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Surrey Pension Team

Providing our customers with a better tomorrow

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23 November 2022

Dear Sir or Madam,

Consultation "Local Government Pension Scheme (England and Wales): Governance and reporting of climate change risks"

Surrey County Council (Surrey) welcomes the opportunity to respond to this consultation on Governance and reporting of climate change risks from the Department of Levelling Up, Housing and Communities (DLUHC).

Surrey is the Administering Authority for the Surrey Pension Fund (the Fund) as part of the Local Government Pension Scheme (LGPS). The Fund has assets of over £5billion and over 300 employers.

The Fund has long recognised the imperative to address climate change as a systemic and long-term investment concern for our stakeholders. It poses material financial risks across all asset classes with the potential for loss of shareholder value.

Achieving a just transition to a net zero economy cannot be achieved by companies or investors alone. It also requires government action to raise standards across the piece. With the provision of a clearly identified legislative framework on carbon reductions, companies and investors will be able to make the necessary decisions and financial commitments to provide the short and long-term solutions to decarbonisation of the economy that are needed.

The Fund therefore is a strong supporter of the introduction of mandatory carbon emissions and risk reporting. We support the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) report and considers all market participants should be encouraged to aim for the fullest relevant implementation. The Fund itself has produced a TCFD based report on a voluntary basis in each of our Annual Reports from 2020, to help our stakeholders understand how climate is integral to investment decisions and reporting.

The Fund agrees that all funds should report against TCFD. However, we recommend that proposed guidance includes specific sections for smaller funds, especially with regard to metrics and scenario analysis.

There also seems to be misalignment between government objectives and regulation regarding scenario analysis. Clearly it would be unfair and inconsistent to have different obligations for LGPS funds than to issuers or occupational pension funds regulated by the DWP. It would, however, appear sensible to have alignment with government policy regarding scenarios. Achieving net zero by 2050, as enshrined in the UK Climate Act, implies a 1.5 degree rise rather than 2 degrees and therefore requirements should focus on this figure. As such, the Fund would encourage government, its departments and its agencies, to adopt 1.5 degrees as the required benchmark for all issuers, asset managers and asset owners. Not doing so creates financial and investment risks associated with government policy pushing for 1.5 degree reduction but disclosures judged against
14 a 2 degrees standard.

Finally, while the Fund supports TCFD reporting, an area of concern is the oversight of the social implications of the transition within the TCFD framework. Failing to consider the impact of the transition on workers, communities, supply chains and consumers carries financial risks. These include opposition to climate action which will slow the pace of the transition (economy-wide and for individual companies). There are also specific issues around skills, employment standards and human rights, which create legal and operational risks as well as reputational ones and we believe the consultation underlined the need to take forward the recommendations of the Good Governance Project led by the Scheme Advisory Board.

Alongside the risks there is considerable opportunities to improve social outcomes which can help support economic and financial stability. The Fund recommends that issues around the just transition are included within the government's approach to TCFD regulation.

The rest of this response is focused on the specific questions outlined in the consultation document.

Question 1: Do you agree with our proposed requirements in relation to governance?

We believe the proposals set out in this consultation underline the need to take forward the recommendations of the Good Governance Project led by the Scheme Advisory Board, particularly in terms of ensuring both officers and members have the appropriate level of training and understanding and that roles and responsibilities are clear.

Question 2: Do you agree with our proposed requirements in relation to strategy?

Climate change is a systemic risk which poses significant investment risks, but also opportunities, with the potential to impact long-term shareholder value and investment returns. We agree that it is therefore essential that LGPS Funds identify and assess climate-related risks and opportunities that impact their investment strategies.

Question 3: Do you agree with our suggested requirements in relation to scenario analysis?

We recognise that conducting scenario analysis at the overall Fund level is relevant for LGPS Funds to assess the impacts over the medium and long-term on their assets, liabilities and strategies.

Carrying out scenario analysis, reporting on appropriate metrics that include greenhouse gas emissions, and setting appropriate targets, would also provide valuable inputs to inform a LGPS Fund's investment strategy. It would further allow LGPS Funds to monitor and review progress and to make amendments to the investment strategy where necessary. Disclosing this information would provide greater transparency to members and taxpayers about how their money is being managed.

We welcome the recognition that the use of climate scenarios is still new, that current assumptions and methodologies vary and data quality and availability may also be a problem for some asset classes, and that the proposed regulations would require LGPS Funds to conduct scenario analysis as 'as far as they are able to'. Scenario analysis is only significantly developed for equities and some fixed income assets. As a result, there would have to be some extensive simplifying assumptions to be able to apply it across other asset classes, raising questions about the usefulness of any conclusions.

