Two Years After ‘Aiming for A’: Where Are We Now?

This report discusses Royal Dutch Shell Plc’s response to the 2015 shareholder resolution on climate disclosure co-filed by ShareAction and outlines how investors might respond.
The ‘Aiming for A’ resolution filed at Royal Dutch Shell Plc, which passed with 98.91% of the vote in May 2015 can be found below. The full supporting statement is in Appendix 1.

That in order to address our interest in the longer term success of the Company, given the recognised risks and opportunities associated with climate change, we as shareholders of the Company direct that routine annual reporting from 2016 includes further information about: ongoing operational emissions management; asset portfolio resilience to the International Energy Agency’s (IEA’s) scenarios; low-carbon energy research and development (R&D) and investment strategies; relevant strategic key performance indicators (KPIs) and executive incentives; and public policy positions relating to climate change. This additional ongoing annual reporting could build on the disclosures already made to CDP (formerly the Carbon Disclosure Project) and/or those already made within the Company’s Annual Report and Sustainable Development Report.
Executive summary

Background

The conventional business model of oil and gas companies poses a double-edged threat to investors. On the one hand, rapid advances towards a decarbonised energy mix threaten to drastically decrease demand for hydrocarbons. On the other hand, a greater danger is posed if fossil fuels continue to be produced and consumed at today’s rates. If this happens, investors could face portfolio-wide value destruction through the systemic risks that unmitigated temperature rise poses for the global economy. These challenges speak to the urgent need to ensure that the integrated oil majors are swiftly transitioning their businesses to achieve resilience in a low-carbon world.

It was in the light of these dynamics that in December 2014, a coalition of shareholders filed a resolution mandating Royal Dutch Shell (Shell hereafter) to produce enhanced disclosures on the company’s assessment and management of climate-related risks and opportunities. The resolution passed with 98.91% support. Five distinct topics were identified in the resolution for enhanced climate-related disclosures (see resolution wording on page 3). Each of these is addressed in this report.

The successful filing of the ‘Aiming for A’ resolutions paved the way for subsequent shareholder resolutions on climate-related disclosure at oil and gas companies such as Exxon and Occidental Petroleum, and at other high-carbon companies in the mining and utilities sectors. These pioneering resolutions set the scene for the establishment of the Task Force on Climate-Related Financial Disclosures (TCFD). While enhanced disclosures are critical to investor risk management, investors must focus on the underlying risks not merely on the quality and quantity of corporate reporting on climate-related risk. This report not only analyses the progress made by Shell with respect to the disclosures mandated by the ‘Aiming for A’ resolution, but also analyses what these disclosures reveal about the risk on the table for shareholders in Shell.

Two years on, ShareAction finds that Shell has met the minimum requirements of the resolution. However, the company’s disclosures are weak in many areas. More importantly, Shell’s disclosures on climate-related risk management lend no comfort that the board has grasped the growing pace of the low-carbon transition nor its implications given directors’ duties to protect shareholders’ capital.

This report provides a detailed analysis of Shell’s second year response and offers recommendations to inform investor engagement with the company. It has been written to support the ongoing engagement of both the original co-filers of the 2015 resolution and of the signatories to the Global Investor Statement on Climate Change. It is also aimed at assisting the ongoing work of member organisations such as the Principles for Responsible Investment (PRI), the Asia Investor Group on Climate Change, Ceres, the Investor Group on Climate Change (IGCC) and the Institutional Investors Group on Climate Change (IIGCC). The investors in these organisations, most of whom invest on behalf of pension savers in economies across the world, have a fiduciary duty to protect savers from investment risks in high-carbon companies.

Our findings suggest fiduciary investors with a holding in Shell should now escalate engagement with the company in order to protect their capital and help achieve a swift, orderly transition to a prosperous low-carbon economy. Investors should be asking Shell to go beyond the requirements of the ‘Aiming for A’ resolution and put forward a strategy for achieving commercial success in a world that meets the goals of the Paris Agreement.

The world has changed since the successful vote on the 2015 ‘Aiming for A’ resolution. In particular, a low oil price has dictated management actions, investor views and market valuations. Shell has worked hard over the last two years to reduce operating costs.

and improve its gearing ratio, which has translated into improved free cash flows for the company. Its recent focus on capital discipline is welcome.

Given the possibility of an imminent new capital expenditure (capex) cycle, investors should robustly question the likely return on capital deployed of all new high-carbon projects, and request that Shell justify growth-related capital investment decisions with reference to a range of low-carbon scenarios. ShareAction will outline its analysis of capex risks in greater detail in a separate investor briefing, soon to be published.

We suggest that investors escalate pressure on Shell through the following two mechanisms:

Engagement

This document runs through the five areas of the 2015 ‘Aiming for A’ resolution and highlights where Shell has either addressed the relevant risks or fallen short of doing so. Given Shell’s limited progress, ShareAction believes investors should escalate their engagement with Shell, according to the recommendations provided below.

Voting

ShareAction encourages investors to vote in support of shareholder resolutions that mandate the business to align its strategy with the goals of the Paris Agreement.

