DERBYSHIRE
County Council

FOR PUBLICATION

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

8 December 2021

Report of the Director of Finance & ICT

Climate Risk Report

1. Purpose

1.1 To present Derbyshire Pension Fund's (the Pension Fund/Fund) Climate Risk Report dated November 2021, prepared by LGPS Central Limited, to the Pensions and Investments Committee.

2. Information and Analysis

2.1 Climate Risk Report

LGPS Central Limited (LGPSC) has prepared a Climate Risk Report for the Fund structured around the Taskforce for Climate-related Financial Disclosures' (TCFD) four thematic areas of: governance; strategy; risk management; and metrics and targets. It includes the assessment of financially material climate-related risks within the Pension Fund's investment portfolio, highlights climate-related opportunities and provides a base to set an annual Climate Stewardship Plan for the Pension Fund.

This is the second Climate Risk Report prepared by LGPSC, with the first report being presented to the Pensions and Investments Committee in March 2020.

Recognising that there is considerable uncertainty in the crystallisation pathway for climate risk, LGPSC believes that a suite of carbon risk metrics and climate scenario analysis currently provides the most appropriate method of analysing climate risk to support the development of a detailed strategy for integrating climate risk into investment decisions.

LGPSC's contractual arrangements with the third-party provider of the carbon risk metrics data prevents the publication of the full Climate Risk Report because the report contains some propriatary information in respect of individual investment manager and stock holding carbon metrics, which is subject to a non-disclosure clause. The full report will be presented in the restricted part of the meeting. However, a public version of the report, which provides largely the same degree of overall portfolio and asset class information but omits the propriatary information noted above, is attached as Appendix 2.

2.2 Governance

The Climate Risk Report notes that the Fund has made considerable progress in terms of its responsible investment and climate change practice in the last 16 months. In LGPSC's first Climate Risk Report, LGPSC issued 12 governance recommendations, all with medium term horizons. The November 2021 LGPSC Climate Risk Report notes that eleven of these recommendation have been completed. The one remaining recommendation relates to the Fund signing-up to the new 2020 UK Stewardship Code, particuarly Principle 7 which refers to climate risk. The Inhouse Investment Management Team (IIMT) note that the Fund was previously a Tier 1 signatory to the Financial Reporting Council's 2012 UK Stewardship Code. This has been recently replaced with the 2020 UK Stewardship Code, which requires organisations to reapply to achieve signatory status. The IIMT expects that the Fund will report against the code in 2022.

2.3 Climate Scenario Analysis

The LGPSC Climate Risk Report includes the climate scenario analysis included in LGPSC's first report, using data at 31 July 2019. Given the long-term nature of the scenario analysis, it is not approriate to re-run the analysis on an annual basis. The scenario analysis has been carried out at the asset class level and estimates the effects of different climate scenarios on key financial parameters (e.g. risk and return) over a selection of time periods.

The climate scenario analysis covers: (i) the actual asset allocation at 31 July 2019 (the reporting date used Fund's first Disclosures Report); (ii) the strategic asset allocation benchmark at 31 July 2019; and (iii) an alternative strategic asset allocation benchmark (the alternative allocation) which is a close proxy for the Fund's new final strategic asset allocation benchmark which will become effective on 1 January 2022.

Key findings of the climate scenario analysis in relation to the alternative allocation are:

- A 2°C scenario would have a positive impact on the Fund's returns considering both a timeline to 2030 and to 2050. This positive impact is boosted by the 29% allocation to Global Sustainable Equities in the alternative allocation.
- A 3°C scenario (which is in line with the current greenhouse gas trajectory) has a mildly positive impact on the Fund's annual returns.
- A 4°C scenario would reduce the Fund's annual returns, with most asset classes expected to experience negative returns.

The scenario analysis produces more positive relative returns for the alternative allocation under a 2°C and a 3°C scenario than the actual allocation, and the benchmark allocation, at 31 July 2019. Under a 4°C scenario, returns across all three scenarios are negatively impacted.

The scenario analysis supports the Fund's ongoing transition to the new final strategic asset allocation benchmark from 1 January 2022.

It should be noted, that the climate scenario analysis only forecasts the climate related impact on relative returns, and does not take account of any other factors which may have an impact including economic and market conditions; political and geopolitical events; monetary policy conditions, etc. It is also important to note that the asset allocation required to capture the upside under one scenario, may have a negative impact under an alternative scenario.

