LOCAL PENSION BOARD – 7 FEBRUARY 2024

NET ZERO CLIMATE STRATEGY PROGRESS UPDATE

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

Purpose of the Report

1. The purpose of this report is to provide an update on the latest Climate Risk Management Report for the Leicestershire County Council Pension Fund and activities of the Fund since approval of the Net Zero Climate Strategy.

Policy Framework and Previous Decisions

2. The Fund must follow the law and statutory guidance for preparing and maintaining its Investment Strategy Statement and must take proper advice and act prudently when making investment decisions. Subject to this, the Fund should consider any factors that are financially material to the performance of its investments, including environmental, social and governance (ESG) factors. This includes considerations over the long term, dependent on the time horizon over which the Fund's liabilities arise. These decisions are taken by the Local Pension Committee.

3. In November 2021 the Local Pension Committee agreed to commence work on producing the Fund's first Climate Strategy, recognising the systematic impact climate change could have on the Fund. Following extensive engagement and consultation with scheme members, the Committee, advisors, and the Local Pension Board, a Net Zero Climate Strategy (NZCS) was approved 3 March 2023.

Background

4. As set out in the Fund's Investment Strategy Statement the Fund holds investments in various asset classes, which includes the world's biggest companies in sectors that include manufacturing, technology, and transport. Climate change is a systematic risk where the climate actions, or inaction, of companies can positively or negatively affect other companies, as well as the overall economy.

5. The NZCS outlines the Fund's strategic approach to managing climate risk, and proposed approach to achieving net zero by 2050, with an ambition for sooner. This includes some changes to the metrics and targets engaged on in

order to simplify and better align the targets to the guidance provided by the Institutional Investor's Group for Climate Change.

6. The NZCS aligns with the investment belief set out in the Investment Strategy Statement that the Fund must ensure the portfolio is not overexposed to specific risk factors, ensuring it remains well-diversified across regions, technologies, and sectors. This may relate to technological risk and ensuring the Fund does not overvalue 'green' assets as part of a 'green bubble', does not have overexposure to new technology without proven track record, or be at risk from governmental policy reversals, for example.

7. In recognition of the risk climate change poses, LGPS Central on behalf of the Fund has produced a Climate Risk Report annually since 2020. This report combines bottom-up and top-down analysis and is 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 enables 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.

Progress Against the Fund's Net Zero Climate Strategy

8. The latest Climate Risk Management Report takes a snapshot of Fund data as at 31 March 2023. Progress against the Fund's Net Zero Climate Strategy targets are set out at a high level below. These all contribute to the Fund's high-level primary target of net zero by 2050, with an ambition for sooner.

9. In some cases, the Fund's baseline data as of 31 December 2019 has been restated due to improved data available through the data provider. Any targets have been compared against the most up to date and accurate data available.

Interim Primary Target	2019 (restated)	2023	Difference
40% absolute carbon emissions reduction for the Equity Portfolio by 2030 (tco2e).	196k tco2e	158k tco2e	-19.4%

10. This 2030 interim target measures the total amount of greenhouse gases (scope 1 and 2) attributable to the Fund's ownership of shares in underlying companies.

11. 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	Difference
50% carbon intensity reduction by 2030 for the Equity Portfolio (tCO2e/$m)	164.4	102.0	-38%

12. This 2030 interim target is calculated by dividing a company's scope 1 and 2 emissions per million dollars in sales, for each portfolio company and calculating the weighted average by portfolio weight. This measure 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.

13. This measure has decreased by 38%. This is largely led by a decline in asset allocation by the Fund's 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 companies income growth outstripping emissions growth.

14. Both 2030 interim metrics progress well in relation to Fund targets, they are also outperforming the reference market index, with all actively managed portfolios having lower carbon metrics compared to the relevant 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 companies owning fossil fuel reserves, thermal coal reserves or utilities deriving more than 30% of their energy from coal. This can be considered a measure of exposure to the risk of stranded assets. However, this does not account for the company's revenue from fossil fuels, potentially including companies with lower actual risk. The Fund's exposure is also below the reference benchmark portfolio of 7.7%.

