HYMANS ROBERTSON

Warwickshire Pension Fund

Climate risk policy and Net Zero strategy

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For and on behalf of Hymans Robertson LLP

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Introduction

Purpose and scope

This paper has been prepared for the Officers and Investment Sub-Committee ("ISC") of the Warwickshire Pension Fund ("the Fund"). It outlines a proposed policy and strategy for managing the risks, and opportunities, generated by climate change.

The paper is structured as follows:

- Section 2 outlines the Fund's high-level investment principles/beliefs regarding climate change
- Section 3 sets out a proposed policy on dealing with climate change
- Section 4 covers the Fund's long-term goal of achieving Net Zero
- Section 5 outlines the metrics it is proposed the Fund uses to track progress
- Section 6 proposes short-/medium-term decarbonisation objectives
- Section 7 describes the strategies that could be employed by the Fund, focusing on capital reallocation and stewardship
- Section 8 covers the further development of the Fund's policy and strategy.

Background

The Fund's primary purpose is to pay pensions and related benefits, and it aims to be fully funded on a 20 year view. It follows that the primary objective of this climate policy and strategy should be to increase the resilience of the Fund to climate change, given it represents a significant, systemic and long-term risk.

Two supporting objectives are to:

- Mitigate the key risks of climate change, notably transition risk and physical risk;
- Provide capital to decarbonisation solution providers, where there is a strong investment case for doing so.

Physical risks relate to the direct impacts of climate change such as damage to property, disruption to businesses or long-term changes in agricultural yields. It is generally assumed that companies will be able to protect against, or adapt to physical risks, providing of course that governments do not "lose control" of climate change. A key focus of engagement activity is making sure portfolio companies take the necessary action.

Transition risks arise when companies are no longer able to operate normally, as a result of climate-driven policy, technological or societal change, and suffer a loss in value. They are generally considered more significant for long-term investors, and more challenging to manage. The reason being that many companies with significant transition risk provide products/services which are critical to the economy today and cannot be phased out overnight.

The Fund's primary purpose is not to solve the climate crisis, but there are strong arguments for providing capital to companies which provide solutions that facilitate decarbonisation. Such companies represent potential investment opportunities for the Fund.

Investment principles

The ISC has agreed a set of principles that guide the Funds investment policies and decision making, of which the following relate specifically to climate change:

- The Fund invests for the long-term, so Environmental, Social and Governance ("ESG") factors including climate change are expected to have a material impact on investment outcomes.
- The Committee believes that a Responsible Investment ("RI") approach will enhance long-term investment outcomes as well as benefiting the economies and societies in which the Fund invests and is therefore consistent with the Fund's primary purpose [of providing pension benefits to members]. RI is the practice of integrating consideration of Environmental, Social and Governance ("ESG") factors, including climate change, into the investment process (as further defined by the UN Principles for Responsible Investment – www.unpri.org).
- The Committee believes that climate change and the expected transition to a low carbon economy will have a significant long-term impact on the Fund and considers managing the associated financial risks to be part of its fiduciary duty.
- The Committee believes that the transition to a low carbon economy will create investment opportunities and will mandate the Fund's investment managers to seek out these opportunities.
- The Fund should consider as broad a range of investment opportunities as possible, subject to these being compatible with its risk appetite and RI considerations.
- Investment risk should only be taken where the Committee believes it will be rewarded over the longer term.
- The Committee believes that an RI approach will enhance long-term investment outcomes as well as benefiting the economies and societies in which the Fund invests and is therefore consistent with the Fund's primary purpose.
- The Committee believes that, in relation to the management of ESG factors, ongoing engagement with portfolio companies is preferable to divestment. Divestment should remain an option if engagement proves unsuccessful.
- The Fund should retain responsibility for setting RI policy but will delegate much of the implementation to BTC and its other investment managers. The Committee regularly monitors and evaluates its investment managers' approach to RI.
- The Fund should only invest with managers who comply with relevant regulations and codes of practice (eg UK Stewardship Code) and have committed to provide full disclosure on ESG issues.
- The Fund expects its investment managers to invest responsibly and to engage proactively with the management of portfolio companies on key ESG issues, including climate change, wherever it is cost effective to do so. The aim of such engagement should be to enhance investment returns and risk profile by positively influencing portfolio companies on such matters.
- Full disclosure of the Fund's RI policy and activity strengthens accountability and should be embraced.

The Committee considers that climate change has the potential to disrupt economic, financial and social systems and therefore represents financially material risks to the Fund. The Committee also believes that decarbonisation will create significant investment opportunities. However, the potential impact on the Fund is unknown given uncertainties around the physical response of environmental systems to climate change and society's policy, technological and economic response to it.

Risks to the Fund arising from climate change include, but are not limited to:

- Economic risks: risks that the assumptions made in valuing the liabilities are inappropriate;
- Demographic risks: risks that demographic experience is different to that assumed as a consequence of climate related impacts;
- Asset risks: risks that the performance of the Fund's assets is lower than assumed due to investments being affected by physical impacts from climate change ("physical risks") or the impacts of policy, economic, societal, technological, or other changes relating to the transition to a lower carbon economy ("transition risks").

Climate change and the transition to a low carbon economy is a long-term financial risk to Fund outcomes and is considered to be part of the Committee's fiduciary duty.

The Committee recognises a RI approach to climate change will necessitate purposeful decarbonisation of its current investments over time.

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Climate change policy

Management and governance

The Committee has overall responsibility for the management of climate-related risks and opportunities and takes these issues into consideration in setting investment strategy, making new investments and monitoring portfolio performance.

Climate-related risks are monitored through the Fund's overall risk management process and the Committee regularly reviews the level of exposure and the actions being taken to mitigate the risks. The Fund monitors the level of exposure to climate-related risks and opportunities on an annual basis. Current metrics used include the level and intensity of Greenhouse Gas ("GHG") emissions, exposure to fossil fuel reserves and the level of investment in companies providing decarbonisation solutions.

The Committee considers climate-related risks and opportunities in setting the Fund's investment strategy. This includes testing the resilience of the strategy to different climate-related scenarios, noting the uncertainty in the future path of climate change.

The Committee also considers climate-related risks when agreeing employer funding strategies at each formal actuarial valuation. Climate change has the potential to affect long term funding outcomes due to its impact on economic variables, such as inflation, and on longevity.

The Fund delegates management of climate-related risks and opportunities relating to individual investments to its investment managers, including Border to Coast ("BTC"). The Fund expects all its investment managers to disclose their latest policies on climate change and cover climate-related risks and opportunities in their regular reporting. The Committee will monitor investment managers compliance with their stated climate change policies and will take remedial action if issues are identified.

