DF/23/60
Investment and Pension Fund Committee
16 June 2023

CLIMATE CHANGE AND CARBON FOOTPRINT

Report of the Director of Finance and Public Value

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

1) Recommendation

That the Committee be asked to:

(a) Approve the revised climate change policy as set out in Appendix 1 to the report for inclusion in the Investment Strategy Statement.
(b) Note the current progress against the targets to reduce the Fund's carbon footprint.
(c) Consider whether the allocation to passive equities should be consolidated in the World Developed Paris Aligned Benchmark Fund.

2) Introduction

2.1 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.

2.2 In 2021 the Investment and Pension Fund committed that the Devon Pension Fund's portfolio of investments will be net-zero by 2050 at the latest and adopted a climate change policy in support of that objective. The Fund works with the Brunel Pension Partnership to implement its policies and in early 2023 Brunel approved a revised climate change policy. In addition, the Government has now published new requirements for LGPS funds on climate reporting that will need to be implemented in the 2023/24 Annual Report.

2.3 This report therefore reviews the Fund's policies on climate change in the light of Brunel's revised policy and the new regulatory requirements.

2.4 A key element of the Fund's climate change policies will be the 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 2022.

3) Climate Change Policy

3.1 The Fund's current climate change policy to achieve net zero investment portfolios by 2050 at the latest sets out the following targets:

- That the Weighted Average Carbon Intensity (WACI) of the Fund's investments will be reduced by a minimum of 7% per annum, and by between 50-75% by 2030, based on the March 2019 calculation of the WACI.
- That 5% of the Fund will be invested in renewable energy infrastructure by 2025.
- 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 should be net zero by 2030 in line with Devon County Council's policy.

3.2 These targets are still considered appropriate and are aligned with the trajectory set out in the Paris Agreement. However, in line with the revised Brunel climate change policy it is considered that these should be enhanced by further targets and metrics. These are included in the revised policy set out at Appendix 1 to this report and summarised below.

Engagement

3.3 It is proposed that the Fund continues to prioritise engagement over divestment, particularly for listed equities, as the means to achieve its objectives. What matters, if the world is to meet the challenge of climate change, is that we see emissions reductions across the global economy. Therefore, 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.

3.4 Therefore, it is appropriate to set out targets for engagement. The following are proposed:

- Implement an engagement goal to ensure 70% of financed emissions in material sectors are either Net Zero, aligned to Net Zero pathways, or subject to direct or collected engagement and stewardship actions. We propose to achieve the target for listed equity and corporate bonds by June 2024.
- The Net Zero Investor Framework proposes the threshold should be 90% by 2030 at the latest. We propose to achieve the target for listed equity and corporate bonds by June 2027.

3.5 These targets are consistent with the 2023 Brunel Climate Change Policy.

Alignment

3.6 Another key area that features in the new reporting requirements is the extent of alignment of the companies invested in to the Paris Agreement. For a company to be considered to be aligned they need to:

- Have credible targets to achieve net zero and a strategy to deliver them.
- Engage positively to achieve those targets (including not lobbying against climate change mitigation, directly or via affiliations).

- Align financial processes and accounts.
- Publicly disclose on the above.

3.7 The precision around what ‘credible’ looks like is under development and Brunel is actively involved in shaping the recommendations.

3.8 It is therefore proposed that the following targets be set for alignment, consistent with Brunel’s policy, subject to the ability to be able to assess and measure whether companies are achieving it. The proposal is that:

- 100% of developed listed equities should be aligned or aligning by 2030.
- 100% of all listed equities should be aligned or aligning by 2040.

3.9 This acknowledges that companies operating in emerging markets are likely to be both more difficult to assess, but also may take longer to align, given the need to ensure a “just transition”.

