DATE: April 27, 2016

TO: The Honorable Dave Jones, California Insurance Commissioner

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SUBJECT: Thermal Coal Divestment Request and Carbon Economy Data Call

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Dear Commissioner Jones,

Thank you for the discussion with industry representatives on March 2nd and the responses to many of the questions posed in the February 9th letter to you from various insurance trade associations, concerning your request in connection with investments in thermal coal.

Since that discussion our members have continued to attempt to positively respond to your stated concern that certain investments may become “stranded assets” and pose an undue risk on investment portfolios.

The need to provide for payment of promised benefits by balancing risk and returns has always been of paramount importance to our member insurers. Certainly changing circumstances and regulatory situations are constantly evaluated by experts in companies charged with the duty of protecting solvency and providing attractive products to insurance consumers. Similar in nature to the CalPERS Board’s fiduciary duty and the lens they look through at the legislative request to divest from thermal coal investments, insurers too must adhere to their duty.

It is with those thoughts in mind that we respectfully request that the following comments be considered when the responses to the Department's request are evaluated.

While certainly not unanimous, it is our impression that the vast majority of the responses will recognize emerging aspects of risk with respect to the mining of thermal coal. It is also likely that many companies will point out difficulties with strict compliance with your request for divestment that affect (1) difficult to change long-term investment positions and (2) quantification of percentages of thermal coal "used" by regulated industries.

During the March 2nd call, attention was drawn to new legislative policies and their short and long-term effect on utilities and those that invest in utility equity and debt instruments. We would note that the utility sector is heavily regulated at the state level. State PUCs, especially California's PUC, have been at the forefront of mandating an increasingly green footprint throughout the utility sector. In 2006, California utilities were asked to not renew contracts in the future for thermal coal (not to divest), but even now there are some utilities (such as LADWP) still working on the transition away from coal. As explained in the balance of this letter, future actions to limit the impact from the usage of hydrocarbons by the utility industry may be impaired if access to long-term capital was restricted.

Divestment v. Engagement

In terms of investment risk assessment, your request has resulted in widespread introspection by insurers. Under your direction, our members are pausing, diving deep into, and looking carefully at their portfolios. We hope that this is recognized by the Department and on its website, as the companies are seeking to reconcile the request with their sincerely held beliefs that their investments provide policyholders with attractive benefits, and are safe, sound and lawful.

As you know, the uniformity that can be achieved through the NAIC has helped companies operating across the 50 states. Many insurers incorporate the viewpoint of the NAIC Securities Valuation Office (SVO) into their credit decisions. It has been clear that the SVO has been aware of the risks inherent in coal mining companies and related service companies. Certainly, some mining operations have seen their credit profile deteriorate over time, while others remain strong. When it comes to utilities that include coal as a percentage of their fuel mix, however, the SVO has viewed the vast majority of these companies as low risk, with nearly 70% receiving the SVO's highest creditworthiness designation.

We recognize that the disinvestment request applies to companies that generate 30% or more of their revenue from the "use" of thermal coal. Unfortunately, insurers will find it very difficult to ascertain that percentage. To do so would require companies to make significant assumptions, which would likely vary and thus lead to materially different conclusions.

Employing conservative assumptions will result in divestment from bond issuers that are high-quality utilities and power generators, including investment grade vertically integrated electric utilities, and generation and transmission cooperatives, potentially causing an asset-liability mismatch. As noted at the recent NAIC meeting in the climate change committee by other regulators, these entities, as well as thermal coal companies are key employers in their respective states, and contribute significantly to those state economies. Moreover, these utilities are engaged in diversifying their generation resources, and are focused on environmental issues. Importantly, utilities are highly regulated and provide a fair rate of return, which minimizes solvency concerns.

Policyholders and claimants are also protected against heightened insurer solvency risk by existing risk based capital and other statutory investment restrictions. Moreover, insurers are now required via the Risk Management and Own Risk and Solvency Assessment Model Act (ORSA) to employ rigorous risk management disciplines. When selecting and monitoring these investments, assessing risk (including stranded asset risk) is an integral part of credit research and the due diligence process. Many insurers use a vigorous risk management discipline across portfolios, which includes scenario analyses based on the internal price forecasts for fossil fuels. In addition many insurers also conduct regular sector reviews that address the largest portfolio risks, including climate change issues and new statutes like last year's SB 185 and SB 350.

As CalPERS recently noted while looking at holistic evaluations of investments under ESG (Environmental, Social and Governance) principles, ESG considerations don't require total divestment from an item. The ability to apply ESG is dependent on their ability to stay invested as an owner.

It is also important to note that the utilities themselves are addressing the transition from coal-based to clean and renewable energy sources. During industry transitions in the past, such as the deregulation of the late 1990s, the utility industry had an excellent record of minimizing the risk associated with "stranded assets" which are corporate balance sheet assets that have little to no value. These are items that have become obsolete or nonperforming well ahead of their expected useful life. If unable to earn an economic return these stranded assets would lead to write-downs and presumably a weaker credit profile for entities that invested in them.

For oil & gas and mining companies, this has historically referred to undeveloped assets in the ground that ultimately have no value. For utility companies, the term has been used for generating plants or transmission lines no longer in use.

The risk of stranded assets is not new and is, in fact, an important part of our members' credit analysis process. For regulated utilities, the risk of loss due to stranded assets is remote. Utility companies operate on a cost-plus system. Precedent is in place that supports the recovery of all costs deemed to have been prudently incurred.

In this regard, during the deregulation of the late 1990s, utilities recovered the cost of the generation plants that were unbundled and sold. For instance, the Shoreham nuclear plant constructed in Long Island cost $6B and was completed in 1985, but never was placed into service due to public opposition. The cost of the plant was recovered through rates.

State-regulated utilities have historically recovered the cost of environmental compliance for coal generation plants, through their rates, and are expected to continue to recoup these costs in the future.

As companies and rating agencies look to the future, they are embracing holistic evaluations of risk related to climate activity. The concerns you have raised are echoed by others, and investment actors are moving towards engagement over divestment as a way to positively influence the marketplace. The CalPERS investment policy as articulated as recently as last month is illustrative, in that it found that divestment runs counter to its ability to be effective as an ESG investor, and instead it strives for constructive engagement. We hope that the Department considers engagement equally as important as wholesale divestment from these industries, which carries along its own set of risks.

Conclusion

Our member insurers have paid close attention to your request, and considered again their risks, including those related to their investment portfolios. Thus, it is with a high degree of confidence that we can report that current investments in utilities and power generators are safe and prudent.

We believe that it is important for policyholders to be aware that where an insurer finds that it is prudent not to divest from fossil fuel investments at this time, it is acting lawfully and subject to its legal duties. Accordingly, we respectfully ask that a proper explanation be included in this regard on the Department's website so policyholders and the public will understand and not be unnecessarily confused and concerned.

We appreciate your consideration of our request, and stand ready to discuss these matters further with you and your staff.

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cc: Geoffrey Margolis, Deputy Commissioner and Special Counsel, Department of Insurance
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