The Committee recognises that all companies have some level of exposure to climate-related risks, particularly transition risks. Stock selection decisions are delegated to the Fund's investment managers who, in deciding whether or not to invest, take into consideration factors such as the level of risk, the prospective return and investment timeframes

The Committee recognises that the methods available to monitor and manage climate-related risks and opportunities are developing and is committed to extending the range and improving the robustness of the techniques used.

The Committee will monitor changes in market practice to ensure that they are aware of, and where appropriate making every effort to act upon, changing best practice.

The Fund will report on the implementation of this Climate Change Policy and Strategy, including stewardship activities undertaken on behalf of the Fund, on an annual basis. The document will also be reviewed annually.

The Fund is committed to being transparent and accountable in terms of climate change. As such the Fund will publish its Climate Change Policy and Strategy and reporting online.

ESG focus

The number of themes prioritised by ESG-driven investments vary widely. L&G's popular Future World range of passive equity strategies, for example takes into consideration 30 different metrics covering a wide range of ESG themes. Others have a narrower focus such as climate change. Covering a broad range is likely to reduce or even reverse the impact on specific themes of interest to the Fund. The Future World strategies, for example,

reduce emissions relative to the wider market but also have lower exposure to green revenues (which measures the Fund's exposure to companies providing sustainable products/services).

In the context of this Climate Change Policy and Strategy, the Fund has a preference for strategies which focus on climate impact – mitigating climate risk and increasing exposure to climate opportunities – and its other three engagement priorities. It has also adopted the principle of "do no harm", believing that the carbon transition should and can be managed in such a way as to avoid negative impacts such as mass unemployment due to the displacement of labour from fossil fuel industries, repurposing of agricultural land to produce biofuel, or the abuse of labour rights in the mining of metals critical to the transition.

The Fund also recognises the close relationship between climate and **biodiversity** risks. It is now generally accepted that global warming is having an adverse impact on biodiversity through habitat loss such as the destruction of coral reefs for example. At the same time, positive action on biodiversity such as the restoration of peatland can be supportive of efforts to combat climate change. With this in mind, the Fund has a preference for decarbonisation strategies which have a positive impact on biodiversity and seeks to avoid those with a negative impact.

The Fund invests only via pooled funds and acknowledges that compromises on ESG priorities have to be made to reach consensus on fund mandates.

Engagement vs divestment

The Committee has a preference for engaging with portfolio companies on decarbonisation rather than divestment. It believes that the positive changes brought about by effective stewardship will enhance outcomes for the Fund as well as for society and the wider economy. Where, over a considered period, there is no evidence of a company making visible progress towards GHG emissions reduction or to address associated climate risks, divestment will be considered.

The Committee will actively support engagement activity that seeks to achieve:

- Increased disclosure of information on the climate related risks that could affect the value of an investment;
- Transparency on how portfolio companies are adjusting to a low carbon economy.

The Fund also participates in joint initiatives collaborating with other investors including other pools and groups such as the Local Authority Pension Fund Forum ("LAPFF") on climate risk related issues.

Decisions on divestment of individual portfolio companies are delegated to investment managers, but the Fund expects them to divest where appropriate. This includes situations where it becomes clear that:

- The Fund's values and those of portfolio companies are misaligned
- Few opportunities exist to transition to a more sustainable business model
- Investors have low leverage, e.g. a controlled company, lack of legal recourse
- Company management is not receptive to ongoing engagement
- Other escalation measures have already been exhausted

Exclusion lists provide a simple mechanism for managing climate risk exposure and pre-empt the need for divestment. The Fund has a preference for leaving often complex decisions on the purchase or sale of individual stocks to its investment managers which are better placed to make them. However, it believes that limited use of exclusion lists can be justified in circumstances such as those listed above. The Fund supports commonly applied exclusions which include:

- Companies with material interests in thermal coal or oil sands (reserve ownership, mining, exploration and production, power production, ancillary services)
- Manufacturers of controversial weapons
- Companies in perennial breach of the UN Global Compact

Note: we recommend discussion on potential additions/deletions from this list, as strong preferences on exclusions can have a material impact on the selection of potential investments.

Climate risk vs opportunity

The Fund's primary purpose is not to solve the climate crisis, but there are strong arguments for providing capital to companies which provide solutions that facilitate decarbonisation:

- As a responsible investor, the Fund has committed to considering the environment and social impact of its investment decisions.
- The Fund invests widely across most geographies and sectors, and is therefore dependent on society, economies and capital markets operating normally. Climate change poses a significant, systemic risk, so the Fund, acting with other long-term investors, has an interest in financing companies that can help address climate change for the benefit of society as a whole (this concept is referred to as "Universal Ownership").
- Successful decarbonisation will require huge amounts of capital investment, creating a large number of potentially attractive investment opportunities. The Fund has a fiduciary duty to consider those opportunities which offer attractive risk-adjusted returns.
- The Fund will be required by regulation (eg the Taskforce on Climate Related Financial Disclosures or TCFD) to demonstrate what action it has taken to address climate change.

The choice of decarbonisation solutions is proliferating rapidly and now covers a very wide range of service types, technologies, economic sectors, and business models. The Fund expects its investment managers to consider the widest possible opportunity set (within their investment mandates) including:

- Solutions which help other companies reduce emissions, e.g., renewable power producers,
- Companies which offer GHG removal services, e.g., forestry businesses
- Solutions which help other companies remove emissions, e.g., providers of carbon sequestration technology.

