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Annexe 3

Fossil Fuel Exclusion Impact Analysis

Surrey Pension Fund

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A business of Marsh McLennan

Background

At the December 2023 Committee meeting of the Surrey Pension Fund ("the Fund"), the Fund's exposure to the top 25 largest fossil fuel related companies, ranked by revenue, was shared with the Committee. It was agreed to undertake analysis to consider what potential impact excluding these companies from the investable universe might have on expected returns for the Fund (looking at positive and negative outcomes) relative to a benchmark index and green house gas metrics.

The proposal was to review two definitions of the "largest fossil fuel related" companies. The process being as follows:

- Mercer used the MSCI All Countries World Index (the parent index) as at 29 March 2023, to construct two lists.
- The index was filtered to those companies within the "Oil, Gas and Consumable Fuels" industry.
- With the lists to be based on "size", Mercer used two different definitions of this, the first ranked companies by market capitalisation (i.e. size of company by investible market valuation) and the second ranked companies by trailing 12-month revenue.
- There were a number of companies which appeared on the list more than once, with the different entries representing different share classes. Mercer combined the market capitalisation for these companies so that they were only included once in the final list.

Following the creation of the lists, the Committee approved the exclusions list wherein companies were ranked by trailing revenue. Following agreement, the next step was for analysis to be conducted to assess the impact any exclusions of the companies would have on the respective investable universe. Border to Coast Pension Partnership ("BCPP") and Legal & General Investment Management Ltd ("LGIM") were asked to provide analysis for the mandates to which the Fund has exposure to, outlining the estimated impact on tracking error of the 'new' benchmark with the 25 companies excluded (as relevant), along with the impact on the benchmark's green house gas metrics.

Important notes

- Analysis in this paper comes from BCPP and LGIM for their respective equity funds in which the Fund invests in as at 31 March 2024; as such it is a single point in time and will be subject to change. The analysis looks at the impact of the exclusions to the benchmark index for the respective funds invested in. The tracking error analysis does not allow for any prevailing differences in the underlying portfolios relative to the respective index, for example, due to active management positions in the BCPP funds. The tracking error analysis for Global Equities is a reasonable proxy applicable to the BCPP and Newton Global equity assets.
- Analysis in this paper only considers the impact of the potential exclusions on the Fund's listed equity portfolio (due to the availability of data and analysis). There could be exposure in other parts of the Fund's assets.
- The analysis is intended to be illustrative in nature to aid discussion and is no guarantee of actual outcomes.
- This paper does not consider the practical implications of implementing an exclusions policy. This would need to be subject to further consideration, if required.

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Exclusions under consideration: top 25 companies by revenue

ISIN	Name	Revenue (USD millions)	Country	Weight of MSCI ACWI Index %
SA14TG012N13	Saudi Arabian Oil	494,795	Saudi Arabia	0.03
CNE1000002Q2, CNE0000018G1	China Ptl.& Chm	444,504	China	0.02
CNE1000003W8, CNE1000007Q1	Petrochina	425,242	China	0.03
US30231G1022	Exxon Mobil	334,697	USA	0.64
GB00BP6MXD84	Shell (Lon)	316,619	United Kingdom	0.30
FR0000120271	Total Energies	218,945	France	0.21
GB0007980591	BP	210,130	United Kingdom	0.15
US1667641005	Chevron	196,913	USA	0.39
US56585A1025	Marathon Petroleum	148,379	USA	0.11
US7185461040	Phillips 66	147,399	USA	0.10
US91913Y1001	Valero Energy	144,766	USA	0.08
INE002A01018	Reliance Industries	109,323	India	0.15
NO0010096985	Equinor	106,847	Norway	0.03
INE242A01010	Indian Oil	104,830	India	0.01
BRPETRACNPR6, BRPETRACNOR9	Petroleo Brasileiro	102,464	Brazil	0.09
IT0003132476	Eni	101,285	Italy	0.05
JP3386450005	Eneos Holdings	99,324	Japan	0.02
TH0646010Z00	PTT	90,379	Thailand	0.01
INE213A01029	Oil & Natural Gas Corp	85,287	India	0.01
PLPKN0000018	Orlen	85,258	Poland	0.01
ES0173516115	Repsol Ypf	63,742	Spain	0.03
JP3142500002	Idemitsu Kosan	61,561	Japan	0.01
KR7096770003	SK Innovation	59,647	Korea	0.01
INE029A01011	Bharat Petroleum	58,929	India	0.01
US20825C1045	Conocophillips	56,141	USA	0.21
Total				**2.70**