Given the wide range of scenarios based on a 2°C or lower temperature rise there is a risk of selection bias. We believe it would be more appropriate for the statutory guidance to mandate the scenario analysis to be undertaken for the common scenario analysis across all LGPS Funds.

We consider alignment of scenario analysis with the valuation cycle is appropriate. The proposed regulations should therefore clarify whether scenario analysis is expected in 2023/24 given this is mid-valuation.

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We agree that LGPS Funds should have the discretion over whether scenario analysis should be repeated within a valuation cycle and explain that approach.

Due to the actuaries of LGPS Funds also conducting scenario analysis there may be some duplication leading to additional costs for LGPS Funds, different outputs and potential conflicts.

Question 4: Do you agree with our proposed requirements in relation to risk management? Conclusion

We agree with the broad principles set out around risk management and look forward to seeing the detail in the statutory guidance. However, there is the risk that LGPS Funds may not have sufficient resource and may lead to an over reliance on consultants. We believe the statutory guidance should set out what a best practice approach in this area could look like.

Question 5: Do you agree with our proposed requirements in relation to metrics?

We support the use of the absolute emissions (total financed carbon emissions) metric to measure overall carbon emissions attributable to the fund's invested assets but further clarity is needed on the calculation and formula for this proposed metric.

We would question the usefulness of reporting total carbon emissions at a whole fund level. Such a figure would have the potential to be a highly misleading indicator where change from year to year is driven by complex underlying reasons which cannot be explained by a single number. The uncertainty created by the figure is likely to lead to questions and queries that put further unnecessary strain on limited resources. We consider metrics to be most useful when calculated at the portfolio or asset class level. In our response to Question 8 we set out our concerns about the aggregation of data underpinned by modelling and estimations at scheme level and have similar concerns at fund level.

We support the use of an emissions intensity metric, however, further clarity is needed on the calculation and formula for this proposed metric. This is to ensure there is no ambiguity and that the calculation is aligned with current best practice.

There should be no reason why LGPS Funds would be able to provide Weighted Carbon Intensity data but is unable to provide the Carbon Footprint data. Providing the option to use a different intensity metric will make it harder to aggregate at Scheme level. As carbon emissions are the common input into all of the suggested intensity metrics it would be more appropriate to permit LGPS Funds to use a different intensity metric in addition to the carbon footprint metric.

We are supportive of including metrics on data quality and acknowledge the role that the LGPS can play in using its influence to encourage increased data reporting across asset classes. The proposal is for LGPS Funds to show the percentage of the value of their assets for which emissions have been verified, reported, estimated or where data is unavailable. However, the reporting of data as 'verified' is not currently standard with third-party data providers. This would need to be on a best endeavours basis, and to be improved and reported over time.

We do not agree with reporting Scope 1, 2 and 3 data separately as well as aggregated for each proposed metric. Whilst it is understood that Scope 3 should be disclosed, there are issues regarding data quality, with high levels of estimation required and the significant risks of double counting of emissions. In addition, there is an absence of sufficiently robust methodologies and issues with the data quality and availability.

Modelling or estimating emissions for assets not covered is problematic. Different methodologies could be used by data providers, LGPS Funds or their pooling companies, potentially leading to very different results and outcomes; for example, using the Listed Utilities sector as a proxy for renewables investments in Private Markets would result in a high carbon profile (under Scope 1/2) and perhaps result in unintended consequences impacting renewables investments.

14 To help pension schemes meet their obligations under the Climate Change Governance and Reporting Regulations, and associated DWP Statutory Guidance, a template was developed by a working group which included the PLSA, ABI and Investment Association. This template was also developed to help insurers and investment managers fulfil their obligations under the FCA's ESG Sourcebook. This template requests managers to report Scope 1 and 2 emissions in aggregate and Scope 3 separately. Some managers will already be reporting data in this format. Reporting of data by third-party providers varies, some do not report Scope 1 and 2 separately but as an aggregated figure. Requiring LGPS Funds to reports all three scopes separately may add extra cost to extract the data.