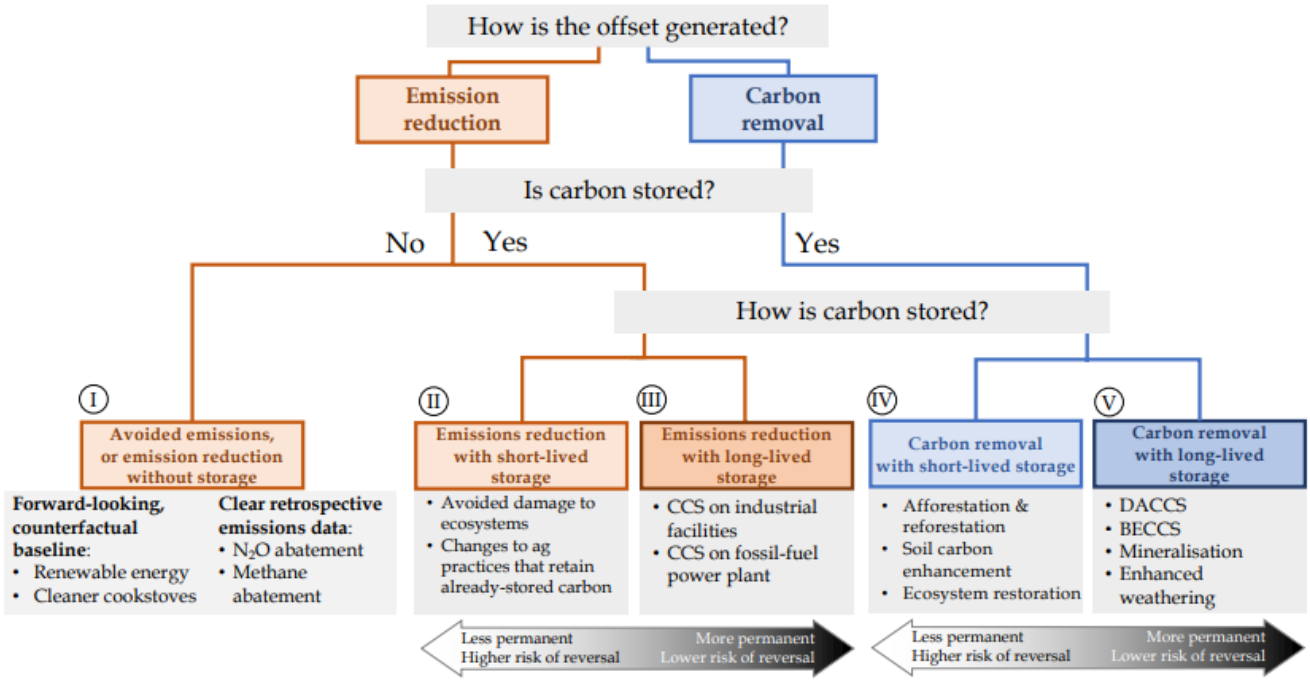
A growing challenge for investors is to determine whether or not the assets they own are making a meaningful contribution to addressing climate change. The Fund relies on its investment managers to make these judgments, but ensures they are using appropriate frameworks (such as the EU Taxonomy) to do so and are reporting portfolio exposure on a consistent basis.

The aims of mitigating climate risk and increasing exposure to decarbonisation solutions can sometimes conflict especially in the short-term. For example, the manufacture of turbines and construction of windfarms are currently GHG-intensive activities leading to higher upfront emissions (on a Scope 3 basis) but positive climate impacts over the long-term. Similarly, the Fund may wish to continue financing high emissions companies with robust decarbonisation plans whilst they implement those plans, even though transition risk is higher, providing that the investments are accretive to returns over the long-term. For this reason, the Fund is willing to tolerate higher short-term emissions providing the associated transition risk is acceptable and the long-term benefits are sufficiently attractive.

Responsible use of offsets

Negative emissions assets are those which remove (or avoid) more GHGs from the atmosphere than they contribute and can, under certain circumstances, be used to create verifiable emissions offsets. Offsets can be used to reduce the net emissions of a portfolio or sold to another party for the same purpose.

The chart below illustrates the nature of different carbon offsets, including how the offset is generated and the carbon subsequently stored[1]:



Reliance on negative emissions assets/offsets is controversial, although policymakers accept that some will be required to offset emissions in hard-to-decarbonise sectors like long haul air travel. They are also vulnerable to abuse, which is why the Oxford Principles also sets out specific requirements for robust offsetting:

- Prioritise emissions reduction over offsetting;
- Use verifiable offsets that ensure additionality;
- Focus on offsets which directly remove GHGs rather than avoid emissions, and those which ensure long-term storage of emissions captured;
- Support the development of a market in NZ-aligned offsets.

The IIGCC has produced guidance for investors on the use of offsets within its Net Zero Investment Framework (NZIF). The NZIF notes that:

> *As a general principle, investors should not use purchased offsets at the portfolio level to achieve emissions reduction targets. They should also adopt a precautionary approach when assessing assets' alignment with net zero and the use of offsets. Recognising the finite availability of offsets from land use in particular, and the need to rapidly decarbonise all activities within sectors to the extent possible, investors should not allow the use of external*

[1] Source: Oxford Principles for Net Zero Aligned Carbon Offsetting

> *offsets as a significant long-term strategy for achievement of decarbonisation goals by assets in their portfolios, except where there is no technologically or financially viable solution.*[2]

Similarly, both the Net Zero Asset Owner Commitment and the Net Zero Asset Managers' Initiative note that the role of carbon offsets should be limited to where there are 'no technologically and/or financially viable alternatives to eliminate emissions, investing in long-term carbon removals'.[3]

The guidance here is clear and consistent with the approach to NZ outlined above – carbon offsets should be considered only as the last resort for addressing residual emissions at an asset level, rather than a strategy that should be employed by asset owners at a portfolio level.

In light of the above, the Fund's position on negative emissions assets/offsets is as follows:

- It will not purchase third party offsets or retain offsets generated in its own portfolio
- It will consider investments in negative emissions assets
- It will sell high quality, verified offsets generated by negative emissions assets into the secondary market in a way which maximises financial returns.

The rationale for this position is as follows.

Although purchasing/retaining offsets at portfolio-level would reduce the Fund's net emissions, it does not reduce the transition risk associated with its other investments. Transition risk arises at portfolio company level, when for example policies on carbon taxation changes, and is not mitigated by offsets held elsewhere in the Fund's portfolio. Purchasing/retaining offsets also reduces financial returns; the impact can be material and will increase as the market price of offsets increases over time.

There is legitimate demand for negative emissions assets and the offsets they generate, so it is appropriate that the Fund should consider financing them. But they should be evaluated in the same way as any other investment opportunity and progressed only if the investment case is strong and the assets are managed in a responsible manner.

Offsets sold into the secondary market should be of high quality and independently verified in order to mitigate against reputational risk. Sales should be timed to maximise financial returns, and this may involve "holding" the offset for some time. The Fund acknowledges that during the holding period the offset cannot be used to reduce its own emissions.

[2] Net Zero Investment Framework Implementation Guide – IIGCC

[3] PAII-Net-Zero-Asset-Owner-Commitment-Statement.pdf (parisalignedinvestment.org)

Long-term Net Zero goal

Definition of Net Zero

The term Net Zero covers two concepts: (i) a dramatic reduction in anthropological greenhouse gas ("GHG") emissions and (ii) the removal of residual emissions through a sustainable combination of technological means and natural processes. Net Zero therefore represents more than the simple concept of carbon neutrality, ie emissions=removals.

The Paris Agreement requires countries to achieve Net Zero by 2050 in order that the rise in global temperatures be limited to below 2deg (ideally 1.5 deg) compared with the pre-industrial average. The expectation is that this will avert the worst potential impacts from climate change.

Many GHGs persist in the atmosphere for long periods, so it is cumulative emissions which determine the degree of climate change. The pathway to Net Zero is of critical importance therefore: if limited action is taken until 2050, cumulative emissions will be much higher and global temperatures will overshoot the Paris goal. It is estimated that future emissions (counting from 2018) must not exceed 580 GtC02e for there to be at least a 50% chance of meeting the Paris goal; this is effectively a remaining global emissions budget. Current global emissions are c40GtC02e.

