Report of the Section 151 Officer

Pension Fund Committee – 15 September 2016

CLIMATE CHANGE AND A CARBON INVESTMENT POLICY

Purpose:	To formulate a carbon investment policy.
Reason for Decision:	To approve the commission of a study into the impact of carbon investment/disinvestment on the portfolio.
Consultation:	Legal, and Finance.
Recommendation(s):	It is recommended that a formal analysis of the impact of carbon investment/disinvestment on the portfolio is commissioned to assist in the formulation of a carbon policy for the City & County of Swansea Pension Fund.
Report Author:	Jeff Dong Chief Treasury & Technical Officer
Finance Officer:	Mike Hawes Section 151 Officer
Legal Officer:	Stephanie Williams
Access to Services Officer:	N/A

1 Background

1.1 Following the COP meeting in Paris climate change is increasingly in the public eye, as governments around the world look to put in place a legally binding agreement to minimise global warming. The City & County of Swansea Pension Fund routinely receives lobbying from interested parties about its investment policy and strategy, including Friends of the Earth (Cymru) on the climate change debate which are considered objectively alongside the pension fund's duty to pay LGPS pensions.

1.2 This Fund recognises that climate change is a key risk, which we are working hard to understand and manage.

1.3 The fund also continues to work with the Local Authority Pension Fund Forum to engage directly with companies on climate change, and to push for greater disclosure and transparency around companies' business models.

1.4 The fund also continues to make investments in clean tech and renewable energy via its private equity portfolio, where we can find investments that provide appropriate risk adjusted returns net of costs.

1.5 In exercising their duties, the Pension Fund Committee must remember their first duty is to pay member's pensions when they retire and that disinvestment from carbon assets without alternatives which provide commensurate returns would create economic uncertainty and would be irresponsible to begin a programme of disinvestment which impacted on the fund's ability to pay people's pensions.

2 Climate Change

2.1 Developing a responsible investment strategy for an asset owner often requires monitoring and analysing market trends, and trends amongst key players in the capital markets, both in the UK and around the world.

2.2 Perhaps on no other issue is this intelligence gathering process more important than on the controversial agenda of climate change.

2.3 As more and more data and analytics appear around the climate change agenda, the volume of rhetoric has been steadily increasing. With national newspapers taking sides in the debate about what is actually happening to the world's climate, it wasn't long before asset owners, particularly pension funds, had to respond.

2.4 The climate agenda for pension funds, whilst not new, was in sharp contrast to the usual focus on issues such as equity and fixed income performance, market prices across a range of assets from property to commodities, strong asset manager performance and weak investment returns in volatile markets. But beyond the rhetorical argument, the issue of what pension funds can actually do about climate risks was a relatively unexplored area, with little practical advice around on which to base portfolio construction and investment strategy more generally.

3 Carbon Assets

3.1 Expert analysis has shown that the coal, oil and gas in the ground far exceeds the carbon budget remaining to 2050 to have a reasonable chance of limiting global warming to 2 degrees. This scientific conclusion has been confirmed by the IEA, Shell, BP and UCL, amongst others. However many of these companies have not yet explained how they can square the contradiction between recognising the imperative to prevent dangerous levels of climate change, and having a strategy to grow a business based on fossil fuels.

3.2 The direction of travel is for further constraints on fossil fuel demand – through greater efficiency, air quality measures, cheaper alternatives, new technologies, as well as regulatory and policy instruments aimed specifically at carbon. A year ago most models assumed Chinese coal demand would continue to grow, yet the data for 2014 and the first half of 2015 shows that it has peaked. The Indian government is seeking to improve domestic coal efficiency and increase solar generation to cease importing coal. This demonstrates that the seaborne coal market is in structural decline, with diversified miners confirming the poor outlook by trying to offload thermal coal

assets.

3.3 This represents a downside from business as usual for fossil fuels. This is unlikely to affect demand across fuels and geographies equally – hence we have produced carbon supply cost curves for each of oil, coal, and gas, with regional analysis for coal and gas markets. The majority of fossil fuel production is used for combustion purposes resulting in greenhouse gas emissions. This is our focus – hence we use the term unburnable carbon, ie hydrocarbons which cannot be burnt unmitigated within a low carbon scenario.

3.4 The feedback effect of lower demand and emissions is that less capital expenditure is required to develop new fossil fuel production. This also reduces the long-term equilibrium prices required to cover the costs of marginal production. As a result of lower prices and volumes, projected revenues for the extractives sector fall. Capex approved now will not be producing until post-2020, which could be a very different environment. It therefore makes sense to review high cost, high carbon capex which may not be needed in a low carbon, low demand scenario.

3.5 A number of companies have indicated they are betting on business as usual, giving very little probability to any further efforts to constrain emissions, and not allowing for alternatives becoming cheaper all the time. The energy transformation has already started, as evidenced by the decline of the US coal mining sector, (currently filing for bankruptcy), and the EU utilities sector, (currently looking to restructure around new business models). There are already examples of stranded assets – coal mines which are operating at a loss, and power plants which are not likely to repay their capital costs. This is not about declaring assets as worthless – but highlighting that shareholders are not going to get a return from the capital companies are investing on their behalf.

3.6 To run through each fuel in turn, it becomes clear that this is not about a blanket approach to reviewing hydrocarbon exposure. The world will not stop using fossil fuels overnight, and there will be winners and losers depending on their position and fund managers (expectedly) argue that engagement with energy companies to invest more efficiently is the answer rather than wholesale disinvestment.

4 Conclusion

4.1 It should be recognised there is no easy answer to climate change and adopting an appropriate carbon investment policy, therefore it is recommended to commission an analysis of the current portfolio's carbon impact with a view to formulating a coherent carbon investment policy.

5 Legal Implications

5.1 There are no legal implications arising from this report.

6 Financial Implications

6.1 The cost of the study will be contained within estimated budget.

7 Equality Impact Assessment Implications

7.1 None.

Background papers: None.

Appendices: None.