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Dear Sir / Madam

Local Government Pension Scheme (England and Wales): Governance and reporting of climate change risks

Derbyshire Pension Fund (the Fund) has the following comments on the proposals:

Governance

Question 1 – Do you agree with our proposed requirements in relation to governance?

The Fund agrees that the governance of climate risks and opportunities in relation to LGPS investments resides with administering authorities (AAs) and that, in the majority of cases, a pensions committee (in Derbyshire a Pensions and Investments Committee) is responsible for pension fund governance on behalf of the AA, assisted by a local pension board.

It follows that the responsibility for overseeing the identification, assessment and management of climate risks and opportunities in relation to investments resides with the AA/pensions committee (PC) alongside oversight of investment strategy, responsible investment, funding strategy, risk management and investment pooling.

Properly qualified advisers would require broad commercial experience across investments, economics and markets, in addition to possessing climate related knowledge and skills, to ensure that climate advice is provided in the context of the broader range of risk and reward considerations.

The pool operating companies have an important role to play in assessing and managing climate risks and opportunities, overseen by AAs/PCs.

As an increasing percentage of LGPS assets are transitioned to the management of the pools, the importance of LGPS funds receiving independent advice on climate-related investment matters will increase to support AA/PC assessments of the climate related risks and opportunities of products launched and managed by the pools.

Strategy

Question 2 - Do you agree with our proposed requirements in relation to strategy?

The Fund broadly agrees with DLUCH's proposed requirements in relation to strategy which will support the continuous assessment of the implications of climate change on LGPS funds' strategies.

It is logical that any assessment of climate risks and opportunities should be considered at the same time as other strategies such as the investment strategy and the funding strategy and should be considered over the same time horizon as those strategies.

Scenario analysis

Question 3: Do you agree with our suggested requirements in relation to scenario analysis?

The Fund agrees that, at a minimum, two climate related scenarios should be considered.

It would also be beneficial for AAs to have the flexibility to consider a range of different temperature scenarios.

The Fund's latest 2022 Climate Risk Report, produced by LGPS Central Ltd (LGPSC), with Scenario Analysis from Mercer, considers three scenarios:

- A rapid transition (<1.5°C temperature rise)
- An orderly transition (1.6°C temperature rise)
- A failed transition (4°C temperature rise)

The outcome for global warming and the transition to net-zero is highly uncertain. There is, therefore, significant value in considering a range of temperature rises and the Fund broadly supports the approach taken by Mercer to consider 3 scenarios (rapid, orderly and failed transitions).

A requirement to carry out scenario analysis on at least a three-year basis to fit in with the triennial valuation cycle makes sense, as does a requirement to consider whether scenario analysis should be repeated on any material change in strategy.

It is important that the current limitations of climate scenario analysis, which is a relatively new discipline, are recognised, particularly if such analysis is expected to increasingly inform strategic asset allocation and funding decisions.

In its current form, Scenario Analysis is at its most useful when used as a directional indicator. As with any forecasting model, small changes to the methodology, or the underlying assumptions and inputs, can result in significant changes to model outputs. Scenario analysis is likely to be directionally accurate, but with low levels of absolute precision.

It will be vital for the outputs of climate scenario analysis to be caveated when reported to stakeholders.

Further progress on the development of climate scenario expertise and methodologies to reach a position of greater consistency will be welcomed.

The Fund agrees with the consultation response from the Local Authority Pension Fund Forum (LAPFF) on a 1.5°C scenario, which is summarised below:

There is broad consensus around the need to achieve temperature rises of no more than 1.5°C

- A scenario of 1.5°C would more closely align with the UK government's commitment to reduce greenhouse gas emissions by at least 100% by 2050, enshrined in the 2019 Climate Change Act.

- The objective of limiting warming to 1.5 degrees was also the clear message from the UK government after COP26 in Glasgow.

Using 2 degrees would, therefore, seem to undermine the ultimate objective of UK policy and would create transition risks for asset owners if they are not considering the ultimate objective of UK policy (i.e., regulatory risks).

Risk management

Question 4: Do you agree with our proposed requirements in relation to risk management?

The Fund supports TCFD's recommendations that aim to ensure that risk management in relation to climate risks is rigorous, comprehensive and fully integrated into wider risk management.

The Fund also supports the proposal to require AAs to integrate climate-related process in their existing risk management processes.

Metrics

Question 5: Do you agree with our proposed requirements in relation to metrics?

The Fund agrees that a number of metrics should be used to manage climate related risks and opportunities. Each metric used tends to have limitations and should not be assessed in isolation. A range of metrics will allow a Fund to assess the trajectory of its investment portfolio in terms of carbon emissions.

We welcome the flexibility to use alternative metrics to those identified in the consultation document.

Scope 1, Scope 2 and Scope 3 Emissions

The Fund in general supports the principle of expanding the emissions coverage to include Scope 3 emissions. However, the quality and completeness of Scope 3 emissions is very patchy at present, with company reporting outside the control of the Fund. Estimation techniques differ and can result in significantly different carbon metric outputs for the same company, sector or geography depending on the data provider and modelling technique used.

