CT/21/55
Investment and Pension Fund Committee
18 June 2021

CLIMATE CHANGE AND CARBON FOOTPRINT

Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

Recommendation: (1) that the Committee approves the revised climate change section of the Investment Strategy Statement set out at Appendix 2 to this report.
(2) that the Committee approves the allocation of an additional £100 million to the Brunel Sustainable Equities portfolio to be funded from the UK Passive allocation.

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1. Introduction

1.1 Climate change continues to be a significant concern nationally and internationally. Locally, Devon County Council has declared a climate emergency and continues to be lobbied to do more. The Devon Pension Fund believes climate change poses significant risks to global financial stability and could thereby create climate-related financial risks to the Fund's investments, unless action is taken to mitigate these risks.

1.2 The Investment and Pension Fund Committee at its February meeting resolved to commit the Fund to achieving net zero investment portfolios by 2050. The full text of the commitment, which was launched by the Institutional Investors Group on Climate Change (IIGCC) in March, is set out at Appendix 1 to this report. The full detail of the commitment will require further strengthening of the Fund's policies on climate change, and this is addressed further by this report.

1.3 A key element towards achieving the net zero target will be continued monitoring of the Fund's carbon footprint and exposure to extractive industry and potential stranded assets. A full analysis of the Fund's carbon footprint is carried out on an annual basis, and this report provides details of the assessment as at 31 December 2020.

2. IIGCC Net Zero Commitment

2.1 At its February meeting the committee resolved to be a signatory to the IIGCC's net zero commitment, as set out at Appendix 1. In addition to the headline pledge to achieve net zero portfolios by 2050, the commitment also
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requires the Fund to consider interim targets and publish a climate action plan within a year of making the commitment.

2.2 The Fund's policy in relation to climate change is set out within section 5 of the Investment Strategy Statement. It is therefore proposed to revise the section on climate change to meet the requirements of the commitment and to make clear the Fund's objectives. A revised policy on climate change is therefore set out at Appendix 2 to this report. The revision should not be seen as a radical change of direction for the Fund, but as a further strengthening of commitments already made and continued progress along a journey that the Fund has been undertaking in recent years.

2.3 The key changes are:

(a) Moving the net zero commitment to be at the forefront of the Fund's policy.
(b) Setting interim targets for progress by 2030.
(c) Setting a target for investment in renewable energy infrastructure (consistent with the Fund's current strategic asset allocation).
(d) Recognising the impact of strategic asset allocation on the Fund's carbon footprint.
(e) Further strengthening the Fund's expectations with regard to the work that Brunel and the Local Authority Pension Fund Forum do on behalf of the Fund.

2.4 The policy continues to emphasise that we want to see real reductions in global emissions, which means that we need to see investee companies reducing their emissions, rather than simply divesting from higher emitting companies and investing in lower emitting companies, which will do little to make any real difference to global emissions. The policy also reinforces that any review of our investments must continue to ensure that the Fund meets its fiduciary duty to achieve investment returns to meet its pension liabilities.

