DIGGING DEEPER

"The law of holes: if you find yourself in a hole, stop digging."

- The Bankers Magazine, 1964 (and others)

When it comes to climate change humanity is in a very deep hole. Most of the world's fossil fuel reserves can't be burned if we want to hold global warming below the critical 2°C mark. Yet fossil fuel companies are exploring for even more unburnable coal, oil and gas reserves, often offering bonuses for executives to continue this unsustainable practice, endorsed year after year by Australia's superannuation funds. We need to stop digging.

MARKET FORCES

SUPER SWITCH

PHOTO: CLERMONT MINE - LOCK THE GATE ALLIANCE

INTRODUCTION

The climate crisis is unfolding before us and our chances of preventing global warming from spiralling out of control are on a knife edge.

The Paris Agreement saw 197 nations agree to limit global warming to well below 2°C, compared with pre-industrial levels. At just 1°C of warming, we are already seeing devastating climate change impacts including unprecedented coral bleaching, sea level rise, record high temperatures and increasingly severe storms, floods and bushfires.[1]

TO LIMIT GLOBAL WARMING TO 2°C

95%

OF AUSTRALIA'S COAL RESERVES MUST REMAIN IN THE GROUND

Limiting warming to 2°C doesn't guarantee runaway climate change can be avoided, but even that limit will require drastic emission reductions, demanding massive changes to the global energy system.[2]

Carbon Tracker states that around 80% of known global reserves of coal, oil and gas must stay in the ground if we are to have a 75% chance of staying below 2°C.[3] At a country level, the carbon budget imposed by a 2°C limit means that over half of Australia's known oil and gas reserves are unburnable, as is 95% of our coal.[4]

With over five times as much carbon in proven global fossil fuel reserves than can be safely burned, the last thing we should be doing is exploring for more fossil fuels. Yet that's exactly what many Australian companies are doing. Executives are even incentivised to explore via their remuneration packages.

These companies are accountable to their shareholders, including superannuation funds which collectively hold approximately 20% of the market capitalisation of all ASX-listed companies.[5] Despite many funds claiming to be concerned about climate change, they continue to vote for executive bonuses linked to the expansion of fossil fuel reserves.

As fiduciaries, super funds have a legal duty to act in the best long-term interests of their members.[6] According to UNEPFI, fiduciaries must recognise, analyse and manage the risks posed by climate change.[7]

In the interests of members who want to avoid catastrophic climate change, super funds should ensure the companies they invest in are operating in accordance with the goals of the Paris Agreement. They should be engaging with fossil fuel companies to promote a rapid shift away from a fossil fuel-dependent economy.

Super fund members are in a unique position. They have the ability to influence how their fund engages with companies perpetuating unsustainable business models.

EXECUTIVE SUMMARY

Australian-listed fossil fuel companies are continuing to search for more unburnable carbon, with $12.69 billion spent on fossil fuel exploration by just fifteen companies since July 2012. Another $14.62 billion has been spent by just ten foreign companies on fossil fuel exploration in Australia between 2013-2015.

In many cases, exploration is encouraged through executive remuneration packages. Seven companies in the S&P ASX300 explicitly refer to reserve replacement or exploration targets in their executives' bonus structures, as do six international companies with major Australian fossil fuel operations.

Senior executives at the seven Australian companies stand to make a combined $2.02 million in additional bonuses each year if their reserve targets are met.

Please note all monetary values in this report are in Australian dollars unless otherwise stated.

Australia's super funds are failing to effectively challenge this business model, despite their stated belief in engagement as a strategy for changing the behaviour of companies. In the last year, only three Australian energy companies incurred a significant vote against their remuneration packages, none of which were an explicit protest against reserves-based incentives.

Only eighteen of Australia's 50 largest super funds disclose their complete proxy voting record, making it difficult to determine which funds are genuine 'active owners.' Our analysis of twelve funds' voting records shows only three voted against any Australian-listed energy company's remuneration package in the last year. Major funds including AustralianSuper, First State Super, MLC and ANZ OnePath supported the remuneration packages of every Australian energy company they held shares in.

Australia's super funds must have effective engagement policies and practices, and demonstrate how these are being implemented to ensure companies they invest in are compatible with a low carbon future. An obvious step to demonstrate alignment with the goals agreed to in Paris is for funds to reject fossil fuel exploration incentives.