Summary of key recommendations and challenges

Greenhouse gas (GHG) emissions management

Shell’s operations are highly emissions intensive and remain so two years on from the ‘Aiming for A’ resolution. Shareholders should request that Shell:

• Sets ambitious targets to reduce emissions relating to the company’s operations (i.e. Scope 1 and 2 emissions). These should cover both absolute emissions at a company-wide level and emissions per unit of energy produced and used in key divisions and projects
• Reports to shareholders on the impacts of carbon pricing on demand for the company’s products
• Outlines a plan for reducing total lifecycle emissions (i.e. Scope 1, 2 and 3) as part of the company’s low-carbon transition strategy

Asset portfolio resilience to post-2035 scenarios

Since the ‘Aiming for A’ resolution, Shell’s strategic priorities and capital allocation decisions have remained heavily tilted towards hydrocarbons. Shareholders should request that Shell:

• Provides more detailed analysis on the resilience of its portfolio of assets (operational and in reserve) in a <2°C scenario in which the goals of the Paris Agreement are met
• Produces a plan, with quantifiable milestones, to make the company commercially resilient against the IEA’s 450 scenario, explaining in the company’s audited annual report how this is being operationalised in respect of capital allocation decisions

Low-carbon R&D and investment strategies

Capital allocated to Shell’s ‘New Energies’ low-carbon portfolio is set to represent just 3% of its total capital expenditure by 2020. Shareholders should request that Shell:

• Outlines in greater detail how executive management is assessing the opportunities and risks around diversification into low-carbon assets, including its plans and options for low-carbon R&D.
Strategic KPIs and executive incentives

Shell’s remuneration policy and strategic KPIs encourage executives to increase hydrocarbon production, regardless of whether these products are likely to be required under low-carbon scenarios. Shareholders should request that Shell:

- Clarifies how strategic progress towards <2°C resilience will be articulated in the CEO scorecard and integrated into other decision-making on remuneration
- Reduces the volume-based focus of its KPIs and incentives, and includes new indicators that help track how the company is transitioning its business model for success in a Paris compliant global economy
- Updates its annual bonus to include an incentive that recognises the year-on-year decisions that executives will be required to make as part of a long-term <2°C strategy

Public policy interventions

Oil and gas companies have been active lobbyists, and Shell is no exception. These positions are not always consistent with shareholders' long-term interest in a swift and orderly low-carbon transition. Shareholders should request that Shell:

- Discloses memberships of all entities to which the company is linked or those that act on its behalf on issues of climate or energy policy, including: trade associations and federations, Chambers of Commerce, general business forums, PR consultants, think tanks, advertising agencies, and special interest advocacy groups
- Discloses its position on and engagement with key upcoming climate legislation
- Outlines a policy for dealing with member-led bodies whose climate change policy and lobbying contradict corporate policy or initiatives
This section of the report analyses Shell’s response to the five areas on which the firm is required to provide enhanced information following the ‘Aiming for A’ shareholder resolution.

Shell has not provided a formal response to the resolution in either 2016 or 2017. However, relevant information pertaining to the five areas of the resolution can be found dotted throughout its corporate disclosures. Documents taken into consideration for this analysis include Shell’s Annual Report 2016, Sustainability Report 2016, Notice of Annual General Meeting, and other supplementary climate documents.

The analysis and recommendations in this report reflect the expectations of shareholders and other stakeholders following the ratification of the Paris Agreement.

Greenhouse gas (GHG) emissions management

The ‘Aiming for A’ resolution directed Shell to report on how it is reducing its operational emissions (those resulting from operative practices such as gas flaring, well testing and refining). A more holistic approach to addressing the firm’s overall carbon footprint would also address Scope 3 emissions i.e. those expended by consumers of Shell’s products. Scope 3 emissions make up around 80-90% of Shell’s total lifecycle emissions. This was the request put to Shell in a shareholder resolution filed in 2017 by the Dutch shareholder network, Follow This.\(^1\) The resolution requested that the firm set targets to reduce its Scope 1, 2 and 3 emissions.\(^1\) Shell has so far resisted requests from shareholders to set targets around its emissions, and suggested these could be counterproductive to its low-carbon strategy.

Key findings

- Shell has refused to publish targets for reducing its Scope 1 or 2 emissions, and argued such emissions might need to increase for the company to pursue a low-carbon strategy
- Shell has not set out a strategy to reduce its Scope 3 emissions, and has said it would not be “constructive” to do so\(^2\)

We may potentially be developing resources that require more energy and advanced technologies to produce... this could result in an associated increase in direct GHG emissions from our upstream facilities.

Scope 1 and 2 emissions

In 2016, Shell reduced its overall Scope 1 and 2 emissions relative to 2015.\(^3\) Shell attributes this to factors including divestments, operational efficiencies and a reduction in flaring. The firm has not set targets to further reduce its Scope 1 and 2 emissions, although the company does have a range of initiatives which should assist in doing so, such as energy efficiency, flaring and venting programmes. The firm also suggests that its operational emissions may increase, stating that:

\[\text{“as energy demand increases and easily accessible oil and gas resources decline, we may potentially be developing resources that require more energy and advanced...“}\]
While Shell’s Scope 1 and 2 emissions are significant, focusing only on these would be a mistake considering Shell’s broader exposure to climate-related financial risk. The most significant threat the firm faces is faster-than-expected demand destruction for its products. Achieving efficiencies and reductions in Scope 1 and 2 emissions, whilst positive, does not address this risk.

Shell applies an internal carbon price of $40 per tonne of CO$_2$ equivalent to its operational emissions. For projects with a high exposure to government imposed carbon pricing or legislation, Shell applies other tougher standards and stress tests. While this is to be welcomed, the company has not yet shared with shareholders the results of applying a carbon price to emissions expended by its consumers (i.e. Scope 3 emissions). The impacts of a carbon price on the consumption of Shell’s products is what shareholders need to see, as this would have a far greater impact on the resilience and profitability of Shell’s business. Carbon pricing, including carbon taxes, would reduce demand for fossil fuels and increase the competitiveness of renewables. As Shell is one of a number of integrated oil and gas companies who publicly support carbon prices, including a carbon dividend resolution in the United States of America, the company should provide shareholders with analysis of how such carbon pricing and taxes would impact the business if introduced.

Scope 3 emissions

In 2017, a resolution was filed at Shell by the Dutch shareholder network, Follow This, requesting the firm sets targets to align its scope 1, 2 and 3 emissions with the goals of the Paris Agreement. Shell’s board advised investors to vote against this resolution, stating that it was “unreasonable with regard to what the Company can be held accountable for and would be ineffective or even counterproductive”.