Scientifically based decarbonisation pathways have been defined for all high emissions sectors which, if followed by companies operating in them, are consistent with the goal of Net Zero by 2050 and the remaining global emissions budget. Alignment with relevant decarbonisation pathways should therefore be a key measure of portfolio alignment with the global Net Zero goal.

Carbon dioxide is not the only GHG produced by human activity, nor is it the most potent (see table below). But it is the most common and hence has received the greatest attention.

Greenhouse Gases	Atmospheric Lifetime (years)	Global Warming Potential[4]	Sources relating to human activity
Carbon Dioxide	1000+	1	Transport; electric power; industry (cement, metals, chemicals) buildings
Methane	10	30	Oil and gas, agriculture (livestock), waste management (landfill)
Nitrous Oxide	100+	270	Agriculture (arable), waste management (water), combustion engines
Hydrofluorocarbons and other fluorinated gases	270+	14800+	Refrigerants, aerosol propellants, solvents, fire retardants

[4] Source: Environmental Protection Agency. 1. Global Warming Potential of other GHGs over 100 years expressed as a multiple of that of CO2

Almost every economic sector has a role to play in decarbonisation, but the table above highlights the sectors which account for a disproportionate share of total emissions. Companies operating in these sectors are typically the focus for action on climate change.

Long-term target

We are aware many LGPS funds have set long-term targets to be Net Zero by a specific date. Such targets provide a clear statement of intent but can be counterproductive. For example, if economies decarbonise slower than expected, a specific Net Zero target date may require funds to invest in increasingly concentrated portfolios of lower emissions companies, increasing investment risk and potentially compromising returns. If decarbonisation takes place faster than expected, a specific Net Zero target date may leave the Fund exposed to excessive transition risk.

From an investment perspective, the key issue is the pace of decarbonisation **relative** to the economies in which the Fund invests. This has significant implications for investment strategy:

- If the Fund decides to decarbonise in line with underlying economies, it could remain invested largely as at present, but this would entail increased vulnerability to transition risk when/if climate policy changes;
- If the aim was to decarbonise moderately ahead (say 3-7 years) ahead of underlying economies, then reallocating capital to a range of climate-driven strategies, such as the LGIM Low Carbon Transition Index fund in which the Fund invested in 2023. Some changes in strategic asset allocation may also be required but the Fund is likely to be able to maintain a broadly diversified portfolio;
- Faster decarbonisation (10+ years ahead of underlying economies) would likely require more significant changes in asset allocation and a more concentrated, higher risk portfolio.

In 2022, the ISC agreed a goal of decarbonising moderately ahead (say 3-7 years) of the economies in which it invests, but no later than the prevailing global target date (currently 2050).

Metrics

The Fund has adopted a range of climate change metrics[5], which is designed to give a fuller picture of its exposure to climate risks and opportunities. The intention is to measure them across the whole portfolio in time, although data limitations currently preclude this. The chosen metrics are as show overleaf (see Appendix for fuller definitions):

Metric	Units	Purpose
Absolute emissions ("Financed Emissions")	tCO_2e	Measures the Fund's share of total emissions by portfolio companies it finances
Weighted Average Carbon Intensity ("WACI")	$tCO_2e/\$m$	Measures the emissions intensity of companies operations, hence their vulnerability to climate regulations and tax policy
Emissions Intensity (EVIC)[6] "Carbon Footprint"	$tCO_2e/\$m$	Measures absolute emissions normalised by the amount of capital invested. Can be applied across the whole portfolio. Provides a more robust basis for comparing funds decarbonisation progress.
Fossil Fuel Ties[7]	%	Measures exposure to companies active in the production and exploitation of fossil fuels, ie potential stranded assets. Also provides indication of future emissions.
Green Revenues	%	Measures exposure to (some of) the investment opportunities likely to be created by decarbonisation
Climate Engagement	%	Measures the extent to which the Fund's investment managers are engaging with portfolio companies to ensure they have credible decarbonisation plans and are on track delivering them
Transition Pathway Alignment	%	Forward-looking measure of the progress portfolio companies are expected to make decarbonising their operations
Data Quality	%	Measures how much of the portfolio is covered by climate data actually reported rather than by estimates

[5] Metrics selected are consistent with the recommendations of the Institutional Investors Group on Climate Change ("IIGCC")

[6] Previously expressed per £m equity invested, and therefore only applicable to equity investments

[7] BTC currently focus on the narrower measure of companies with material fossil fuel reserves. There is an argument for adopting the same measure.

None of these metrics can currently be measured across the Fund's overall portfolio, so this list should be viewed as aspirational. The Fund will work with its managers to develop the necessary reporting. Going forward, it will also only engage managers who can report these metrics or close equivalents, or are committed to doing so within a reasonable timeframe.

Short-/medium-term targets

Background

The Fund is expected to set short- and medium-term targets around key decarbonisation metrics such as emissions reduction and exposure to the providers of decarbonisation solutions. The benefits of setting such targets include:

- Informing decisions on capital allocation and development priorities
- Strengthening accountability
- Meeting prospective regulatory requirements, eg TCFD
- Highlighting the urgency and signalling the Fund's intent regarding decarbonisation.

Poorly designed targets can easily lead to sub-optimal decisions particularly, as in this case, the data needed to measure progress remains imperfect. Potential targets therefore require careful consideration.

Key considerations

Key considerations when setting targets include:

- Current position, both in absolute terms and relative to the markets in which the Fund invests
- The Fund's long-term goals
- Global requirements, notably those of the Paris Agreement
- Commitments and plans of the Fund's investment managers and portfolio companies
- Balancing different decarbonisation drivers and avoiding complexity
- Data availability
- Best practice

Current position: The Fund's current position on each of the key decarbonisation metrics will have a material impact on what is achievable over the coming years. If portfolio emissions are already materially lower than the wider markets in which the Fund invests, it may be very challenging to decarbonise faster than the market in the coming years. It is therefore vital to establish a robust baseline for each metric targeted.

At the time of writing, both LGIM and BTC provide metric data on a differing basis which makes the calculation of an overall Fund level metric difficult to calculate to have any meaning. We will continue to work with the managers to try and provide consistent data across all the Fund holdings so this can be achieved with a level of accuracy.