FOSSIL FUEL EXPLORATION EXPENDITURE BY STATE & TERRITORY 2011 - 2016 ($AU MILLIONS)

Source: Australian Bureau of Statistics, Mineral and petroleum exploration, Cat. No. 8412.0

TRACKING THE MONEY

The Australian Bureau of Statistics reports that private expenditure on fossil fuel exploration in Australia was $20.57b in the five years to 30 June 2016. Offshore oil and gas exploration accounted for 63% of that total, while onshore oil and gas accounted for 26%, and coal 11%.[8]

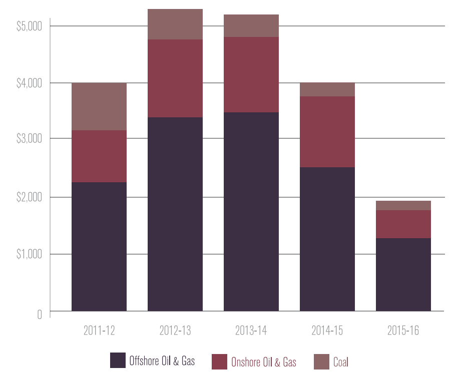
The majority of oil and gas exploration has taken place in Western Australia, accounting for two thirds of expenditure in the five years to 30 June 2016. Expenditure on coal exploration has been directed almost exclusively to NSW and Queensland.[9]

While exploration expenditure has diminished since the peak of 2012-13, fossil fuel companies are still spending billions of dollars each year seeking out more reserves of coal, oil and gas that simply cannot be burned under any scenario of serious climate change action.

Market Forces' analysis shows that foreign companies account for as much as 80% of expenditure on exploration in Australia. Additionally, ASX-listed firms are directing up to 65% of their expenditure to exploration overseas. Expenditure is heavily concentrated - just a handful of companies are responsible for the majority of exploration expenditure.

The fifteen Australian-listed companies included in this analysis are all members of the S&P ASX300.[10] South32 Ltd and Wesfarmers Ltd were excluded due to duplication (with BHP Billiton) and lack of disclosure respectively. The vast majority of international fossil fuel companies operating in Australia disclose minimal or no information

AUSTRALIA'S ENERGY EXPLORATION EXPENDITURE ($AU MILLIONS)



QUEENSLAND EXPLORATION EXPENDITURE

OIL & GAS: $2,683.7 MILLION

COAL: $1,815.4 MILLION

NEW SOUTH WALES EXPLORATION EXPENDITURE

OIL & GAS: $141·4 MILLION

COAL: $314 MILLION

VICTORIA EXPLORATION EXPENDITURE

COAL: $1.1 MILLION

FIFTEEN AUSTRALIAN-LISTED COMPANIES HAVE SPENT

$12.69 BILLION

ON FOSSIL FUEL EXPLORATION SINCE JULY 2012

FOSSIL FUEL EXPLORATION BY AUSTRALIAN COMPANIES, 2012-2016 ($AU MILLIONS)

COMPANY	AUSTRALIA	INTERNATIONAL	TOTAL
BHP Billiton Ltd	$917	$2,104	**$3,021**
Woodside Petroleum Ltd	$739	$2,746	**$3,485**
Oil Search Ltd	-	$2,178	**$2,178**
Santos Ltd	$846	$237	**$1,083**
Karoon Gas Australia Ltd	$365	$510	**$875**
Beach Energy Ltd	$512	$72	**$584**
Rio Tinto Ltd	$281	-	**$281**
Senex Energy Ltd	$236	-	**$235**
Origin Energy Ltd	$296	-	**$296**
AWE Ltd	$74	$87	**$161**
Seven Group Holdings Ltd	$47	$72	**$119**
New Hope Group	$106	-	**$106**
Sino Gas & Energy Holdings Ltd	-	$95	**$95**
FAR Ltd	$11	$119	**$131**
Whitehaven Coal Ltd	$35	-	**$35**
Total	**$4,464**	**$8,221**	**$12,685**

about their exploration programs; for that reason many were excluded.[11]

Domestic and international firms, including Chevron, ExxonMobil, Karoon Gas and Woodside Petroleum, have spent significantly exploring offshore Western Australia basins - Bonaparte, Browse and Carnarvon. Additionally, BP has invested $605m in exploring for offshore petroleum in the Great Australian Bight, with additional expenditure of $1.37b planned for the next four years.[12]

The Cooper/Eromanga and Bowen/Surat onshore basins have seen significant exploration investment from local companies including Santos, Beach Energy and Senex Energy. Foreign companies Chinese National Offshore Oil Corporation (CNOOC) and Royal Dutch Shell have invested heavily in unconventional gas exploration in the Bowen/Surat Basins.