Key recommendations

Shareholders should request that Shell:

- Sets ambitious targets to reduce emissions relating to the company’s operations (i.e. Scope 1 and 2 emissions). These should cover both absolute emissions at a company-wide level and emissions per unit of energy produced and used in key divisions and projects
- Reports to shareholders on the impacts of carbon pricing on demand for the company’s products
- Outlines a plan for reducing total lifecycle emissions (i.e. Scope 1, 2 and 3) as part of the company’s low-carbon transition strategy

Asset portfolio resilience to post-2035 scenarios

A key concern for investors is that integrated oil and gas companies are allocating capital to explore for and produce hydrocarbon reserves that are surplus in low-carbon scenarios, leaving assets and infrastructure economically stranded. Shell’s shareholders need assurance that the company has a business strategy that is commercially resilient in low-carbon scenarios where demand for hydrocarbons is falling quickly.

Shell has taken steps to assess the implications of low-carbon scenarios, including the IEA 450 scenario (in which there is a 50% chance of keeping global temperatures to 2°C of warming). While these are positive steps, the emphasis must now shift from scenario testing to scenario planning, with active steps taken to protect the company from costly impairments and destruction of shareholder’s capital.

---

Key findings

- Shell states it tests its portfolio against a range of scenarios including IEA 450, and in 2016 it produced a narrative account of a <2°C pathway. The firm does not yet make available to shareholders quantitative analysis of its resilience to these scenarios.
- The high oil price assumptions underpinning Shell’s analysis on the IEA 450 scenario lead to results that do not fully capture the disruptive implications of other possible low-carbon scenarios, namely scenarios with falling and sustained low oil prices.
- Analysis of the firm’s strategic priorities and capital allocation decisions show that Shell’s current business model and base case for planning is consistent with 3–5°C+ of global warming, an outcome which is unacceptable and highly risky for many of Shell’s investors. Furthermore, the company confirms that it has “no immediate plans to move to a net-zero portfolio over our investment horizon of 10 - 20 years.”
- This appears to contradict the statement made in Shell’s 2017 Notice of AGM that “Shell has a clear strategy, resilient in a 2°C world.”

In 2016, Shell produced ‘A better life on a healthy planet’, a report providing a non-quantitative account of a <2°C energy pathway. Whilst instructive, the company did not provide analysis of its own resilience to this scenario. In its 2016 and 2017 reporting, Shell states that its portfolio would be resilient under the IEA 450 scenario. Shell admits that this is in large part due to the high oil prices assumed in the IEA’s 450 scenario. Investors should question the methodology used to produce this result. It appears that Shell has only taken into consideration its current portfolio of assets, rather than those it is likely to be operating by 2030. If so, this provides a potentially misleading account, as it assumes no further investments will be made to develop assets that would make up the portfolio by 2030.

In describing the transition to a low-carbon economy, Shell tends to emphasise scenarios favourable to its business model, such as a switch from coal to natural gas and the scaling up of carbon capture and storage (CCS) technologies. Investors should request information about less favourable outcomes such as those with a more limited role for gas as a transitional fuel, or those where stricter legislation is enforced in growth markets such as India.

“... When questioned about the goal of limiting temperature rise to “well below 2°C, with an ambition for 1.5°C” at the 2017 AGM, the CEO described this ambition as in the “realm of the fantastic.”

In the 2017 Notice of AGM, when providing shareholders with arguments for voting against the Follow This resolution, Shell stated that it has a “clear strategy, resilient in a 2°C world.” However, the firm has not provided evidence that its current business strategy is resilient in scenarios where the goals of the Paris Agreement are met. Indeed, statements such as the disclaimer that Shell has “no immediate plans to move to a net-zero portfolio over our investment horizon of 10 - 20 years” the company continues to assume its current asset portfolio and strategy are safe.

Shell named its two key scenarios the “Mountains” and “Oceans” scenarios. Neither of these anticipate disruption to the dominance of fossil fuels, and both assume the goals of the Paris Agreement will not be met. When questioned about the goal of limiting temperature rise to “well below 2°C, with...
an ambition for 1.5°C” at the 2017 AGM, the CEO described this ambition as in the “realm of the fantastic”. Such comments suggest that Shell’s board does not see a Paris compliant outcome as one that needs planning for. In contrast, Total uses the IEA 450 scenario as its base case for planning.12

“ERC finds [Shell’s Sustainability Report 2016] ambiguous on the necessary pace of change, plus how Shell discusses the evolution of its business sometimes seems at odds with the report’s own commentary on the urgency implied by the science of climate change as well as trends in many other sectors.”29

The ERC also notes “the lack of discussion about how exploration and production will change over time or how in these two areas Shell will prioritise investments and activities”. Information about Shell’s intentions and readiness in these areas is critical to building investor confidence that the firm is well positioned to succeed in a lower carbon world. The 2015 resolution’s supporting statement asked for information regarding “the role exploration, disposals and cash distributions to investors will play in the nearer term”. Insufficient information has so far been produced to illuminate how Shell will balance these factors so as to protect shareholders’ capital as the global energy mix shifts away from hydrocarbons.

Key recommendations
Shareholders should request that Shell:

• Provides more detailed analysis on the resilience of its portfolio of assets (operational and in reserve) in a <2°C scenario in which the goals of the Paris Agreement are met
• Produces a plan, with quantifiable milestones, to make the company commercially resilient against the IEA’s 450 scenario, explaining in the company’s audited annual report how this is being operationalised in respect of capital allocation decisions

Low-carbon energy R&D and investment strategies
Investors are asking questions regarding which oil and gas companies have the necessary competencies to successfully move into unfamiliar

ERC finds [Shell’s Sustainability Report 2016] ambiguous on the necessary pace of change, plus how Shell discusses the evolution of its business sometimes seems at odds with the report’s own commentary on the urgency implied by the science of climate change as well as trends in many other sectors.”