Scope 3 emissions are also complicated by the risk of double counting (i.e., one company's Scope 1 and 2 emissions are another company's Scope 3 emissions).

If Scope 3 emissions are to be reported, they should be reported separately and not combined with Scope 1 and 2 emissions. As an absolute measure, Scope 1, 2 & 3 emissions, take no account of a fund's size or asset allocation. This will need to be considered when comparing different funds with each other.

The requirement to report Scope 1, 2 & 3 emissions at a whole fund level is likely to extremely difficult at present, given the patchy nature of the data disclosures at present. As noted in our response in respect of Data Quality below, disclosures vary significantly by asset class and the Fund believes that the use of estimates to 'fill-in the gaps' is likely to lead to misleading data sets and high levels of volatility.

There might be merit in delaying the requirement to report Scope 3 emissions until more reliable methodologies have been developed, reporting is commonplace, and a specific methodology can be agreed upon for AAs to apply to ensure that the reported figures are consistent and comparable.

Emissions Intensity Metric

The Fund notes the proposed methodology for calculating an Emissions Intensity Metric. The Fund currently uses the widely used Weighted Average Carbon Intensity metric (WACI) to report the carbon footprint/intensity of the Fund's listed equity and corporate bond portfolio and would welcome the flexibility to continue to use this metric going forward. This would help to ensure that the carbon metrics reported by the Fund are consistent and comparable over time. The Fund has used the WACI metric since the Fund's first TCFD Report was published in 2020. This metric has been used to set the 2020 baseline for monitoring the Fund's progress relative to the targets set out in the Fund's Climate Strategy. It also allows the Fund to monitor the carbon footprint/intensity of the listed equity and corporate bond portfolios relative to the market benchmarks and allows the Fund to assess which parts of the portfolio account for the majority of carbon emissions and target stewardship engagement accordingly.

Data Quality

The Fund agrees that it is important to report data quality wherever possible. However, LGPS funds have limited control over the reporting of data quality by service providers and this may make setting targets for this metric difficult.

It should also be recognised that data quality differs by asset class and the setting of metrics and data quality targets should not result in a situation where LGPS funds are discouraged from investing in asset classes purely to improve the quality of their carbon reporting. For example, disclosures in respect of emerging markets, small cap stocks and unlisted investments (e.g., private equity, infrastructure, private debt) are less well developed than those for large cap listed equities.

The Fund has significant concerns in respect of using estimated data to fill 'gaps' in reporting for asset classes with low coverage. The Fund does not support having to estimate carbon metrics for these asset classes when the accuracy and completeness of the estimates is likely to be low, potentially leading to misleading data sets. As reporting improves and more data becomes available, there could be significant volatility as actual data replaces estimated data, fluctuations over which the Fund has no control.

Paris Aligned Metrics

The IIGCC net zero investment framework asks for aligning/aligned measurement which requires analysis of the quality of the net zero commitment/ target. The Fund considers this to be an insightful indicator of risk and the future trajectory of the portfolio. However, not all Net Zero commitments/ targets are the same, some are more challenging and comprehensive than others. Consideration needs to be given to the detail of the commitment and the company's ability to deliver it. A binary metric could miss this important nuance.

It is important to make a distinction between metrics that are focused on measuring the impact of the portfolio and those metrics that are intended to provide insights into the risk exposure of the portfolio.

Implied temperature rise/ Paris aligned metrics are often a point in time analysis and do not necessarily give a strong indication of how a company or portfolio might look in 3 years' time, for example. They do not necessarily give an indication of the direction of travel for a company or the portfolio in terms of carbon nor do they necessarily assess the potential for a company's product portfolio to contribute to the transition in a positive way. It is important to take a broad set of factors into consideration when making investment decisions looking at a company's strategy, R&D spend, capex plans, the progress of technology innovation and the pipeline of regulation and legislation.

It is important to be clear and transparent about the limitations of these metrics when presenting results.

Targets

Question 6: Do you agree with our proposed requirements in relation to targets?

The Fund generally agrees with the proposals to set and measure progress against carbon reduction related targets.

The Fund has already made substantial progress in this area, including publishing a Climate Strategy in November 2020, including supporting the ambitions of the Paris Agreement and aiming to achieve a portfolio of assets with net zero emissions by 2050. The Fund has also set initial decarbonisation and sustainable investment targets.

Consistent with its wider governance responsibilities, the Fund believes that the targets should be set by the AA. The AA has a fiduciary duty to the beneficiaries of the scheme. Targets should be set by AAs to reflect the specific characteristics and investment strategy of the relevant Fund, rather than being set at a pool level.

Whilst the Fund agrees that progress against any targets should be monitored and reported on an annual basis through the Fund's Annual Report and TCFD report, the Fund does not believe that the targets should be reviewed on an annual basis. The targets should be longer-term in nature, and it would be more appropriate to review targets every three to five years, with the targets aligned to achieving net zero by 2050.

