The Second Steps – The Climate Capitalists

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1. Introduction

As I'm starting this paper, I've finished the primary source, the book in reference 1 below.[1] I will have completed four papers after this paper is posted, listed below.

- The First Steps – Low Carbon Cement
  https://energycentral.com/c/ec/first-steps-low-carbon-cement
- The Second Steps – Carbon Capture & Sequestration (CCS)
  https://energycentral.com/c/ec/second-steps-carbon-capture-sequestration
- The Second Steps – Big Oil's Transition
  https://energycentral.com/c/og/second-steps-big-oil%E2%80%99s-transition
- The Second Steps – The Climate Capitalists – This Post

You might ask what there is only one first step, and three second steps. The two types of actions ("steps") that mankind needs to take to mitigate climate change is (1) to convert all processes that produce greenhouse gas (GHG) to those that greatly reduce those emissions, and (2) remove much of the GHG from the atmosphere.

In the process of doing (1) we will displace major industries, and it seems that (2) might be a good destination (future work) for those industries. For instance, one obvious process we need to mitigate is the production and burning of fossil fuel, (coal and petroleum products). The primary process for accomplishing (2) is carbon capture and sequestration (CCS), the petroleum industry developed this process. It would be efficient for them to continue to host CCS, and migrate from producing large quantities of combustible fuel to mostly carbon management. In this, and the prior two papers we explored this idea. CCS is a complex but difficult process for a number of reasons, and thus the three papers covering it.

Also, the first step is already well underway (mainly conversion from burning stuff for energy to using renewables and other zero-carbon processes), and I have written frequent posts on it. I included the first step paper, because my reference book had an excellent treatment of the transition to "Low Carbon Cement."

This paper takes a deep dive into what will be (and has been) required to move massive petroleum corporations from producing fuels to carbon management. If a particular corporation refuses to go along with this program, the process of forcing them to do this becomes a really nasty corporate war. Although this paper is likely to be to longest in the series, I will try to keep it within 5,000 words. However, this paper does not start out with this battle, but with:

[1] Akshat Rathi, Climate Capitalism, Section 11, The Capitalist, Copyright, Greystone Books, 2024

2. The World's Most Sustainable Company

The world's most sustainable company makes toilet cleaners, deodorants and mayonnaise. Unilever, with brands like Ben & Jerrys, Degree, Dove, Hellman's, and Vaseline has been ranked first every year since 2011 by GlobeScan, which surveys leading sustainability professionals. And it is miles ahead of others that make the top of the list, including Tesla, Microsoft and Orsted.

That's a remarkable achievement for a company with a huge variety of products, which Unilever says some 2.5 billion people in the world use every day. Few corporations in the world have such reach. The story of how a consumer goods company has a higher sustainability rating than Elon Musk's Tesla, Bill Gates's Microsoft and the only large oil company to go fully renewable, 0rsted, is key to understanding how corporations can be a part of the climate solution.

Unilever seems to have found a way of turning corporate social responsibility plans from nice to have into the core of its business model. In a world of almost identical consumer goods differentiated only by packaging and branding, Unilever has made doing good a key selling point for consumers and attracting top talent.

If anything, the sustainability push may have saved Unilever. Between 1990 and 2010 the company was losing market share to competition from US giant Procter & Gamble and Swiss company Nestle. 'Unilever got terribly off track to be honest,' says Paul Polman who served as CEO of Unilever between 2009 and 2019. 'It was run by finance people for short-term profits chasing targets that they couldn't deliver.'

The result was cutting spending on training employees and brand development just to prop up numbers that would please shareholders. 'It was a milking strategy,' says Polman, 'And you get into a downward spiral.' There was a risk Unilever wasn't thinking about the long term and milking itself so dry of resources it wouldn't recover.

Through past experiences at P & G and Nestle, Polman understood that Unilever needed something different. Aged fifty-two at the time, it was likely going to be the last big job he'd take at a multinational and he wanted to use his power as the new CEO in 2009 to also do something bigger: reform capitalism. 'I wanted to make it clear that Unilever wasn't just working for the shareholders,' he says. 'We were optimizing for multiple stakeholders: the people who worked for Unilever, our customers and the planet.

Phrases about 'making the world a better place' are easy to find in investor brochures, but greenwashing is rife in the corporate world, and companies rarely live up to those promises. And Polman wasn't saying anything that many reformists hadn't already said before: running capitalism for short-term profits is going to mean less value in the long term. He wanted to show that a more sustainable form of capitalism is possible. The surprising thing is that, in his decade at Unilever's helm, Polman actually did it. The company's market capitalization grew threefold during his tenure; revenues rose 30%, and direct emissions more than halved.