The ERC also notes “the lack of discussion about how exploration and production will change over time or how in these two areas Shell will prioritise investments and activities”. Information about Shell’s intentions and readiness in these areas is critical to building investor confidence that the firm is well positioned to succeed in a lower carbon world. The 2015 resolution’s supporting statement asked for information regarding “the role exploration, disposals and cash distributions to investors will play in the nearer term”. Insufficient information has so far been produced to illuminate how Shell will balance these factors so as to protect shareholders’ capital as the global energy mix shifts away from hydrocarbons.

Key recommendations
Shareholders should request that Shell:

• Provides more detailed analysis on the resilience of its portfolio of assets (operational and in reserve) in a <2°C scenario in which the goals of the Paris Agreement are met
• Produces a plan, with quantifiable milestones, to make the company commercially resilient against the IEA’s 450 scenario, explaining in the company’s audited annual report how this is being operationalised in respect of capital allocation decisions

Low-carbon energy R&D and investment strategies
Investors are asking questions regarding which oil and gas companies have the necessary competencies to successfully move into unfamiliar
## Table 1: Shell’s strategic priorities

<table>
<thead>
<tr>
<th>Strategic priority</th>
<th>Challenges to low-carbon resilience</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash engines: conventional oil and gas, integrated gas, oil products</td>
<td>Natural gas makes up over half of Shell’s asset portfolio. With lower emissions than coal and oil, gas is often described as a ‘transitional fuel’. For more commentary regarding the low-carbon credentials of gas, please see section 2.3 of this report.</td>
</tr>
<tr>
<td></td>
<td>Liquefied natural gas (LNG) is a key cash engine for Shell. Many LNG assets have high-cost operations, putting them at risk under low-price, low-demand scenarios. Short-term concerns related to market oversupply sit against a backdrop of medium and longer term risks around the strength of gas demand. A number of factors could contribute to demand being lower than Shell currently forecasts. For example, recent analysis of the UK market reveals that wind, solar and energy efficiency have taken most of the brunt in replacing coal power, rather than gas. This could exacerbate the current trend of falling gas demand in Europe – which dropped 23% between 2010 and 2014.</td>
</tr>
<tr>
<td></td>
<td>Two years ago, analysts predicted problems with projects such as Shell’s Prince Albert LNG project in British Columbia, given their reliance on high-demand scenarios. Shell has recently announced its intention to shelve this project. This example suggests investors should question the resilience of Shell’s LNG portfolio if disruptions to forecast energy demand continue.</td>
</tr>
<tr>
<td></td>
<td>Shell has also recently announced its intention to drop tar sands projects. This is a welcome move, as numerous analysts have shown how these projects do not fit into a low-carbon portfolio and are inconsistent with the goals of the Paris Agreement.</td>
</tr>
<tr>
<td>Growth priorities: deep water and chemicals</td>
<td>Deepwater is Shell’s core growth priority. Shell currently produces 600,000 boe/d in deepwater projects, and is proposing to expand this to 900,000 boe/d in the early 2020s. With high break-even prices, these projects are at risk of being left economically stranded in many low-carbon scenarios. Shell has invested billions of dollars in costly deepwater projects like Stones, the world’s deepest at 9,500 feet. Many of Shell’s deepwater projects were initiated when oil prices were $100 a barrel.</td>
</tr>
<tr>
<td></td>
<td>Shell is focused on finding ways to reduce costs of deepwater projects, with a “budget” strategy allowing one of its new Gulf of Mexico projects to break-even below $40 per barrel. Whilst welcome, these budget cuts</td>
</tr>
</tbody>
</table>
Future opportunities: shales and new energies

Without adequate guardrails in place, shale gas production can lead to significant methane leakages. Analysis suggests that when these emissions are included, the total GHG footprint of shale gas can be higher than oil and even coal. Methane leakages are often significantly higher than companies report. A recent study found that natural gas power plants release up to 120 times more methane than earlier estimates suggested. In light of these challenges, investors must query if future investments - particularly in higher-cost shale oil and gas - represent a prudent ‘future’ option. Shales currently receive more than three times the investment deployed by Shell in renewable energy.

Shell states that some of its deepwater projects have production lifespans of 50 years. While this looks attractive from an economies of scale perspective, the lack of capital flexibility involved could undermine Shell’s resilience in low-carbon scenarios. By making major upfront investments that rely on strong multi-decade demand forecasts, capital is inevitably at risk should the world experience a rapid change in the energy mix and/or policy changes to limit greenhouse gas emissions.

In 2016, Shell formed its New Energies portfolio to pursue three new areas: new fuels for transport (biofuels, hydrogen); integrated energy solutions; and digitalisation of energy systems. The capital allocated to this division represents a very modest proportion of the firm’s overall expenditure. Shell plans to increase investment in New Energies to $1bn a year by 2020 - representing around 3% of its anticipated budget. This does not point to a transformation of Shell’s portfolio on anything like the scale required to align the company with the Paris Agreement.
Markets. DONG Energy is an encouraging example of a firm that has used its fossil fuel revenues to shift into renewables. Admittedly, value is at risk if firms deploy large amounts of shareholder capital into renewable projects that are not commercially successful. For some companies in the integrated oil and gas sector, it may be more prudent to return capital to shareholders instead of seeking to transition wholesale into green energy.

Shell notes that its major contributions towards reducing global GHG emissions fall into four areas: supplying more natural gas to replace coal for power generation; developing alternative energies; progressing CCS technologies; and implementing energy efficiency measures. While movement on all four of these areas is welcome, as a cluster of strategies they currently fall short of the scale required to transition Shell for success in a Paris compliant global economy.

