SURREY PENSION FUND COMMITTEE – 15 DECEMBER 2023
ITEM 4A – MEMBER QUESTION

QUESTION FROM STEVE WILLIAMS:

The Surrey Pension Fund has set a target of Net Zero by 2050 or sooner for its underlying investments and this was based on advice by commissioning Mercer, the Fund's investment consultant, as stated in a recent Press Release issued on behalf of the Fund on 26th September 2023 (in response to a press release issued on behalf of Extinction Rebellion).

Given that recent evidence from a report by Professor Steve Keen and the financial think tank Carbon Tracker, *Loading the DICE Against Pensions*, published in July 2023, https://carbontracker.org/reports/loading-the-dice-against-pensions , suggests that pension funds are risking the retirement savings of millions of people by relying on economic research, such as Mercer's, that ignores critical scientific evidence about the financial risks embedded within a warming climate,

(i) Do professional officers now consider that the Net Zero date of 2050 should be reconsidered in favour of an earlier date for decarbonizing the portfolio, and that further independent advice on this matter should be commissioned?
(ii) Do professional officers now consider that assets whose principal source of income is based on the extraction of fossil fuels carry too much risk and investment in such assets is in breach of our fiduciary duty?

RESPONSE:

Given that recent evidence from a report by Professor Steve Keen and the financial think tank Carbon Tracker, *Loading the DICE Against Pensions*, published in July 2023, https://carbontracker.org/reports/loading-the-dice-against-pensions , suggests that pension funds are risking the retirement savings of millions of people by relying on economic research, such as Mercer's, that ignores critical scientific evidence about the financial risks embedded within a warming climate,

(1) Do professional officers now consider that the Net Zero date of 2050 should be reconsidered in favour of an earlier date for decarbonizing the portfolio, and that further independent advice on this matter should be commissioned?
(2) Do professional officers now consider that assets whose principal source of income is based on the extraction of fossil fuels carry too much risk and investment in such assets is in breach of our fiduciary duty?

Mercer's general response to the Carbon Tracker report
"Mercer welcomes input on our climate change work. We also contribute to third-party reports to help increase awareness and understanding of how climate change may affect investments and in particular, pensions. We are disappointed that Carbon Tracker's report presents an incomplete, and therefore misleading, summary of Mercer's climate change analysis.
Carbon Tracker's report analysis focusses on older versions of Mercer's climate change model. Climate scenario models evolve as more information about climate change and global warming becomes available. They include an element of qualitative judgment and are just one input investors should consider to manage the risks and opportunities of climate change in their portfolios. As Carbon Tracker acknowledge, Mercer has developed a new model in collaboration with Ortec Finance. This model reflects our current point of view and produces scenarios with different impacts than those cited in the report.

It is Mercer's view that limiting global warming to 1.5°C can improve economic outcomes for long-term investors. To help investors understand areas of risk and opportunity within their own portfolios, Mercer can help them measure portfolio-level carbon emissions, set net-zero-

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aligned targets to reduce those emissions and create a transition plan setting out how to achieve those reductions (see following link for more details: https://www.mercer.com/content/dam/mercer/attachments/global/investments/gl-2022-net-zero-report.pdf).

Mercer has always sought and welcomed external input on our climate change work, from our first major global research report on climate change in 2011, Investing in a Time of Climate Change report in 2015 ("the 2015 report") and Investing in a Time of Climate Change – The Sequel in 2019 ("the Sequel"). Indeed, we were very grateful that Carbon Tracker joined our advisory group for the 2015 report. In respect of our latest climate scenario model released in May 2022, we have partnered with Ortec Finance (who in turn partner with Cambridge Econometrics) as well as seeking input from a wide variety of clients and external stakeholders.

Given Mercer has very much led the way in advising institutional investors on climate risk for more than a decade and has intentionally shared much of our intellectual capital publicly, it is inevitable that our work is often cited in reports and press articles on climate scenario analysis.

Much of the negative press comment is in relation to our 2015 and 2019 models and has, in our opinion, been taken out of context e.g. quoting the annualised return impacts, ignoring the parallel stress testing analysis and not referencing the modelling limitations set-out publicly in the Sequel report (on pages 28 to 31).
A key conclusion from our latest model is that; "A successful transition is an imperative". We support this by quantifying the impact of a Failed Transition (a 4°C+ scenario) on a global equity portfolio, which our scenarios show to be a reduction in value of between 35% and 40% over a 40 year period compared to a baseline scenario representing what we think the market is currently pricing-in."

Mercer's response specifically in relation to the Surrey Pension Fund
"Mercer stands by its recent advice and the processes followed to arrive at the recommendations that supported the Committee's decision to set a Net Zero target date of 'Net Zero 2050, or sooner'. We note that it was agreed to regularly review this (e.g. annually), which we fully support. Mercer dedicates significant resource to consider the potential financial implications of climate change when delivering investment advice, noting that this is an evolving area. As part of the recent net zero project for the Fund, we considered a comprehensive and wide range of issues, which was fully discussed with the Committee. This included: (1) a combination of bottom-up holdings/sector and top-down asset class analysis, (2) assessment of traditional financial metrics, (3) climate specific analysis, (4) quantitative and qualitative perspectives around real-world impact and (5) implementation feasibility of a preferred policy. Our recommendations were grounded in an overall assessment of the results of the multi-factor analysis.

