LOCAL PENSION BOARD – FEBRUARY 2025

DIRECTOR OF CORPORATE RESOURCES

NET ZERO CLIMATE STRATEGY PROGRESS UPDATE

Purpose of the Report

1. The purpose of this report is to provide an update to the Local Pension Board (LPB) 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. Responsible investment (RI) factors have long been a consideration for the Leicestershire County Council Pension Fund having satisfied itself that potential investment managers take account of RI as part of their decision-making processes before they are considered for appointment.

3. The Fund must follow the law and statutory guidance for preparing and maintaining its Investment Strategy Statement (ISS) 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 (LPC).

4. Climate change factors have been considered by the Fund for a number of years. This was enshrined in the Fund's ISS and Net Zero Climate Strategy (NZCS), both approved on 3 March 2023 by the LPC. These climate considerations have also been built into other strategies and the Fund's risk register.

Background

5. The term 'responsible investment' refers to the integration of financially material ESG factors into investment processes. It has relevance both before and after the investment decision and is a core part of the Fund's fiduciary

duty. It is distinct from ‘ethical investment’, which is an approach in which the moral persuasions of an organisation take primacy over its investment.

6. The Fund’s approach to RI matters have been incorporated into the ISS and all actions the Fund undertakes. These are considered in two key areas:

   - Sustainable Investment: considering the financial impact of ESG factors on its investments.

   - Stewardship and Governance: acting as responsible and active investors/owners through considered voting of shares and engaging with investee company management as part of the investment process.

7. In relation to climate risk specifically, 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 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.

8. 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 alongside eight other targets, 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

<u>Net Zero Climate Strategy Progress</u>

9. The latest Climate Risk Management Report was reported to LPC on 29 November 2024. 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 as at 31 March 2024.

10. Progress against the Fund’s NZCS 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.

11. High-level progress against these targets is set out below which show where the Fund has exceeded initial expectations for its net zero journey for in-scope investments.

    a. The Fund has achieved its first interim target of reducing the weighted average carbon intensity (WACI) by 50% by 2030, with an actual reduction of 52.8%, meaning the Fund is less exposed to carbon price risk for in-scope investments.

b. The Fund has also achieved its second interim target of having reduced its financed emissions by 40%, with an actual reduction of the total carbon emissions the Fund is responsible for by 40.4% from a baseline set in 2019, by 2030 for in-scope investments.

c. The Fund now has over £1.3billion (circa 20% of the total Fund) directly allocated to climate-related investments across equity, debt, infrastructure and forestry.

d. Within the equity portfolio 75.7% of equity financed emissions are considered to be aligned/aligning to the Paris Agreement, or under and engagement programme. This sets the Fund on a positive trajectory to 2050 in supporting real-world change.

e. The Fund is able to measure 57.4% of total Fund assets up from 47% in 2023 ahead of the scheduled timeline within the NZCS.

12. This progress is against the backdrop of increasing assets under management and equities that are continuing to outperform the market benchmark, showing the Fund is continuing these positive climate actions in a way that is supporting the Fund's fiduciary duty.

13. It is important to keep in mind that performance will not be linear and that many different factors can impact carbon metrics. Up to this point the Fund has made some of the most significant changes through asset allocation decisions which are not as available for remaining asset classes at this point in time. In support of real-world carbon reductions, the Fund will need to engage with its partners and investment managers on where further success can be achieved.

14. The Climate Risk Management Report goes into further detail on all the actions that the Fund and LPC has taken in line with best practice. Progress shows early success which would not have been possible without a strong direction and commitment to net zero by the LPC.

Interim (2030) Primary Targets

15. Where indicated the Fund's baseline data as of 31 December 2019 has been restated within the report due to improved data available through the data provider. This is where estimated data has been replaced by company reported data. Any targets are compared against the most up to date data available.

	Use Case	2019[1]	2023[2]	2024	% chg since 2019
50% carbon intensity reduction by 2030 for the Equity Portfolio (tCO2e/$m sales)	Exposure to carbon-intensive companies.	162.3	91.5	76.7	-52.8%
40% absolute carbon emissions reduction for the Equity Portfolio by 2030 (tCO2e).	Total carbon footprint of the Fund.	189k	144.9k	112.8k	-40.4%

16. The majority of the reductions can be attributed to the significant changes to the Fund's equity portfolio since 2019 in investing in the Low Carbon Transition fund and Climate Multi-Factor fund. As at the snapshot the Fund held an overweight to the all-world passive equity fund and had yet to divest from an emerging market fund. All else being equal this would have further improved these metrics.

