ROYAL MINISTRY OF FINANCE

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Report to the Storting (white paper)

Energy Stocks in the Government Pension Fund Global

Recommendations of the Ministry of Finance of 8 March 2019, approved by the Council of State on the same day. (Government Solberg)

Summary

The accumulation of financial assets in the Government Pension Fund Global (the GPFG) is the result of Norway having managed its oil and gas resources in a sound manner. The state's risk taking through the petroleum tax system and its direct financial interest in the operations on the Norwegian continental shelf have contributed to major parts of the value added having accrued to the nation as a whole. At the same time, the fiscal policy framework has uncoupled the spending of the petroleum revenues from the timing of their accrual, thereby shielding the fiscal budget and the mainland economy from the volatility of oil and gas revenues. The framework facilitates preservation of the wealth from a non-renewable resource, thus enabling it to also serve as a source of welfare funding for future generations.

Compared to wealth exclusively embedded in the Norwegian continental shelf, the establishment of the GPFG has facilitated significant diversification of risk by reinvesting considerable oil and gas wealth in the form of broadly diversified financial wealth abroad. Nonetheless, petroleum resources still account for a larger proportion of national wealth in Norway than in many other countries. The value of these resources is uncertain and fluctuates in tandem with the oil price. This makes Norway vulnerable to a permanent decline in the oil price; so-called *oil price risk.*

It is anticipated that the oil price risk in national wealth will continue to be reduced in coming years, in line with the extraction of the remaining petroleum resources. It is expected that about 60 percent of the remaining resources, as measured in net present value, will be extracted and transferred to the GPFG over the next decade or so. In principle, the risk may also be reduced more swiftly. Either one might sell part of the ownership interests that would otherwise generate uncertain future petroleum revenues, for a consideration in the form of a certain payment now, or one might change the composition of the investments in the GPFG in such a way that changes in the value of the Fund would to a greater extent offset changes in the value of the remaining petroleum resources in response to oil price changes.

Assessments as to whether oil price risk should influence the composition of the investments in the GPFG, beyond the choice of risk level for the Fund as a whole, have principally addressed a potential divestment of the Fund's equity investments in the oil and gas sector. The Ministry of Finance has considered such an adjustment on several occasions, most recently in the report on *Long-Term Perspectives for the Norwegian Economy 2017.*[1] In its deliberation of the said report in the spring of 2017, the Storting endorsed

[1] See Meld. St. 29 (2016-2017), *Long-Term Perspectives for the Norwegian Economy 2017.*

the Government's assessment that a divestment of the oil and gas stocks in the GPFG is an inappropriate and inaccurate tool for reducing Norway's oil price risk. The issue of whether the GPFG should be invested in this sector was also addressed in the reports to the Storting on the Government Pension Fund in the spring of 2009[2] and 2014[3].

In November 2017, Norges Bank advised the Ministry of Finance to exclude the oil and gas sector from the benchmark index for the GPFG.[4] The Bank's reasoning is that this would serve to reduce the oil price risk associated with the state's wealth. Analyses indicate, according to the Bank, that oil and gas stocks largely move in line with general stock market developments, but are to a much greater extent than stocks in other sectors exposed to oil price changes. The Bank emphasised that this advice is exclusively based on financial arguments and does not reflect any specific view on oil price developments, or the future profitability or sustainability of the oil and gas sector.

Norges Bank's proposal implies that the composition of the investments in the GPFG would be changed in order to offset, to a greater extent, any reduction in the value of the remaining petroleum resources in the event of a permanent oil price decline. The Bank notes that the effect of this advice has not been assessed against other policy tools that might be used to reduce the vulnerability of the Norwegian economy to a permanent oil price decline, and observes that such an assessment would fall outside the scope of its role as advisor to the Ministry of Finance on issues relating to the investment strategy for the GPFG.

Against the background of the advice from Norges Bank, the Ministry of Finance appointed, in February 2018, an expert group to assess whether the GPFG should be invested in *energy stocks*. The group was chaired by Professor Øystein Thøgersen, rector of the Norwegian School of Economics. It was noted in the terms of reference for the group that FTSE Russell, the index provider of the equity benchmark for the Fund, had decided that the oil and gas sector, which the Bank proposed to omit from the Fund's benchmark index, would change name to the *energy sector*[5] from 2019.[6] The change of name reflects that the sector encompasses energy businesses in the broader sense, including exploration and prodution companies, integrated oil and gas companies, oil services companies and renewable energy companies.