Key findings

- Capital allocated to the ‘New Energies’ low-carbon portfolio is set to represent just 3% of Shell’s total capital expenditure by 2020.

The shift to gas

Natural gas makes up over half of Shell’s portfolio. Research from the Stockholm Environmental Institute finds that natural gas can only be considered a transitional fuel if robust guardrails are applied, including: eliminating methane leakages, strategically yielding the greatest substitution effect by displacing coal, and preventing low-carbon technology lock-out (i.e. developments in gas made at the expense of progress in renewables).

Moreover, a number of challenges threaten the short, medium and long-term forecasts for gas demand, which pose further threats to Shell’s emphasis on gas. The International Gas Union’s 2016 World LNG Report predicts weakening demand from Asia, whilst slowing growth in China is also cutting into demand projections. Analysis from Deloitte highlights a number of potential disruptions to LNG markets, including excess global liquefaction capacity, price volatility and global competition from renewables. For example, recent analysis by Australia’s largest integrated energy company found that the combination of wind, solar and battery storage is already cheaper than energy produced from new gas generators. In the UK, coal power has largely been substituted by wind, solar and energy efficiency gains, rather than gas.

Given the uncertainty that surrounds future gas demand growth, investors should encourage Shell to pursue a cautious capital expenditure strategy that does not leave shareholders open to value destruction in low-demand scenarios.

Alternative Energies

Shell created a ‘New Energies’ business in 2016 to “explore opportunities in alternative transport fuels, such as biofuels and hydrogen, along with new ways to connect energy producers and consumers.”
in detail its small-scale biofuel, solar, wind and energy efficiency projects.

The firm intends to invest $1 billion in its ‘New Energies’ division by 2020. In 2016, Shell announced that capital spending would be in the range of $25-$30bn a year to 2020. This means spending on ‘New Energies’ will represent around 3% of total capex by 2020. This approach will certainly prevent shareholder value from being destroyed if Shell finds itself unable to successfully diversify its business model. However, if the company does seek to transition into alternative energies, there is a need for a relatively greater strategic focus on this pillar.

If, on evaluation, Shell concludes that it is not prudent to allocate large sums of capital into alternative investments (renewables and otherwise), investors should be asking whether the firm will instead return more cash to shareholders rather than allocating their capital to risky new hydrocarbon projects that may end up selling into a market that is characterised by slowing energy demand and falling prices for oil and gas.

Carbon Capture and Storage (CCS)

Working in partnerships such as the Oil and Gas Climate Initiative, Shell is seeking to increase capacity and knowledge of CCS. Shell’s flagship Quest CCS facility captured around one million tonnes of CO₂. This represents less than 2% of Shell’s total operational carbon footprint, which was 70 million tonnes of CO₂ equivalent in 2016. CCS does not help to reduce consumer expended emissions, which make up the majority of Shell’s total lifecycle GHG footprint. Vast injections of capital and an industrial-scale increase in capacity would be required for CCS to provide the emissions reductions required to achieve the goals set by the Paris Agreement.

Key Recommendations

Shareholders should request that Shell:

- Outlines in greater detail how executive management is assessing the opportunities and risks around diversification into low-carbon assets and opportunities, including its plans and options for low-carbon R&D

Strategic KPIs and executive incentives

The supporting statement for the 2015 resolution specified: “Transitions that span decades are complex to manage and often require lead indicators and incentives. Investors are interested in Shell’s evolving approach to KPIs and executive incentives, in the context of the transition to a low-carbon economy”.

Since strategy determines a firm’s KPIs and executive incentives, companies must first clarify their long-term plans for low-carbon resilience before these can be translated into appropriate metrics and targets for senior executives. Depending on the pathway pursued, different indicators might be appropriate. For example, a strategy of slowing total capex and returning more cash to shareholders would require different indicators to a substantial transition into green energy. Once a strategy is determined, investors can assess whether specific indicators and targets are conducive or counterproductive to achieving it.

Key findings

- Shell’s remuneration policy, which was voted through by shareholders in 2017, remains heavily weighted towards hydrocarbon production. It also contains cash flow targets that could encourage executives to focus on maintaining hydrocarbon volumes
- The aforementioned policy may incentivise executive behaviour that is misaligned with the long-term interests of shareholders, due
to performance and vesting timelines that do not reflect the risk horizons associated with hydrocarbon projects.

- Shell fails to include indicators that meaningfully focus executive attention on transitioning the firm’s business model for commercial resilience in a lower-carbon world. The 10% weighted GHG metric focuses on operational emissions only, rather than more fundamental change to a lower emissions world that the Paris Agreement demands.
- Investors should push for great clarity regarding how long-term strategic changes for low-carbon resilience will be integrated into the firm’s KPIs and executive incentives.

Volume-based incentives

Volume-based incentives that encourage executives to increase hydrocarbon production, regardless of whether these products are likely to be required under low-carbon scenarios, incentivise behaviour that puts shareholder value at risk. Shell’s remuneration policy contains features that reward hydrocarbon production at all costs, including:

- 12.5% weighting for LNG liquefaction volumes
- 12.5% weighting for maximising oil and gas production
- 12.5% weighting for project delivery

Volume-related remuneration metrics and project delivery targets reward executives for actions that do not reflect the short-term economic performance of assets, nor whether they contribute to the company’s future resilience.

Another 30% of the annual executive bonus is calculated using ‘cash flows from operations’. ‘Cash flow from operating activities growth’ accounts for 25% of Shell’s Long-Term Incentive Plan (LTIP), encouraging “capital expenditure commitments” that support growth. Executives are often required to maintain – and in the case of Shell’s LTIP, even increase – production volumes to achieve group cash flow targets. Again, these incentives do not necessarily reflect the short-term economic performance of assets, nor whether they contribute to the company’s future resilience.

