment Committee approved the co-filing of a resolution asking ExxonMobil to report to shareholders by the end of November 2015 about its plans for reducing total greenhouse gas emissions from its products and operations. As noted in a February article in Pensions & Investments "BP PLC, London, on Friday endorsed a shareholder proposal filed at the company by a group of global pension funds and other institutional investors, calling for more disclosure by the company on climate risk…. the proposal was co-filed Jan. 21 by a group that includes the $29.4 billion Connecticut Retirement Plans & Trust Funds, Hartford; the Montpelier-based Vermont Pension Investment Committee, which oversees $4 billion in assets of three state retirement systems; and Christian Brothers Investment Services."

Again contrary to testimony you heard last week, there is a value to shareholder engagement and our speakers will address that. In his testimony, Eric Becker contended that shareholder activism cannot work in the fossil fuel companies because such changes can occur when addressing operational issues but not when addressing their core business. He asked "what can we ask them to do other than to go out of business?"

I believe that this statement does not reflect the mainstream of shareholder activism and the fact that while some companies, in changing economic environments, do not stay profitable, others have, in fact, evolved and thrived. I recently had the opportunity to work with Reed Hunt, CEO of the Coalition for Green Capital and former Chairman of the Federal Communications Commission. He has written extensively how the communications industry transformed itself, its core function if you will, to the model we have today. I can assure you as a user of Ma Bell phone services in the 70's, it is a very different industry today. Industries can adapt. In fact, building on the model used to "unleash the telecommunications revolution", he asserts the energy sector needs to undergo a profound transformation – towards cheap renewable energy. While much of his discussion is on electric grids, it has application to larger industries.

I do not dispute the fact that many of the big oil companies have abandoned or minimized their renewable energy investments in recent years. According to reports, BP shut down its solar business in 2011, Chevron moved away from its renewable sector about a year ago and as stated in a recent article "ExxonMobil has expressed zero interest in renewable energy". But with changing economies and pricing on solar, for instance, on scale with grid process, some companies are looking at change. This change is not coming from altruism but a hard look at the business model, something investors, through shareholder activism, have been able to articulate.

One such company is Total SA, it is an integrated oil and gas company and 7th on the carbon tracker 200 list. It now holds a 2/3 ownership in a solar industry leader, SunPower, and a stake in a company called Amyris, a renewable supply company. As noted in a recent article, "In the process, it has built large positions in two companies that could eventually transform the company"[4]

And let's not forget that taking on the oil giants on their own turf can have a significant impact. Activist David Sirota stated,

> "[T]he enormous size that makes multinational companies like ExxonMobil seem so immovable is precisely why these seemingly minute victories are actually huge. If you get a giant corporation with global reach to change even a tiny bit, you have made a global impact. If, like these activists did today, you force the company that has produced 5 percent of all the human-created carbon emissions in history to even vaguely acknowledge that global warming is occurring, you have potentially started changing the planet."[5]

Sirota further notes that, since 2007, due to shareholder activism, ExxonMobil has significantly cut back its donations to climate change denial groups and has come out publicly in favor of a carbon tax. I would like to note, that I am planning on going to the ExxonMobil annual meeting in May with Sister Pat and I know that my seat at the table will be given full weight given Vermont's status as shareholder.

It was suggested that you don't need to have shares to participate in the Investor Network for Climate Risk (INCR), of which Vermont is a founding member. That is correct. But it is the combined shareholder power of the network that gives it its strength. As noted on the Ceres web site INCR "is a network of 100 institutional investors representing more than $13 trillion in

[4] "One Big Oil Company that Sees a Future in renewable Energy", The Motley Fool, January 17, 2015.
[5] 'So what have Shareholder Activists Ever Done For Us?", David Sirota, CSR Strategy Group

assets committed to addressing the risks and seizing the opportunities resulting from climate change and other sustainability challenges” One of its primary methods of doing this is to engage with companies in their portfolios. As I have said many times, selling your shares and walking away from the table dilutes this useful tool.

One of the sad outcomes from the divestment debate is that multiple constituencies, all of whom care deeply about the environment, have become polarized. It very much reminds me of the type of stalemate we see in Washington, in our national institutions. While this is happening, we miss some of the opportunities to take these issues to the climate change deniers and those companies that are doing harm to our environment. This is not the Vermont way of getting things done. My experience has been one of collaborative effort to reach mutual goals. Last year, Senator White asked if there are ways we can work together. I very much hope there are areas of mutual interest where we can effectively work together to address and mitigate the risks of climate change. Our sustainability report has a series of “next steps”. I would be pleased to come back or work with a subgroup to discuss these with our friends in 350.vermont. Again, thank you for your time today and I will turn this over, with your permission, to our expert team.

NOTE:

We want to take this debate as an opportunity to work together with all stakeholders in the effort to battle climate change. I see three areas that we should all be working on as a team in achieving substantive change in this arena:

> -Engaging the SEC to enforce its own rules and regulations on Political Contributions and Carbon Disclosures;
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> -Working towards achieving success with the Carbon Disclosure Project; and
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> -Engaging with our investment managers in regard to the Carbon Bubble.