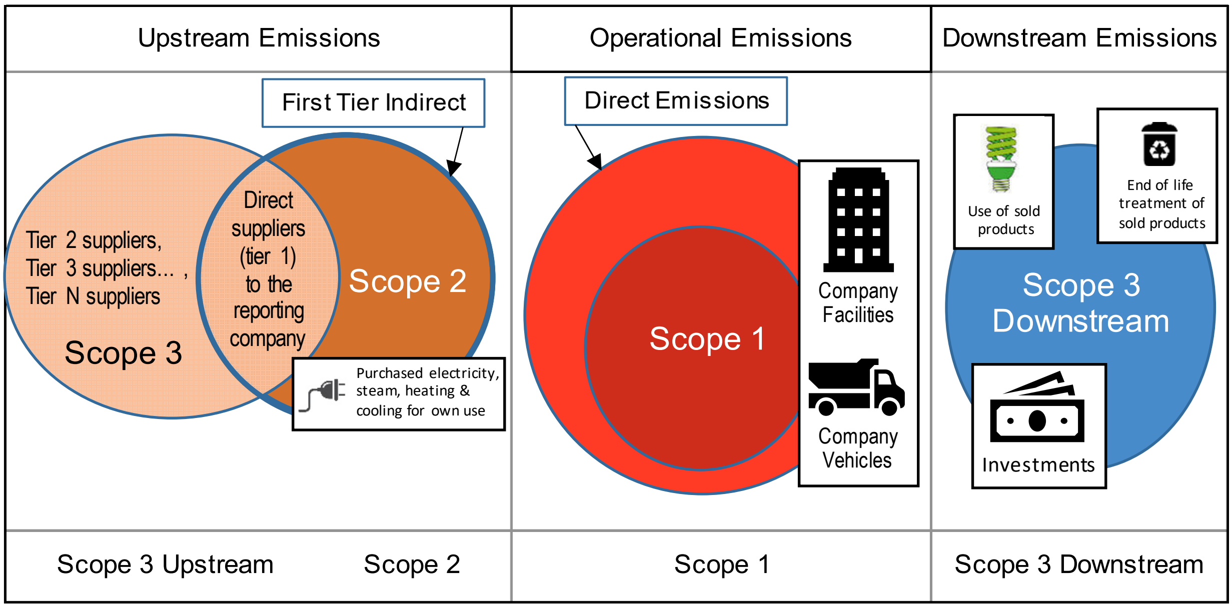
3. Carbon Footprint

3.1 Calculating the impact of a company's emissions involves looking not only at the operations of the company itself, but also looking at the impact of the products that it sells and the impact of its supply chain. Emissions are therefore split into scope 1, scope 2 and scope 3 emissions:

- Scope 1 – The direct emissions of the company's own operations.
- Scope 2 – The emissions related to the purchase of electricity, steam, heating and cooling for the company's use.
- Scope 3 Upstream – The emissions of the company's supply chain.
- Scope 3 Downstream – The emissions associated with the companies' products as they are consumed by customers.

These are illustrated in the following diagram.