Climate stress testing analysis suggests that should a 2°C scenario suddenly be priced in by the market, the Fund could benefit in terms of financial returns, whereas the opposite is true should a 4°C scenario be priced in by the market.

2.4 Alternative Asset Class Review

The LGPSC Climate Risk Reports highlights that the poor availability of data in respect of asset classes other than listed equities and investment grade bonds prevents the preparation of carbon metrics in respect of these asset classes (e.g. private equity; infrastructure; fixed income; private debt & diversified multi-asset credit; property, etc).

The IIMT plans to carry-out a review of these asset classes in the next six to twelve months to better understand the climate related risks and opportunities of these investments.

2.5 Climate Stewardship Plan

The LGPSC Climate Risk Report sets out a review of the progress made in respect of the Fund's inaugural Climate Stewardship Plan. Stewardship activities remain an important aspect of the Fund's approach to managing climate risk. The Fund expects all investee companies to manage material risks, including climate change, and the Fund believes that climate risk management can be meaningfully improved through focussed stewardship activities by investors. As a largely externally managed pension fund, the identification and assessment of climate-related risks is also the responsibility of individual fund managers appointed by the Fund. Existing fund managers are monitored on a regular basis to review the integration of climate risks into the portfolio management, and to understand their engagement activities.

The IIMT note that eight of the nine companies included in the Fund's current Climate Stewardship Plan are covered by the Transition Pathway Initiative (TPI). The TPI framework evaluates companies based on their climate risk management quality and carbon performance in terms of alignment with the Paris Agreement. The former includes an assessment of policies, strategy, risk management and targets, with the TPI awarding a quality level to each company assessed under the framework, ranging from Level 0 – unaware of (or not acknowledging climate change) to Level 4* - satisfies all management quality criteria. Of these eight companies covered by the TPI framework, seven were awarded the top two scores achievable in respect of the climate risk management quality assessment (Level 4 & Level 4*), and one was awarded a Level 3 score.

In terms of carbon performance and alignment with the Paris Agreement, TPI assessed that two companies covered were below 2°C aligned; 1 company had Paris pledges; and 4 companies were not Paris aligned. One company assessed from a climate risk management quality perspective was not assessed in terms of carbon performance.

Since the preparation of the Fund's Climate Stewardship Plan, the Fund has sold several investments which were included in the inaugural Climate Stewardship Plan. Furthermore, the transition to the Fund's new final strategic asset allocation benchmark by 1 January 2022 will see further sales from investments included in the existing Climate Stewardship Plan. As a result, the Fund, in collaboration with LGPSC, has developed a forward Climate Stewardship Plan which will include targeted engagement with investee companies of particular significance to the Fund's portfolio following the transition to the Fund's new final strategic asset allocation benchmark. The forward Climate Stewardship Plan includes: BP; CRH; Gazprom PA; Rio Tinto; Shell; and Taiwan Semiconductor Manufacturing.

2.6 Carbon Risk Metrics

Carbon risk metrics analysis on the Fund's listed equities (52.9% of total investment assets at 31 March 2021) and investment grade bond (6.1% of total investment assets at 31 March 2021) portfolios considers: portfolio carbon footprint (weighted average carbon intensity); fossil fuel exposure; thermal coal exposure; and clean technology (portfolio weight in companies whose products and services include clean technology).

Key findings of the carbon risk metrics analysis are:

- The Fund's Total Quoted Equities portfolio is around 27% less carbon intensive than the blended benchmark; 37% lower than the 2020 Benchmark (the blended benchmark is based on the regional allocations of the portfolio).
- Each regional equity portfolio has a lower carbon footprint that its regional benchmark.
- The Fund's Total Quoted Equities portfolio has around 25% less weight in fossil fuel reserves than the blended benchmark, 44% lower than the 2020 benchmark.
- The Fund's Total Quoted Equities portfolio weight in thermal coal reserves is 29% lower than the blended benchmark.
- The Fund's Total Quoted Equities portfolio has around a 12% lower exposure to clean technology than the blended portfolio benchmark.
- The Fund's investment grade bond portfolio is around 20% more carbon efficient than the benchmark.