4) Carbon Footprint as at 31 December 2022

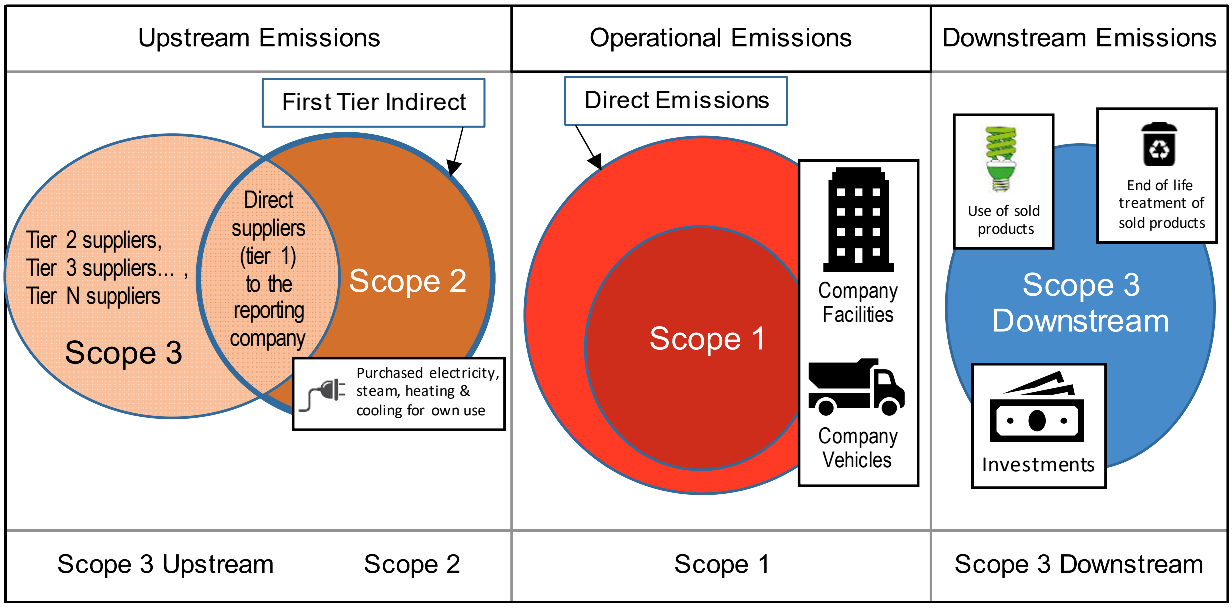
4.1 Brunel in partnership with Trucost have analysed the Devon Fund’s carbon footprint as at 31 December 2022. This is the fifth annual assessment of the Fund’s carbon footprint.

4.2 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.