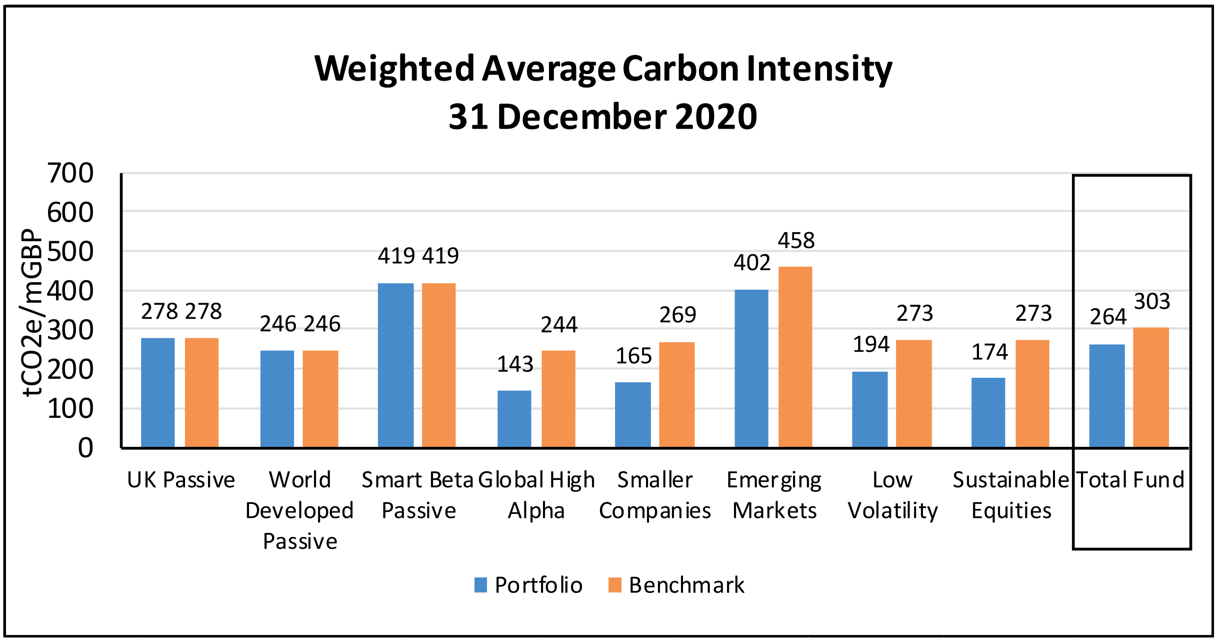
Greenhouse Gases – Scopes



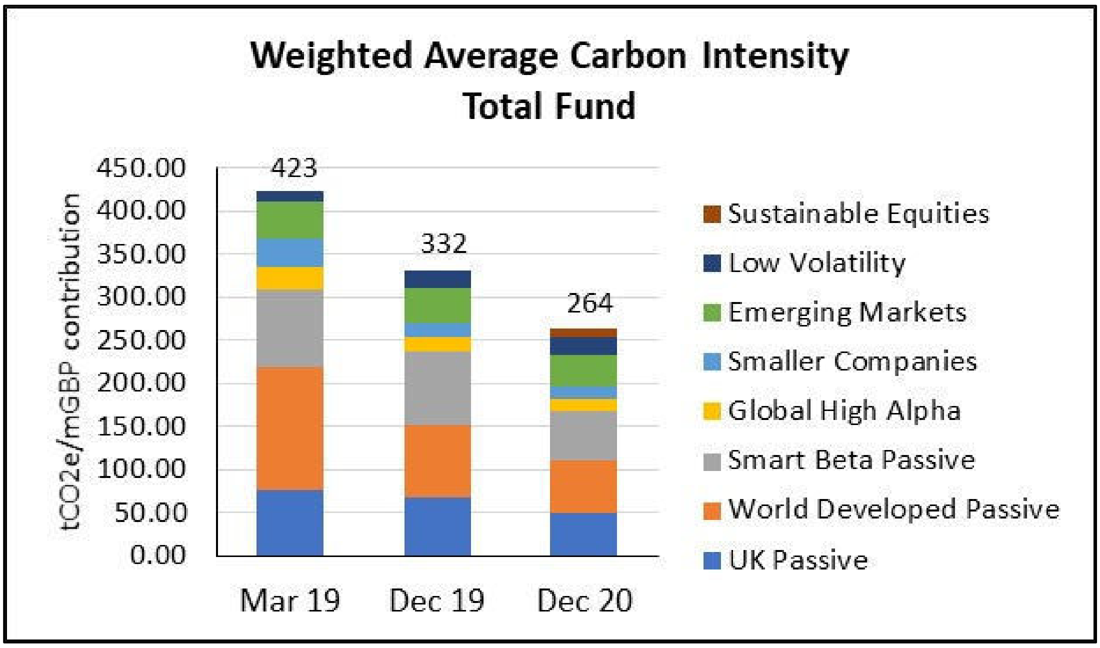
3.2 In analysing a portfolio of investment companies, there is the danger of double counting, where the scope 1 direct emissions of one company are the scope 3 downstream emissions of another company in the portfolio. However, from an investment risk perspective it is useful to know both the attribution of carbon risk (what is in the company’s direct control) and also the aggregate risk, from carbon risk within the supply chain. The Brunel/Trucost analysis of the Devon Pension Fund’s equity investments therefore takes into account Scope 1 direct emissions, Scope 2 (e.g. purchased power) and the first tier Scope 3 (immediate supply chain) emissions of investee companies, as shown in the diagram above. .

3.3 The analysis undertaken quantifies greenhouse gas emissions (GHG) embedded within a portfolio, presenting these as tonnes of carbon dioxide equivalents (tCO2e). Comparing the total GHG emissions of each holding relative to either revenues generated or capital invested, gives a measure of carbon exposure that enables comparison between companies, irrespective of size or geography. The weighted average carbon intensity (WACI) of each portfolio is measured by summing the product of each holding's weight in the portfolio with the company level carbon/environmental revenue intensity.

3.4 The WACI for each portfolio and for the Fund’s total equity holdings as at 31 December 2020 is shown in the graph below. The total Fund WACI has fallen from 332 tCO2e/mGBP in December 2019 to 264 tCO2e/mGBP in December 2020, a reduction of 20.5%. The WACI in December 2019 was below the benchmark and in December 2020 is further below the benchmark of 303 tCO2e/mGBP.



3.5 This is the third annual assessment of the Fund's carbon footprint. Progress since March 2019 is shown in the following chart, with the proportionate contribution from each equity portfolio also highlighted.



