Leicestershire County Council

LOCAL PENSION COMMITTEE – 1 DECEMEBER 2023

DIRECTOR OF CORPORATE RESORUCES

CLIMATE RISK MANAGEMENT REPORT 2023

Purpose of the Report

1. The purpose of this report is to provide the Local Pension Committee with background information on Leicestershire County Council's Pension Fund (the Fund) 2023 Climate Risk Management Report (formerly known as the Climate Risk Report), and progress toward net zero targets.

2. A PowerPoint presentation will be delivered at the meeting by representatives from LGPS Central, a copy of the Leicestershire County Council Climate Risk Management Report is attached as the appendix to the report.

Policy Framework and Previous Decisions

3. Climate change factors have been considered by the Fund for a number of years. This was enshrined in the Fund's Investment Strategy Statement last approved by the Committee on 3 March 2023, as well as the approach to climate related risk and opportunities within the Net Zero Climate Strategy, also approved 3 March 2023. Climate considerations have also been built into the Fund's Investment Strategy Statement and Funding Strategy Statement.

Background

4. The Fund has produced a climate report annually since 2020, formerly known as the Climate Risk Report. Through a combination of bottom-up and top-down analysis, the report has been designed to give the Fund a view of the climate risk held throughout its entire asset portfolio, accompanied by proposed actions the Fund could take to manage and reduce that risk. This allows the Fund to analyse progress against the baseline of data from previous reports, reassess the Fund's exposure to climate-related risks and opportunities, and identify further means for the Fund to manage its material risks.

Climate Report Analysis 2023

5. A copy of Leicestershire Pension Fund's Climate Risk Management Report is attached as the appendix to the report. LGPS Central will deliver a PowerPoint presentation to cover the key points in the report at the meeting.

6. The report is structured to align with the four pillars of the Taskforce on Climate-Related Financial Disclosures (TCFD) and facilitates public disclosure against this framework: Governance, Strategy, Risk Management, and Metrics and Targets.

7. The report is split into two distinct sections, Section 1: Climate Analysis which for the first time compares the Fund's current approach set out within its various documents and strategies to that of what may be required as part of the outcome of Government's TCFD consultation, and what is considered best practice across the financial sector, alongside recommendations for the Fund. Section 2 sets out the Fund's climate metrics.

Progress Against the Fund's Net Zero Climate Strategy

8. The data set out within the climate metrics section is at 31 March 2023. Progress according to the Net Zero Climate Strategy targets is set out at a high level below. These all contribute to the Fund's high-level target primary target of net zero by 2050, with an ambition for sooner.

9. Progress against the two other primary interim targets and the remaining secondary targets is highlighted below. At a high-level the Fund is on track to achieve its targets, especially in regard to achieving 50% carbon intensity reduction by 2030. However, it is important to note that the Fund's performance against these metrics is unlikely to be linear due to the nature of the markets, and the influence of asset allocation year on year on the Fund's underlying figures.

10. In some cases, the Fund's baseline data as of 31 December 2019 has been restated within the report due to improved data available through LGPS Central's data provider. Any targets will be compared against the most up to date data available. More information on restated values are set out within page 32 of the Appendix.

Interim Primary Target	**2019 (restated)**	**2023**
40% absolute carbon emissions reduction for the Equity Portfolio by 2030 (tco2e).	196k tco2e	158k tco2e

11. This interim target is calculated using an attribution factor and a company's scope 1 and 2 emissions. The attribution factor is determined by the Fund's outstanding amount in a company, and the value of the financed company. This measures the absolute ton of scope 1 and 2 emissions for which the Fund is responsible.

12. The 19.4% reduction is between 2019 and 2023, and has been achieved despite a 19.8% increase in assets undermanagement over the same time period.

Interim Primary Target	**2019 (restated)**	**2023**
50% carbon intensity reduction by 2030 for the Equity Portfolio (tCO_2e/$m)	164.4	102.0

13. This interim target is calculated by dividing a company's scope 1 and 2 emissions by their million dollars in sales, for each portfolio company and calculating the weighted average by portfolio weight. This acts as a proxy for carbon price. Were a global carbon price to be introduced in the form of a carbon tax this would be more

financially detrimental to carbon intensive companies, than to carbon efficient companies.

14. This measure has decreased by 38%. This is largely led by a decline in asset allocation by active managers in hard-to-abate sectors such as energy and materials, as well as a backdrop of declining carbon intensities of companies within these sectors, partially driven by revenue growth outstripping emissions growth. As the Appendix shows these metrics both progress well in relation to Fund targets, they are also outperforming reference indices (A benchmark of 209.8), with all actively managed portfolios having lower carbon metrics compared to their market index.