Glencore, Rio Tinto, New Hope Group and Whitehaven Coal continue to explore for Australian coal reserves, having collectively spent $2.11b since July 2012, mostly looking to expand brownfield projects in Queensland and NSW.

ASX-listed companies have also spent heavily on international fossil fuel exploration, most significantly BHP Billiton in the United States, Woodside Petroleum in Myanmar, and Oil Search and Santos in Papua New Guinea.

Of ASX-listed companies, BHP Billiton ($917m) and Santos ($846m) have spent the most on fossil fuel exploration in Australia since July 2012. Of the international companies operating in Australia, CNOOC ($4.27b) and ExxonMobil ($4.05b) spent the most on fossil fuel exploration between 2013-2015.

FOSSIL FUEL EXPLORATION IN AUSTRALIA BY INTERNATIONAL COMPANIES, 2013-2015 ($AU MILLIONS)

COMPANY	TOTAL
CNOOC Ltd	**$4,267**
ExxonMobil Corp	**$4,054**
Glencore PLC	**$1,689**
Chevron Corp	**$1,211**
Inpex Corp	**$985**
Royal Dutch Shell PLC	**$925**
BP PLC	**$605**
Murphy Oil Corp	**$454**
Hess Corp	**$259**
ConocoPhillips	**$168**
Total	**$14,617**

Santos	Oil Search	Karoon Gas Australia ltd
KEVIN GALLAGHER	PETER BOTTEN	ROBERT HOSKING
MANAGING DIRECTOR & CEO	MANAGING DIRECTOR	MANAGING DIRECTOR
MAX. EXPLORATION BONUS: $847,625	MAX. EXPLORATION BONUS: US$451,475	MAX. EXPLORATION BONUS: $247,174

REWARDING CLIMATE DESTRUCTION

Remuneration packages are designed with the intention of growing long-term shareholder returns. Practically, this is achieved by aligning the company's strategic objectives with remuneration outcomes.

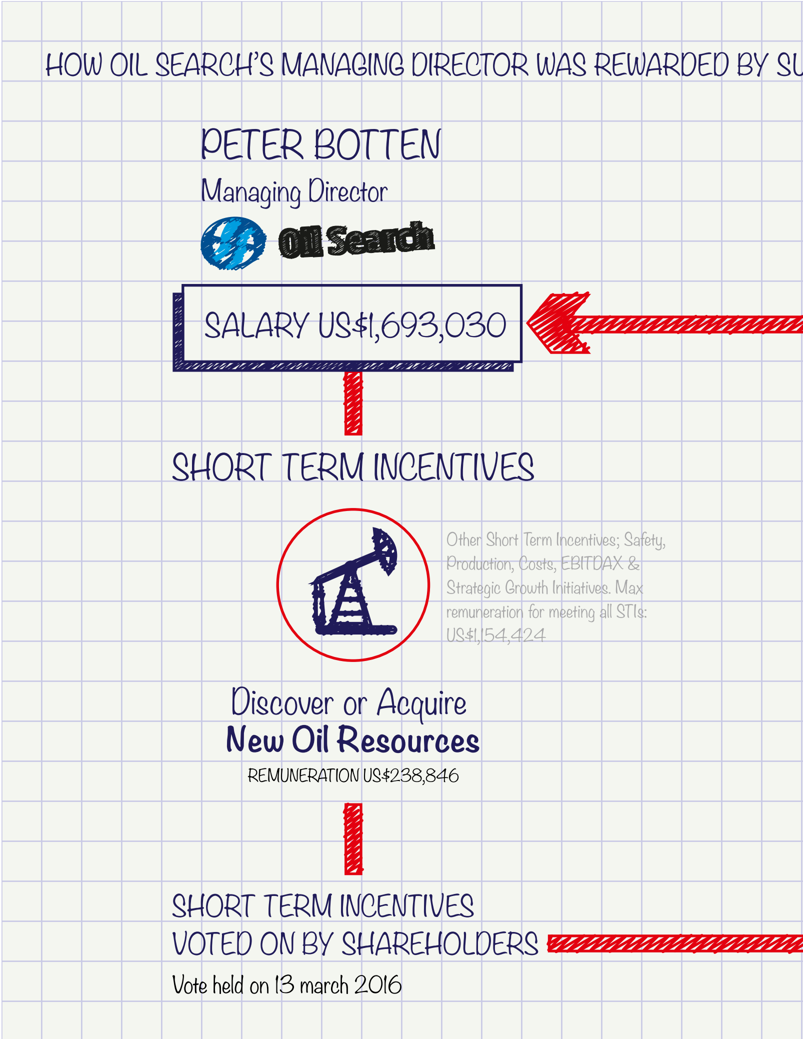
Remuneration is typically made up of a fixed salary, plus variable short-term and long term-incentives or bonuses; which are 'at risk' based on company and individual performance. Short-term incentives are typically paid via a mix of cash and share-based payments, while long-term incentives are almost exclusively awarded in share-based payments, usually with a vesting period to encourage long-term returns.

