MEMORANDUM

Devon Energy Corporation Shareholder Resolution 2015
Report on Goals & Plans to Address Carbon Asset Risk
Filed by
New York State Comptroller - Retirement Funds and
The George Gund Foundation

Devon Energy Corporation  Symbol: DVN

Vote “For”

Resolved: Shareholders request that Devon prepare a report by October 2015, omitting proprietary information and prepared at reasonable cost, on the company’s goals and plans to address global concerns regarding the contribution of fossil fuel use to climate change, including analysis of long and short term financial and operational risks to the company.

The resolution’s supporting statement requests that the report include:

- The risks and opportunities associated with various low-carbon scenarios, including reducing GHG emissions by 80 percent by 2050, as well as a scenario in which global oil demand declines;
- How the company’s capital allocation plans account for the risks and opportunities in these scenarios, and how it will manage these risks; and,
- The Board of Directors’ role in overseeing capital allocation and climate risk reduction strategies.

We believe that investors should vote FOR this resolution for the following reasons, each of which is discussed in more detail later in the memo:

1. Devon Energy is exposed to Carbon Asset Risk. According to the Carbon Tracker Initiative, approximately 27 percent of Devon’s possible future liquids project portfolio requires a price of $80 per barrel to break even.¹ With oil trading around $50 per barrel, investors are concerned that action on climate change, along with other factors, makes a return to the high prices necessary to break even, uncertain in the foreseeable future.

¹ Based on data sourced from Rystad Energy’s database as of March 17, 2015.
² See Devon 10-K at p. 20 noting:
2. **Devon has inadequate disclosure on this issue**, meaning that investors don’t have the ability to properly evaluate the company’s exposure to Carbon Asset Risk. Devon’s disclosure on climate-related risk via the Carbon Disclosure Project (CDP) survey and its 2015 Sustainability Report focus on reducing emissions from operations, but we could not find any disclosure and analysis of scenarios that keep the global temperature increase below 2 degrees Celsius as requested in the resolution. The relevant 10-K disclosures are limited to language that acknowledges a risk to its core business, but fails to provide any meaningful assessment of the scope of the risk. Instead, it relies on largely boilerplate language, which is unhelpful to investors.

3. **The disclosure requested in the resolution is reasonable** and would be of use to investors. The disclosure request is based on a blueprint developed by the Global Investor Coalition, a group of investors representing over $23 trillion in assets, and similar disclosure requests are being made of dozens of companies in the oil and gas sector. Most of these requests are put forward in cooperative dialogue. Where companies have not been open to dialogue, as is the case at Devon, investors have been forced to put forward shareholder proposals.

4. **Devon Energy is exposed to Carbon Asset Risk.** Research by Carbon Tracker makes clear that, as costs have risen, the oil and gas industry is now highly vulnerable to any drop in oil prices driven by a drop in demand. The industry has affirmed this view. According to Statoil, roughly half of the world’s largest oil projects require prices higher than $120/barrel to break even, more than double the current price, demonstrating just how vulnerable the industry is to decreases in demand.

Even absent aggressive global action on climate change, a variety of existing trends have the potential to erode demand for Devon’s products. These trends include: increased transportation efficiency in North America; clean air

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2 See Devon 10-K at p. 20 noting:
   Cap-and-trade programs could be relevant to us and our operations in several ways. First, the equipment we use to explore for, develop, produce and process oil and natural gas emits greenhouse gases. We could therefore be subject to caps and penalties if emissions exceeded the caps. Second, the combustion of carbon-based fuels, such as the oil, gas and NGLs we sell, emits carbon dioxide and other greenhouse gases. Therefore, demand for our products could be reduced by imposition of caps and penalties on our customers.


regulation in China; and rapid growth of wind and solar energy production. Global action to limit emissions of greenhouse gases could exacerbate this erosion.

Despite these trends, Devon continues to expend millions of dollars in capital on finding and developing additional high cost reserves. According to PricewaterhouseCoopers, at current emission rates, within 19 years carbon dioxide concentrations in the atmosphere will exceed those likely to keep global atmospheric warming below the 2 degrees Celsius goal adopted in the United Nations Framework Convention on Climate Change.

Like many oil and gas companies, Devon has made significant investments in high-cost projects. Devon’s Canadian reserves are likely to have high production costs relative to most other fossil fuel resources: As Rigzone has reported, even though deepwater drilling costs have skyrocketed, oil sands retain their position as the highest marginal cost resource to produce. Improvements in renewable energy technologies along with emerging climate and energy efficiency regulations have the potential to pressure high cost oil projects in much the same way that technology advances in natural gas production has pressured high cost coal reserves in the electric generation sector. Devon’s disclosures do not acknowledge this risk or describe strategies to manage it.

We Believe that Devon’s Disclosures on Climate Risk are Inadequate for the Following Reasons:

1) Devon’s opposition statement to the same resolution in 2014 raises concern by demonstrating an apparent lack of consideration of the threat that climate change poses to the fossil fuel industry. Devon’s 2014 opposition statement states:

“In sum, the proposal requests that the Company provide a report on matters unrelated to its business and involving societal concerns that are vague and beyond the scope of its business and experience.”

This statement also fails to consider the US Securities and Exchange Commission’s 2010 issued interpretive guidance on climate risk stating:

“For instance, a company may face decreased demand for goods that

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9 At the time that this memo was prepared, Devon’s statement regarding the 2015 resolution had not yet been issued.
produce significant greenhouse gas emissions or increased demand for goods that result in lower emissions than competing products. As such, a company should consider, for disclosure purposes, the actual or potential indirect consequences it may face due to climate change related regulatory or business trends.”

The resolution requests disclosure on these matters.