Source: Databank, Bloomberg for revenue, as at 15 April 2024. Please note, where multiple ISINs are included within the same line this is representative of multiple share classes within the same company

Companies in the **Energy** sector and **Oil, Gas and Consumables** industry as at 29 March 2024

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Summary – Financial Metrics

Currently invested with	BCPP (active)			Newton (active)	LGIM (passive)			
Equity class	**UK**	**Global**	**Emerging Markets**	**Global**	**Future World Global**	**Europe ex UK**	**Japan**	**Pac ex Japan**
Total Surrey assets, £m	£366.9m	£873.8m	£287.6m	£478.5m	£1,307m	£61.3m	£19.8m	£46.1m
Percentage of index excluded (i.e. reduction in opportunity set)	10.8%	2.7%	3.8%	2.7%	1.2%	2.3%	0.4%	0.2%
Tracking error vs. index % p.a.	2.1%	0.5%	0.6%	0.5%	0.2%	0.4%	0.1%	0.1%

Data as at 31 March 2024.

Largest impact on expected tracking error is on UK equities; impact on other equity classes is modest

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Summary – Carbon Metrics

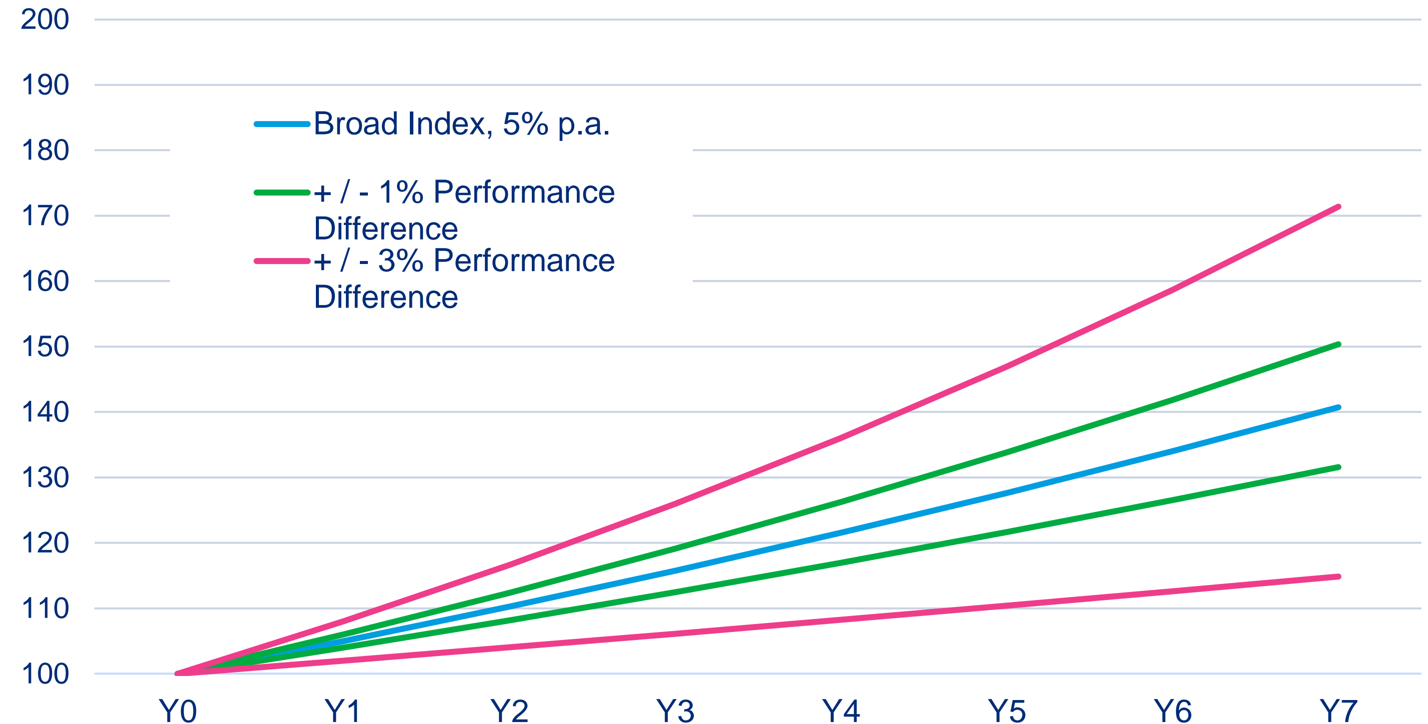
Currently invested with	BCPP (active)			Newton (active)	LGIM (passive)			
Equity class	**UK**	**Global**	**Emerging Markets**	**Global**	**Future World Global**	**Europe ex UK**	**Japan**	**Pac ex Japan**
Weighted Average Carbon Intensity impact vs. benchmark	-21%	-3%	0%	-3%	-5%	-5%	-1%	0%
Carbon Intensity impact vs. benchmark	-24%	-4%	+1%	-4%	-5%	-6%	-3%	0%
Potential / Financed Emissions Impact vs. benchmark	-35%	-9%	-3%	-9%	-10%	-8%	-3%	-1%

