FOR PUBLICATION

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

WEDNESDAY, 24 JANUARY 2024

Report of the Director - Finance and ICT

Climate Risk Management Report

1. Purpose

1.1 To present Derbyshire Pension Fund's (the Pension Fund/Fund) public Climate Risk Management Report dated January 2024, prepared by LGPS Central Limited, to the Pensions and Investments Committee.

2. Information and Analysis

2.1 Background

LGPS Central Limited (LGPSC) has prepared a Climate Risk Management Report (LGPSC Climate Risk Management Report) for the Fund, which sets out an anaylsis of the Fund's approach towards climate-related risks and oppourtunities.

The LGPSC Climate Risk Management Report is structured around the Department for Levelling Up, Housing and Communities (DLUHC) potential recommendations on climate-related risk management as set out in the DLUHC consultation document 'Local Government Pension Scheme (England and Wales): Governance and reporting of climate change risks' dated September 2022.

The LGPSC Climate Risk Management Report uses the Taskforce on Climate-Related Financial Disclosures (TCFD) Maturity Map as a foundational framework for assessing an organisation's maturity in understanding, manageing and addressing the risks and oppourtunities relating to cliamte change.

This is the fourth Climate Risk Management Report (previously entitled Climate Risk Report) prepared by LGPSC, with the first, second and third reports being presented to the Pensions and Investments Committee in March 2020, November 2021 and January 2023, respectively.

Recognising that there is considerable uncertainty in the future development of climate risks and of the solutions for climate risks, LGPSC and the Fund's In-House Investment Management Team (IIMT) believe that using a variety of different carbon risk metrics and climate scenario analysis tools currently provides the most appropriate method of analysing and managing climate risk within an investment portfolio.

It is appropriate to consider the Fund's climate strategy and climate-related metrics alongside the Fund's long-term investment strategy, which is to maximise the returns from investments within acceptable levels of risk, contributing to the Fund having sufficient assets to cover accrued benefits, enabling employer contributions to be kept as stable as possible and limiting costs to local taxpayers. Furthermore, it is important to maintain access to a diversified portfolio of assets to reduce concentration risk and minimise performance volatility.

LGPSC's contractual arrangements with MSCI, the third-party provider of the carbon risk metrics data, prevents the publication of the full Climate Risk Management Report as the report contains some proprietary 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 Committee meeting. 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.

2.1 LGPSC Climate Risk Management Report Findings

LGPSC notes that based on the Fund's current processes and disclosures, the Fund is well positioned to meet DLUHC's potential requirements on climate change governance and disclosures.

LGPSC concludes that on average, using an assessment based on the TCFD Maturity Map, the Fund is disclosing at a Moderate level. The TCFD Maturity Map ranks disclosures into three categories: Limited, Moderate and Full Disclosure, although LGPSC notes that, based on its analysis, no single peer is able to achieve leader status (i.e. Full Disclosure) across all elements. LGPSC further notes that the Fund does have the potential to move towards leader status in several elements and is most advanced within its disclosure of its governance structures, including climate training and inclusion of climate considerations within the Funding Strategy/Valuation Report.

The LGPSC Climate Risk Management Report includes a number of considerations and recommendations, several of which were addressed in the Fund's updated Climate Strategy (currently subject to consultation with the Fund's stakeholders). The remaining recommendations, largely relating to governance and reporting are currently being considered by the Fund.

2.3 Carbon Risk Metrics

Carbon risk metrics analysis on the Fund's listed equities (51.0% of total investment assets on 31 March 2023) and listed investment grade bonds (5.7% of total investment assets on 31 March 2023) portfolios considers:

- Portfolio carbon footprint (Scope 1 & 2 – Scope 1 covers emissions from sources that an organisation owns or controls directly, whereas Scope 2 covers emissions that a company causes indirectly and come from where the energy it purchases and uses is produced): the weighted average carbon intensity (WACI) of the portfolio
- Total financed emissions (Scope 1 & 2): a measure of absolute tons of CO_2 emissions for which an investor is considered responsible
- Total normalised emissions (Scope 1 & 2): normalised by a portfolio's AUM to provide a measure of carbon intensity
- Portfolio Scope 3 carbon footprint: Scope 3 covers emissions released through the value chain of the company, both upstream and downstream
- Fossil fuel exposure: the proportion of the portfolio with exposure to companies with fossil fuel reserves

- Thermal coal exposure: the proportion of the portfolio with exposure to companies with thermal coal reserves
- Coal power exposure: the proportion of the portfolio which relates to utilities which derive more than 30% of their energy mix from coal power
- Clean Technology exposure: the proportion of the portfolio invested in companies whose products and services include clean technology
- Data Quality: a score between 1 and 5; with 1 being the most preferred and relating to actual audited data and 5 being the least preferred and relating to estimated data with limited evidential support
- Engagement: the proportion of financed emissions which are covered by direct or indirect LGPSC engagement, excluding any engagement carried out by the Fund's other investment managers/engagement providers
- Low Carbon Transition: the proportion of financed emissions associated with a company with an above median score in respect of the management of risks and oppourtunities related to the low carbon transition. The metric is scored between 1 and 10, with 0 (worst) and 10 (best)
- Implied Temperature Rise in the year 2100 or later: the proportion of financed emissions within a portfolio with an Implied Temperature Rise of 2ºC or lower
- Science-Based Targets: the proportion of financed emissions which are accounted for by portfolio companies with a science based target, which indicates that a company commits to a medium and/or long-term net zero target that are considered science-based (i.e. in line with what the latest climate science deems necessary to meet the goals of the Paris Agreement)
- Paris Alignment: the proportion of financed emissions which are considered to be Paris Aligned based on: the company has a Low Carbon Transition score greater than 5, as well as either an Implied Temperature Rise of 2ºC or lower, or a Science-Based Target