2) The Devon 2014 10-K contains only one paragraph describing how climate change regulations such as a carbon tax or cap-and-trade program could impact the company. The 10-K does not consider the potential for a global agreement on regulatory measures to limit climate change. Unlike some of its peers Devon provides no analysis of the impact of carbon pricing on demand for its products. Notably, one of the auditors engaged to review Devon’s reserves estimates discusses the risk of potential climate regulation – risks which Devon does not sufficiently analyze or mitigate:

“In addition, future changes in taxation affecting oil and gas producing companies and their products, and changes in environmental and administrative regulations may significantly affect the ability of Devon to operate and produce oil and gas at the projected levels.”

3) Devon’s 2015 Sustainability Report includes only one page on the issue of climate change and indicates that Devon has not conducted any analysis of the impacts of potential reduced demand scenarios.

4) Devon’s CDP Survey Response received a score of 82 B, for disclosure and performance, respectively. However, none of these disclosures address the issue that the resolution has asked Devon to consider -- that is, how much of its portfolio is vulnerable under a lower price or lower demand scenario. Although Devon provided additional information about the scope of the risks that it faces in the U.S. and Canada through its CDP disclosures, it refused to attempt to quantify the impacts of these risks. For example, after describing the significant impacts that existing regulations are having in Canada and the U.S., Devon noted:

“The uncertainty imposed by impending and additional regulatory burdens and legislative requirements creates a kind of risk in Devon’s business that is real, but difficult to quantify. Further, with

11 Devon 10-K, Exhibit 99.1, Letter from LaRoche Petroleum Consultants, Ltd to Devon Energy (January 21, 2015).
respect to any future climate legislation or regulation, unknowns such as the point of regulation, the style of regulatory approach that will ultimately prevail, and the uncertainty of not knowing what facilities might be affected, creates difficult challenges where budgetary planning is concerned.” (emphasis added)

The resolution asks the company to look beyond existing regulations and consider how to address fundamental threats to its current business model that features heavy investment in high cost-of-production projects, such as oil sands. Existing International Energy Agency (IEA) scenarios and analysis provide a reasonable set of assumptions to ground such a review.

The following disclosures as requested in the resolution are reasonable and would be of use to investors

1) Consideration of the risks and opportunities associated with various low-carbon scenarios, including reducing GHG emissions by 80 percent by 2050, as well as a scenario in which global oil demand declines

Nearly every nation agreed in the Copenhagen Accord to limit the average global temperature increase to 2 degrees Celsius. There is widespread agreement that meeting this goal will require a 50% reduction in greenhouse gas emissions globally by 2050 entailing an estimated 80% emissions reduction by 2050 in developed countries.

HSBC reports that: “In its low-carbon 450 PPM scenario, the IEA (International Energy Agency) estimates that demand for fossil fuels would still grow up to 2020. Oil demand, for example, is forecast to grow at 0.4% annually. However, from 2020 onwards, the IEA projects that oil demand would decline, though not as much as coal…. Together, the oil price and the unburnable carbon effects are equivalent to between 34% and 52% of market capitalisation.”13 (This analysis covers Shell, BP, Total, Statoil, Eni and BG.)

Since carbon capture and storage (CCS) technology seems highly unlikely to be widely deployed for the foreseeable future,14 a dramatic reduction in the use of fossil fuels is one plausible scenario to avoid exceeding 2 degrees Celsius in climate warming. Investors need to know how Devon’s reserves will be impacted by plausible low-carbon emission scenarios.

2) How the company’s capital allocation plans account for the risks and opportunities in these scenarios, and how it will manage these risks

According to its 10-K, Devon plans to spend between $4.7 and $5.2 billion on capital expenditures in 2015. As Carbon Tracker explains, “fossil fuel capex is a key leading indicator of future carbon emissions.”

It is not in the best interest of investors for companies to expend capital on low-return projects, particularly those projects aimed at developing high-cost, high-carbon reserves that may ultimately be uneconomic. Given the magnitude of the threat that climate change presents to the oil and gas industry, management should assess these capital allocation strategies that make the most sense to prepare for low-carbon and/or low-demand scenarios. Options include:

- Investing a greater percentage of capex in lower carbon fossil fuel reserves, such as natural gas plays, if methane is properly controlled
- investing in renewable energy
- investing in hydrogen production / distribution
- investing in energy storage / battery businesses (for transport, homes/businesses, or utility scale storage)
- increasing dividends or buying back shares
- offering investors something like royalty trusts. Examples of these include Prudhoe Bay Royalty Trust (NYSE: BPT) and the Sandridge Mississippian Trust II (NYSE: SDR). A royalty trust is a bond-like investment vehicle (although more volatile than many bonds due to commodity price swings), with tax advantages and a finite life. It passes income from an oil & gas project through to investors. “Its value slowly declines over time until it’s no longer economically feasible to pull oil and gas from a well....” In June of 2014 there were approximately 20 oil and gas royalty trusts traded on U.S. markets according to the Motley Fool.

3) The Board of Director’s role in overseeing climate risk reduction strategies and related capital allocation

Given the importance of the risks posed by climate change to Devon’s financial performance and viability, investors need to know what the Board is doing to guide

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15 See Devon 10-K at 42.
management in addressing these critical issues. Key issues such as the risk of stranded assets due to carbon pricing and other carbon emission reduction measures are not being assessed or disclosed to investors. Yet these issues present an existential threat to Devon – a threat the Board needs to understand and manage.

**Conclusion**

Since climate change creates fundamental risks to Devon, and because Devon’s disclosure on carbon asset risk is inadequate, investors are encouraged to vote “for” this important request for enhanced disclosure.