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XX November 2022

Dear Sirs,

RE: Governance and reporting of climate change risks- open consultation

Dear Sirs,

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

The Nottinghamshire County Council Pension Fund have comments on the consultation on the proposals as follows:

Governance

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

Additional guidance is required regarding these requirements. Nottinghamshire Pension Fund already has processes to monitor climate related risks and report to the Pension Fund Committee, but it is not clear from the consultation document whether this is sufficient to meet these proposed requirements. Pension Fund officer resources are limited, and despite the significant support we receive from our pool and our investment managers, responsible investment, including climate related risks, already takes up a significant proportion of that resource. Any growth in this area will require additional resources.

Critiquing the work of externally appointed experts who have been appointed for their specialist expertise and ability to fill knowledge and skills gaps is complex. The Pension Fund is highly reliant on our pool for monitoring of investment managers, proxy voting and stewardship, and the oversight of the delivery of data, research and analysis.

“on an ongoing basis” is a particularly unhelpful phrase to indicate how often the fund should assess these risks. We expect the assessment of climate-related and other risks to be integrated into investment decisions by our investment managers, but beyond ensuring that we are aware of emerging issues (ad hoc) and that investment managers are managing risk (which for our fund is a quarterly process) the data does not change sufficiently for this to be a sensible exercise more than our current annual Climate Risk Analysis and TCFD report.

Strategy

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

Again 'continuous' seems unrealistic, and the wording could be improved here. Clear guidance would be welcome. We review our investment strategy formally on an annual basis, including assessing the impact of climate risk on the strategy. Investment specific risks or new opportunities would not be regarded as 'strategic', and we expect our investment managers to assess these on an ongoing basis.

We should recognise that climate risk at company and portfolio level is not entirely captured by backwards looking emissions metrics data. The transition to a lower carbon economy and the associated changes in consumption patterns and regulations portend physical and transition risks that go beyond risks indicated by a company's carbon emissions.

Carbon emissions related targets and metrics will not be enough to discharge an AA's climate risk management obligations, nor the obligations bestowed upon their appointed investment managers. Detailed stock, sector and regional analysis is required and should be delivered through robust ESG integration. The transition to a lower carbon economy and the emissions reductions required to achieve it will not be linear and shorter-term risks and opportunities will need to be considered along-side this longer-term trend to achieve attractive investment returns.

Scenario Analysis needs to evolve as a discipline to provide further insights that direct asset allocation decisions.

Scenario analysis

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

Nottinghamshire Pension Fund already produces scenario analysis at approximately this frequency, with the assistance of our pool company. We have also been contacted by our actuary proposing to repeat this work for the purposes of the triennial valuation. Standardisation and clarification would be helpful to reduce the duplication of effort and cost in this area. However analysis of the impact of climate risk on liabilities from our actuary will be very welcome.

We are supportive of a sub 2° scenario which Nottinghamshire is pleased to include this year. However this analysis indicates the limitations of the modelling and data. Nottinghamshire hopes that DLUHC's expectation of improvements in this area is correct.

As investors it is important that we assess the implications of possible outcomes as well as desirable outcomes.

Pool companies would be well placed to work alongside traditional investment/actuarial advisors to perform scenario analysis and develop optimal investment strategy outcomes

Risk Management

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

Yes. Statutory guidance would be welcome. More development is required on the impact on liabilities. Actuaries are the obvious choice to develop this expertise.

Metrics

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

We do not entirely agree. Scope 3 emissions drive a multiplication of emissions as soon as related investments are aggregated because of the way they are defined. i.e. one company's scope 1 and 2 emissions are another company's scope 3 emissions. If the whole market were owned, the total figure would be a significant multiple of the actual emissions. Mechanisms will need to be developed to ensure this is accounted for correctly and consistently across funds before Scope 3 emissions can be reported in a meaningful way - these emissions can only be seen as indicative. If these are to be disclosed, this should be a separate disclosure and should not be amalgamated with Scope 1 and 2 emissions. Furthermore any targets should exclude Scope 3 emissions because of this element of multiple counting.

There are further challenges as Scope 3 emissions are not widely reported and the estimation of scope 3 emissions can be complex leaving scope for inconsistent techniques across different data providers. As real data becomes available the aggregated emissions numbers will fluctuate as real emissions data replaces estimated. It will be impossible to tell whether these changes are due to decarbonisation or changes in carbon accounting.

Scope 1,2 and 3 emissions do not provide a complete reflection of the transition risk and physical risk exposure of a fund. Nor do these metrics capture all of the upside opportunities. This will need to be explained when presenting the results of this analysis.

Nottinghamshire reports carbon emissions currently and describes them as 'Financed Carbon Emissions'. This helps to distinguish between emissions that relate to investments as opposed to implying that these emissions are caused by investments. This naming convention may help to dispel the misunderstanding that owning an investment causes emissions which is a damaging misconception as it encourages the approach of divestment which merely transfers ownership and has no real world impact, and also risks the transfer of responsibility for emissions from the decision maker to an investor. (e.g. an individual chooses to drive rather than walk to their destination, but the carbon impact is seen as the responsibility of the fuel extractor).