LGPSC notes that climate data is an evolving field, with methodologies being continuously updated by governments, data providers and companies. The data used by LGPSC (as supplied by MSCI) is subject to frequent revisions, as data coverage expands, and estimated data gets replaced by reported data. To the extent possible, the LGPSC Climate Risk Management Report, has restated the Fund's climate metrics for prior years to incorporate the most current information (the Restated Basis).

The IIMT notes that these restatements can be significant and indicate that the climate metrics set out in the LGPSC Climate Risk Management Report should not be considered as definitive, and ongoing improvement in the consistency, comparability and quality of climate-related data is likely to have further impact (either positive or negative) in the future.

The key highlights of the carbon risk metrics analysis are as follows:

Listed Equities:

- Carbon footprint is 47.0% more carbon efficent than the 2020 Weighted Benchmark, rising to 49.8% on a Restated Basis
- 35.1% reduction in the carbon footprint between 31 July 2019 and 31 March 2023, rising to 41.6% on a Restated Basis
- 34.9% reduction in total financed emissions between 31 July 2019 and 31 March 2023, falling to 31.5% on a Restated Basis
- 44.6% reduction in total normalised financed emissions between 31 July 2019 and 31 March 2023
- Total Scope 3 carbon footprint 18.5% lower than the 2023 benchmark. Top 10 investee companies account for 43.6% of total Scope 3 emissions
- 5.7% of the portfolio invested in fossil fuel companies on 31 March 2023, 460 basis points lower than on 31 July 2019 (370 basis points lower on a Restated Basis), and 280 basis points lower than the 2023 benchmark
- 38.5% of the portfolio invested in companies with exposure to clean technology, in line with the 2023 benchmark, and up from 30.4% on 31 July 2019 (29.7% on a Restated Basis)
- Average Data Quality score of 2.1, with a WACI coverage of 96.6%
- 63.5% of total financed emissions covered by direct or indirect LGPSC engagement
- Low Carbon Transition percentage of 39.0%, compared to a FTSE All World average of 32.6%
- Implied Tempreture Rise Percentage of 28.1%, compared to a FTSE All World average of 12.3%
- Science-Based Targets Percentage of 32.4%, compared to a FTSE All World average of 8.1%
- Paris Alignment Percentage of 22.1%, compared to a FTSE All World average of 11.5%

The LGPSC Climate Risk Management Report reports that the Total Listed Equities weight in fossil fuels reserves was 5.7% on 31 March 2023. 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:

- The LGPSC figure is the percentage weight of the Total Listed Equities portfolio, whereas the IIMT estimate is the percentage weight of the Fund's total investment portfolio; listed equities only account for 51% of the total investment portfolio.

- The IIMT's esimate includes the Fund's actual holdings in the widely recognised oil producing majors (ExxonMobil; Chevron; Total Energies; BP; Shell; ConocoPhillips; and Eni). The methodology used in the LGPSC Climate Risk Report to calculate the weight in fossil fuel reserves includes the full weight of any company which has either fossil fuel reserves, thermal coal reserves or derives more than 30% of its energy mix from coal power, regardless of how much those activities/reserves represent of the company's total operations.

As noted in the LGPSC Climate Risk Management Report, when apportioned by revenue, only 2.0% of the Total Listed Equities portfolio (3.8% at a benchmark level) derives revenue from fossil fuel reserves, indicating that most of companies with fossil fuel reserves are diversified businesses, including exposure to clean technology.

Listed Investment Grade Bonds:

- Carbon footprint including sovereigns is 10.4% less carbon efficent than benchmark
- 31.4% reduction in total absolute financed emissions between 31 March 2022 and 31 March 2023 on a restated basis, following a rise in the previous year
- 5.2% reduction in total normalised financed emissions between 31 July 2019 and 31 March 2023
- Total Scope 3 carbon footprint 39.5% lower than the 2023 benchmark. Top 10 investee companies account for 65.2% of total Scope 3 emissions
- 4.4% of the portfolio invested in fossil fuel companies on 31 March 2023, 190 basis points lower than benchmark
- 22.3% of the portfolio invested in companies with exposure to clean technology, 660 basis points lower than the benchmark
- Average Data Quality score of 2.2, with a WACI coverage of 87.3%
- 51.6% of total financed emissions are covered by direct or indirect LGPSC engagement
- Low Carbon Transition percentage of 26.1% (benchmark not available)
- Implied Tempreture Rise Percentage of 38.9% (benchmark not available)
- Science-Based Targets Percentage of 39.7% (benchmark not available)
- Paris Alignment Percentage of 24.4% (benchmark not available)

It should be noted that 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 and commitments amounted to more than £250m on 31 March 2023.