Mercer understands that, on balance, a key driver of the Committee's decision making related to the size of the investment universe under the Net Zero target date portfolios analysed. This was informed by an analysis of the number of companies in the MSCI ACWI universe with projected scope 1 and 2 greenhouse gas (GHG) emissions aligned with a relevant target date (e.g. 2030, 2040, 2050). A key finding was that, as at 31 December 2022, there were only 126 companies aligned with a 2030 Net Zero target date out of a universe of 2,765. This number would fall to 35 if scope 3 emissions were incorporated into the analysis. The number of companies with a 2040 net zero target was shown to be c.200 and did not materially increase until a date of 2050 was targeted. The concentration risk associated with an equity portfolio constructed from these companies, based on a single selection criterion, was not considered to be appropriate with the Fund's wider fiduciary responsibilities and a key driver of the decision making.

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Reflecting the relative importance of this analysis, Mercer proposed that this part of the analysis is updated on an annual basis with significant developments in the number of companies aligning with different target dates feeding into a review of the Fund's Net Zero target. In short, if the number of companies increases, across all sectors, with credible plans to reduce their GHG emissions over time, the more viable it becomes for the Fund to target a Net Zero date for its own portfolio over an accelerated period.

Climate scenario analysis, which is the focus of Carbon Tracker's paper, formed only one part of the assessment. This part of the analysis was based on Mercer's latest 2022 model, which the Carbon Tracker report acknowledges as demonstrating impacts "closer to damages of the order that the science might suggest". Limitations of the analysis, including challenges associated with modelling the physical impact of climate change, such as certain 'tipping points' and the absence of impacts such as climate-related migration were clearly disclosed to the Committee.

Acknowledging the limitations, the key finding from the scenario analysis was that a portfolio aligned with an earlier Net Zero target date would be expected to outperform under a rapid transition and underperform under a failed transition over the short term. This finding is driven by the nature of the policy environment under the scenarios considered. Over the longer term, a failed transition would be expected to lead to indiscriminate damages to investment returns. For context, a failed transition scenario is consistent with temperature warming of 2.6oC by 2062 with an associated reduction in global GDP of around -25%. This level of damage is in fact higher than under the damage functions proposed in the Carbon Tracker report (around -20% of GDP under their exponential and logistic illustrations).

Whilst it is certainly plausible that actual investment returns could be even more negative than projected under a failed transition (regardless of model used), it is not apparent to Mercer that this would have impacted the Committee's decision making in relation to the chosen Net Zero target date. As noted above, the relatively small investable universe of companies that have credible plans in place to reduce their GHG emissions before 2050 was a key driver of decision making. As mentioned above, the level of stock concentration involved was not considered to be appropriately diversified to invest in, at this time."

Fund/Officer response to questions.

1) **Do professional officers now consider that the Net Zero date of 2050 should be reconsidered in favour of an earlier date for decarbonizing the portfolio, and that further independent advice on this matter should be commissioned?**

The brief for the consultancy work on Net Zero date setting and the appointment of Mercer to carry out the work was decided by the Committee. The Responsible Investment Sub Committee, RISC, met twice to review the proposal from Mercer. The first meeting covered their whole approach. The RISC had a follow up question as a result of this meeting, reproduced below.
Please provide further information regarding the methodology and assumptions underpinning the climate scenario models (see slide 11) and why they were considered appropriate. In addition provide further insight in to the E3ME model and the rationale for why it was selected?
The second meeting focused solely on this question. After this meeting the RISC recommended to the Committee that Mercer be appointed for the project.
After a further presentation by Mercer on the output of the project, taking into account the climate modelling, risk and return assumptions, opportunity set and implementation, the Committee decided that a date of 2050 or sooner was currently appropriate. The 'or sooner' comment was considered significant.

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The RISC had a meeting dedicated to reviewing the models and assumptions Mercer would use in its analysis. However, it was noted that all models and understanding of climate change, as well as the potential investment opportunity set, would change over time. Therefore, it was also agreed that a summary review of the opportunity set would be carried out each year, at which point the Committee would decide if a full review was necessary. Officers do not dictate the policy approach taken by the Committee and instead seek to advise on its implementation.

2) Do professional officers now consider that assets whose principal source of income is based on the extraction of fossil fuels carry too much risk and investment in such assets is in breach of our fiduciary duty?

Fiduciary duty is best carried out when all factors that can impact the risk/return balance of an investment decision are considered by those that have the information, experience, qualification and skill to make those decisions. The RI policy requires that ESG factors, amongst others, are included in the investment decision making process by the Fund's investment managers, such that the risk/return trade-off is fully understood. The Fund's Investment Managers are best placed to make these decisions and have been charged with that responsibility accordingly.

Any decisions that reduce the investable universe potentially negatively impact the risk adjusted returns the Fund is capable of making.