MarketWatch

Opinion: Exxon Mobil cover-up case shows why energy investors need a new strategy

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Published: Nov 13, 2015 12:04 p.m. ET

Pricing energy assets is about to change as the government treats Big Oil as it did Big Tobacco

Exxon Mobil's shares rose from about $69 at the end of August to $87 just last week before the New York attorney general issued subpoenas as part of an investigation into whether Exxon suppressed its climate-change research and findings. Exxon's shares are now trading at around $78.

Investors should take the climate change cover-up investigation into Exxon Mobil as a wake-up call: Climate change considerations — and how they will affect both energy suppliers and users — should now be central to nearly any investment decision.

A recent BlackRock report on the impact of climate change on investing posed the question: "Do securities of companies most susceptible to physical and regulatory climate risks already trade at a discount to the market?" Interestingly, the answer was "no."

The global asset manager wrote: "We have not observed such a discount." That may be largely true historically (though valuations in the coal sector have already taken a hit), but it certainly won't be the case for long.

Take the case of Exxon Mobil XOM, +1.75% the world's largest publicly traded international oil and gas company. Its shares rose from about $69 at the end of August to $87 just last week before the New York attorney general issued subpoenas as part of an investigation into whether Exxon suppressed its climate-change research and findings. Exxon's shares are now trading at around $78. The company rejects the allegations, but nevertheless, decades of its internal research and dialogue will now be exposed. Who knows where that will lead?

Like the legal woes of the tobacco industry before it, the legal issue of the impact of carbon emissions is in vogue and more cases are likely to follow. Already, coal giant Peabody Energy BTU, +1.58% settled with the New York attorney general about its disclosures related to climate change.

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Michael Mann, director of the Earth System Science Center at Pennsylvania State University and co-founder of the climatology blog RealClimate, says: "The expectation among those bringing the lawsuit is that they will find similarly damning materials to those that were discovered when the attorneys general of several states were pursuing similar actions against the tobacco industry — documents that clearly indicate that Exxon was aware of the threats of continued fossil fuel burning and knowingly misled others about that."

Mann believes "the floodgates could be about to open." He anticipates lawsuits forthcoming against members of the now-defunct Global Climate Coalition, which he says orchestrated "a massively funded disinformation campaign" and covered up evidence of climate change.

The Exxon Mobil case may lead to a definitive court ruling on whether climate change is real and whether corporations can be held accountable — a game changer for investors that would make liabilities for companies much clearer. Already, the U.S. Supreme Court has ruled that carbon dioxide is a pollutant, suggesting that lower courts could also be convinced of the validity of climate-change science.

World Bank research reveals that the United States is behind much of the world when it comes to considering carbon-pricing instruments, but that cannot remain the case forever.

Investors should get ahead of the issue, perhaps employing a Stranded Assets approach — assessing the environmental impact of various energy sectors and to what degree the energy assets they are targeting is going to need to stay in the ground as new technologies develop to replace fossil fuels. This idea is not yet on the radar for many U.S. investors, but it could become crucial to realistic valuations of energy companies.

For a valuation of an oil company, for example, investors should ask how much money does it spend finding new reserves? And given that, globally, we have more reserves than we can ever use, is that oil easy, or even cost-effective, to extract? Reserves now on balance sheets as assets could become liabilities if they cannot be effectively commercialized. Such considerations will produce very different valuations and might lead investors to favor companies that can extract oil inexpensively and avoid firms with hard-to-commercialize reserves.

This is not simplifying things to a "sell dirty and buy green" approach. Instead, investors should score companies based on management's ability to address increasing regulatory risks. Investors should buy energy stocks of companies addressing those risks, including renewable-energy firms, as well as traditional suppliers that are investing aggressively in energy efficiency, carbon reduction and cost competitiveness.

Reid Capalino, a senior energy analyst at the Carbon Tracker Initiative, says such considerations could hit mid-cap companies much harder than larger, diversified energy firms.

Still, a report by the Carbon Tracker Initiative says Exxon isn't doing enough to take climate change seriously. The report says Exxon appears unprepared for a shift in oil markets and could be too heavily invested in projects that could deliver an unacceptably low return to shareholders. The report also said Exxon wasn't giving enough consideration to the likelihood that global oil demand will begin declining within 10 to 15 years, even without robust climate policies.

Many energy companies, including oil and electric, have preferred not to know the real impact of climate change because ignorance can mask liabilities. The fact that Exxon has researched the topic for decades means it may have indeed known better, and that could be significant exposure. Once courts rule, the management of energy companies can no longer remain ignorant as a strategy. Their auditors will insist upon it.

In many ways, this is good news. Acknowledging a problem is always the first step to resolution and a brighter future. In the case of climate change, it could trigger a renaissance where investors sell units that fail to meet the times and buy companies with progressively minded business plans ready to develop innovative solutions to tackle the problem.

Addressing climate change requires acknowledging mistakes, a willingness to lead and making the necessary investment to protect our future — in short, the very best of capitalism.

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