Supporting guidance to drive better consistency in attributing carbon emissions to investments would be welcome.

There are significant challenges with reporting at whole fund level as certain asset classes are still lacking data. It would surely be beneficial to provide an asset class breakdown which could then be accompanied by some commentary about the reliability of the data and any particular drivers in a fund's investment strategy.

The Carbon Footprint metric will be hard to communicate as this term is widely used as an absolute metric, not an intensity metric – perhaps at the least the name could be reviewed. Previously the carbon intensity metric Nottinghamshire Pension Fund has used has been the Weighted Average Carbon Intensity which is relative to the turnover of the companies invested in. This was selected because it gives an indication of the level of risk to our investments arising from the potential for carbon taxes or similar. It is not clear of the purpose of the proposed metric or how it helps funds to monitor or manage their risk. There is a risk instead that this will lead to comparisons of funds where one with a low score is regarded as better than a fund with a higher score, ignoring any potential benefits that the fund is driving through engagement or improvements in practice. This could incentivise funds operating exclusion policies in contradiction to the stated aims of the approach which explicitly emphasises that this is not the desired outcome.

The total absolute emissions of a fund are heavily influenced by the size of the fund. Carbon intensity metrics that use the market cap of the fund will fluctuate in accordance with market valuations. As such, the carbon footprint of a fund will be influenced by factors other than the carbon emissions of the underlying investments. It will be challenging to explain these changes when reporting aggregated emissions at fund level.

We welcome the reporting of data quality and believe this will help to improve understanding of these metrics. Clear definitions will be helpful. The difficulty in managing data in certain asset classes should be recognised, for example disclosure in emerging markets, small cap and private markets tends to be lagging. Consequently figures will often be driven by strategic asset allocations. There is a risk that local investments in smaller companies and private assets could be discouraged. Furthermore the reporting is challenging as some private equity funds have excellent reporting, but there seems to be no central way for this to be recorded. Consequently reflecting this information at Pension Fund level can only be done with manual input which cannot be resourced, and even then would likely only be partial and inconsistent information. It is hoped that greater consistency of reporting will also drive better reporting by companies and funds. Increased regulatory requirement for companies and funds to disclose this information would support this initiative, alongside investor efforts to achieve greater disclosure across asset classes through engagements and voting. In addition it can be hard to apportion emissions from private assets as it isn't always possible to identify what proportion of a fund is owned. This disclosure would also be required to enable the suggested reporting.

Similarly we welcome the reporting of Paris Alignment, despite the current shortcomings with the data available in this area. The IIGCC net zero investment framework asks for aligning/aligned measurement which requires analysis of the quality of the net zero commitment/ target. We consider this to be a more insightful indicator of risk and the future trajectory of the portfolio. We consider that not all Net Zero commitments/ targets are the same, some are more challenging and comprehensive than others. Consideration needs to be given to the detail of the commitment and the company's ability to deliver it. A binary metric could miss this important nuance. A net zero target quality score at portfolio/ fund level should also be considered. Similar to that provided by Net Zero Zeal.

It is important to make a distinction between alignment metrics that are focused on measuring the impact of the portfolio and those metrics that are intended to provide insights into the risk exposure of the portfolio.

Implied temperature rise/ Paris aligned metrics are often a point in time analysis and do not necessarily give a strong indication of how a company or portfolio might look in 3 years' time for example. They do not necessarily give an indication of the direction of travel for a company or the portfolio in terms of carbon nor do they necessarily assess the potential for a company's product portfolio to contribute to the transition in a positive way. It is important to take a broad set of factors into consideration when making investment decisions looking at a company's strategy, R&D spend, Capex plans, the progress of technology innovation and the pipeline of regulation and legislation. It is important to be clear and transparent about the limitations of these metrics when presenting results. We expect our active managers to consider these factors when making investment decisions.

Investors can play an important role in encouraging companies to disclose more data around climate risks and ESG risk more generally. However, we consider that there is also an important role for government in mandating this disclosure.

There will be a challenge ensuring that these metrics are explained properly to stakeholder groups and in dealing with queries and questions around methodology, data and alignment.

Targets

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

The movement of these metrics are likely to be volatile as data improves as well as due to genuine underlying trends. This should be recognised, including the difficulty of communicating this to stakeholders. Appropriate metrics need to be chosen, noting the reservations in the metrics section.

Targets should be aligned to achieving Net Zero. An approach consistent with the UK Government's stated objectives and ambitions agreed at Paris. We know that the transition to Net Zero will not be linear in terms of the decarbonisation of the real economy events such COVID19 and the invasion of Ukraine can change international priorities in the short term which effect market views of sectors and sector performance. The importance of the longer-term decarbonisation of real economy is clear, we favour medium and long terms targets which we consider reflects this non-linear decarbonisation. These targets will need to be measured and monitored annually however we consider that mandating an annual target could prove to be a distraction from the achievement of longer-term ambitions which we consider to be consistent with our fiduciary responsibilities.