Secondary Target	**2019 (restated)**	**2023**
Reduce exposure to fossil fuel reserves within the Equity Portfolio	5.7%	5.2%

15. This metric includes any company that own fossil fuel reserves, thermal coal reserves or utilities deriving more than 30% of their energy mix from coal power. The Fund considers this a measure of its exposure to the risk of stranded assets. However, this does not account for the amount of revenue a company generates from fossil fuel activities. This may mean this includes companies who in reality may not bear as much stranded asset risk, as those that generate a high proportion of revenue from fossil fuels. The Fund's exposure is also below the reference benchmark portfolio of 7.7%.

16. Given the relatively basic form of this metric since 2022 Central have also provided another measure to work around limitations of the above metric based on fossil fuel revenue which identifies the maximum percentage of revenue, either reported or estimated, derived from conventional oil and gas, unconventional oil and gas as well as thermal coal. These values by companies are summed and weighted by the portfolio weights to produce a weighted exposure. For the first time the Fund can report a 2019 baseline for this measure of 2.3%, this has reduced to 1.9% in 2023. It is worth noting this measurement estimates where reported values are not available and may overestimate exposure.

Secondary Target	**2019 (restated)**	**2023**
Increase exposure to climate solutions within the Equity Portfolio	36.6%	39.4%

17. This metric shows the weight of the Fund's equity portfolio in companies whose productions include climate solutions such as alternative energy, energy efficiency, green buildings, pollution prevention and sustainable water. It is worth noting that this metric is compiled from a wide range of the data providers data points and there is no universal standard definitive list for climate solutions.

18. When considering this metric by revenue, as in paragraph 15, we can see an increase from 4.3% to 5.4%. This allows for a comparison of the portfolio exposure to clean technology adjusted according to a proportion of the underlying companies

size. This measure is also using maximised estimated where data is not available, meaning there is a potential to overestimate exposure.

Secondary Target	**2019**	**2023**
Increase Asset Coverage	45%	47%

19. The current data able to be analysed as part of the Appendix is 47% of the Fund's assets under management. While additional underlying funds have been included in this year's climate report, data coverage has remained limited. LGPS Central's next focus will be to improve data availability for fixed income and adding sovereign emissions data which will further improve these measures.

Secondary Targets	**2023**
90% of the Fund's assets under management in material sectors are classified as achieving Net Zero, aligned or aligning by 2030.	68.3%
90% of the Fund's financed emissions have net zero targets, alignment pathway or subject to engagement by 2030.	80.7%

20. These targets provide the Fund with a forward-looking measure to understand the extent to which the underlying portfolio is aligning to net zero. The Fund's Net Zero Climate Strategy set out the intention to work with LGPS Central to set alignment targets.

- For the material sectors target we can consider sectors such as mining, metals and construction which are largely the highest impact companies especially.
- For the financed emissions target this will support the former target, as well as drive increased engagement with companies.

21. A company is considered at least aligning to the Paris Agreement by LGPS Central at this stage if:

    a. The company scores above median in the Low Carbon Transition Score, and it meets one of the following criteria:

    b. The company has a science based target **<u>or</u>** the company has an implied temperature rise rating of 2degrees or lower.

22. This metric is set out in more detail on pages 26 and 27 of the appendix. The Fund will be able to monitor progress against these targets in future years, as well as looking at how the Fund can consider

23. The last of the Fund's secondary targets relate to Leicestershire County Council and LGPS Central becoming net zero operationally by 2030. Leicestershire County Council has set a net zero 2030 operational target. LGPS Central are looking to set an operational target during 2024.

24. Evidently the Fund's portfolio appears to moving in the right direction in line with what was set out within the Net Zero Climate Strategy not only in relation to progress against the Fund's baseline, but in comparison to reference indexes. The

Fund will continue to monitor and report on progress against these targets, with a view to the review of the Net Zero Climate Strategy due in 2026.

25. These metrics are not the Fund's only method of monitoring climate risk and opportunity as set out in more detail within the appendix. This includes metrics expected to be required from the Department for Levelling Up, Housing and Communities (DLUHC) and other metrics available to LGPS Central which provide the Fund with a deeper assessment of climate risk and opportunity.

26. Some highlights from each asset class analysis are set out below:

<u>Listed Equity (£2.5bn AUM)</u>

a. Data availability remains high for listed equity, however the majority of data is company reported data. LGPS Central are looking to enhance the approach to data validation process to reflect the real quality of data that is used.

b. Carbon metrics for equities have consistently outperform the reference indices. All actively managed portfolios have lower carbon metrics compared to the reference index. This may suggest that delegated managers are managing climate risk exposure in their respective portfolios.

c. Cement producers CRH, Holcim, Cemex and Huaxin were negative contributors to the Fund's relative financed emissions due to their relative overweight positions. However, these have had an overall positive effect on financed emissions, as investment managers selected these names against worst relative emitters in the Materials sectors.

d. Relative to reference indices the Fund's equities portfolios have lower exposure to fossil fuels, thermal coal and coal power generation.

e. 69.5% of financed emissions within equity is in one or more climate engagement plan by the Fund and its engagement partners and providers. However, currently only four out of eight of the Fund's climate stewardship focus list companies are in the top 10 of contributors of emissions, which the Fund may need to review with LGPS Central.

