SURREY PENSION FUND COMMITTEE

FRIDAY 23 SEPTEMBER 2016

ITEM 4 QUESTIONS AND PETITIONS

MEMBER QUESTIONS

(1) MR JONATHAN ESSEX TO ASK:

Surrey Pension Fund recently stated that, 'through its participation in the Local Authority Pension Fund Forum (LAPFF) it aims to push for an orderly carbon transition by requiring companies to identify and tackle carbon risks in their business models'. This differs from the commitments and statements made by London's new mayor and his Conservative mayoral challenger, Zac Goldsmith. London's new mayor has committed to 'take all possible steps to divest the London Pension Fund Authority of its remaining investments in fossil-fuel industries'[1], a stance echoed by his Conservative opponent Zac Goldsmith[2]. Meanwhile, distinguished close observers including Sir Mark Moody-Stuart (for eight years chairman of Shell UK) and Sir Jonathan Porritt are on record despairing that any substantive amendment by global hydrocarbon companies of their climate-damaging practices and extractions will take place, including those funded in part by Surrey's Pension Fund.

i) In light of this, what specific evidence can the Surrey Pension Fund, its advisors or committee identify where an extractive programme or programmes has been halted by a hydrocarbon company, or a change or changes of policy, or a business model or models being amended by a hydrocarbon company, as a consequence of LAPFF's 'engagement strategy'?

ii) Please supply as many examples as possible, and with details.

Reply:

The Local Authority Pension Fund Forum (LAPFF) aims to push for an orderly carbon transition by requiring companies to identify and tackle carbon risks in their business models. Company actions are in response to a number of factors including engagement with a wide variety of shareholders and stakeholders, so it is not possible to cite them as a direct or sole consequence of engagement by LAPFF. However, LAPFF has been undertaking research and engaging on climate risk since 2001. The following are examples of companies LAPFF has engaged with and changes, actions and initiatives companies have taken in recent years.

Programmes halted

- Shell halted its Alberta Oil Sands Project (Carmon Creek) in October 2015. The company justified its actions on commercial grounds, given the high cost of this project set against the low oil price and the need to cut costs.

Change or changes of policy

[1] See www.sadiq.london/a_greener_cleaner_london.
[2] See www.theguardian.com/environment/2016/apr/22/zac-goldsmith-backs-fossil-fuel-divestment-movement-london-mayor

LAPFF engages with companies in the influencing of policy on climate change.

- Glencore: now referring publicly to carbon pricing and explaining its approach to stranded assets. Prior to 2015, this was not the case.
- BP, ENI, Shell, Total and others are all members of the Oil and Gas Climate Initiative and have stated publicly 'we are researching what scenarios intended to limit the global temperature rise to 2C or below mean for the oil and gas industry. Our ultimate aim is to identify the most effective levers for oil and gas companies to help deliver this goal collectively and transform ourselves individually.'
- BP, BHP Billiton, Shell, Eni, Total and others are members of the World Bank's Carbon Pricing Leadership Coalition.
- BP, BG, ENI, Shell, Statoil and Total all signed a joint letter to UN Framework Convention on Climate Change calling for carbon price (2014).
- BP has made a notable shift away from oil and towards gas.

Business model or models

LAPFF funds co-filed shareholder resolutions on strategic resilience to climate change to BP and Royal Dutch Shell in 2015, and to Rio Tinto, Glencore and Anglo American in 2016. These resolutions all have five elements including asking for companies to provide an assessment of the company's portfolio of asset resilience against the range of International Energy Agency scenarios and/or other relevant post 2035 scenarios to be outlined to investors in routine reporting from 2016

- BP: LAPFF has engaged with BP over a number of years. BP formerly only set out one 'scenario' for the energy transition. In BP's 2016 Energy Outlook, a 'base case scenario' is outlined but, also for the first time, it sets out a 'faster transition' scenario. Whilst this falls short of the International Energy Agency 450 Scenario (limiting emissions to 2 degrees), it goes further than the pledges previously made.