Long-term goal. The Fund aims to decarbonise moderately ahead (say 5 years) of the markets in which it invests. There are many routes to achieving this goal, but we believe that progressive decarbonisation moderately ahead of a recognised, scientifically based pathway is optimal as it will allow the Fund to:

- Maintain a broad investment universe – faster decarbonisation in the early years may significantly limit the range of companies in which the Fund can invest
- Mitigate transition risk – slower decarbonisation is likely to increase transition risk
- Strike a balance between reducing portfolio emissions and exposure to the providers of decarbonisation solutions

- Limit the Fund's cumulative emissions to its "fair share" of the remaining global emissions permitted under the Paris Agreement.

Although the long-term goal is to reach Net Zero before the wider market, the Fund does not need to "get ahead" of the market straightaway, and it may be impractical to do so, [especially given current emissions are higher than the market]. In the next section, we recommend that the Fund sets interim objectives to decarbonise 3 years ahead of the markets in which it invests.

Global requirements. The overarching goal of the Paris Agreement is to limit the rise in average global surface temperatures to well below 2deg versus pre-industrial levels, and preferably to 1.5deg. It also established the aim of Net Zero global emissions by 2050, whilst allowing different countries/sectors to take different pathways to Net Zero reflecting different levels of economic and technological development. Since then a number of scientifically based reference pathways have been defined which meet the requirements of the Paris Agreement; examples include the Transition Pathway Initiative, the Science-based Targets Initiative, the One Earth Climate Model 2050 Net Zero Reference Pathway and the IEA's Net Zero 2050 Scenario.

It is important that global GHG emissions are reduced quickly, but it would be economically and socially impractical for the world to cease emitting GHGs immediately. It is vital though that companies establish and maintain alignment with an appropriate reference pathway as soon as practicable. It would not be appropriate for the Fund to prescribe a specific pathway for its portfolio companies, but being aware of the pathway(s) being used by portfolio companies and investment managers (notably BTC) to guide their decarbonisation activity, will enable it to set realistic emissions targets.

In 2022, BTC adopted the IEA's Net Zero 2050 Scenario to support its work on decarbonisation. This is a well-regarded, scientifically-based framework which complies with the Paris Agreement. It aims to achieve an orderly transition whilst safeguarding energy security. It establishes different reference pathways for different regions (advanced economies and developing countries) and different sectors including power generation, high-emissions industries, transportation and buildings. It assumes that a wide range of current and prospective clean energy technologies are ultimately deployed but does not allow for increase GHG removals through changes in land use. One key limitation is its focus on the generation, transmission and use of energy which account for a high proportion, but not all of global emissions; other material emissions sectors include agriculture and waste management.

The table below shows the path projected under the IEA scenario for net emissions from the energy sector globally[8], which peak at nearly 40GtCO2e per year, falling to zero by 2050. The table also shows the annualised percentage reduction in emissions implied by the IEA pathway in each 5 year period. It is important to note that the projections cover absolute emissions; emissions intensity (eg emissions per $m revenue or emissions per £m capital invested) will need to fall at a faster rate to allow for real economic growth over the period[9]. The annualised reduction in emissions intensity is shown in the final row of the total.

Global Energy Sector		2022	2025	2030	2035	2040	2045	2050
Absolute emissions	GtCO2e, pa	36.930	30.235	24.030	13.375	6.470	2.499	0

[8] 'International Energy Agency (2021), Net Zero by 2050, IEA, Paris'

[9] The table assumes real GDP growth of 3.2% for 2023-25 and 2.8% thereafter based on IMF projections. Source: IMF World Economic Outlook April 2024

Annualised change over each period	%pa	-	-6.5%	-4.5%	-11.1%	-13.5%	-17.3%	-
Annualised reduction in emissions intensity	%pa	-	-9.4%	-7.2%	-13.5%	-15.9%	-19.6%	-

LGIM have aligned with the Net-Zero Asset Managers Initiative (NZAMI). NZAMI, is a group of international asset managers committed to supporting the goal of net zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5 degrees. No specific decarbonisation pathway is mandated.

Investment manager plans. The Fund should also set targets which take into account the decarbonisation commitments/plans of its investment managers and portfolio companies. Specific holdings will change over time due to natural turnover, so here we focus on the objectives of the Fund's investment managers, particularly BTC. In 2022, BTC set a goal of Net Zero by no later than 2050 and the following interim targets relative to a 2019 baseline:

- Emissions intensity (financed emissions per £m capital invested): -53% by 2025, -66% by 2030
- Pathway alignment (percentage of financed emissions aligned or aligning with a recognised pathway): 55% by 2025, 70% by 2030, 85% by 2035 and 100% by 2040
- Engagement (percentage of financed emissions subject to meaningful engagement): 80% by 2025, 100% by 2030
- Initial targets set for Scope 1 and 2 emissions for listed equities and certain fixed income assets which cover 60% of overall AUM

It also aims to increase its exposure to clean technologies and to reduce its exposure to companies which own material fossil fuel reserves, but no specific targets were set due to concerns about data availability and integrity. As an aside, the Fund has adopted more conservative metrics for each of these drivers but they are also affected by data availability and definitional issues (eg what counts as a clean technology). See appendix A for further detail. The above targets currently cover only listed equities and investment grade credit, and only Scope 1 and 2 emissions, again due to constraints on available data.

The targets reflect the importance of engaging with portfolio companies as soon as practicable to ensure alignment with recognised decarbonisation pathways and drive down emissions at the required rate.

LGIM has set an interim net-zero aligned AUM target of 70% by 2030. This has been based on a top down approach whereby they forecast the proportion of funds by region and client type that they expect to have adopted net-zero strategy by 2030. Funds are considered aligned if they meet either a reduction of at least 50% in carbon intensity by 2030 relative to a 2019 baseline or implied portfolio temperature alignment of 1.5 degrees by 2030.

LGIM consider themselves a long-term investor and as such look to engage with policymakers at an early stage to help identify and address emerging risks. Their stewardship team leads on policy engagement on climate and sustainability issues. Engagement is an important component of our framework: for a fund to meet our net zero standards, LGIM require engagement with issuers on net zero such that 50% or more of portfolio emissions have a science based target or have been engaged with, in relation to climate change.

LGIM's targets are formulated in a different way to BTC's which unfortunately makes a comparison of the two managers' approaches very difficult.

Many large, listed companies now publish their decarbonisation commitments and plans over the next 5-10 years and these are captured by major climate data providers (such as MSCI). These can be used to project future emissions for specific portfolios of listed equities and corporate bonds. Such projections suffer from the obvious limitation that the Fund's holdings of equities and corporate bonds will change over time, but the Fund may wish to consider using them to inform its emissions reduction targets.

Balance and complexity. Setting a range of targets should help the Fund achieve an appropriate balance between different decarbonisation drivers, which are likely to conflict at least in the short-term. For example, an excessive focus on short-term decarbonisation targets may lead the Fund to miss out on the returns generated by high emissions companies which decarbonise effectively. They may also rule out investment in the providers of certain clean technologies (such as windfarm manufacturers/developers) which are critical to global decarbonisation efforts and may represent attractive investment opportunities, but suffer from high upfront emissions. Setting too many targets, or targets based on metrics which are not robustly defined, may equally lead to a loss of focus and/or inappropriate investment decisions. A balance needs to struck.