2.4 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.

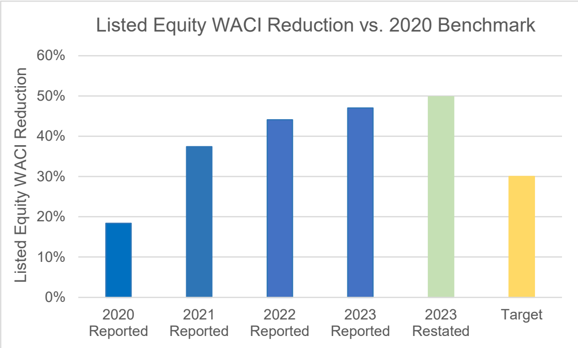
The Climate Strategy included two targets: (i) reduce the carbon footprint (Scope 1 & 2) of the Fund's listed equity portfolio by at least 30% relative to the weighted benchmark in 2020 by the end of 2025; and (ii) invest at least 30% of the Fund portfolio in low carbon & sustainable investments by the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

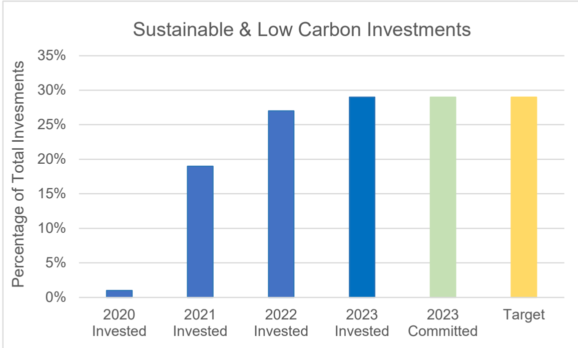
The table below, shows the progress to date in respect of the two targets:

Target	Target by end of 2025	Actual on 31 March 2023
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%)	Reported: (47%) (1) Restated: (50%) (1)
Invest at least 30% of the Fund portfolio in low carbon & sustainable investments by the end of 2025	30%	Invested: 29% Committed: 30%

(1) The 'Reported' reduction is relative to the 2020 Weighted Average Benchmark (182.8tC02e/SM Revenue) as reported by LGPSC in its first Climate Risk Management Report published in February 2020, whereas the 'Restated' reduction is relative to the restated 2020 Weighted Average Benchmark (192.8tC02e/$M Revenue) as reported by LGPSC in its fourth Climate Risk Management Report published in January 2024

The year-on-year trend in the Fund's progression towards the targets is shown below:





The Fund has already achieved the first target and has met its second target on a committed basis. As highlighted above, ongoing improvement in the consistency, comparability and quality of climate-related data is likely to have an impact (either positive or negative) on the Fund's carbon metrics relative to the targets noted above.

The Fund's climate related targets are expected to show a sizeable increase once the updated Climate Strategy is finalised.

2.5 Other Asset Classes

The carbon metrics in the LGPSC Climate Risk Management Report relate to the Fund's listed and investment grade bond portfolios, representing 56.7% of the Fund's total investment assets on 31 March 2023. The poor availability of data in asset classes other than listed equities and investment grade bonds (e.g. Sovereign Bonds, Infrastructure, Property, Private Equity, etc) prevents a more complete analysis at the present time. The IIMT notes that several of these asset classes are naturally tilted towards lower carbon industries (e.g. Infrastructure and Private Equity) or supported by national net zero commitments (e.g. Sovereign Bonds), albeit like other assets, they are not immune to climate risk, particularly those with a growth tilt. The majority of the Fund's underlying asset managers have made net zero commitments and are working towards reduced carbon emissions in line with the Paris Agreement.

2.6 Climate-Related Disclosures

The Fund prepares and publishes an annual Climate-related Disclosures Report (the Disclosures Report), which includes:

- information on the Fund's governance of climate risk
- information on the Fund's climate-relate stewardship activities
- the high level results of climate scenario analysis

- carbon risk metrics analysis in respect of the Fund’s listed equity and investment grade bond portfolios
- progress against the Fund’s Climate Strategy targets
- an overview of the climate-related risks and responsibilities in respect of the Fund’s asset classes other than listed equities and investment grade bonds

The annual publication of a Disclosure Report represents best practice and the Fund plans to issue an updated Disclosure Report by the end of June 2024, following the finalisation of the Pension Fund’s updated Climate Strategy in March 2024.

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 by the Pension Fund.

5. Appendices

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

6. Recommendation(s)

That Committee:

a) notes the Climate Risk Management Report attached as Appendix 2

7. Reasons for Recommendation(s)

7.1 The Committee is responsible for reviewing and approving the Pension Fund’s statements, strategies and policies, including the Fund’s Climate Strategy and monitoring progress against the Fund’s carbon-related decarbonisation reduction targets.

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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