16. To address limitations, a new measure based on fossil fuel companies' revenue was introduced. It calculates the maximum revenue percentage from conventional and unconventional oil, gas and thermal coal. The 2019 baseline for this measure of 2.3% 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 16, 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 estimates 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 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 pathway, in keeping global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius, by LGPS Central at this stage if:

    a. The company scores above median in the Low Carbon Transition Score, which assesses how well a company manages risks and opportunities related to the low carbon transition, and it meets one of the following criteria:

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

22. 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, aligning with the Net Zero Climate Strategy. It is making progress against the 2019 baseline and when compared to reference indexes. This will be kept under review annually, with a review of the Net Zero Climate Strategy due in 2026. It is important to note performance may not be linear due to market fluctuations and yearly changes in asset allocation.

25. The Fund additionally uses other methods to monitor climate risk, including metrics expected to be required from the Department for Levelling Up, Housing and Communities (DLUHC) and other metrics available to LGPS Central. These provide a deeper assessment of climate risk and opportunity.

Action Taken

26. Alongside the targets and metrics within the Net Zero Climate Strategy there are also key areas around investment, engagement and stewardship. Some highlights are set out below.

27. Investments: As at the end of 2023 the Fund has already invested over £1billion in funds that ties in climate friendly factors with positive financial performance:

    a. Forestry investments, the Fund's holdings sequester the equivalent to the annual emissions from 233,000 cars. A recent investment has also been into a Carbon Offset Fund which looks to plant new forests, and reforestation to provide a source of sustainable low carbon wood and verifiable carbon offsets.

b. £800million in a climate fund, which favours investment in companies that take a proactive approach to environmental factors, tilting away from the worst emitters.
c. £55m in solar power with battery systems, to support the decarbonisation of the energy system, and as part of demand from data centres.
d. A Low Carbon Transition Fund that reduces exposure to fossil fuel, while improving exposure to climate solutions and decarbonises yearly.

28. Engagement with companies: The Fund works with its partners including LGPS Central and the Local Authority Pension Fund Forum and investment managers. In 2022/23 the Fund voted at 6,256 meetings (76,588 resolutions), opposed one or more resolutions in 4,165 meetings (mainly on board structure), and supported all resolutions in 1,963 meetings.

29. Annual progress reports from LGPS Central and the Local Authority Pension Fund Forum are received, and the Local Pension Committee receives quarterly reports on engagement matters.

30. The Fund engages with investment managers who consider climate risks, supporting the Fund's long-term goal. Many of the Fund's external managers have set net zero ambitions and have already begun measuring the impact of their portfolios, given these portfolios do not include climate factors as a mandate requirement. Officers monitor manager data and engage with them on progress made, even where these asset classes remain out of scope of the Fund's annual climate report.

Next Steps

31. Actions arising from the latest Climate Risk Management Report were included within the Responsible Investment Plan 2024 as agreed by the Local Pension Committee in January 2024.

32. 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.

33. The Pension Fund as a long-term investor must take a long-term view of its approach to investments. The Fund will review the NZCS and targets at least every three years and monitor progress annually as part of the Climate Risk Report. This will be supported through other Fund documents such as the Strategic Asset Allocation, Investment Strategy Statement, Funding Strategy Statement, and risk register.

Equality and Human Rights Implications

34. The Strategy recognises many human rights factors are adversely affected by climate change. While there are no direct implications from the Net Zero Climate Strategy, as part of the Fund's approach to Responsible Investment the Fund seeks to ensure it continues to incorporate Environmental, Social and Governance issues in all areas of investment practices in line with the Principles for Responsible Investment as set out in the Investment Strategy Statement.

35. These considerations include engaging with companies through investment managers, the Local Authority Pension Fund Forum and LGPS Central to ensure they manage risks around the transition to a low carbon economy that includes key issues around labour and human rights.

Background Papers

Local Pension Committee – 1 December 2023 – Climate Risk Management Report
https://democracy.leics.gov.uk/documents/s179981/LPF_Climate-Risk-Management-Report_Public.pdf

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