- Total: LAPFF has met with Total individually over the years. Total issued a dedicated report 'Integrating Climate into our Strategy' at its May 2016 AGM. Of all these type of reports issued to date, Total's appears the most advanced for an oil company by publicly aligning its strategy with a two degree scenario. It sets out that it will move 20% of its portfolio to renewable energy over the next 20, will invest 7.4bn USD in the next four years on research and development including cleantech and will not get involved in Arctic drilling. They have also bought a 1.1bn USD stake in a battery company and continue to increase their solar manufacturing and ownership.

- ENI: Recently released its Sustainability Report that had an enhanced section on climate change. This includes very granular detail on its cost structure for resource development and operating expenditure. ENI has also set up a new business line called Energy Solutions that aims to complement and supplement traditional sources of energy with production from renewable sources.

Other points

- It is important to emphasise the long term nature of engagement on carbon risk in that there is no specific end point where 'success' can be identified across all companies. LAPFF recognises that succeeding in getting companies to disclose against shareholder strategic resilience resolutions is not sufficient in itself, so LAPFF is now analysing these scenarios, to inform ongoing engagement with these companies. In particular, LAPFF will now be asking for evidence of how

companies stress test their portfolios against the scenarios they devise, and how this informs their investment decisions.

- LAPFF continues engaging on companies' public policy positions in recognition of the power and influence that these companies hold, e.g., asking BHP to reconsider its membership of the Minerals Council of Australia and the Business Council of Australia (BHP AGM 2015) and asking BP to reconsider its membership of the American Petroleum Institute (BP AGM 2016). Whilst neither company has responded positively so far, LAPFF aims to continue to engage on these issues, alongside other investors.
- LAPFF also continues to push for improvements in the link between climate change and executive pay, and will be picking this up in engagement over the next year.

(2) MR JONATHAN ESSEX TO ASK:

Research such as by The Grantham Institute of Climate Change and the Environment (Unburnable Carbon: Wasted capital and stranded assets, 2014)[3] highlight the risk of 'stranded assets' due to investment in fossil fuels. This particular report calls for investors to re-evaluate energy business models against carbon budgets, to prevent a $6 trillion carbon bubble in the next decade. In response:

i) What specialist advice has either the SPF committee, or alternatively the Local Government Pension Scheme, sought in the past 24 months relating to the increasingly systemic danger recognised by investment professionals of investments in high-carbon companies becoming 'stranded assets' and thus ultimately worthless? And

ii) What investment actions - including sales and liquidations - has the Surrey Pension Fund or the LGPS taken in the past 24 months, in consequence of the 'disclosure of climate risks' cited by the county's leader as a benefit of the LAPFF's 'engagement policy'?

Reply:

LAPFF and Carbon Tracker launched the report 'Engaging for a Low Carbon Transition' in July 2016, which addresses the issue of stranded assets under different demand trends, noting that companies can face both physical and financial stranding. The report notes 'the implication of these demand trends is that, should the fossil fuel industry continue with a business as usual approach, supplies of oil and gas could outpace demand. Companies will then face the choice between shutting in capacity or starting a price war to force others to do so. Both choices will lead to stranded assets: the first leads to physical stranding, the latter to financial stranding.

A Carbon Tracker Initiative report in 2015 estimated that the fossil fuel industry could waste investments of 2tn USD by 2035 if it continued to invest under a growth model. It is already too late for coal with no new projects needed under a two-degree demand scenario. But the oil and gas industry has time to avoid the massive value destruction

[3] See www.carbontracker.org/wp-content/uploads/2014/09/Unburnable-Carbon-2-Web-Version.pdf

seen in the coal industry, but only by curtailing capital expenditure and returning any additional cash generated to shareholders.

This is supported by the LAPFF policy position that 'LAPFF will continue to press companies on aligning their business models with a 2°C scenario. For coal, oil and gas companies, particular attention is given to carbon asset risk, by promoting a low carbon transition. For oil and gas companies, the focus should be on value at risk, particularly from high cost projects and support can be given to returning capital to investors where appropriate'.

An example of LAPFF promoting this strategy in practice is voting advice provided on shareholder resolutions to Chevron in 2015 and 2016, supporting the request that the board adopt a dividend policy increasing the amount authorised for capital distribution to shareholders in light of the risk of the Company having stranded assets in the future. Surrey's Statement of Investment Principles (SIP) delegates full authority for purchase and sales decisions to its external investment managers and meets with them regularly to discuss such decisions in the light of their research and analysis.