The Ministry of Finance received the expert group's report in August 2018. Like Norges Bank, and in conformity with the research literature, the group noted that the return on energy stocks largely moves in line with general stock market developments and that the correlation with oil price changes is stronger than for other equity sectors, but relatively weak in absolute terms. Historically, oil price changes have accounted for a limited portion of the risk associated with investing in energy stocks.

The expert group has, in accordance with its terms of reference, addressed a broader set of considerations in its assessment of the energy stocks in the GPFG. The group observes that Norway has a high capacity for absorbing oil price risk because, inter alia, the fiscal policy framework implies that uncertain oil and gas revenues are not spent on an ongoing basis. Moreover, the risk associated with the remaining petroleum resources is historically low and declining. Most of this wealth has already been converted into financial wealth in the GPFG, and a large portion of the remaining resources will be extracted over the coming decade. The group concludes that a divestment of the energy stocks in the GPFG will only make a limited contribution to further reduction of this risk. Besides, it is highlighted that a divestment of the energy stocks in the GPFG would mark a departure from the current investment strategy for the Fund, which seeks to broadly diversify the investments and has a high threshold for exclusion.

The expert group takes the view, based on an overall assessment of the various considerations, that the GPFG should remain invested in energy stocks. The group notes that other policy tools are better suited if there is nonetheless a need for further reducing the oil price risk in the Norwegian economy. The group believes, at the same time, that it may be appropriate to review climate risk efforts in relation to the GPFG — climate change, climate policy and their effect on technological developments — and assess whether these should be strengthened.

Both the advice from Norges Bank and the report from the expert group have been circulated for public consultation. Many of the bodies invited to submit consultative comments appear to agree with the assessment of the expert group that the economic impact of the Bank's proposal on oil price risk in the Norwegian economy would be minor, but there are nonetheless diverging opinions as to whether the energy sector should be excluded from the GPFG. Whilst a number of the consultative comments emphasise that it would be a step in the right direction to omit all or parts of the energy sector from the GPFG, others note that it may undermine the financial objective of the Fund and encompass companies with major and expanding renewable energy operations.

2 See Meld. St. 20 (2008-2009), *On the Management of the Government Pension Fund in 2008*.

3 See Meld. St. 19 (2013-2014), *The Management of the Government Pension Fund in 2013.*

4 The Ministry of Finance asked, in a separate follow-up letter of 13 February 2018, for additional information from Norges Bank. The reply letter from the Bank was sent to the Ministry on 26 April 2018. The discussion of the advice in this report is based on both letters from the Bank.

5 This report will throughout use the term «energy», also in the subsequent discussion of Norges Bank's advice and consultative comments.

6 The change was announced on 5 September 2017, with a planned commencement date of 1 January 2019. FTSE Russell stated, in an announcement on 21 December 2018, that the change has now been postponed, from 1 January to 1 July 2019.

This report to the Storting is organised as follows: Chapter 2 provides a brief description of the current investment strategy for the GPFG and the composition of the benchmark index for the Fund, including the energy sector. The advice from Norges Bank and the public consultation thereon are discussed in chapter 3, whilst the report from the expert group and the public consultation thereon are discussed in chapter 4.

The Ministry of Finance's assessment of the energy stocks in the GPFG is presented in chapter 5. In its assessment, the Ministry has, in particular, attached weight to the following:

The Norwegian economy is vulnerable to oil price risk. A permanent petroleum revenue reduction will have implications for Norwegian production and employment. Mainland businesses providing investments, goods and services to petroleum operations will face reduced demand. Other industries may, at the same time, experience an increase in demand, depending, inter alia, on the impact of a lower oil price on the world economy and the Norwegian kroner exchange rate. In order to respond to these challenges, it is important to have an economic policy that facilitates high adaptability in all parts of the economy and eases the impact of such shocks. The petroleum tax system and the state's direct financial interest in the operations on the Norwegian continental shelf have generated large revenues for the nation. At the same time, the state assumes a significant portion of the risk. A permanent decline in the value of the remaining petroleum resources will have long-term implications for public finances. Reduced transfers to the GPFG will over time reduce the Fund's funding contribution to the fiscal budget.

The oil price risk has been significantly reduced over time, and the capacity to absorb such risk is now high. A large portion of the oil and gas resources has already been extracted from the Norwegian continental shelf and converted into broadly diversified financial wealth abroad. This represents a significant diversification of risk. It is anticipated that the risk will continue to be reduced in coming years, in line with the extraction of the remaining petroleum resources. Furthermore, the fiscal policy framework implies that the spending of petroleum revenues is uncoupled from the timing of their accrual. This shields fiscal policy and the mainland economy from developments in uncertain petroleum revenues, and provides a high capacity for absorbing the oil price risk associated with the remaining resources.