While investors have an interest in free cash flows to ensure firms can maintain debt and dividend payments, Shell needs to decouple these measures from hydrocarbon volumes. Depending on the proposed low-carbon transition strategy chosen, different alternative indicators might be appropriate. Negative free cash flows are not bad in themselves, if investments are being made in low-carbon assets with good returns. On the other hand, if the firm decides not to put shareholders’ capital to work in either low-carbon or high-carbon projects, earnings could be used to make debt and dividend payments.

Performance timelines that do not reflect risk horizons

For hydrocarbon projects with long lifespans, decisions about capital expenditure made by executives today will have consequences for shareholder value far into the future. For example, Shell states it has an investment horizon of 10-20 years. Shell’s performance shares include a three-year performance measurement and additional three-year vesting period. 50% of the annual bonus is delivered in shares rewarded after a three-year vesting period. These timeframes do not reflect the risk horizons associated with projects that executives are making investment decisions on.

There are, however, concerns about extending performance measurements far beyond the likely tenure of executives - i.e., the idea of a 10-year LTIP. A potential way around this could be for the company to identify steps needed to protect shareholder value over 20+ years, then to translate these factors into measures that support the delivery of a long-term strategy on a year-by-year basis. This means executives are not tied to inflexible 10-year plans, but can still be rewarded for pursuing strategies consistent with the long-term interests of shareholders. What this would look like in practice for Shell would depend on the chosen transition strategy.

In the 2016 Annual Report, Shell recognised
the limitations of the LTIP’s time horizons, but
suggested that by requiring executives to hold
large shareholdings, executive interests are aligned
with those of investors. While there is a case for
equity-based rewards, this is only true if the holding
periods are meaningfully extended. For example,
before filing for Chapter 11 bankruptcy, Peabody
Energy executives cashed in stock options worth
a combined $47 million between 2008 and 2011.
In July 2015, Peabody’s stock closed at $1.20 per
share, compared to $63.98 at the end of 2010.43
Furthermore, institutional investors with portfolios
containing stock that will be adversely affected by
high-carbon scenarios – such as agriculture, forestry
and vulnerable physical infrastructure – have
considerably different interests from those of Shell’s
executives. While Shell might be able to profit under
scenarios consistent with 3+°C of warming, most
institutional investors will suffer losses at a portfolio-
wide level in such scenarios.

GHG target and CEO scorecard

Shell’s annual bonus has a 20% weighting for
’sustainable development’. This is split between
process safety (5%), personal safety (5%), and
environmental targets (10%). The previous year’s
environmental targets (water use, oil spill volumes
and Refinery Energy Intensity Index) have been
replaced by a 10% weighted metric for GHG
operational emissions management. The removal
of emphasis on water use and oil spills is not a
welcome move. These should be in focus for all
fossil fuel companies, with water use being a major
environmental issue for shale oil/gas operations
in particular. It would have been preferable for
the 10% GHG weighting to have been taken from
elsewhere - for example, from the 50% weighting for
‘operational excellence’.

The new metric for GHG management focuses
on reducing operational emissions from refining,
chemical plants and upstream flaring. As discussed
earlier, operational emissions make up a small
proportion of the company’s total lifecycle
emissions, the majority of which are expended by
consumers on combustion. Reducing operational
emissions therefore plays a limited role in ensuring
Shell’s commercial resilience in low-carbon, low
demand scenarios; and does not address the risk
of stranded assets. For example, running an oil
refinery on renewable electricity does not address
the fact that over 80% of known fossil fuel reserves
must be kept in the ground to achieve the goals
set by governments in the Paris accord. While it
is not unwelcome that Shell seeks to reduce its
operational emissions, an approach that accounts
for likely demand-side changes would better
prepare the company for commercial resilience
in a world where the energy mix is changing fast
and renewables are responsible for the majority of
marginal growth in energy demand.

The previous year’s environmental targets
(water use, oil spill volumes and Refinery
Energy Intensity Index) have been replaced by
a 10% weighted metric for GHG operational
emissions management. The removal of emphasis
on water use and oil spills is not a welcome move.

In the 2017 Annual Report, Shell recognises that
there is more to the energy transition than managing
operational emissions, and states “We will embed
progress in ‘New Energies’ into the personal
performance agreement with the CEO. The energy
transition, however, still is in an early phase and
for the coming decade(s) energy supply will still
continue to depend for a significant proportion on fossil fuels”. As previously noted, the New Energies division – while a welcome step – does not amount to a portfolio-wide transformation, and accounts for a small proportion of the firm’s planned annual expenditures. As such, this inclusion continues to fall short of the investor expectations underpinning the ‘Aiming for A’ resolution, which asked the company to link KPIs and executive incentives to the long-term strategic changes required for Shell to be successful in the context of the transition to a low-carbon global economy.

Key recommendations

Shareholders should request that Shell’s remuneration committee:

- Clarifies how strategic progress towards <2°C resilience will be articulated in the CEO scorecard and integrated into other decision-making on remuneration
- Reduces the volume-based focus of its KPIs and incentives, and includes new indicators that help track how the company is transitioning its business model for success in a Paris compliant global economy
- Updates its annual bonus to include an incentive that recognises the year-on-year decisions that executives will be required to make as part of a long-term <2°C strategy

Public policy interventions

In the last year, Shell has issued a mixture of both constructive and concerning statements in relation to climate policy. Shell remains a member of several trade bodies that have taken obstructive positions on climate and energy policies. It is not clear what internal governance mechanisms the firm has in place to address inconsistencies in the positions taken by membership organisations to which the company belongs. Shell must address these issues in order to meet the public policy requirement of the ‘Aiming for A’ resolution.

Key findings

- Shell has been vocally supportive of the Paris Agreement, however it remains unclear if Shell supports action on the scale and timelines required to meet the <2°C goal set in Paris
- There remains a need for greater transparency on trade association memberships and policy alignment, as well as internal governance mechanisms for dealing with inconsistencies.