Reporting extra data and numbers also has the potential to make reporting more confusing for stakeholders with no perceivable benefits. We are supportive of aligning portfolios with the Paris goal, limiting global warming to well below 2°C (and preferably to 1.5°C), compared to pre-industrial levels. However, whilst we recognise the importance of an alignment metric, we are concerned that over reliance on some alignment metrics, such as implied temperature rise (ITR), may drive investment decisions that improve the alignment score rather than actively manage the underlying climate risks, such as reducing or divesting entirely from currently high emitting companies and sectors. Reporting a Binary Target Measure based on the proportion of assets that have set a Paris-Aligned target is more appropriate and can be improved and added to over time. It is also important to consider the credibility of these targets and whether they are achievable. We believe it would be more appropriate to mandate an approach to determining alignment such as the Paris Aligned Investment Initiative (PAII) criteria, as this is already enshrined in Net Zero guidance so easier to ensure mass adoption.

We agree with the reservations expressed about the use of implied temperature models; these were highlighted in the TPI's TCFD consultation response from June 2021 which we co-signed. Different models from different data providers can produce very different ITR results, which could lead to 'model shopping' to find the metric which produces the lower score. There are also data gaps, inconsistencies and lack of reliability across many asset classes which limits the value of the metrics.

Although we shouldn't let 'perfect be the enemy of good,' and see how an ITR can be used to engage beneficiaries, the lack of a standardised methodology and decision-usefulness still remain, and we therefore agree that ITR models should not be used to support the proposed Paris alignment metric.

Although DLUHC is not mandating the use of ITR models, it is encouraging their use. This, and the suggestion LGPS Funds could pursue other metrics, risks creating a perception that some LGPS funds are less committed in this area than others when the reality may be grounded in capacity and proportionality. If the use of ITR is to be progressed, the methodology should be mandated otherwise there is no way to ensure comparability.

Question 6: Do you agree with our proposed requirements in relation to targets?

There is a fundamental tension in the approach set out in the consultation which prescribes the use of specific metrics, allows target setting against those or other metrics chosen by individual LGPS funds and the intention to produce a Scheme-level climate risk report.

We are supportive of our pooling company's approach which sets targets to increase the proportion of portfolio companies aligned to Net Zero. Their portfolio target is broken down into asset class level targets which together aim for a more ambitious emission reduction trajectory than the IEANZE2050 pathway.

We would argue that to promote a degree of consistency across the Scheme, one metric against which a target is set should be mandated. In our view, carbon footprint would be the most appropriate metric against which the target should be set. Where targets are set, we believe that LGPS funds should explain the rationale for their choice of metrics and targets and should disclose this in their TCFD report. 14

Question 7: Do you agree with our approach to reporting?

Given the urgent action required regarding climate change, there is a need for a consistent approach across the pensions industry with regard to reporting on climate-related risks and opportunities. We therefore in principle, due to the public nature and transparency of the LGPS and to ensure that all stakeholders have access, support publishing reporting in line with the recommendations of the TCFD.

However, the proposals will place the same requirements on all LGPS funds from April 2023, regardless of size, in contrast to the approach taken in regard to occupational pension schemes where a ratcheted approach was adopted initially focusing on compliance from the largest schemes. There would further appear to be a tension between the timelines for reporting set out in these proposals and the requirements of the FCA's TCFD regime which requires the first public disclosures to be made by June 2023.

Implementing these reporting requirements from April 2023 and the production of first reports by December 2024 will pose a significant and perhaps insurmountable challenge for many LGPS funds, particularly those smaller in scale. We say more about the role of LGPS pools in our answer to question 9 but note here that pools are not all constructed in the same way and capabilities in this area will be varied.

The consultation emphasises the importance of LGPS funds having access to the relevant expertise and advice. Given the timescale of this consultation and the proposed implementation, it is difficult to see how LGPS funds could practically procure that expertise in the time available. Procurement of this expertise will also create additional costs. It is not clear there is sufficient supply of external advice to meet demand which will likely further drive costs upwards. We say more about skills in our answer to question 11.

We agree that LGPS funds should have the freedom to choose whether their Climate Risk Report is a standalone document or part of its Annual Report, that it should be readily available to members and it should be accessible to non-specialists.

Question 8: Do you agree with our proposals on the Scheme Climate Risk Report?

We are unclear as to the purpose and usefulness of the proposed Scheme Climate Risk Report, beyond providing signposting to the reports produced by individual LGPS funds.

The consultation acknowledges the lack of available data, the quality of data and the limitations of metrics as challenges facing LGPS funds in terms of reporting and recommends the use of modelling and estimation to fill them. As previously discussed, data availability is varied for different asset classes and non-existent for some. Use of data providers and the underlying methodologies will vary across

LGPS funds leading to metrics not being calculated in the same way. Until there is a standard industry approach to carbon footprinting, it would not make sense to aggregate the data for the four metrics from each AA's Climate Risk Report as the data would be neither comparable nor compatible.