The LGPSC Climate Risk Report reports that the Total Quoted Equities weight in fossil fuels reserves was 6.53% at 31 March 2021. The difference between this reported weight in fossil fuel reserves and the IIMT's quoted internal estimate of around 2.5% reflects two key drivers:

1. The LGPSC weight relates to the Total Quoted Equities portfolio, whereas the IIMT estimate relates to the Fund's total investment assets; listed equities only account for around 52% of the total investment assets; and

2. The IIMT's esimate includes the Fund's actual holdings in the widely recongnised oil producing majors (ExxonMobil; Chevron; Total Energies; BP;

Royal Dutch Shell; ConocoPhillips; and Eni), together with a revenue weighted estimate in respect of the major mining companies (e.g. BHP Group; Rio Tinto; Anglo American; Glencore, etc). The methodology used in the LGPSC Climate Risk Report to calculate the weight in fossil fuel reserves differs and includes the full weight of any company which has either fossil fuel reserves, thermal coal reserves or derives more than 30% of their energy mix from coal power, regardless of how much those activities/reserves represent of the company's total operations.

For example, the full weight of BHP Group (0.16%) is included in the weightings, even though the associated revenues from these activities/reserves account for less than 10% of total company revenues. To put the methodology further into context, the FTSE All World benchmark weight in fossil fuel reserves was reported as 6.47% at 31 March 2021, of which the weighting in the widely recognised oil producing majors was 1.42%. The remaining 5.05% cuts across multiple companies; sectors, industries and geographies.

The measure for clean technology exposure should be treated with some caution as there appears to be a moderate positive correlation in the dataset between sectors that have a high carbon intensity and those that have a higher weight in clean technology. Furthermore, the analysis takes no account of the Fund's unquoted onshore & offshore, solar and hydro renewable energy infrastructure investments. These investments & commitments were in excess of £275m at 31 March 2021.

2.7 Climate Strategy Targets

The Fund developed a standalone Climate Strategy which was approved by Committee in November 2020. The Climate Strategy sets out the Fund's approach to addressing the risks and opportunities related to climate change, including a statement that the Fund supports the ambitions of the Paris Agreement, and aims to achieve a portfolio of assets with net zero carbon emissions by 2050.

The Climate Strategy included two targets: (i) reduce the carbon footprint (Scope 1 & 2) of the Fund's listed equity portfolio by at least 30% relative to the weighted benchmark in 2020 by the end of 2025; and (ii) invest at least 30% of the Fund portfolio in low carbon & sustainable investments by the end of 2025.

The table below, shows the progress to date in respect of the two targets:

Target	Target by end of 2025	Actual at 31 March 2021
(1) Reduce the carbon footprint (Scope 1 & 2) of the Fund's listed equity portfolio by at least 30% relative to the weighted benchmark in 2020 by the end of 2025	(30%)	(37%)
(2) Invest at least 30% of the Fund portfolio in low carbon & sustainable investments by the end of 2025	30%	19%

The Fund has already achieved the first target and expects to make further progress on this measure and significant progress in respect of the second target in 2021-22 as part of the ongoing move to the new final strategic asset allocation benchmark. It is expected that additional material progress will need to be supported by emissions reductions by companies in the Fund's investment universe in order to avoid the risk of unbalancing the equity portfolio and limiting diversification.

It should be noted that any improvement in the consistency, comparability and quality of climate-related data is likely to have an impact on the Fund's carbon metrics relative to the targets noted above.

The targets will be reviewed in 2023, and at least every three years thereafter, and are expected to increase in line with the stated ambition of achieving a portfolio of assets with net zero carbon emissions by 2050. The impact of the significant ongoing transitions on performance and risk within the investment portfolio will be closely monitored and assessed.

2.8 Climate-Related Disclosures

In collaboration with LGPSC, the Fund has prepared a second Climate-related Disclosures Report (the Disclosures Report) for publication, which includes the high level results of the climate scenario analysis, carbon risk metrics analysis and progress against the Fund's Climate Strategy targets. The Disclosures Report also includes information on the Fund's governance of climate risk and on the Fund's climate-related stewardship activities. Publication of a Climate-related Disclosures Report represents best practice.

3. Implications

3.1 Appendix 1 sets out the relevant implications considered in the preparation of the report.

4. Background Papers

4.1 Papers held in the Investment Section.

5. Appendices

5.1 Appendix 1 – Implications.
5.2 Appendix 2 – LGPSC Climate Risk Report

6. Recommendation(s)

That Committee:

a) notes the LGPSC Climate Risk Report attached as Appendix 2.

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Appendix 1

<u>Implications</u>

Financial

1.1 None

Legal

2.1 None

Human Resources

3.1 None

Information Technology

4.1 None

Equalities Impact

5.1 None

Corporate objectives and priorities for change

6.1 None

Other (for example, Health and Safety, Environmental Sustainability, Property and Asset Management, Risk Management and Safeguarding)

7.1 None