Data availability. We believe the Fund should only set a quantitative target in cases where data of sufficient robustness and coverage exists to establish a baseline and measure progress. Data quality and availability is improving, but currently imposes the following constraints on the targets that can be set:

- Asset classes: listed equities, credit and sovereign bonds. The provision of data by private markets managers is improving but remains patchy
- Emissions categories: Scope 1 and 2 emissions. Many listed companies now report Scope 3 emissions, but coverage is still limited and there remain concerns about the robustness of the estimates used. Not all managers report Scope 3 emissions.
- Green revenues: There is no industry-standard definition of what constitutes a clean technology product or service, although some frameworks such as the EU taxonomy are well regarded. Some frameworks cover products/services which support wider sustainability aims not just climate change. Nonetheless, green revenues is a measure of exposure to the investment opportunities generated by climate change and is worth measuring even if it is not explicitly targeted.
- Pathway alignment: This is an important forward-looking indicator of future emissions and we believe it should at least be measured. However, assessing the level of alignment with reference pathways takes into consideration not just current emissions but also a company's decarbonisation plans and the capacity and commitments of its management to deliver them. Forming such assessments is time consuming and requires considerable qualitative input which introduces a level of uncertainty. At the same time, plans evolve and management teams change.
- Engagement: This metric is also subject to considerable uncertainty. In particular, what exactly constitutes meaningful engagement and are engagements effective in terms of real-world decarbonisation. Engagement is however a key lever for the Fund and other long-term asset owners, so again we believe it is appropriate to track engagement even if it is not explicitly targeted.

Best practice. There is now a wealth of best practice/guidance on Net Zero for asset owners. One well regarded framework is the Net Zero Investment Framework ("NZIF") published by IIGCC which was presented to the ISC in 2022 and has been adopted by BTC and certain partner funds. NZIF now provides extensive guidance on all aspects of Net Zero, both at portfolio-level and across most key asset classes. Target setting is

a key component, and the framework recommends that asset owners set, as a minimum[10], portfolio-level targets covering:

- Portfolio Decarbonisation Reference Objective: medium-term (<10y) emissions (scope 1 and 2), expressed in absolute terms or using an emissions intensity metric
- Climate Solutions Objective: medium-term allocation to climate solutions providers
- Operational emissions (scope 1 and 2) generated by the Fund itself

And targets at asset class level covering

- Alignment Objective: short-term (<5 year) target for alignment with recognised decarbonisation pathways, with the expectation that 100% of assets will be aligned by 2040 and will achieve Net Zero by 2050
- Engagement Objective: immediate requirement that 70% of financed emissions in sectors with material emissions are subject to meaningful engagement (or are already achieving Net Zero or are Net Zero-aligned), with the threshold rising to 90% by 2030 at the latest.

Proposed targets

We recommend that over time the Fund considers setting targets around emissions reduction as well as three other key decarbonisation drivers: exposure to climate solutions, transition pathway alignment and engagement, in line with regulatory requirements, best practice guidance and commitments made by its investment managers. In the short-term, the targets set should however reflect practical constraints.

Robust targets require careful definition in the following areas:

- Level of target, ie portfolio-level vs individual asset class
- Drivers and reference metrics
- Asset coverage
- Emissions scope (where applicable)
- Baseline year (for emissions reduction metrics)
- Timeframe(s)
- Data quality
- Quantum of improvement expected

Level of target. Some market participants (including BTC) advocate the setting of targets at portfolio-level and individual asset classes. We recommend the Fund sets only portfolio-level targets at this stage. This reflects a preference to minimise the number of targets, data quality constraints and the benefits of retaining changes in investment strategy as a way of influencing climate outcomes. We further note that the asset class targets set by BTC for listed equities and credit are in any case very similar to those set at portfolio-level.

Drivers and reference metrics. The Fund will be expected to set short- and medium-term targets for **emissions reduction**. A number of possible reference metrics now exist including absolute emissions, emissions intensity (WACI) and emissions intensity (EVIC). We recommend emissions intensity (EVIC) is targeted as this is the metric over which the Fund has the best visibility and control. Absolute emissions are

[10] Essential action points only. NZIF also recommends a range of additional steps that could be taken: Source: IIGCC 2024

determined by emissions intensity and the quantum of capital deployed, over which the Fund has limited influence. Emissions intensity (WACI) is impacted by trends in corporate revenue which may not be apparent to the Fund.

We do not recommend the Fund sets a quantified target for **exposure to climate solutions (green revenues)** at this stage. In part, this is due to the lack of a consistent portfolio-wide baseline because the Fund's managers report on different bases. It also reflects a preference that exposure to such solutions be driven by the quality of investment opportunities available to the Fund's investment managers. We do recommend that the Fund aims to increase its exposure to this opportunity set and ensures that the managers of the portfolios in which it invests have access to a wide range of such opportunities.

We do recommend that the Fund sets a target for **alignment with reference pathways** in line with the targets set by BTC and LGIM and NZIF guidance. Pathway alignment is a key driver of future emissions and a robust baseline has now been established.

We do not recommend that the Fund sets a target for **engagement**. Although we acknowledge that engagement with portfolio companies should be a key driver of future emissions, we believe that the data currently reported by managers does not adequately address the quality and effectiveness of engagement activity. We do recommend that the Fund pushes its managers to increase the quantity, quality and effectiveness of engagement and maintains an awareness of developments in the measurement of these key variables.

Asset coverage. We believe the quality and coverage of available data is (just) sufficient to support the setting of targets in **listed equities and credit**. It is still not clear how the emissions financed by sovereign debt should be accounted for, nor how they should be compared with other portfolio emissions. Most managers including BTC and LGIM still do not report sovereign debt emissions. Some managers of other (private markets) asset classes have started reporting some metrics but coverage is patchy. The Fund should continue to encourage all managers to improve reporting in this area.

Emissions scope. We recommend that the Fund targets only **scope 1 and 2 emissions** at this stage. Some listed and private companies have started reporting Scope 3 emissions but coverage is limited and the estimates provided are subject to significant uncertainty. We do recommend the Fund starts to monitor Scope 3 emissions using available data, but gains experience of the progression of this metric over several years before any target is set.