Implementation of a target across all asset classes is challenging, as in some cases data is not comprehensive. A target that is specific to asset classes such as listed equity and corporate credit assets only may be more achievable. Any reporting against target should be accompanied by the data coverage of AUM.

The statement that there is no expectation that AAs should set targets which require them to divest or invest in a given way, and the targets are not legally binding is welcome.

Reporting on climate risks

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

The detailed list of disclosures is welcome.

We consider the oversight of governance activities to be critically important and agree with the recommendations in this area. There is an important role for pooling companies in providing assistance with establishment and delivery of this governance. This section does not cover the oversight of investment management activities and in particular the vital integration of ESG into the investment process and the delivery of Stewardship and voting.

Please clarify whether the Scenario Analysis section is required every year, or just when this is refreshed in line with the triennial valuation.

We consider that short, medium and long term horizons could be considered as 3 years (triennial valuation cycle), 7 years (to 2030 interim target date) and 25 years (Net Zero target date) respectively. We would welcome the alignment of timeframes with these transition mile stones.

Investment mandates are not necessarily managed over medium/ long term horizons even though pension funds are considered long term investors.

Nottinghamshire Pension Fund already publishes a TCFD risk report with the assistance of our pool company. We usually publish at the November or December Pension Fund Committee meetings. However each of the pool partner funds has a schedule for this report across the financial year. Setting a deadline in line with the annual report will concentrate all the work into half of the year and it will be difficult for the pool to meet these deadlines without additional resources.

Timing aside, the data provider requires strict confidentiality on much of the report, so our longer Climate Risk Report is exempt and provided to the Pension Fund Committee and officers only, alongside detailed training to explain the technicalities, complexities and uncertainties of the data. Our public reports are intended to be accessible to lay readers, but the realities of this data should not be overlooked (again, note the reservations on the metrics).

Scheme climate risk report

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

No. Please see the comments on Scope 3 emissions and the metric names for question 5 which are applicable here.

Please also note the concerns over aggregating data from private assets in the same section.

We recognise the merits of scheme wide reporting but consider that it would be very difficult in practice. It would require consistent methodologies across funds and pools which would need to be mandated. This question also proposes "each AA must report the proportion of its assets for which overall emissions data is: Verified, Reported, Estimated or Unavailable. We are in agreement with this requirement subject to data vendor classification methodologies.

A dashboard of metrics is required to understand the trajectory of a portfolio in terms of carbon emissions. Intensity metrics are important as they provide context for absolute emissions and portfolio/ asset class level metrics provide an explanation to fund level changes. They should be considered together rather than in isolation.

If these issues can be resolved then we are supportive of the Scheme level reporting. The LGPS is transparent and all this information will be in the public domain. The risk of being compared unfairly is significant and the resource requirements for those schemes in that situation should not be overlooked.

The role of the LGPS asset pools

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

LGPS Central currently provides climate risk reporting and scenario analysis to partner funds that covers both assets managed within and outside of the pool. LGPS Central has been essential in supporting us with our climate risk strategy with advice, analysis and significant input to our responsible investment and stewardship. However many of our private equity and infrastructure investments and some other legacy investments are very difficult for the Pool to assess (even where they are held inside pool funds).

The LGPS asset pools have no involvement in the liabilities of the LGPS. Consideration of the impact of climate risk on liabilities seems to be lagging behind analysis relating to assets (perhaps naturally). Actuaries seem the obvious choice to develop expertise in this area. Climate risk is significant to both investments and liabilities, but the expertise in these areas lies in different places. It would be good to see this formalised.

It is inappropriate to suggest that AAs align their strategies and targets within their pool. The governance of each LGPS scheme rests with a democratically elected body responsible for managing the scheme. This should not be changed.

Guidance and reporting template for administering authorities

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

Yes, this is welcome. Clear and comprehensive guidance is essential if there is an intention to make reporting comparable and consistent at scheme level, i.e. across funds and pools. As discussed above reporting Scope 1,2 and 3 emissions at fund level presents a number of practical and philosophical questions that have significant implications for the resulting numbers.

We agree if scheme level reporting is required, the absence of such guiding documents may compromise the consistency and comparability of reporting.

Knowledge, skills and advice

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

Yes. Nottinghamshire Pension Fund is advised by our pool on these services.

LGPS Central currently provides advice to its partner funds on the management of climate risk and can assist with the appointment and management of external vendors and the assessment of scenario analysis results. Central also provides assistance in respect of climate strategy development and climate governance.

Pools can provide assistance in respect of procurement and centralised contracts can help to keep costs down.

Consideration of impact on protected groups

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?

Nottinghamshire Pension Fund shares your belief that there would not be impacts on protected groups from the proposals in this consultation.

Yours faithfully,

Nottinghamshire County Council Pension Fund