3.6 The chart shows an overall reduction of 37% in the Fund's WACI since March 2019, which is good progress towards the target of a 50-75% reduction by 2030, and well ahead of the 7% per year target. It should be noted, however, that the COVID pandemic will have had an impact on the figures, as a reduction in economic activity has had a beneficial effect on reducing emissions. The growing share of the market of tech companies, with lower levels of emissions than traditional industries, will also have contributed. Therefore, it may be more difficult going forward to maintain this level of progress.

3.7 The chart also shows that the Fund's passive allocation contributes significantly to the WACI. In December 2020 the value of the passively managed assets was 56% of the total equity allocation, but accounted for

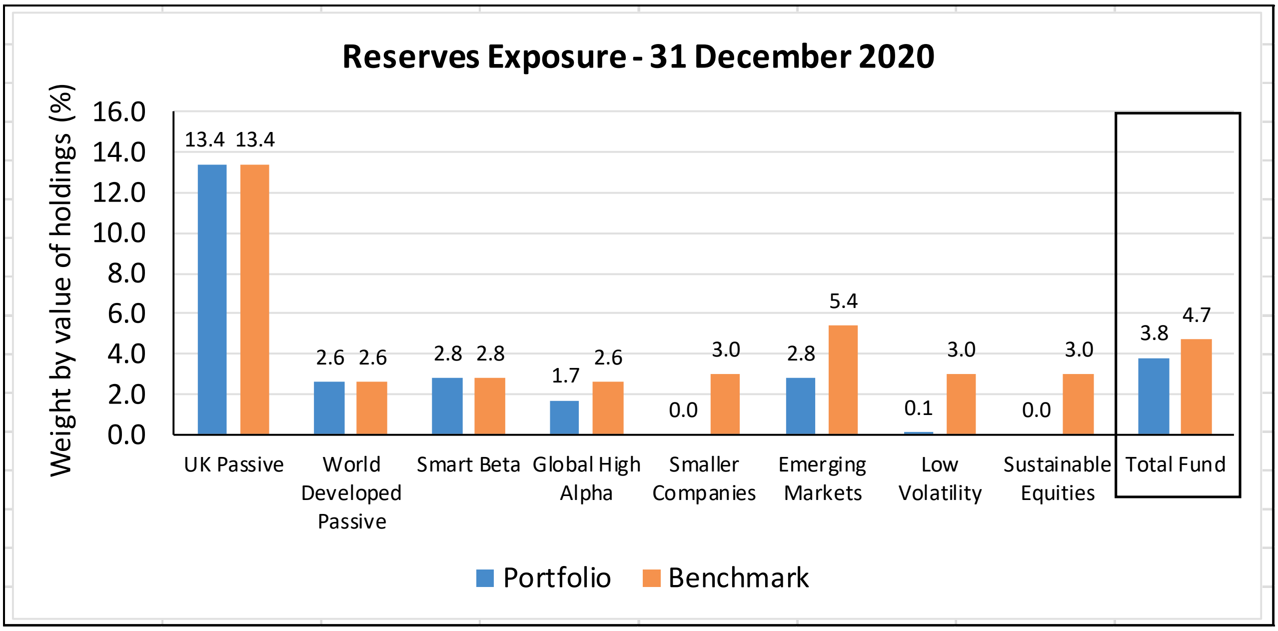
64% of the WACI. This demonstrates the impact of asset allocation, as the reduction in the proportion of equities managed passively from 71% in March 2019 to 56% in December 2020 will have contributed to the reduced carbon footprint. However, it is also the case that the WACI of the passive mandates has reduced which demonstrates that real economy emissions reductions are being achieved.