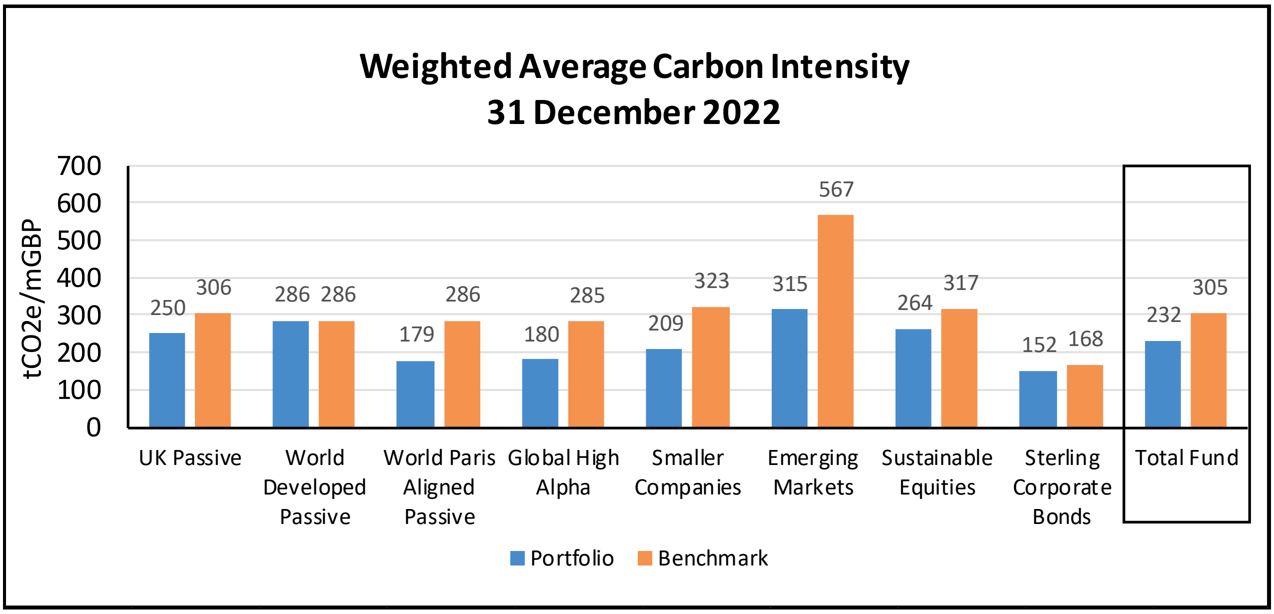
Greenhouse Gases – Scopes



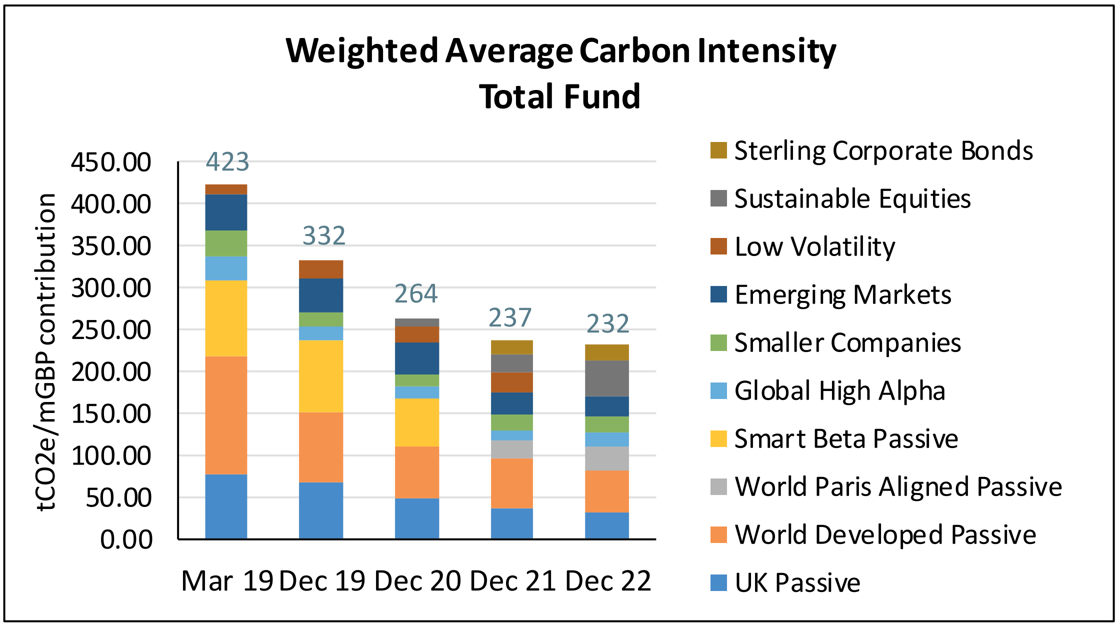
4.3 In analysing a portfolio of investment companies, there is the danger of double counting, where the scope 1 direct emissions of one company are the scope 3 downstream emissions of another company in the portfolio. However, from an investment risk perspective it is useful to know both the attribution 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.

4.4 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.

4.5 The WACI for each portfolio and for the Fund's total equity and sterling corporate bond holdings as at 31 December 2022 is shown in the graph below. The total Fund WACI has fallen marginally from 237 tCO2e/mGBP in December 2021 to 232 tCO2e/mGBP in December 2022, a reduction of 2.1%. The WACI in December 2022 is below the benchmark of 305 tCO2e/mGBP.



4.6 Progress since March 2019 is shown in the following chart, with the proportionate contribution from each equity portfolio also highlighted.



4.7 It is disappointing that there has only been a small reduction in the Fund's carbon footprint (WACI) during the year, but this should be set in the context that 2022 saw negative returns across markets particularly in growth stocks, meaning that many companies with lower carbon footprints lost value, while value stocks, including oil companies, performed much better in financial terms and therefore formed a larger part of the market. The WACI of the benchmarks that our funds are compared to went up from 284 tCO2e/mGBP to 305 tCO2e/mGBP over the year, so the small decrease in the Fund's WACI is a reasonable outcome in the circumstances.

4.8 The reduction of 45% in the Fund's WACI since March 2019 still represents good progress towards the medium term target of a 50-75% reduction by 2030.