Baseline year. We recommend setting a **baseline year of 2022** for emissions reduction targets. This was the first year the Fund carbon footprinted its portfolio and the level of data quality achieved was adequate (albeit within the constraints outlined above). It was not a "normal" year in capital markets but this does not imply the baseline is particularly onerous. Indeed it was a year in which the market capitalisation of energy and other emissions-intensive manufacturing industries rose significantly, boosting their weight in the Fund's portfolio. The valuations of large information technology and other growth stocks, which typically have low emissions at least on a Scope 1 and 2 basis, also suffered putting further upward pressure on portfolio emissions.

Timeframes. The Fund will be expected to set short- and medium-term targets at least in relation to emissions reductions, but has discretion over the specific timeframes chosen. We believe the Fund should choose timeframes which are meaningful in the context of its valuation cycle, over which key decisions on investment strategy are taken, and its long-term goals. We therefore recommend that the Fund sets targets for **2028** and **2035** and, for simplicity, applies these timeframes as consistently as possible across the board.

Data quality. Targets are only meaningful if the data available to monitor progress have sufficient coverage and accuracy. We recommend that the Fund focuses only on targets where the available data covers at least [80%] of in-scope portfolios and is based on values reported by companies and independently validated (eg by an auditor, data provider or the investment manager) rather than estimates.

Proposed interim targets. We recommend that the Fund considers setting the following targets (further explanation of the proposed emissions intensity target:

Target	Reference metric	ST target	MT target	Comment
Emissions intensity	Emissions/£m capital invested (EVIC), tCO2e/£m	2028: - 45%	2035: - 65%	Relative to 2022 baseline
Climate solutions	Green revenues, %	-	-	No quantitative target but aim to increase exposure to this opportunity set
Pathway alignment	Percentage of financed emissions aligned or aligning, %	2030: 70%	2035: 85%	In line with existing BTC targets and best practice guidance
Engagement	Percentage of financed emissions subject to meaningful engagement	-	-	No quantitative target but intention to increase the quantity, quality and effectiveness of engagement activity

Rationale for proposed decarbonisation objectives. In the previous section, we proposed that the Fund should aim to have decarbonised 3 years ahead of the wider market by 2028. This will involve decarbonising **in line with** the wider market and by improving the Fund's carbon footprint **relative to** the wider market. To help shape what this may look like, we have estimated the current position using a range of data sources to gauge what this could look like. We should caveat that this is very much a rough estimate and should not be relied upon, but we believe the Funds emissions were c. [10%] higher than the wider market as at 2022.

The reduction in emissions intensity required to achieve this aim depends on whether one assumes the market will decarbonise at the **required rate** implied by a recognised NZ pathway (c8% p.a. per the IEA NZ 2050 scenario) or at the rate currently **projected** (c3% p.a. for global equity markets). Setting the target based on the required rate would set a strong signal to the market, but it would become progressively more difficult to achieve without fundamental changes in investment strategy if markets failed to decarbonise at that rate as currently seems likely. The difference between the two approaches is substantial: by 2028 emissions intensity needs to fall by 59% vs the 2022 baseline if the required decarbonisation rate is assumed, but only 32% based on the projected rate. The interim target proposed in the table is set at the mid-point of this range. If the Fund wanted to decarbonise more rapidly,

and accepted a higher risk of failing to achieve the target, a target closer to the top end of the range could be considered.

The interim target reduction of 45% is comparable the BTC's target of a 44% reduction (after adjusting approximately for different target and baseline years[11]) which seems appropriate. The formulation of LGIM decarbonisation target does not facilitate a straightforward comparison with its approach.

A similar approach has been adopted to derive a target for 2035, although it should be noted that the degree of uncertainty over what level of decarbonisation is possible over this longer period is greater. The proposed target of -65% vs the 2022 baseline is set at the midpoint of the range of decarbonisation outcomes: 45% to 85%.

[11] Based on the assumption that emissions fall at a constant rate

Climate change strategy

The Fund will employ two generic strategies for dealing with climate change: capital reallocation and asset stewardship.

Capital reallocation.

Capital reallocation will take place at three levels, all of which can potentially have a material impact on climate change metrics:

- Changes made by the Fund to the strategic asset allocation.
- Changes made by the Fund to its investment structure, and in particular the choice of investment managers/strategies.
- Stock selection decisions made by underlying investment managers, as a result of taking climate change into account in their investment processes.

Strategic asset allocation ("SAA"): in its 2022 review of investment strategy, the Fund considered a series of changes to the SAA which were expected to have a positive impact on climate metrics and were shown to have a modest, but positive impact on projected funding outcomes. These included increased allocations to renewable infrastructure and companies developing decarbonisation solutions (via private equity and debt allocations), plus a reallocation away from higher emissions Emerging Markets. However, the Fund lacked sufficient data to quantify the impact on climate metrics and the market timing of the required transactions was considered sub-optimal. The Fund agreed to revisit climate-driven changes in SAA at the next valuation/investment strategy review (2025).

Manager/strategy selection: In recent years, there has been a proliferation of managers/strategies aiming to deliver reduced exposure to climate risk and/or increased exposure to climate opportunities relative to the wider market. The Fund can use these approaches to decarbonise its portfolio faster than the economies in which it invests. The range of strategies include:

- ESG-tilted passive strategies (listed equity and credit) tracking indices in which capital is tilted away from high emissions companies and/or towards those with significant involvement in sustainable products and services. The LGIM Low Carbon Transition Index fund in which the Fund invested last year is one such investment.
- ESG-integrated active strategies in which managers are required to take ESG factors into consideration in their investment processes. All the Fund's actively managed strategies fall into this category.
- ESG-thematic active strategies in which managers use sustainability themes including climate change to guide their search for investment opportunities. In this category, delivering financial returns remains the primary objective.
- ESG-impact funds which pursue strategies with dual objectives of delivering financial returns and achieving sustainability impacts. Some strategies in this category require a trade-off between financial returns and sustainability impact: this may be because of an over-supply of capital (a good example of this is UK offshore wind which saw yields dip below 4% recently) or because the impacts targeted are inadequately rewarded (more common in social impact strategies).

There is a wide choice of managers/strategies in listed asset classes and increasing availability in private markets too. Such strategies can have a material impact on climate metrics: in listed equities for example, they can reduce emissions intensity by 40-70% and/or increase exposure to companies providing decarbonisation

solutions by up to 4x compared with the wider market, depending on the specific approach adopted[12]. Some managers also commit to subsequently reducing emissions intensity by 7% year-on-year which enables them to claim "Paris Alignment". The upfront reduction in emissions intensity is equivalent to 5-8 years of the required year-on-year reductions.

The Fund will consider strategies in each of these categories providing that:

- A robust investment case exists,
- Expected financial returns are commensurate with the level of investment risk.
- Projected climate impacts are necessary to achieve the Fund's climate objectives.

Fiduciary obligations would allow the ISC to accept lower financial returns for the Fund in exchange for increased climate impact, providing that it believed members of the Fund would support this course of action. There is no appetite to do so at present.