Short-term incentives are awarded on an annual basis, based on any number of operational outcomes. These can include financial metrics like net operating cashflow, earnings per share, or production costs; as well as non-financial metrics like staff safety and engagement or customer satisfaction.

The metrics used to determine short-term incentives encourage an array of behaviours. Companies typically engage consultants to align remuneration packages with operational strategy, and to ensure that perverse outcomes are not built in. For example, FAR Ltd does not currently generate profits or net operating cash flows, so "the performance of the overall exploration and appraisal program"[13] drives the company's performance, and hence the remuneration structure.

According to AMP Capital, remuneration structures tell us "not only who but also what a company values."[14] Apparently, many oil and gas companies value efforts to expand fossil fuel reserves, regardless of how incompatible they are with a safe climate future.

Market Forces has identified seven energy companies in the ASX300 that explicitly refer to reserve replacement or exploration targets in their executives' bonus structures – AWE, FAR Ltd, Karoon Gas Australia, Oil Search, Santos, Senex Energy and Sino Gas & Energy.



In addition, there are several ASX300 companies that imply the importance of reserve replacement. Beach Energy refers to "exploration efforts" and "growth options" in one of its "four strategic pillars;"[15] while Woodside Petroleum references a "growth agenda," which implies a link to exploration, given the company also prominently reports its reserve replacement ratio.[16]

REMUNERATION OF FOREIGN COMPANIES OPERATING IN AUSTRALIA ($US)

COMPANY	CEO/MD	MAX. EXPLORATION BONUS
BP PLC	Bob Dudley	$1,131,867
Murphy Oil Corp	Roger Jenkins	$975,000
ExxonMobil Corp	Rex Tillerson	$904,857
ConocoPhillips	Ryan Lance	$262,727
Hess Corp	John Hess	$150,000
Chevron Corp	John Watson	$111,810

Senex	AWE	FAR	SINO Gas & Energy
IAN DAVIES	DAVID BIGGS	CATH NORMAN	GLEN CORRIE
MANAGING DIRECTOR & CEO	MANAGING DIRECTOR & CEO	MANAGING DIRECTOR	CEO
MAX. EXPLORATION BONUS: $140,250	MAX. EXPLORATION BONUS: $140,000	MAX. EXPLORATION BONUS: $100,000	MAX. EXPLORATION BONUS: $86,400 ($US)

In its 2016 Annual Report, Beach Energy's key performance indicators (KPIs) revealed a measure of operating costs had replaced underlying net profit after tax (NPAT),[17] presumably due to low oil prices. It also replaced reference to reserves with "strategic objectives" to be determined by the Board; yet it does not seem to preclude exploration.[18]

Whitehaven Coal also has an allocation in its short-term KPIs for "leadership and individual key performance indicators as agreed between the Managing Director and the Board, for example project development targets."[19] There is nothing to suggest that this couldn't include a program of exploration, new mine development or acquisitions to increase reserves.

Origin Energy is the only member of the ASX300 Energy sector that quite clearly doesn't reference exploration or growth. Origin's primary financial metric is Net Cash from Operating and Investing Activities (NCOIA), which was introduced this year to "strengthen the linkage between the STI plan hurdles and short term profitability."[20] Notably, given its financial distress from excessive investment in now potentially stranded LNG assets, Origin recently retreated from international exploration to focus on Energy Markets and Integrated Gas.[21]

Most importantly, not a single member of the ASX300 Energy sector references sustainability anywhere in their remuneration structures. This is reflective of the operational strategies within the energy sector in Australia. Only Origin identifies "changes in regulatory policy as a result of climate change" as a material business risk.[22] Oil Search states that it is developing a "climate change strategy," but there is no indication when this will be made public.[23]

Market Forces has also identified six international energy companies operating in Australia – BP, Chevron, ConocoPhillips, ExxonMobil, Hess and Murphy Oil – that explicitly incentivise exploration and/or reserves in their remuneration packages.