The complete opposite of Unilever in this regard is the oil giant ExxonMobil. The world's most valuable corporation as recently as 2013, it has experienced a decade of turmoil. Sustained resistance to acting on climate change and years of poor financial performance finally led to a rebellion at the highest level.

In December 2020 a small hedge fund called Engine No. 1 launched a campaign to appoint new directors to ExxonMobil's board and get the company to change its direction from doubling down on fossil fuels to working on a plan fit for the energy transition. It's a David vs Goliath battle with implications for whether capitalism is a solution for a planet on fire.

3. The Battle for a Corporate Soul

Before we get to how the fight played out, let's remind ourselves of what unhappy shareholders can do to make a company like Exxon change its course.

They can put out a press release or tell journalists why Exxon continuing to rely only on fossil fuels and not investing in renewables puts the company's future at risk. Company management, especially CEOs, prefer to be liked and respected. A bad news story can be embarrassing, but does not force a company to do anything.

A shareholder can ask others to vote on non-binding resolutions that would ask Exxon to, say, prepare a climate impact report. If a majority vote in-favor then the company is under more pressure than usual to do something and it might just produce the report, as Exxon did in 2018, saying that the company's strategy posed no material risk to its business. (Experts labelled the report 'defective and unresponsive'.)

Each year, Exxon's management has to ask shareholders to approve executive pay packages. If the majority vote against, that also adds pressure although the vote remains non-binding and the senior executives at Exxon can get their compensation anyway.

Similarly, each year Exxon's board of directors are up for election, and shareholders can vote against them. If a majority vote against a director then the person may be required to hand in a resignation and Exxon will have to nominate someone else. Still, the board does not strictly have to accept the resignation. Of course, if an Exxon shareholder is unhappy with what Exxon does in response to these votes, they can always sell their company shares; indeed, some climate activists have successfully pressured large shareholders, for example university pension funds, to divest from their recalcitrant fossil fuel companies. In 2020 the Church of England Pensions Board did exactly that. After Exxon repeatedly failed to set goals to reduce emissions from customers' use of its fossil fuels, the Church's board sold its stake in the company. The theory goes that if enough shareholders divested from Exxon then its stock price will go down, which will hurt the company's ability to raise money and perhaps eventually take away its social license to operate.

However, a divestment strategy does not do much to hurt a company's fundamental business. If a company is making heaps of profit extracting and selling fossil fuels, divestment from a green-minded shareholder just makes it easier for someone else to benefit even more. Those profits also ensure that access to capital remains easy for the company. It's one reason Bill Gates held out on divesting from fossil fuels, despite a years-long campaign by activists. In 2019 he finally did it, saying that he did not want to be profiting from the destruction of the planet. But he warned activists that it wasn't going to do very much to change the trajectories the companies take.

There are two other strategies shareholders can take to enforce a change. One is the above-mentioned hostile takeover; another is a proxy fight lodged through efforts to take control of the board.

In a hostile takeover a large fund could convince other shareholders that it's time to take the public company private. In return, the public company's shareholders would typically be rewarded with a share price that's higher than what the stock market offers. Once private, the new owners can fire the board and the CEO and replace them with those that agree with a greener strategy.

But a hostile takeover becomes harder the bigger the company. Kraft Heinz failed to do that to Unilever at a market capitalization $143 billion, despite offering an 18% premium on the stock price. In December 2020 Exxon's valuation stood at about $160 billion and so there was little risk of a takeover.

That's why Engine No. 1 pursued a proxy fight.[2] This is where a shareholder can write in names of new candidates for the company's board, arguing that they will steer the company towards a direction that's better for the company and thus for all shareholders. Specifically, Engine No. 1 argued that none of the directors on Exxon's board had any expertise in the energy industry. It is 'just common sense that an energy company should have at least some people with energy experience on the board', Chris James, founder of Engine No. 1, told the podcast Capitalisn't. That they didn't, he said, 'tells you a lot about the kind of culture of the company. They didn't really want to be questioned.'

James was also hoping to harness Exxon shareholders' frustration with the company's repeated refusal to accept the reality of the current energy transition, to disclose all its emissions or to set out a science-aligned strategy to reduce emissions that would help the world meet the Paris Agreement goals. But 'we didn't talk about climate change as an ideological issue', he said. 'We spoke about it consistently as an economic issue.'

A proxy fight is not cheap. The shareholder going on the offensive has to first spend money finding and convincing the right candidates for board seats, and then has to spend much more selling those candidates to all the other shareholders, whose backing is crucial. When Engine No. I launched its campaign, it had a budget of $30 million for the Exxon battle.