Shell has publicly supported the “overall ambition” of the Paris Agreement, and endorses proposals to support carbon pricing mechanisms and increased government support for CCS. However, forensic analysis conducted by NGO InfluenceMap highlights that Shell’s lobbying does not reflect the scale and timeline for actions required to meet the <2°C goal. The company scores a D on InfluenceMap’s performance scoring.

Membership of obstructive trade associations

Shell is a member of several trade bodies that routinely take positions against the advancement of ambitious climate and energy policy. These include American Petroleum Institute, the National Association of Manufacturers, Business Europe, International Association of Oil & Gas Producers, American Petroleum Institute, European Roundtable of Industrialists, FuelsEurope, International Council of Chemical Associations, Australian Petroleum Production and Exploration Association. Investors should question and encourage Shell to use its position within these respective institutions to demand positions on climate action which reflect the firm’s own stated desire for a policy landscape that creates certainty around the low-carbon transition.

Transparency and governance around climate policy

Shell’s disclosures on lobbying and trade body memberships remains limited. The company does not disclose a full list of trade associations it belongs to and funds, or the oversight and governance
procedures for dealing with inconsistencies between its own public policy positions and those taken by trade associations which it belongs to.

Where Shell decides it cannot leave trade associations that have taken different positions than its own on climate change, it could be encouraged to use its leverage within these trade bodies to shift their position to one more supportive of robust action on climate change.

**Key Recommendations**

Shareholders should request that Shell:

- Discloses membership of all entities to which the company is linked or those that act on its behalf on issues of climate or energy policy, including: trade associations and federations, Chambers of Commerce, general business forums, PR consultants, think tanks, advertising agencies, and special interest advocacy groups
- Discloses its position on and engagement with key upcoming climate legislation
- Outlines a policy for dealing with member-led bodies whose climate change policy and lobbying contradict corporate policy or initiatives
Analysis of Shell’s second year reporting on the areas covered by the ‘Aiming for A’ shareholder resolution indicates that while some progress has been made, this needs to be built on rapidly if the firm is to convince investors it can thrive in a world undergoing a rapid low-carbon transition.

In light of the disclosures to date, we recommend that shareholders escalate engagement with Shell in order to protect their capital. Shell still lacks a time bound and quantifiable low-carbon transition strategy. This should include a focus on capital allocation decisions, and should follow the framework prepared by the Taskforce on Climate-related Financial Disclosure (TCFD).

Institutional investors, particularly those with fiduciary duties to younger pension savers, are increasingly under scrutiny to show that their engagements with high-carbon companies are delivering meaningful results to reduce risks. Investors in Shell should set clear timelines around their engagements with the company, with milestones and appropriate escalation strategies. If credible risk reduction is not achieved within the pre-determined engagement timeline, fiduciary investors should consider divesting their holdings in Shell.
## Annex I: Comparative analysis of Shell’s reporting in 2016 and 2017

### Table 2: Comparative analysis of Shell’s reporting in 2016 and 2017

<table>
<thead>
<tr>
<th>Area of resolution</th>
<th>2017 analysis</th>
<th>2016 comparative analysis</th>
</tr>
</thead>
</table>
| Portfolio resilience and low-carbon strategy | Shell’s core planning scenarios, Mountains and Oceans, remain aligned with 3 – 5°C+ warming  
Shell reports resilience against IEA 450. A 2016 report ‘A better life on a clean planet’ provides a non-quantitative of a <2°C scenario.  
Limited in-depth or quantitative assessment of resilience under IEA 450 or <2°C scenario  
Shell’s strategic priorities and capital allocation plans suggest the firm is not aligning for <2°C resilience.  
The firm has reaffirmed it has “no immediate plans to move to a net-zero portfolio over our investment horizon of 10 - 20 years”  
This appears to contradict the statement made in the Notice of AGM that “Shell has a clear strategy, resilient in a 2°C world” | While it is welcome that Shell has taken steps to assess low-carbon scenarios, the rigour of these can be called into question.  
Shell does not appear to have made any substantial progress since last year  
Shell has not updated its core scenarios, and has not announced intentions to do so  
Investors require more information on how Shell will adjust its strategy for <2°C resilience, and the current value at risk under this scenario |
| KPIs and executive incentives | Volume-based targets remain in the firm’s remuneration policy and KPIs  
No indicators that signal long-term wholesale strategic changes for low-carbon resilience | Since 2016, Shell has included a target linked to operational emissions reduction in its remuneration policy. However, this falls short of providing an indicator of the strategic changes the firm will make to ensure resilience |
| Low-carbon capital allocation | While progress has been made with the 'New Energies' low-carbon portfolio, this is only likely to represent 3% of Shell’s total capital expenditure by 2020. | Shell provides more details about its existing low-carbon projects, although current commitments do not signal portfolio-wide transition. |
| Emissions targets | No targets for reducing operational emissions. No strategy for reducing total lifecycle emissions. | No improvement since last year’s disclosures. |
| Public policy interventions | Mixed policy positions on energy and climate. Supports Paris Agreement and carbon pricing, but takes positions that could undermine rapid transition to low-carbon economy. Remains a member of trade associations that have lobbied to weaken climate policies. Unclear what governance mechanisms exist to assess and alleviate misalignments. | Since 2016, Shell has continued to publicly support calls for climate action. However, still appears an inconsistency in the ambition of action Shell is prepared to support. No improvement on the transparency around trade association membership, and governance mechanisms for dealing with inconsistencies in positions. |
Annex II: ‘Aiming for A’ 2015 resolution at Royal Dutch Shell Plc

Special resolution – strategic resilience for 2035 and beyond

That in order to address our interest in the longer term success of the Company, given the recognised risks and opportunities associated with climate change, we as shareholders of the Company direct that routine annual reporting from 2016 includes further information about: ongoing operational emissions management; asset portfolio resilience to the International Energy Agency’s (IEA’s) scenarios; low-carbon energy research and development (R&D) and investment strategies; relevant strategic key performance indicators (KPIs) and executive incentives; and public policy positions relating to climate change. This additional ongoing annual reporting could build on the disclosures already made to CDP (formerly the Carbon Disclosure Project) and/or those already made within the Company’s Scenarios, Sustainability Report and Annual Report.