<u>Fixed Income (£521m AUM)</u>

f. Data availability within fixed income continues to lag equties. The fixed income section analyses £201m of £521 assets in scope. Financed emissions for fixed income increased in 2022 due to the addtion of a fund into the model. Any consideration of the metrics should be considered with data weaknesses in mind. .

g. Weighted average carbon intensity within fixed income has decreased year on year, alongside a significant increase in exposure to financials and decrease in exposure to energy.

h. Within fixed income only 43.8% of financed emissions is currently under one or more engagement programme. This recognises difficulties within the asset class facing engagers. This is also exacerbated by high portfolio turnover as engagers cannot commit to long-term engagement plan with a single issuer. This will need to be an area of focus with partners.

Recommendations and Considerations of the Climate Risk Analysis

27. For the first time the report sets out expected climate reporting requirements from Department for Levelling Up Housing and Communities, subject to the outcome of the consultation undertaken in late 2022. LGPS Central have also produced a disclosure maturity map, and industry best practice and recommendations where the Fund, working with LGPS Central can improve future iterations of the Fund's Taskforce for Climate related Financial Disclosure (TCFD) reporting, which the Fund has voluntarily been reporting on since 2020. This is set out on pages 8 to 19 of the appendix.

28. This analysis has focused on pension schemes and financial institutions outside of the LGPS given the Fund can likely be considered in advanced stages compared to many LGPS peers due to its early adoption, and consideration of guidance from the Department for Work and Pensions in relation to occupational schemes. From this analysis there are a number of recommendations we can look to implement in the coming year, as set out below.

Section	**Considerations / Recommendations**
Governance	• Disclosure of participation in responsible investment/climate working group(s). • Additional detail on training program to Pension and Investment committee included in TCFD.
Strategy	• Integrate climate scenario analysis of both the Fund's funding and investment. • Disclosure of choice of scenario within scenario analysis. • Consider further integration of climate considerations with Funding Strategy Statement. • Work with appointed managers to understand how key transition and physical risks are assessed within high impact sectors.
Risk Management	• Continue to review current risk management processes including the list of companies within the Climate Stewardship Plan
Metrics and Targets	• Additional information regarding the choice of metrics, use cases and drawbacks. • Inclusion of engagement statistics in TCFD. • Additional metrics to meet DLUHC requirements shall be included in the next iteration of the Fund's TCFD report.

Next Steps

29. As well as continuing progress against the Fund’s Net Zero Climate Strategy. The Fund will begin preparation for the next Climate Risk Analysis. The Fund looks to utilise climate scenario analysis biennially and will explore with LGPS Central how it can integrate this analysis of both funding and investments.

30. The Fund will continue to work with LGPS Central as part of their review of stewardship activities in how this can support the Fund with net zero ambitions. Given only four of eight climate stewardship companies remain in the Fund’s top emitters, the Fund will work with LGPS Central to monitor this trend, and review if required.

31. Working with LGPS Central and external managers the Fund will look to continue ongoing monitoring of underlying managers, especially in relation to their engagement with top contributors within their portfolios.

32. For January 2024, the Fund will integrate these actions into the Responsible Investment Plan for 2024 alongside the recommendations within paragraph 27, subject to approval by Committee. The Climate Report Analysis has also been shared with the Fund’s external Investment Advisor and will be taken into account as part of the Fund’s Strategic Asset Allocation review.

33. The Fund will communicate high-level results from this report recognising the interest of scheme members in climate related matters.

Supplementary Information

34. An exempt paper is included elsewhere on the agenda which includes information regarding the underlying mandate climate metrics which cannot be included for public consideration due to the contract between the data provider and LGPS Central.

Recommendation

It is recommended that:

a) The Climate Risk Analysis be noted.
b) That the recommended actions and considerations set out in paragraph 28 be approved for inclusion within the Fund’s Responsible Investment Plan 2024.

Equality Implications

35. There are no direct implications arising from the recommendations in this report. The Fund incorporates financially material Environmental, Social and Governance (“ESG”) factors into investment processes. This has relevance both before and after the investment decision and is a core part of the Fund’s fiduciary duty

Human Rights Implications

36. There are no direct implications arising from the recommendations in this report. The Fund incorporates financially material Environmental, Social and Governance (“ESG”) factors into investment processes. This has relevance both before and after the investment decision and is a core part of the Fund’s fiduciary duty

Appendix

Climate Report Analysis 2023

Background Papers

3 March 2023 Local Pension Committee: **Outcome of Consultation on Net Zero Climate Strategy and Responsible Investing Update**

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