(3) MR JONATHAN ESSEX TO ASK:

Given the specific, widely confirmed environmental dangers of oil extraction from tar sands (which from extraction to use is one of the most damaging fossil fuels), how does the Surrey Pension Fund justify its continued £3 million holding in Suncor Ltd, a firm engaged in tar sands extraction in the Canadian Arctic?

Reply:

A shareholder resolution to Suncor at its 2016 AGM asked the company to report on assessing and ensuring long term corporate resilience in a future low carbon economy. The resolution was supported by the company board and a report is expected later this year.

Having engaged with the external fund manager, the Fund is advised that Suncor's investment case is underpinned by strong financial characteristics, specifically funding almost all its capital expenditure and dividend payment from operating cash flow in the current low oil price environment. Consistent operational excellence, capital discipline, investment decisions and excess cash returned to shareholders make the company stand out within the oil industry.

(4) MR JONATHAN ESSEX TO ASK:

Many different organisations have set out why they feel divestment is compatible with their fiduciary duty, for example as set out to the pension fund of the University of Toronto (March 2014)[4]. Reasons why divesting allow one's fiduciary duty to be met are

[4] See http://d3n8a8pro7vhmx.cloudfront.net/to350/legacy_url/54/fossil-fuel-divest.pdf?1418320739, Section 4.

outlined by various reports including by Smith School, University of Oxford (2013)[5], IMPAX Asset Management (2013)[6], HIP Investor Inc. (2013)[7] and Aperio Group LLC (2016)[8]. These state that divestment can remove exposure to significant risk without significantly increasing exposure to other risks, as well as evidencing that fossil free portfolios tend to perform better rather than worse than those which include fossil fuels.

Given the above please could you confirm and explain Surrey Pension Fund's current position regarding whether it believes that selling its investment in the top 200 fossil fuels companies[9] would be compatible with it meeting its fiduciary duty?

Reply:

The LAPFF statement on Climate Change states 'LAPFF members are supportive of investment opportunities afforded by a low carbon future which increases diversification and provides long term returns.'

Divesting is not necessarily the action of selling all of an investment (although it can be) but, rather, it is the action of selling at least a portion of an investment. In this way, LGPS funds are likely to participate in divestment regularly.

Fiduciary duties set out the broad parameters within which the Pension Fund Committee (and the council officers, fund managers and investment consultants appointed) must exercise their discretionary powers with regard to pension fund governance. These duties affect the exercising of discretion to make and manage investments, and require trustees and their agents to act prudently and for a proper purpose.

In the case of the Surrey Pension Fund, the proper purpose is ultimately to pay future pension promises to its members and therefore obtain sufficient returns with which to do so, as set out in the Fund's Statement of Investment Principles. The Fund aims to be at or above a 100% funding level in order that it is able to meet its current and future liabilities and, to this end, the Committee will seek investment returns that are consistently strong and outperform or match those available in the major investment markets and are comparable with other institutional investors.

Surrey's SIP makes clear that environmental, social and governance (ESG) considerations should be delegated to the Fund's external fund managers. The Fund encourages its managers to view and consider ESG factors where it is thought that long-term performance may be enhanced by such consideration and, under current arrangements, such consideration and resultant stock choices will be the responsibility of the external managers employed to select investment on the Pension Fund's behalf.

Fund managers will always need to consider ESG matters in the context of the overriding fiduciary duty of the Pension Fund Committee and investment performance targets.

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[5] See www.smithschool.ox.ac.uk/research-programmes/stranded-assets/SAP-divestment-report-final.pdf
[6] See https://s3.amazonaws.com/s3.350.org/images/Impax--20130704_white_paper_fossil_fuel_divestment_uk_final.pdf
[7] See https://s3.amazonaws.com/s3.350.org/images/Resilient-Portfolios-and-Fossil-Free-Pensions-ByHIPinvestor-GoFossilFree-vFinal-2013Oct31.pdf
[8] See www.aperiogroup.com/resource/138/node/download
[9] As defined by the Fossil Free Index: fossilfreeindexes.com/wp-content/uploads/2015/11/CU200_Final_29-Oct-2015.pdf

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