17. The decreases can also be attributed to a decline in asset allocation by active managers in hard-to-abate sectors such as energy and materials, towards companies within those sectors to better climate credentials. As well as a backdrop of declining carbon intensities of companies within these sectors, partially driven by sales growth outstripping emissions growth.

Secondary Targets

Exposure to Climate Solutions and Fossil Fuels

18. As part of the NZCS it was agreed to set targets to focus on reducing exposure to fossil fuel reserves and increasing exposure to climate solutions in recognition of their respective importance in supporting the climate transition. This was despite these targets not being required or recommended through the TCFD. At the time these were set, the rudimentary nature of these metrics was recognised along with the fact that the measures would need to evolve over time as set out within the NZCS.

19. The key issue with the metrics is that they include any company within the Fund's portfolio that has at least £1 in fossil fuel reserves or climate solutions. For both measures this results in overstating the Fund's exposure. For example, the fossil fuel reserves exposure increase is partly as a result of an increased holding in Berkshire Hathaway, a relatively large holding in the financial sector. While the company derives less than 1% of its revenue from fossil fuel reserves, this measure considers the entire portfolio weight to be exposure to fossil fuel reserves.

[1] Restated figures as per page 33 of Appendix A.
[2] As above.

	2019 (restated)	2024
Reduce exposure to fossil fuel reserves within the Equity Portfolio		
Reserves exposure	5.5%	6.4%
By revenue	2%	1.9%
Increase exposure to climate solutions within the Equity Portfolio		
Climate solutions exposure	35.6%	42.7%
By revenue	4.2%	6.5%

20. As a result, at the meeting on 29 November 2024 LPC agreed to revise the focus of the measure to the ‘by revenue’ metric. This will show how reliant the Fund’s portfolio is on revenue from fossil fuel or climate solutions, though this may still result in some overestimation. For example, where oil prices have risen companies will receive greater revenue from this, despite their exposure not changing. Therefore, it is important to continue to monitor both and understand the reasoning behind any changes rather than the numbers alone.

21. These points remind us of the importance of looking holistically at the Fund’s exposure and reasonings for the figures overtime. While having resolved the overweight, or divesting earlier from specific funds would have looked better in the short-term, these would not have helped the Fund in having to hold excess cash.

Secondary Target	2019	2023	2024
90% coverage of assets measured by 2030	45%	47%	57.4%

22. This target remains ahead of the scheduled NZCS timescale. For the first time LGPS Central (Central) have included private market data in their analysis on Central managed portfolios, though this is still limited on a number of metrics. The Fund will work with Central on how externally managed mandates can be included in future.

Secondary Targets	2023	2024
90% of the Fund’s assets under management in material sectors are classified as achieving Net Zero, aligned or aligning by 2030.	68.3%	64.2%
90% of the Fund’s financed emissions are classified as achieving Net Zero, aligned or aligning, or subject to engagement by 2030.	80.7%	75.7%

23. 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 NZCS set out the intention to work with Central to set alignment targets.

24. A company is considered at least aligning to the Paris Agreement by 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.

24. This is only the second year that these metrics are able to be reported against:

- For the material sectors target we consider the definition set by the Net Zero Investment Framework to ensure efforts are channelled to the material sources of greenhouse gas emissions. While the percentage has decreased since 2023, while the percentage has decreased this is as a result of an increase in material sectors while those categorised aligned or aligning has remained the same.

- For the financed emissions target this will support the former target, as well as drive increased engagement with companies. Since this measure was first reported Central have put in place stricter rules in how they determine engagement, however, the previous year's data is unable to be reattributed. This does not cover assets engaged through the Local Authority Pension Fund Forum, Legal and General or other Investment Managers.

25. The Fund will continue to work with Central on how best to attribute these factors and how to support increased alignment over time.