That kind of spend can make a proxy fight a free-rider problem. Engine No. 1 was betting that if it succeeded then it would lead to an increase in the Exxon share price, which could cover the expense of the proxy fight. In that case, all the other Exxon shareholders would see the value of their portfolio go up, even though they weren't spending any of their own money. But if Engine No.1 lost the fight, then it alone would bear all the cost, the other shareholders don't lose anything. Thus, there's little incentive for other shareholders to join Engine No. 1's campaign and more incentive to just watch what happens.

When the proxy campaign began, in December 2020, Engine No. 1's Exxon stake was a mere 0.02% or worth about $30 million. The hedge fund was ready to spend almost the same amount of money in cash on the proxy campaign. That means Engine No. 1 was betting that it would win the board seats in the vote scheduled for May 2021, and Exxon's stock price would double - at least.

James's calculations showed that, if they could convince three of the biggest shareholders of Exxon then they had an 85% chance of winning enough votes to put at least some of its list of candidates on the company's board. Those three - namely Vanguard, BlackRock and State Street - owned about 20% of the company between them.

[2] Engine No. 1: see last paragraph on page 2.

The Big Three are institutional investors that manage money on behalf of clients - many of whom are ordinary, middle- class people with just enough to invest a little here and there. Indeed, there's a good chance that some of your pension investment is held in one of the funds managed by them. They gained this status after the financial crisis of 2008-9 when the index fund industry boom began.

A stock index aggregates the changes in stock price of a defined set of companies. Which companies make it to an index can vary depending on the criteria set out by the index. The S&P 500, for instance, has 500 companies that are meant to 'represent leading companies in leading industries'. Once created, however, an index can be very powerful. When the US president says that the stock market is booming, he is not basing the comment on one company or one sector but on something like the S&P 500. Popular indexes such as the UK's FTSE 100 or Stoxx Europe 600 can become indicators of the health of the regional economy. You're likely to see the changes to those indexes plastered on the front pages of major news publications.

From a fund manager's perspective, an index is a safer bet than a single stock. Because it consists of a broad set of companies in a big list of sectors, there's little risk of losing money just because one company or industry has a big problem. Crucially, years of financial analysis have shown that financial returns from investing in popular stock indexes can often outperform those who bet on specific stocks.

Most importantly, because an index fund manager doesn't have to do the work of picking what stocks go in a fund, they can charge lower fees for managing your investments. For example, a typical index fund would charge about 0.1% in annual fees for the total sum invested. On the other hand, managed funds can charge as much as 0.5%. The lower the fees the higher the share of the returns an investor can keep.

The combination of lower fees, lower risk and pretty decent returns has made index funds very popular. That's helped the Big Three capitalize on the trend and why they end up owning large portions of most public companies in the world: including often more than 20% of US companies.

That gives the Big Three significant voting power at many of these powerful companies, which until recently they often wielded to reject climate resolutions. That has led to climate activists targeting BlackRock, Vanguard and State Street for abandoning their duties to safeguard long-term return for investors and thus incorporate in their decisions the financial risk that climate change poses. The activists' ire helped make Engine No. 1 case stronger.

Convincing the Big Three to vote in favor would net Engine No. 1 about 20% of the votes. It needed another 30% or more to ensure that the proxy fight would go its way. That's where so-called proxy advisory firms come in.

Institutional investors hold stocks in thousands of companies, each of which might have many resolutions or board seats up for voting each year. That means these firms don't always have the time to consider each proposal on its merits, and they rely on the advisory firms to recommend which way to vote based on investors' preferences.

That means, if Engine No. 1 were able to convince proxy advisory firms and the Big Three, it was guaranteed a win regardless of Exxon's shenanigans. It got help from a forward-looking institutional investor to do just that.

Leading the charge was Aeisha Mastagni, a portfolio manager at California State Teachers' Retirement System, commonly known as CalSTRS. The US's second-largest pension fund, CalSTRS had created a name for itself by playing an active role in shaping the companies it invests in. Over the previous few years Mastagni and Engine No. 1's Penner, who was an activist investor with JANA Partners previously, had successfully lobbied Apple to add parental controls to curb addiction to devices among children, and got McDonald's to add plant-based burgers to its menu.

When Mastagni brought the Exxon proxy fight idea to her boss Christopher Ailman, he was shocked. 'Holy bananas, can't we start with a smaller company first?' he recalled, talking to Bloomberg in June 2021. 'Exxon is a behemoth and can be a bully.' But Mastagni convinced him to sign on; CalSTRS would work behind the scenes, drumming up support, while Penner[3] and Engine No. 1 would be the face of the proxy battle.

That partnership proved essential, giving Engine No. 1 instant credibility when the campaign launched in December. Nobody at the time knew what Engine No. 1 was, whereas CalSTRS managed some $300 billion and owned about 0.2% of Exxon - which might sound small but accounted for ten times as many shares as Engine No. 1 had.