Data as at 31 March 2024
Please note, the metrics provided by BCPP and LGIM are not direct comparators, for LGIM the Carbon Intensity metric represents the Carbon Reserves Intensity, while Financed Emissions represents LGIM's Value Chain Emissions. While Financed Emissions represent the emissions financed in the real economy, Value Chain Emissions is a measure of the emissions created by interaction with entities within the value chain.

Exclusion of the relevant stocks would have a day one positive impact on carbon metrics, but not necessarily so for achieving further progress after this. The impacts on other environmental, social and governance measures for LGIM funds are non-material

Understanding potential impact on returns

- Tracking error is a statistical calculation of the expected performance relative to a particular index (e.g. the FTSE All-Share index for UK equities).
- A tracking error of say, 1% p.a., means that relative performance is expected to be within +/-1% p.a. two-thirds of the time, and outside of this range for the remaining one-third.
- Greater tracking error means greater variation in relative performance (on both the upside and downside) and a wider range of possible outcomes.
- Use of tracking error as a risk measure won't capture all potential risks. For example, excluding large stocks from an index could lead to active management decisions that would otherwise not be taken and lead to further return variation. The impact of this is difficult to quantify.



*The above chart is an **illustrative** example of the cumulative growth of the index ("broad index") over 7 years, and the impact of tracking error (a proxy for different returns) over time, and the deviation it can cause from the index. The chart shows the 1% and 3% performance difference for both upside and downside scenarios. After 7 years the performance difference to the index is c. 7% for the 1% tracking error and c. 22% for the 3% tracking error.*

Reducing the investable universe will introduce tracking error versus a relevant index. The impact could be positive or negative over a given period, which the Committee would need to understand and be comfortable with

Divestment: potential benefits and trade-offs

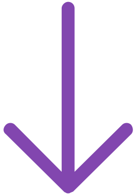
Potential benefits	Trade-offs
Risk & decarbonisation: reduce portfolio exposure to ‘stranded’ assets and carbon intensity.	**Not sufficient for net zero** as other sectors / companies are also carbon intensive.
Escalation tool when engagement fails and companies are too slow to transition.	**Engagement more effective** when tackling systemic and non-diversifiable issues like climate change?
Limited return impact if divesting only impacts a small part of the portfolio.	**Limits real world impact** if no longer supporting high emitters to transition through engagement.*
Signal to market about Fund's ambition and views.	**What about demand?** Investors still hold companies with strong demand for fossil fuels (e.g. utilities).
Increase cost of doing business if enough investors deny fossil fuel companies access to capital.	**Inconsistent with fiduciary duty** if reduced opportunity set impacts returns?
	How to implement in a pooling context?

Divestment may be an effective tool when seeking **value-alignment, where there is the risk of stranded assets and a lack of opportunities for companies to transition to a sustainable business model, or where an investor has exhausted all other escalation options**.

*with few engaged investors left companies may even increase their fossil fuel activities / renege on existing targets / undermine a Just Transition

Summary

The Fund's overall long-term expected return (from all assets) was c. 5.9% p.a. as at 31 March 2022. Around half of this is attributable to the Fund's exposure to equities.



Translating the exclusions/tracking error analysis to a total fund level, in simple terms, we estimate that this would lead to an expected **return variation** of 5.8% to 6% p.a., relative to a baseline of 5.9% p. This **variation** is not material, with the central best estimate return of 5.9% p.a. remaining the same.

From a green house gas emissions exposure perspective, excluding the top 25 fossil fuels companies is expected to reduce the ongoing and potential emissions of the resultant investable universes, albeit, other than for UK equities, the reduction in the green house gas emissions intensity is fairly limited.

Overall, we consider the impact of the estimated tracking error as a result of the exclusions being considered to be relatively small. The actual impact of exclusions will only be known in time and could be positive or negative.

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