4. Reserves Exposure

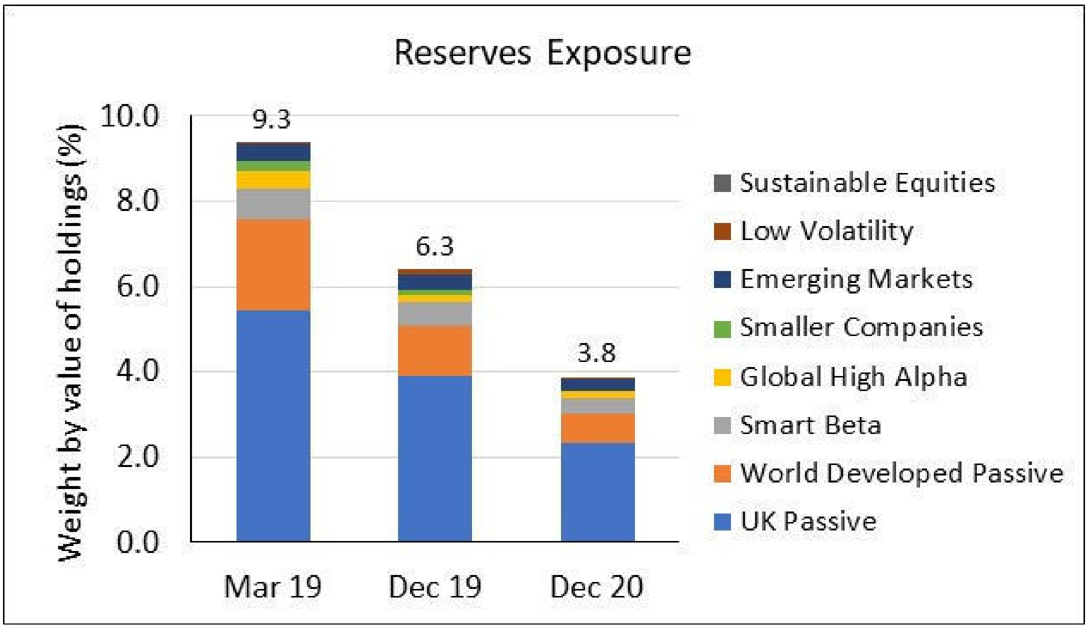
4.1 One of the issues with the WACI measurement is that it does not capture the downstream tier 3 emissions. Downstream Scope 3 emissions based on product in use (or disposal) are not widely calculated by companies or reported. However, downstream Scope 3 are critical when looking at the impact / investment risk of car manufacturers and fossil fuel companies.

4.2 This is linked with the risk involved in stranded assets, where companies may have large reserves of fossil fuels that will not be usable if we are to achieve carbon reduction targets across the economy and so become “stranded”. Exposure to reserves data is therefore a useful proxy for downstream emissions.

4.3 The reserves exposure for each portfolio and for the Fund’s total equity holdings as at 31 December 2020 is shown in the graph below. The figures shown are on a value of holdings basis, which means the value of any company with fossil fuel reserves is included in full in the analysis, regardless of what proportion of their business relates to extraction. Between December 2019 and December 2020, the reserves exposure fell from 6.3% to 3.8%.



4.4 The UK Passive portfolio tracks the FTSE All Share Index, which has a high proportion of resource companies (fossil fuels companies) including Royal Dutch Shell, BP and diversified mining companies. The significant contribution of the UK passive portfolio to the overall reserves exposure is further emphasised in the following graph which also shows the progress to date since March 2019.



4.5 In December 2020 the value of the UK Passive allocation was 17% of the total equity allocation, but accounted for 62% of the reserves exposure. However, it should also be noted that companies such as Royal Dutch Shell and BP are now setting emission reduction targets that do take account of downstream tier 3 emissions as part of their long term transition plans to diversify their business away from reliance on fossil fuels. This is a result of the significant engagement work lead by Climate Action 100+, supported by Brunel and the Local Authority Pension Fund Forum on behalf of the Devon Fund.

4.6 The reduction in reserves exposure should also be seen as good progress since March 2019.

5. Sustainable Equities

5.1 Brunel launched their Sustainable Equities portfolio in September 2020, and the Devon Fund made an initial investment of 3% of the Fund. The ISS sets out a medium term target of a 5% allocation, in line with the review of the Fund's investment strategy undertaken by Mercer Investment consultants in 2019. It is proposed that an additional £100 million should now be invested in the portfolio to bring the allocation up to the medium term target.

5.2 This portfolio includes a higher requirement on managers to look for companies promoting sustainability, which will include looking at issues such as climate change and promoting positive impacts on society. The Sustainable Equities portfolio is likely to provide some mitigation against falling markets and therefore assist with effective risk management.