Then, when Exxon announced its own new board seats in January 2021, while it still did not have the climate or energy transition expertise that the activist investors were seeking, Mastagni began to organize webinars for proxy advisory firms and other large investors. She showed those investors how voting for their list of new board candidates was crucial for shareholders who care about Exxon's future on an overheated planet. As a result, major advisory firms supported Engine No. 1's list of candidates. 'I don't think it would have happened without her,' Penner told Bloomberg. 'She was incredibly forceful in her advocacy.'

While Penner and Mastagni made private calls to other Exxon shareholders, Engine No. 1's public spat with Exxon continued. Apart from appointing its own new board directors, Exxon also announced that it would spend $3 billion over the next five years on carbon capture and other carbon reduction solutions. And the company continued to insist that its climate plan was already aligned with the Paris Agreement.

For a company that had resisted any calls for change for decades, these moves showed it was clearly rattled by the threat posed by a tiny hedge fund.

Engine No. 1 asked David Victor, professor of innovation and public policy at the University of California, San Diego to take a deeper look at Exxon's claims. He read all the fine print on Exxon's many climate change presentations and published his findings in a white paper. It was not only an indictment of the entire oil industry – it showed Exxon was the laggard among the laggards. 'ExxonMobil painted a future unaware of how the world of policy was changing,' he wrote. 'What remains is a shrinking group of oil majors, notably ExxonMobil, that still cling to old forecasting methods and results.'

Separately, Engine No. 1 published its own analysis with insights from Victor's work, finding that Exxon's public were confirmed when they heard from other shareholders who were getting calls from Exxon. To counter the narrative, Engine No. 1's PR firm started calling TV producers to get Penner on as a guest.

[3] Charlie Penner was the head of active engagement for Engine No. 1.

'It has a very banana-republic feel. We're aware that directors of the company are right now calling large shareholders and trying to get them to switch their votes,' he told CNBC while waiting for the recess to come to an end. 'This is a classic kind of skullduggery and this is not the way to move this company forward.'

Exxon said that it was keeping the polls open because votes were still corning in. 'Is there a downside to giving shareholders more time to vote?' asked CNBC's Leslie Picker. 'Do you think that ultimately that would lead to potentially a more holistic result?'

'They are calling people who have already voted, and asking them to change their vote,' Penner replied. 'And they have the sole ability to close the polls as soon as they get enough people to say "yes". This is not a democratic expansion. This is the opposite.'

It didn't work out for Exxon. At the end of the recess the company said two of the four Engine No. 1 candidates had secured enough votes to gain a seat at the board, and one race was too close to call. It was a 'historic loss', concluded Fortune. The CEO was dealt a 'stinging setback', said Bloomberg. 'Wall Street rebels against Exxon', wrote the New York Times.

A week later, on 2 June, Exxon said the race that had been too close to call had gone in favor of an Engine No. 1 candidate, giving them three-seats in total on the board. The company's stock price jumped to $65 - nearly double what it was when the proxy campaign was announced in December. The activist fund had budgeted to spend $30 million, but the final tally was only $12.5 million. The increase in stock price more than paid for those costs…

Final author's comments: Although the above ended up being a rather long post, it wasn't over my limit. I believe that this information was important for any of my readers that (1) believe climate change represents a major threat to humanity, and (2) capitalism may not be well-suited to deal with it. Regarding (2), I believe that capitalism is the only widely-used economic system that can deal with climate change, because it allows broadly diverse viewpoints to merge into a reasonable "best way forward" as described above. This is shown by my home-state's experience, since California is both an economic powerhouse[4] and one of the most environmentally responsible economies in the world.[5]

Also, the above story was influenced by a couple of California organizations: CalSTRS and a University of California, San Diego professor (both highlighted on page 6).

Finally, I have decided to add a short fifth paper to this series taken from another book. This paper is a summary and book review by a guest author. He is mentioned twice in the above paper. The final paper will be posted on November 19, five days after this paper is posted.

[4] California is the 5th largest economy in the world for the seventh consecutive year, with a nominal GDP of nearly $3.9 trillion in 2023 and a growth rate of 6.1% since the year prior, according to the U.S. Bureau of Economic Analysis (BEA). On a per capita basis, California is the second largest economy in the world. https://www.gov.ca.gov/2024/04/16/california-remains-the-worlds-5th-largest-economy

[5] Mark Golden, Stanford Energy, "All eyes on California to figure out energy decarbonization, economic growth, and fairness," February 2, 2024, https://energy.stanford.edu/news/all-eyes-california-figure-out-energy-decarbonization-economic-growth-and-fairness