Incentives that encourage the growth or replacement of reserves are simply not compatible with a carbon budget that is consistent with limiting global warming to less than 2°C. Such incentives encourage the expenditure of billions of dollars searching for resources that can never be burned if efforts to keep global warming below 2°C are successful.

Some investors have questioned fossil fuel companies' business models. In 2013 over 70 investors, managing more than US$3 trillion in assets, demanded fossil fuel companies explain how they are managing financial risks associated with climate change.[24] The letter asked what measures, including fossil fuel asset divestment, low carbon energy investment or returning capital to shareholders, would be adopted. Unfortunately, as the next section demonstrates, many fossil fuel companies have instead retained perverse incentives to carry on exploring for fossil fuels.

SUPER FUNDS ENDORSING UNBURNABLE CARBON

As major shareholders, superannuation funds can influence how companies are managed. This can be achieved through direct engagement, such as meeting with company boards to discuss issues, or by voting on resolutions at the company's annual general meeting (AGM).

In response to the broader fossil fuel divestment debate, super funds claim the only way to change companies' behaviour is through engagement. For example, Australia's largest super fund, AustralianSuper, "engages directly with companies we invest in to ensure they are focussing on ESG issues."[25] Similarly, HESTA claims "it is more effective to engage with underlying companies to seek changes that will result in reduced climate change risks."[26] However, little evidence is made available by funds to demonstrate the effectiveness of this approach.

Of the 50 largest super funds by assets under management, only eighteen disclose a complete proxy voting record for both Australian and international shareholdings. Five funds provide a complete proxy voting record for just their Australian shareholdings. Four funds provide a summary, and the remainder provide no information at all to members about how the fund votes on their behalf.

For the twelve super funds included in our analysis, just three of a possible 80 votes were cast against reserves-linked remuneration packages in the last year. These were cast at Santos's 2016 AGM, which saw significant investor revolt against excessive remuneration awarded whilst low oil prices forced a $2.5b equity raising. So while there are some examples of funds voting against remuneration packages in the energy sector, there has not been widespread voting against exploration incentives.

In the US AGM season earlier this year, several resolutions were put to shareholders which sought to decouple executive remuneration from the expansion of reserves, or withhold the portion of the bonus based on reserves. These included Chesapeake Energy Corporation, ConocoPhillips and Devon Energy Corporation; none of which were carried. In these instances, the vast majority of investors, including many Australian super funds, voted against measures to stop the practice of incentivising fossil fuel exploration.

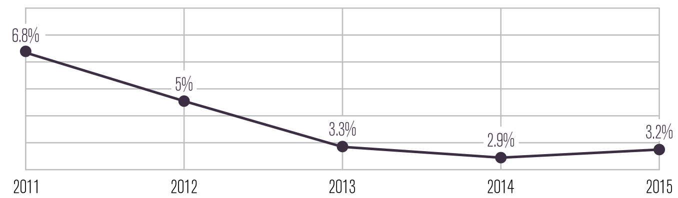
The nature of the institutional proxy voting process may explain some of this apathy. Super funds are likely to be invested in thousands of companies at any given time, so the process of voting on every resolution at company meetings is often delegated to investment managers or proxy advisers. However, funds maintain the right to vote, and should therefore direct advisers and managers to vote down remuneration packages that incentivise fossil fuel exploration.