5.3 It is proposed to fund the increased allocation to Sustainable Equities from the passive equity allocation. This is in line with the medium term target in the ISS and Mercer's recommendation to move to a position of splitting the total equity allocation 50/50 between active and passive mandates. It is proposed that the funding should come from the UK Passive equity allocation. This is also consistent with Mercer's view that the UK allocation should be reduced due to the sectoral biases in the UK market towards the resources and financial sectors. This will also reduce exposure to fossil fuel reserves and help to reduce the Fund's carbon footprint.

Mary Davis
County Treasurer

Electoral Divisions: All

Local Government Act 1972:
List of Background Papers: Nil
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The Paris Aligned Investment Initiative Net Zero Asset Owner Commitment

Commitment

As asset owners with millions of beneficiaries around the world, we reiterate our full support for the Paris Agreement and strongly urge governments to implement the actions that are needed to achieve the goals of the accord, with utmost urgency.

Recognising the need to address the risks that investors and their beneficiaries face from climate change, investors are taking action, but we acknowledge that there is an urgent need to accelerate the transition towards global net zero greenhouse gas emissions and do our part in helping deliver the goals of the Paris Agreement.

In this context, my institution commits to the following consistent with our fiduciary obligations:

1. Transitioning our investments to achieve net zero portfolio GHG emissions by 2050, or sooner
2. Implementing this commitment with the aim of achieving real economy emissions reductions and undertaking a comprehensive set of actions available to investors, drawing on the Paris Aligned Investment Initiative's Net Zero Investment Framework
3. Setting objectives and targets, including an interim target for 2030 or sooner for reducing Scope 1, 2 and 3 emissions associated with our portfolios and setting a target for increasing investment in climate solutions, consistent with a fair share of the 50% global reduction in CO_2 identified as a requirement in the Intergovernmental Panel on Climate Change special report on global warming of 1.5°C
4. Where offsets are necessary where there are no technologically and/or financially viable alternatives to eliminate emissions, investing in long-term carbon removals.
5. Ensure any direct and collective policy advocacy we undertake supports policy and regulation relevant for achieving global net zero emissions by 2050 or sooner
6. Implementing a stewardship and engagement strategy, with clear voting policy that is consistent with an objective for all assets in the portfolio to achieve net zero emissions by 2050 or sooner
7. Engaging with asset managers, credit rating agencies, auditors, stock exchanges, proxy advisers, investment consultants, and data and service providers to ensure that funds, products and services available to investors are consistent with achieving global net zero emissions by 2050 or sooner.

8. Setting a target and reducing our operational (Scope 1 and 2) emissions in line with achieving global net zero emissions by 2050, or sooner.
9. Disclosing objectives and targets, and publishing a clear Investor Climate Action Plan for achieving these goals as soon as possible, no later than one year from making this commitment, and reviewing and updating targets every five years or sooner.
10. Reporting annually on the strategy and actions implemented and progress towards achieving objectives and targets, and in line with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

Our institution's commitment recognises that investors across the globe have different opportunities, constraints and starting points for achieving net zero emissions and there are a range of methodologies and approaches available to investors to set targets and implement strategies. In some asset classes or for some investment strategies, agreed net zero methodologies do not yet exist. We will, therefore, work to address these challenges, including through the Paris Aligned Investment Initiative.

Our commitment is based on the expectation that governments and policy makers will deliver on their commitments to achieve the 1.5°C temperature goal of the Paris Agreement, and in the context of fulfilling our fiduciary obligations.

Any institutional asset owner may sign the Net Zero Asset Owner Commitment and use the Net Zero Investment Framework. To be recognised and showcased as making a net zero commitment under the Paris Aligned Investment Initiative an asset owner must complete and submit a signatory form to one of the four regional investor networks (AIGCC, Ceres, IGCC, IIGCC) indicating their CEO has approved signing on.

Asset owners that are members of AIGCC, Ceres, IGCC, IIGCC will have access to activities to support implementation of the commitment provided by the networks.

A separate Q&A document is available upon request and will be updated as relevant to provide further explanation and clarification of the commitment.