Supporting Statement

It is our intention that this is a supportive but stretching shareholder resolution. It has been prepared by the “Aiming for A” coalition of UK asset owners and mutual fund managers for a larger co-filing group.

The “Aiming for A” coalition includes the £150bn Local Authority Pension Fund Forum and the largest members of the £15bn Church Investors Group. The coalition was convened by CCLA Investment Management in 2011/12. The group is undertaking in depth engagement with the ten largest UK-listed extractives and utilities companies, with a particular focus on the companies’ CDP performance bands.

There are several reasons why UK asset owners and mutualls have come together under the “Aiming for A” initiative to support extractives and utilities companies in their preparations for the low-carbon transition. These range from systemic risk management and our collective fiduciary duty to engage in economic transformation, through to amplifying longer-term investor voices and involving ultimate beneficiaries.

We believe that supportive but stretching shareholder resolutions can play a positive stewardship role in the UK. They could amplify the need to balance the short- and longer-term aspects of shareholder value creation.

The wider co-filing group includes asset owners and some of their fund managers, from both the UK and overseas. The asset owners span charitable foundations, Church investors pension funds and individuals (including clients of Rathbone Greenbank Investments). All the co-filers have been ably assisted by Client Earth and Share Action as part of their ongoing programme work.

Thanks to Mercer and Carbon Tracker’s research, horizon-scanning investors are aware of the portfolio risks of public policy uncertainty and potential asset stranding. Major technology transitions are rarely smooth, and draconian policy action that has to be introduced quickly after prolonged delay increases risks to investors. The resolution covers five related areas:

1. Ongoing operational emissions management

In 2014 Royal Dutch Shell (Shell) achieved a “B” carbon performance band (on an A-E scale) through CDP. Within the performance banding methodology considerable weight is given to operational emissions
management, alongside strategic and governance issues like those below. The “Aiming for A” coalition and other investors are interested in how the company is maintaining progress towards reaching an “A”. For further details see https://www.cdp.net/en-US/Programmes/Pages/CDP-Investors.aspx

2. Asset portfolio resilience to post-2035 scenarios

Shell has a diverse portfolio of assets (operational and in reserve). The role of gas as a transitional fuel is increasingly well reflected in this portfolio. We ask that an assessment of the portfolio’s resilience against the range of IEA, and any other relevant post-2035, scenarios be outlined to investors in routine reporting from 2016. Investors are also interested in the role exploration, disposals and cash distributions to investors will play in the nearer term.

3. Low-carbon energy R&D and investment strategies

Shell is building its biofuel capacity through a joint venture with Brazilian firm Cosan and has a flagship carbon capture and storage (CCS) project in Canada. Investors are interested in Shell’s post 2015 plans for low-carbon energy, from R&D through to investments that could achieve commercial scale.

4. Strategic KPIs and executive incentives

Shell’s new CEO has emphasised the importance of capital discipline. Transitions that span decades are complex to manage and often require lead indicators and incentives. Bearing in mind existing arrangements regarding the inclusion of sustainability factors in the annual bonus, investors are interested in Shell’s evolving approach to KPIs and executive incentives, in the context of the transition to a low-carbon economy, including the role played by the reserves replacement ratio (RRR).

5. Public policy interventions

Shell is a member of the Prince of Wales Corporate Leaders Group and has signed their Climate Change statements, including the recent Trillion Tonne Communiqué. Investors are interested in Shell’s public policy programme, including positions on key policy measures, especially for the critical 2015 to 2020 policy making period.

Finally, we’d also like to highlight the global investor coalition on climate change’s document outlining their expectations for oil & gas majors, which is available from: http://globalinvestorcoalition.org/. This builds on their carbon asset risk (CAR) initiative.
References


10. See reference 3.
11. See reference 8.


29. See reference 3.


31. See reference 3.


36. See reference 15.


41. See reference 7.

42. With thanks to Daniel Godfrey, investment industry thought leader for the suggestion of this idea.


44. See reference 3.


Authors

Juliet Phillips and Jeanne Martin

Disclaimer

ShareAction is not an investment advisor, and makes no representation regarding the advisability of investing in any particular company or investment fund or other vehicle. A decision to invest in any such investment fund or other entity should not be made in reliance on any of the statements set forth in this publication. While ShareAction has obtained information believed to be reliable, it makes no representation or warranty (express or implied) as to the accuracy or completeness of the information and opinions contained in this report, and it shall not be liable for any claims or losses of any nature in connection with information contained in this document, including but not limited to, lost profits or punitive or consequential damages. The contents of this report may be used by anyone providing acknowledgement is given to ShareAction. This does not represent a license to repackaged or resell any of the data reported to ShareAction and presented in this report. If you intend to repackaged or resell any of the contents of this report, you need to obtain express permission from ShareAction before doing so.

About ShareAction

ShareAction (Fairshare Educational Foundation) is a registered charity that promotes Responsible Investment practices by pension providers and fund managers. ShareAction believes that Responsible Investment helps to safeguard investments as well as securing environmental and social benefits.

shareaction.org
info@shareaction.org
+44 (0)20 7403 7800
16 Crucifix Lane
London, United Kingdom
SE1 3JW

Contact

Jeanne Martin
Senior Campaigns Officer - Climate
ShareAction
jeanne.martin@shareaction.org
+44 (0)20 7403 7800