An exclusion of the energy stocks in the GPFG will serve to further reduce the oil price risk, but the effect appears to be limited. Both the expert group and Norges Bank note that energy stocks are more exposed to oil price changes than other stocks. However, the energy stocks in the GPFG account for a very minor proportion of both national wealth and the state's wealth, and the significance of oil price changes in determining historical developments in the value of energy stocks appears to be modest. In a scenario of permanently low oil price, the state's net cash flow from petroleum activities will be considerably reduced. The expert group estimates that about 1 percent of such shortfall would be recouped as the result of the GPFG not being invested in energy stocks, but emphasises that such estimates are uncertain. Some of the consultative comments noted that the risk-reducing effect may be stronger, but most of the consultative comments appear to concur with the view that the economic impact of the Bank's proposal would in any case be limited.

Sector level classifications of companies are inaccurate for reducing oil price risk. The energy sector which it has been proposed to omit from the GPFG comprises energy businesses in the broader sense, and encompasses more than 300 international energy companies. The sector includes, inter alia, exploration and production companies, integrated oil and gas companies with operations throughout the value chain, as well as companies purely focused on renewable energy infrastructure. As the world economy makes progress on reducing greenhouse gas emissions from fossil energy, it must be assumed that the composition of the energy sector will be changed correspondingly. Many integrated oil and gas companies already have significant renewable energy operations, in absolute terms, and both the expert group and Norges Bank note that integrated companies may have significantly larger renewable energy operations than pure play renewable energy companies. Moreover, it is anticipated that companies that do not have renewable energy as their main business will account for about 90 percent of the growth in listed renewable energy infrastructure towards 2030. If the entire energy sector is excluded, or if the GPFG is restricted to only investing in pure play renewable energy companies, it may limit the Fund's scope to participate in this growth.

To exclude exploration and production companies from the GPFG appear more accurate to reduce oil price risk. The remaining petroleum resources primarily take the form of future tax revenues from oil companies' operations on the Norwegian continental shelf and revenues from the state's direct financial interest in oil and gas fields. Net profit taxation and field interests imply that the state's revenues will, as a general rule, follow the profitability of upstream activities. Hence, it would seem more accurate to exclude exploration and production companies in order to reduce oil price risk than to omit the energy sector in its entirety.

Climate risk is an important financial risk factor for the GPFG. Climate change, climate policy and their effect on technological developments may over time have an impact on several of the companies in which the GPFG is invested, including those in the energy sector. However, climate risk must be assessed and managed at the company level. Norges Bank currently has a broad set of tools for managing climate risk, including corporate governance initiatives and risk-based divestment. A conduct-based climate criterion has also been established in the guidelines for observation and exclusion. However, the expert group notes that it may be appropriate to review climate risk efforts in relation to the GPFG, and assess whether these should be strengthened.

Broad support for the financial objective of the GPFG is important, but cannot be taken for granted. The investment strategy for the GPFG furthers the financial objective of the Fund, enjoys broad support, and serves to shelter the Fund from being used as a policy tool for the furtherance of other objectives. If the energy sector is omitted from the GPFG on the grounds that this will promote climate policy objectives, it may undermine the financial objective of the Fund and impair its contributions to future welfare, as noted in several of the consultative comments.

The Government is proposing, based on an overall assessment, to omit companies classified as exploration and production companies[7] from the GPFG's benchmark index and investment universe. This will serve to reduce the aggregate concentration risk associated with these type of activities in the Norwegian economy. Like the advice from Norges Bank, this assessment does not reflect any specific view on the oil price, future profitability or sustainability of the petroleum sector.

The Ministry of Finance will, in consultation with Norges Bank, establish rules for the phaseout of exploration and production companies from the GPFG's benchmark index and investment universe.

Climate risk is an important financial risk factor for the GPFG, and may over time have an impact on several of the companies in which the Fund is invested, including those in the energy sector. The Ministry of Finance will ask Norges Bank to review its efforts relating to climate risk in the GPFG, which review shall include an assessment of the climate risk associated with all investments in individual companies – in both the equity portfolio and the fixed-income portfolio – with the aim of strengthening efforts in relation to those individual companies accounting for the largest contributions to the climate risk associated with the Fund.

The Government furthermore intends to assess, through accumulated experience, the accuracy of excluding exploration and production companies from the GPFG in terms of reducing oil price risk, based on developments in the composition of the energy sector over time.

[7] Companies classified by the index provider FTSE Russell as belonging to subsector 0533, Exploration & Production. As at the end of 2018, this comprised 134 companies with an aggregate market value of about NOK 70 billion.