4.8 Other points to note include:

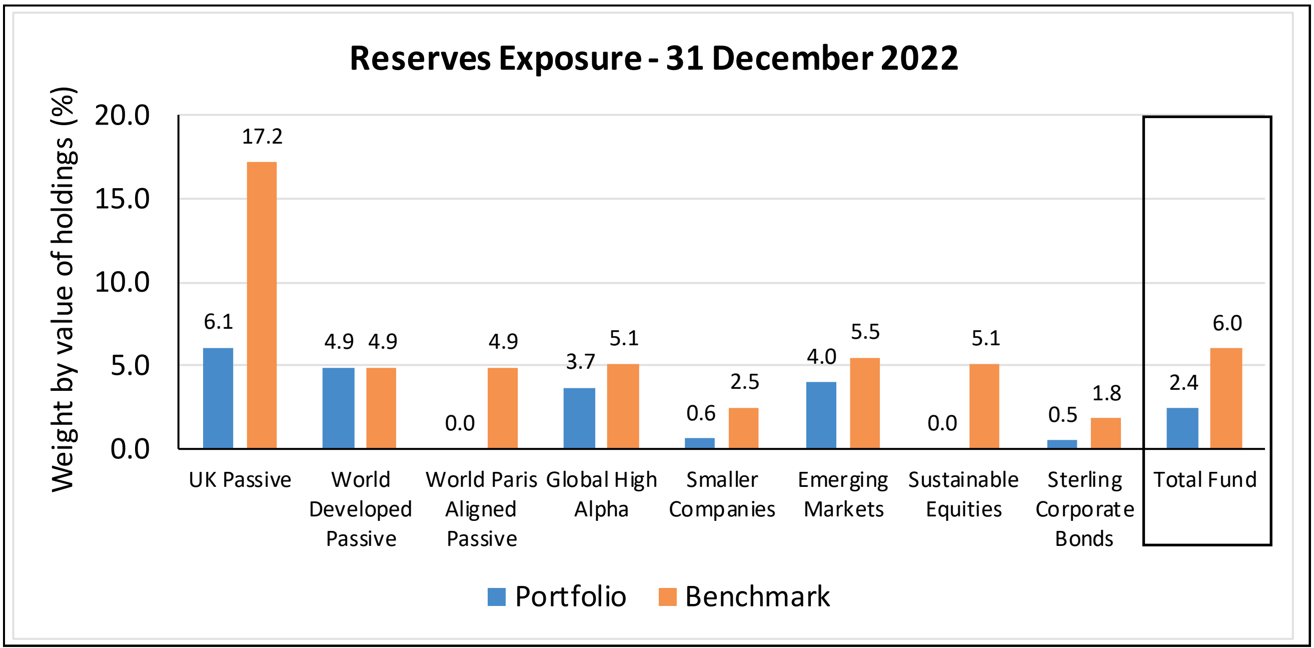
- All actively managed portfolios had a lower WACI than the benchmark.
- The UK Passive allocation transferred to the new UK Climate Transition Fund at the end of February 2022. The UK Climate Transition Fund has a lower WACI than the core UK passive index.
- The Emerging Markets portfolio has the highest WACI. Emerging economies may find it more difficult to transition their economies, and this also raises the issue of securing a just transition that does not penalise those countries with a poorer standard of living.
- The Sustainable Equities portfolio has a relatively high WACI compared to some of the active portfolios. This demonstrates that the numbers only tell half the story. The Sustainable Equities portfolio is focused on solutions, so may include companies who have higher emissions from processes that support the transition, for example the manufacture of wind turbines.

5) Reserves Exposure

5.1 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.