A minority of funds describe themselves as 'active owners,' and duly exercise their voting records across their entire portfolio. However, the vast majority of funds rarely use their power to vote on international shareholdings, opting instead to exercise control over their Australian share portfolios,

SUPER FUND REMUNERATION VOTING RECORD 2015 - 2016

Company	AWE Ltd	Beach Energy Ltd	FAR Ltd	Karoon Gas Australia Ltd	Oil Search Ltd	Santos Ltd	Senex Energy Ltd	Sino Gas & Energy Holdings Ltd	Woodside Petroleum Ltd
AustralianSuper	✓	✓	N/A	N/A	✓	✓	N/A	N/A	✓
First State Super	✓	✓	✓	✓	N/A	✓	✓	✓	✓
MLC	✓	✓	✓	✓	✓	✓	✓	✓	✓
REST	N/A	✓	✓	✓	✓	✗	N/A	N/A	✓
ANZ OnePath	✓	✓	✓	✓	N/A	✓	✓	N/A	✓
HESTA	✓	✓	✓	N/A	✓	✓	N/A	N/A	✓
Cbus	✓	✓	✓	✓	N/A	✓	✓	✓	✓
HOSTPlus	✓	✓	N/A	✓	N/A	✗	N/A	N/A	✓
VicSuper	✓	✓	N/A	✓	✓	✓	✓	✓	✓
Care Super	✓	✓	N/A	✓	✓	✓	N/A	✓	✓
CommBank Super	N/A	✓	✓	N/A	✓	✓	N/A	✓	✓
Catholic Super	✓	N/A	N/A	N/A	✓	✗	N/A	✓	✓
Vote For Rem %	**98.97%**	**97.6%**	**84.34%**	**99.08%**	**98.04%**	**88.93%**	**96.7%**	**98.75%**	**72.41%**

MEDIAN VOTE AGAINST REMUNERATION IN THE S&P ASX300 2011 - 2016



Source: 2015 Overview, Ownership Matters, February 2016

which are much smaller in terms of companies held.

The country in which a company is listed, however, does appear to be a somewhat arbitrary method for determining which companies funds engage with, and which resolutions are actively voted on. For instance, many international companies have significant operations in Australia, employing thousands of Australians, many of whom would be indirect shareholders via their super fund. Yet the majority of super funds elect not to engage with these companies or vote at their annual meetings. If funds can only engage with a limited number of companies, due to a lack of resources, then those companies exploring for and producing fossil fuels in Australia should be a priority.

Active ownership is one of the six UN Principles for Responsible Investment (UN PRI), to which many Australian super funds are signatories, including AMP, AustralianSuper, BT, Colonial First State, First State Super, and HESTA.[27] If these funds are not prepared to identify and challenge energy companies' strategies and remuneration packages that are incompatible with a safe climate, then their commitment to the UN PRI seems hollow.

If claims of active ownership are to be taken seriously, funds need to actively engage on fossil fuel companies' operational strategies and how they are achieved through executive remuneration. Funds should ensure the companies they invest in accept climate science and the implications it has for their long-term future.[28] Funds should be encouraging companies to identify regulatory and transition risk from climate change as material risks to their businesses. Furthermore, funds should encourage companies to incentivise executives to plan for and adapt to these risks.

Executive remuneration structures are one of the few areas which are relatively transparent and subject to a vote at every AGM. Although non-binding, remuneration reports are subject to the two strikes rule. A negative vote greater than 25% in two consecutive years can trigger a board spill. In order to avoid this situation, any significant vote against their remuneration report would likely result in a company making changes that would satisfy shareholders.

Super funds should use the opportunity of voting on remuneration reports to reject incentives for fossil fuel exploration, and encourage the implementation of sustainability metrics into remuneration packages.

RECOMMENDATIONS FOR SUPER FUNDS:

- Divest from companies that are incompatible with or show no willingness to work towards a low-carbon economy.
- Engage with companies to acknowledge and plan for the transition to a low carbon economy; ensuring executives are incentivised to work towards this transition. Divest or apply other punitive measures if engagement fails to deliver satisfactory results.
- Oppose any measures that incentivise additional fossil fuel exploration or other activities incompatible with a 2°C global warming limit.
- Seek disclosure from companies where remuneration structures are opaque.
- Disclose complete voting records via easily accessible and searchable documents, in addition to summary reports.


PHOTO: PORTLAND WIND FARM - JEREMY BUCKINGHAM MLC

RECOMMENDATIONS FOR SUPER FUND MEMBERS:

- Contact your super fund and use your power as a member to encourage them to oppose any executive bonuses that reward fossil fuel exploration or reserve replacement.
- Ask your fund for complete disclosure: holdings, proxy voting records and their policy for managing climate risk.
- Insist that your fund divests from companies that have no place in a low-carbon economy.
- Ensure your fund engages with and votes at company meetings of all energy companies.

YOU CAN DO THIS AT:

WWW.SUPERSWITCH.ORG.AU

Visit Super Switch today and demand real climate change action from your fund.

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