26. The last of the Fund's secondary targets relate to Leicestershire County Council and Central becoming net zero operationally by 2030. Given financial challenges with decarbonising the broader operations Leicestershire County Council agreed that this target would be pushed back to 2035. The Fund continues to discuss with Central its ability to become net zero operationally by 2030.

27. The Fund will continue to monitor and report on progress against all targets, with a view to the review of the NZCS due in 2026.

28. These metrics are not the Fund's only method of monitoring climate risk and opportunity as set out in more detail within Appendix A. This includes metrics expected to be required as part of mandatory TCFD reporting and other metrics available to Central which provide the Fund with a deeper assessment of climate risk and opportunity.

29. Over the years Central in conjunction with the Fund has developed a Climate Stewardship Plan (CSP) to prioritise companies for climate engagements. This list is designed to identify the Fund's top contributors of financed emissions, as well as aligning with Central's climate stewardship priority companies and is intended to support the delivery of meaningful portfolio company research and updates. These companies are chosen following an assessment of issuer contributions to financed emissions and the Fund's capacity to leverage change through engagement.

Company Name	Weight in Total Portfolio (%)	Contribution to Total Financed Emissions
Shell	0.4%	4.3%
Cemex	0.1%	3.4%
CRH	**0.1%**	**2.5%**
Holcim	<0.1%	2.1%
bp	0.2%	1.1%
Glencore	0.2%	1.6%
Linde	0.2%	1.1%
Taiwan Semiconductor Manufacturing	1.2%	0.9%

30. These companies are engaged with by Central on the Fund's behalf. Progress against these companies, and others are reported to LPC quarterly.

Fund Benchmarking

31. Officers have benchmarked the Fund against other LGPS peers where public data is available, and data looks to use the same methodology. Despite this there are still caveats which may prevent like for like comparisons, such as different data providers, assumptions used and the date at which a snapshot has been taken among other factors. It is also important to note that climate risk cannot be distilled into one single metric, and these are only backwards looking measures. Furthermore, it is worth noting that the LGPS funds reporting these figures are doing so before mandating so may also represent those already doing more than an average Fund.

32. The most widely used measure that the Fund can compare relates to the Weighted Average Carbon Intensity (WACI): a portfolio's exposure to carbon intensive companies. A proxy for carbon price risk

33. The Fund is performing comparably and ahead of the majority of peers. For WACI you can consider this an indicator the Fund may be at less risk from the impact of carbon pricing. Of the funds performing comparably or better they are generally on the same trajectory with asset allocation decisions driving the reductions with allocations to funds similar to the LGIM Low Carbon Transition Fund, alongside more standard passive index allocations.

Fund	Snapshot date	WACI (tco2e/$m revenue)
Leicestershire	Mar-24	77
LGPS H	Mar-23	57.6
LGPS C	Mar-24	66
LGPS J	Dec-23	79
LGPS K	Mar-24	84
LGPS E	Mar-22	90
LGPS G	Jun-23	99
LGPS B	Mar-22	100
LGPS F	Mar-23	104
LGPS D	Mar-22	123
LGPS A	Mar-23	153
LGPS I	Mar-23	228

Next Steps

38. The Local Pension Committee is due to consider the RI Plan on 31 January 2025. The Plan was developed following discussion with Central's in-house RI team. The Fund has a continual focus on raising RI standards.

39. Highlights include continued discussions with investment managers, as outlined in more detail below, and continued work alongside Central on their approach to stewardship.

38. Ahead of this reporting cycle, officers had developed and circulated communications to scheme members that have signed up to Member Self-Service, which was subsequently circulated to LPC and LPB members of the 2023 progress against targets. This related to what had been achieved last year in managing climate change risks and opportunities. Officers will look to issue further communications to keep scheme members up to date on the progress of the Fund on this latest update. It is intended that a further newsletter in the year to communicate these latest updates, recognising the interest of scheme members in climate related matters.

Recommendation

39. It is recommended that the report be noted.

Equality Implications

40. 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

41. 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

Background Papers

Local Pension Committee – Friday 29 November 2024 – Climate risk Management Report and Responsible Investment Update:
https://democracy.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7662&Ver=4

Local Pension Committee, 3 March 2023, Minute 110, Outcome of Consultation on Net Zero Climate Strategy and Responsible Investing
Update: https://democracy.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7202&Ver=4

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