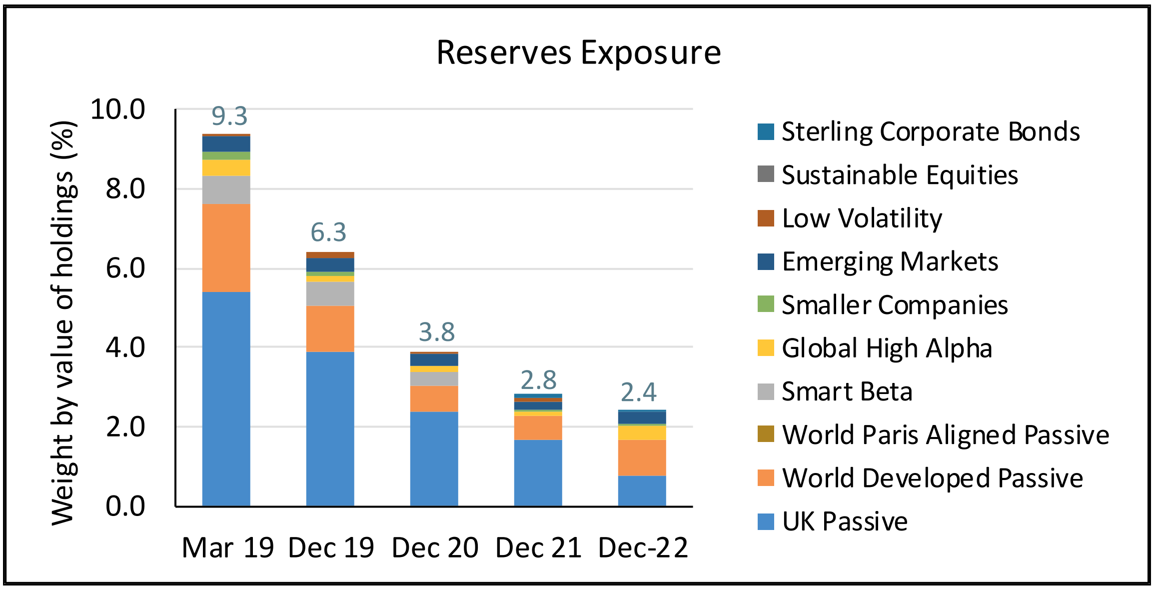
5.2 This is linked with the risk involved in stranded assets, where companies may have large reserves of fossil fuels that will not be usable if we are to achieve carbon reduction targets across the economy and so become “stranded”. Exposure to reserves data is therefore a useful proxy for downstream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

5.3 The reserves exposure for each portfolio and for the Fund’s total equity and sterling corporate bond holdings as at 31 December 2022 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 2021 and December 2022, the reserves exposure fell from 2.8% to 2.4%. This equates to just under 1.5% of total assets.



5.4 The decision to move the UK Passive allocation to the UK Climate Transition Benchmark fund has reduced the reserves exposure of that allocation from 13% in December 2021 to 6% in December 2022, while the benchmark of FTSE All-share companies has increased from 13% to 17%. The UK Passive allocation no longer includes Shell, Anglo American or Glencore, but does still hold BP.

5.5 The reduction in reserves exposure since March 2019 is shown in the following graph:



5.5 The UK Passive allocation previously accounted for around 60% of the reserves exposure, but now only accounts for a third. However, the global developed passive now accounts for a larger proportion as the exposure of the benchmark has increased from 2.9% to 5%, for the same reasons as set out in paragraph 4.7. The passive portfolios continue to have the most significant exposure.

5.6 The following table shows the Devon Fund’s equity exposure to companies with fossil fuel reserves as at 31 December 2022. This excludes the Sustainable Equities portfolio which has no exposure.

Fossil Fuel Reserves Exposure by Portfolio and Company as at 31 December 2022

Company	UK CTB Passive £000	World Developed Passive £000	World PAB Passive £000	Active Global High Alpha £000	Active Emerging Markets £000	Global Smaller Companies £000	TOTAL £000
BP	21,633	1,025	0	0	0	0	22,658
Anglo American	0	467	0	2,920	1,839	0	5,226
Royal Dutch Shell	0	1,996	0	2,833	0	0	4,829
Exxon Mobil	0	4,470	0	0	0	0	4,470
Reliance Industries	0	0	0	0	3,709	0	3,709
Chevron	0	3,414	0	0	0	0	3,414
Suncor Energy	0	426	0	2,551	0	0	2,977
BHP Billiton	0	1,580	0	0	0	0	1,580
Glencore	0	857	0	621	0	0	1,478
Conoco Phillips	0	1,447	0	0	0	0	1,447
Total SA	0	1,423	0	0	0	0	1,423
Vale	0	0	0	0	1,249	0	1,249
Energean Oil and Gas	1,192	0	0	0	0	0	1,192
Meg Energy	0	0	0	1,074	0	0	1,074
Whitecap Resources	0	0	0	0	0	1,063	1,063
Other	141	7,067	207	0	2,710	575	10,700
	22,966	24,172	207	9,999	9,506	1,638	68,489

5.7 Should the Committee wish to take further action to significantly reduce fossil fuel reserves exposure further, it could look to move the UK and World Developed passive allocations across to the Global Paris Aligned Benchmark (PAB) passive fund. The PAB funds include a range of exclusions related to fossil fuels and also enforces a 7% reduction in carbon emissions, with a phasing in of scope 3 emissions into the data. This move would also reduce the overall carbon footprint.