Aggregating these uncertainties and variations across 89 LGPS funds will undermine the reliability of the Scheme-level figures produced, and increase the likelihood of significant shifts in the published headline data from one year to the next driven by the changing quality of the underlying data rather than material changes in the level of climate risk. While individual LGPS funds and pools have the context in which to understand significant shifts in the data, these will be much harder to identify and explain at an aggregated level for the whole Scheme.

In addition, producing such a Report would de facto hold the Scheme Advisory Board responsible
14 for the climate risk in the scheme overall when it has neither the remit nor the powers to effect change in the decisions taken by LGPS funds. The SAB has an important role to play in advising Government on the opportunities and challenges faced by LGPS funds but its ability to do so will not be helped by such a report in this form. Indeed the variations and uncertainties would risk stakeholders drawing erroneous conclusions around the performance in addressing climate change risk, and could lead to misinformed pressures to divest.

Question 9: Do you have any comments on the role of the LGPS asset pools in delivering the requirements?

We see a positive role for LGPS asset pools in driving responsible investment, pursuing active engagement and encouraging the development of stronger data and transparency. However, it is important to recognise that the pools have different operating models and levels of resource to meet these and existing reporting requirements.

We see supporting our Partner Funds in meeting reporting requirements as an important part of the function of polling companies. However, this will take time to develop to meet the demand we might anticipate as a result of these proposals, particularly if there is an expectation to produce data in relation to metrics Partner Funds may choose to measure against over and above the four mandated in the consultation. A consistent approach across Partner Funds would create opportunities around joint procurement on scenario analysis and data. The proposals are likely to involve significant costs around data acquisition, report preparation and other pressures on resourcing.

We believe this collaborative approach is the best way to build confidence in pooling and further unlock its benefits. We do not believe using additional reporting requirements to drive pooling, or appearing to do so, would be effective. We believe the role of LGPS pools in supporting LGPS funds to meet reporting requirements, on climate change risks and other areas, should be addressed as part of a comprehensive approach to the future of pooling in the LGPS aligning roles, responsibilities and capacity. We therefore urge the Government to move forward with the consultation on the future of the pooling framework as soon as possible.

Question 10: Do you agree with our proposed approach to guidance?

We agree with the principles set out in the consultation however we would welcome a clear timetable for the publication of the guidelines and template, both in order to provide feedback but also given the implementation timeline. We have already expressed reservations about the timeline for implementation and we would urge these to be reviewed if guidance is delayed.

Question 11: Do you agree with our proposed approach to knowledge, skills and advice?

The reporting and frameworks around climate change and carbon footprinting of investments remain comparatively immature. As such the talent pool in this area is underdeveloped. The proposals set out in this consultation require the production of annual reports from each of the 89 LGPS funds. Whether from within LGPS funds, LGPS pools or via external advisors, it is highly unlikely there is sufficient talent and capacity within the sector to meet that requirement at this point with the potential for significant recruitment and/or procurement challenges. We are concerned the demand or external consultant support implied by the proposals will drive up costs.

Clear lines of responsibility and delineation of roles and duties is a key part of the TCFD's 'governance' pillar. While ultimate responsibility for managing climate change risks and opportunities lies with LGPS funds, we would like to see the statutory guidance recognise that 14
LGPS funds vary greatly in their degree of reliance on and interaction with advisers: some rely entirely on internal pension teams and managers, whereas others delegate a great deal to external advisers and their pools. We would welcome some flexibility in the statutory guidance to allow LGPS funds to establish and work within a governance framework that best meets their needs.

Taking forward the Good Governance Project proposals from the Scheme Advisory Board would be a welcome step in addressing issues around ensuring participants in LGPS Governance have the appropriate knowledge, skills and advice.

Question 12: Do you have any comments on the impact of our proposals on protected groups and on how any negative impacts may be mitigated?

The transition to a decarbonised economy carries with it social risks. This includes risks to workers, communities, supply chains and consumers. Some protected groups are likely to be disproportionately affected, especially regarding employment impacts and as consumers. These impacts are widely accepted, including within the HM Treasury's Net Zero Review: Analysis exploring the key issues (2021). While the impact of TCFD requirements for LGPS funds alone is unlikely to have a significant impact, the objective of the cross departmental push towards TCFD requirements is intended to support the decarbonisation of the economy. As such, TCFD requirements if effective may have some negative impacts on protected groups. To address the negative impacts, we recommend that TCFD requirements include social considerations within the framework and more broadly that governments, investors and companies are committed to a just transition.

Yours faithfully,

Anna D'Alessandro
Director of Corporate Finance & Commercial

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