Carbon metrics can be volatile, impacted by multiple factors including changing and evolving data sets, manager stock selection, regional performance, sector performance, monetary policy, geopolitical events, one off events (e.g., the Covid-19 pandemic), etc. Reviewing targets on an annual basis increases the risk of short-term and reactionary decision making, an approach which is inconsistent with the general LGPS fund investment philosophy of being a long-term investor. Furthermore, some asset classes (e.g., private equity and infrastructure) are illiquid, with capital being invested for several years, and investment changes take time.

The Fund is also concerned that the implementation of a target across all asset classes may be challenging, as in some cases carbon data is neither accurate nor complete. A target that is specific to asset classes such as listed equity and corporate credit assets only, may be more achievable, albeit the Fund expects that the accuracy and completeness of carbon data in respect of other asset classes will improve over time and become reportable.

The Fund welcomes the comment that AAs should not set targets which require them to divest or invest in a given way, and the targets should not be legally binding. The Fund believes that divestment does not make a problem disappear (e.g., selling oil and gas stocks to improve a fund's carbon emissions does not reduce emissions in the real world) and that engagement is a valuable tool in reducing investment risk and encouraging investee companies during the transition to a net zero economy.

Any reporting against targets should be accompanied by the data coverage of AUM.

Reporting on climate risks

Question 7: Do you agree with our approach to reporting?

The Fund broadly agrees with the proposals for reporting, including having an annual Climate Risk Report. The focus should be on the long-term management and reporting of climate related matters.

The Fund already publishes an annual TCFD report and receives an annual Climate Risk Report from the Fund's pooling company, LGPSC. LGPSC has a schedule for preparing each Partner Fund's Climate Risk Report, and the preparation of the Climate Risk Reports is spread over the financial year. Setting a deadline in line with the annual report will concentrate all the work carried out by LGPSC into a short timeframe and it is likely to be difficult for the Partner Funds and LGPSC to meet these deadlines without additional resources. Furthermore, the external service provider used by LGPSC to prepare the underlying carbon metrics, has imposed confidentiality clauses on much of the granular carbon metric data contained in the full Climate Risk Report. These confidentiality restrictions may limit the ability of the Fund to comply fully with any content guidance issued.

Scheme Climate Risk Report

Question 8: Do you agree with our proposals on the Scheme Climate Risk Report?

The Fund supports the principle of having a Scheme Climate Risk Report but believes that it would be difficult to implement in practice at present because of the different methodologies used by LGPS funds to calculate carbon metrics and carbon metrics are not available for all asset classes, potentially increasing the level of estimation required.

The Fund believes that there is a risk that any Scheme Climate Risk report could potentially lead to inaccurate high-level comparisons between LGPS funds, which fail to take into account each LGPS fund's maturity profile, funding position, asset allocation strategy, or approach to managing climate related risks and opportunities.

The role of the LGPS asset pools

Question 9: Do you have any comments on the role of the LGPS asset pools in delivering the requirements?

The AA is responsible for an LGPS fund's governance, strategy, policies and assets. This role cannot be outsourced to a third party, including the LGPS Asset Pool companies. Investments strategies and targets should be specific to the characteristics of the relevant LGPS fund, and not simply aligned within pools for the ease of climate risk reporting.

The Fund believes that the Fund's pool company has an important role to play in supporting the Fund's carbon risk reporting, including the preparation of an annual Climate Risk Report, and the provision of general assistance with investment engagement and stewardship services.

We refer to our earlier comments in Question 1 in respect of governance requirements and the need for independent advice on climate-related investment matters as a growing percentage of assets are transitioned into products managed by the pools.

Guidance and reporting template for administering authorities

Question 10: Do you agree with our proposed approach to guidance?

The Fund agrees that there should be statutory guidance to accompany the regulations. This guidance will need to be clear and comprehensive. The guidance should be subject to a consultation process.

Knowledge, skills and advice

Question 11: Do you agree with our proposed approach to knowledge, skills and advice?

As mentioned in the response to Question 1, the Fund believes that properly qualified advisers would require broad commercial experience across investments, economics and markets, in addition to possessing climate related knowledge and skills to ensure that climate advice is provided in the context of the broader range of risk and reward considerations.

As an increasing percentage of LGPS assets are transitioned to the management of the pools, it will be important that LGPS funds receive independent advice on the investment products offered by the pools, and that these advisors are able to monitor and assess the pools' ability to manage climate related risks, together with generating the investment returns required by LGPS funds to meet member pension obligations.

The Fund believes that these services could be procured through the use of an LGPS national framework to reduce procurement time and costs.

Consideration of impact on protected groups

Question 12: Do you have any comments on the impact of our proposals on protected groups and on how any negative impacts may be mitigated?

The Fund does not believe that the proposals in this consultation would impact on protected groups.

Yours faithfully,

Dawn Kinley

Dawn Kinley

Head of Pension Fund

For and behalf of Derbyshire County Council as Administrating Authority for Derbyshire Pension Fund