The Fund also believes a prudent approach to capital reallocation is appropriate at this stage. The overall exposure to climate risk is not known and will not be clear until emissions can be measured on a Scope 3 basis across most of the portfolio. In addition, although the science of climate change is now well established, the policy, societal, technological and capital markets responses to it remain uncertain. Furthermore, the track records of climate-driven strategies delivering both financial returns and climate impact are still relatively short. As a result, the risk of taking poor investment decisions and subsequently having to unwind investments is elevated. The Fund will scale back the quantum and pace of climate-driven investments accordingly for the time being.

Stock selection. Stock selection decisions are delegated to investment managers, and the Fund monitors the climate impact of them through its annual carbon foot printing exercise.

Stewardship/engagement

Stewardship/engagement with portfolio companies and other stakeholders can take many forms and is considered to be a key decarbonisation lever for asset owners. Depending on the asset class, it may involve:

- Voting of shares
- Filing shareholder resolutions
- Meetings, or other communications, with company management
- Board representation
- Litigation
- Engaging with policy makers, standard bodies and the media to promote stewardship goals.

The benefits of effective engagement are believed to be material although evidence to support this remains limited. The benefits include:

- Uses influence as capital provider to drive real-world change which will ultimately benefit the Fund
- As an alternative to divestment, avoids high emissions companies being acquired by less responsible investors.
- Enables the Fund to capture its share of the value created when companies successfully decarbonise.

[12] Enhancements observed on a sample of climate-driven strategies, 2022

Approaches to engagement vary, but characteristics of effective engagement include:

- Setting clear engagement themes/priorities – the Fund has for now adopted BTC's priorities of low carbon transition, water/waste management, diversity and social inclusion through better labour management
- Focusing engagement effort on situations where it is likely to be effective. The UNPRI has provided guidance on where engagement is appropriate:
  - Opportunity, and intention to, deliver real-world impact
  - Issue is systemic and non-diversifiable
  - Investors have or can improve their leverage by working collaboratively
  - Persistent influence is possible and likely to be productive
  - Alternative escalation measures remain open to investors
  - Fiduciary constraints on use of divestment
- Setting clear objectives and timescales for each engagement
- Committing sufficient resources to ensure meaningful and informed engagement with high emissions portfolio companies, noting that effective engagement can be a time consuming and resource intensive endeavour.
- Having an appropriate escalation strategy, including the use where appropriate of divestment

As with capital reallocation, stewardship/engagement takes place at multiple levels of the Fund:

- Engagement with portfolio companies: the Fund largely delegates this function to its investment managers, although it also supports LAPFF (Local Authority Pension Fund Forum) which directly engages with selected companies on behalf of its members.
- Engagement with investment managers: the Fund engages with its investment managers to ensure that all aspects of their investment processes including stewardship are effective. *[Note: a handful of LGPS funds are undertaking own research on high emissions sectors and companies they own, in order to more effectively challenge investment managers. The Fund may wish to consider adopting this approach]*
- Engagement with policy makers and other market participants. the Fund largely delegates this function to BTC and LAPFF, though it does respond to selected consultations on climate change matters. *[Note: some LGPS funds have joined relevant industry bodies such as IIGCC and NZAOA in order to remain abreast of the latest thinking on climate change, contribute to the development of standards/best practice and support their advocacy efforts. The Fund may wish to consider joining one of these organisations.]*

The Fund ensures the effectiveness of engagement activities undertaken by its directly appointed managers through its manager selection and monitoring processes and expects BTC to do likewise for managers it appoints. Monitoring includes (i) comprehensive stewardship reporting covering context, actions undertaken by companies and outcomes achieved and (ii) regular manager review meetings which encompass engagement.

Note: the above is intended as a list of criteria the Fund could use to assess the suitability of its engagement oversight, rather than as confirmation that the suggested mechanisms are in place for all managers.

Further development

As noted above the future path of climate change remains uncertain and the availability of solutions to measure and manage climate risk is changing rapidly. Further development of this climate change strategy is thus essential. Key development actions in the next 12 months include:

- Agree the Fund's long-term aim around decarbonisation and the short and medium climate targets as set out in the above paper
- Develop the Fund's policy on key issues such as engagement vs divestment, the generation and use of financial offsets, maintaining biodiversity and ensuring a just transition
- Create action plans on engagement, capital allocation and data quality/reporting with a focus over the next few years
- Extend reporting on key metrics (emissions intensity, green revenues) to all asset classes
- Expand the number of metrics that can be measured (eg Scope 3 emissions, transition pathway alignment, levels of engagement) and improve data quality
- Continue to investigate alternative ways of measuring climate risk and opportunity
- Consider other climate-driven investments as necessary to achieve the targets, including climate-driven strategies in listed credit and private markets
- Strengthen engagement with directly appointed managers including consideration of upgraded manager reporting, formal manager review meetings and a refresh of due diligence on their approach to ESG integration and stewardship

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Appendix 1 - Metrics

Metric	Definition	Units
Absolute emissions ("Financed Emissions")	Sum of the Fund's share of the emissions of portfolio companies, Scopes 1-3, based on its share of their capital structures	tCO_2e
Weighted Average Carbon Intensity ("WACI")	Average Greenhouse Gas ("GHG") emissions per USDm revenue, Scopes 1-3, weighted by the Fund's capital commitment to each portfolio company	$tCO_2e/\$m$
Emissions Intensity (EVIC)[13] "Carbon Footprint"	Absolute emissions, Scopes 1-3, divided by the Enterprise Value of Invested Capital ("EVIC")	$tCO_2e/\$m$
Fossil Fuel Ties	Percentage of capital invested in companies with interests in fossil fuel reserves, power generation using fossil fuels and ancillary services. This is a more conservative metric than the one adopted by BTC which captures only companies with material holdings in fossil fuels.	%
Green Revenues	Average percentage of portfolio companies' revenue derived from clean technology products and services, weighted by capital commitment. The definition of a clean technology should be consistent with a recognised framework such as the EU taxonomy, but in practice may vary between reporting sources. This is a more conservative metric than the one adopted by BTC which accounts for portfolio companies providing clean technology at their full capital weight, irrespective of the materiality of these lines of business to the companies involved.	%
Climate Engagement	Percentage of financed emissions which are subject to meaningful engagement on climate change (Note: can also be defined as percentage of capital invested in companies subject to engagement)	%

[13] Previously expressed per £m equity invested, and therefore only applicable to equity investments

Transition Pathway Alignment	Percentage of capital invested or financed emissions in companies which are already Net Zero, are aligned with a recognised transition pathway or have a credible plan for achieving alignment	%
Data Quality	Percentage of assets covered by metrics reported by portfolio companies and independently validated	%