5.8 Mercer envisaged the move of all the passive allocation to the Global Paris Aligned Benchmark fund in their review of investment strategy in February 2022, as a means to:

- Manage the risks associated with climate change.
- Target sustainability themes, focus on ESG integration and ensure strategies are supporting a decarbonisation pathway.
- Continue to target the same return as the core global developed passive index, albeit with the likelihood of a higher tracking error.

5.9 However, it has previously been decided to maintain the UK and core global developed passive allocations in the short term as:

- The return on the UK market had been poor compared to the World (principally the US) market as a result of investor concerns over Brexit and the outperformance of the big US technology stocks (Apple, Microsoft, etc.), and consensus was that the UK market looked cheap compared to the US (and therefore global) market. 2022 was a relatively good year for the UK market.
- The new World Developed Paris Aligned Benchmark was relatively new, and it was therefore decided to only allocate the previous "Smart Beta" allocation, retain the allocation to the core World Developed Passive fund and review how performance of the two funds compared before deciding whether to switch the entire global passive allocation across.
- There was some concern about the potential for unintended consequences in the way that the benchmark would reshape the portfolio to ensure a 7% year-on-year reduction.

5.8 Performance returns, on an unhedged basis for the three funds during 2022/23 are set out below. These are only one-year returns as the new funds have been in place for less than 18 months. The World Developed Paris Aligned Fund has performed better than the core World Developed Passive Fund. The UK Climate Transition Benchmark Fund returned a marginally better return in what was a good year for the UK market relative to the global market.

Fund	One Year Return to 31 March 2023
World Developed Paris Aligned Benchmark Fund	+0.7%
World Developed Passive Fund (Unhedged)	-0.6%
UK Climate Transition Benchmark Passive Fund	+0.9%

5.9 Should the Committee decide to move the global developed passive allocation to the Paris Aligned Benchmark fund, then it is recommended that the currency hedging strategy in place be applied to the Paris Aligned Benchmark fund.

6) Conclusion

6.1 Progress in reducing the Fund's carbon footprint has been slower over the last year than previous years but is to a large extent the result of the prevailing economic backdrop. There has nonetheless been a small reduction in the Fund's WACI and reserves exposure as at the end of December compared with the previous year. The additional targets and metrics will help to provide a more rounded assessment of the effectiveness of the Fund's climate change policies and ensure we are prepared for the more regulated reporting regime that the Government is looking to introduce.

6.2 The Committee is asked to approve the revised climate change policy for inclusion in the Investment Strategy Statement. The Committee is also asked to review its allocation to passive equities and consider whether the allocation should be consolidated in the World Developed Paris Aligned Benchmark Fund.

Angie Sinclair
Director of Finance and Public Value

Electoral Divisions: All

Local Government Act 1972: List of background papers

Nil

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Devon County Council Pension Fund Investment Strategy Statement

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 Fund also believes investing for a positive climate scenario presents an opportunity to improve asset returns by harvesting a low carbon transition premium. This positive impact is expected to be most material over the period ending 2030.

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 the following targets:

1) 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. This recognises the need for significant progress in the earlier part of the period to 2050, with the intention of achieving a 50-75% reduction by 2030.
2) 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.
3) 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.
4) Alignment to the Paris Agreement - The target is that 100% of developed listed equities should be aligned or aligning by 2030 and 100% of all listed equities should be aligned or aligning by 2040. For a company to be considered to be aligned they need to:
   - Have credible targets to achieve net zero and strategy to deliver them.
   - Engage positively to achieve those targets (including not lobbying against climate change mitigation, directly or via affiliations).
   - Align financial processes and accounts.
   - Publicly disclose on the above.
5) Engagement - Implement an engagement goal to ensure 70% of financed emissions in material sectors for listed equity and corporate bonds are either Net Zero, aligned to Net Zero pathways, or subject to direct or collected engagement and stewardship actions by June 2024, and that the threshold should be 90% by June 2027.

6) 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.

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 Pension 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 therefore prioritises engagement over divestment, particularly for listed equities. 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 divestment may be appropriate based on inability or unwillingness to align to objectives of Paris Agreement, consistent with managing 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 below.

(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) 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 Pension 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.

(h) 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 through the Pension Fund Annual Report. 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 report in line with anticipated LGPS Regulation requirements in the 2023/24 Annual Report.