Climate Change

The Devon Pension Fund believes climate change poses significant risks to global financial stability and could thereby create climate-related financial risks to the Fund's investments, unless action is taken to mitigate these risks. In recognising the need to address the risks associated with climate change posed to both the Fund's investments and our beneficiaries, we acknowledge that there is an urgent need to accelerate the transition towards global net zero emissions and play our part in helping deliver the goals of the Paris Agreement.

The Devon Pension Fund has therefore pledged that its portfolio of investments will be net-zero by 2050 at the latest. In order to achieve this goal, the Fund has set an initial target of a 7% per annum reduction in the Weighted Average Carbon Intensity (WACI) of the Fund's investments, based on the March 2019 calculation of the WACI, to be reviewed in 2022. This recognises the need for significant progress in the earlier part of the period to 2050, with the intention of achieving a 60-75% reduction by 2030. These targets will also be applied to the Fund's exposure to fossil fuel reserves as a proxy for downstream scope 3 emissions which are not captured within the WACI calculation.

This will be achieved by the following strategy.

(a) We recognise that climate change will have impacts across our portfolios. This means we look to the Brunel Pension Partnership and all our asset managers to identify and manage climate-related financial risks as part of day-to-day fund management. The way those risks and opportunities present themselves varies, particularly in evaluating what a portfolio aligned to the Paris Agreement looks like.

(b) The Devon Fund wants to play its part in achieving real economy emissions reductions. This means that we are looking for investee companies to make significant reductions in their emissions, rather than just shifting our investments from higher emitting companies to lower emitting companies. The Fund does not therefore consider a top-down approach to disinvestment to be an appropriate strategy. By integrating climate change into risk management process, using carbon footprinting, assessing fossil fuel exposure and challenging managers on physical risks, we seek to both reduce climate and carbon risk and achieve real reductions in global emissions. Where investee companies fail to engage with climate change issues, selective disinvestment may be appropriate based on investment risk.

(c) We are committed to working with Brunel to decarbonise our investments in listed portfolios. Decarbonisation is achieved by being selective in the allocation of capital, particularly to carbon intense companies. This process is informed by using a variety of tools in combination with industry and corporate engagement. For example, engagement with electric utility companies about their future strategy on energy sources informs the investment decisions relating to those companies and indeed the relative attractiveness of the sector over time.

(d) The Fund will collaborate via the Brunel Pension Partnership, the Local Authority Pension Fund Forum (LAPFF) and the Institutional Investors Group on Climate Change (IIGCC) to advocate policy and regulatory reforms aimed at achieving global net zero emissions by 2050 or sooner. This will include engaging with asset managers, credit rating agencies, auditors, stock exchanges, proxy advisers, investment consultants, and data and service providers to ensure that funds, products and services available to investors are consistent with achieving global net zero emissions by 2050 or sooner.

(e) We expect the engagement and voting conducted on behalf of the Fund by LAPFF, Brunel and underlying investment managers to be consistent with an objective for all assets in the portfolio to achieve net zero emissions by 2050 or sooner. The Fund's stewardship and voting policies are set out more fully in section 6 of the Investment Strategy Statement.

(f) Climate change risk and carbon reduction targets will be a consideration in reviews of the Fund's strategic asset allocation. This will be considered ensuring consistency with the Fund's fiduciary duty to achieve the investment returns required to meet its future pension liabilities.

(g) Within the Fund's infrastructure investments, we would expect a significant proportion to be invested in renewable energy assets. The target is to achieve an allocation of 5% of the total Fund to renewable energy infrastructure assets by 2025.

(h) The Devon Pension Fund adopts the Brunel Pension Partnership's climate change policy, found at the following link: https://www.brunelpensionpartnership.org/climate-change/

The Devon Fund views the Brunel policy as being representative of the climate change objectives of the Fund and in support of the wider objectives of Devon County Council.

(i) Devon County Council has committed to reduce the carbon emissions from its operations to net-zero by 2030. This will include the operational emissions of the Devon County Council Investment Team in the oversight of the Fund's investments, and the administration of benefits by Peninsula Pensions.

(j) We are committed to being transparent about the carbon intensity of our investments through the publication of the Fund's carbon footprint and reserves exposure on an annual basis. This will enable us to measure progress against the targets set out above. The Fund will also report on delivery through the Brunel Annual Climate Action Plan and work towards meeting the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).