SouthYorkshirePensionsAuthority

Submission to the All Party Parliamentary Group for Local Authority Pensions' Inquiry into Responsible Investment for a Just Transition by South Yorkshire Pensions Authority

Introduction

South Yorkshire Pensions Authority is a unique organisation within the Local Government Pension Scheme, being the only democratically accountable single purpose pensions authority amongst the various LGPS Administering Authorities. The Authority has a long history of positive involvement in the area of responsible investment and was an early adopter of its own climate change policy and of the requirements of the Task Force on Climate Related Financial Disclosure. Consequently the Authority welcomes both the APPG's inquiry and the opportunity to present its views during the evidence gathering stage. The Authority has also set a goal to make its investment portfolios net zero by 2030, one of the first LGPS funds to do so.

The South Yorkshire Pension Fund for which the Authority is responsible has assets of £9.xbn and xxxk members as at the end of March 2021 and deals with 5xx employers. The Authority is one of 11 administering authorities that form part of the Border to Coast Pensions Partnership. More information about the Authority's activities and investment approach is available at www.sypensions.org.uk

As South Yorkshire represented the heart of the British coal mining industry the Authority has, perhaps, a unique perspective on the just transition to a low carbon economy, given that this place could be seen as the victim of an unmanaged, and hence unjust, transition away from coal.

Context

Any consideration of how the Local Government Pension Scheme can make more purposive investment in support of wider policy goals while continuing to meet its fiduciary duties also needs to reflect on the way in which LGPS funds now invest. The pooling of LGPS investments in England and Wales through the 8 asset pools creates both risks and opportunities in this respect and the nature of these will vary from pool to pool depending upon the degree to which pooling represents a move from unique to collaborative delivery of investment solutions.

However, the LGPS is also a unique investor with each fund being connected to and rooted in a place. While the transition to a low carbon economy will impact on individual people, it will impact on people collectively in the places in which they live and LGPS is uniquely positioned to recognise the opportunities that this could present.

Submission

This submission, which was approved at a meeting of the Authority on March 18th 2021 follows the broad headings provided in the inquiry's terms of reference in order to assist with assimilating our views into the inquiry's own debates.

1. What are the main barriers for investors and companies?

The most significant barriers that we see in this area for investors are:

- The balance between fiduciary duty and addressing what present as non-financial issues, particularly in the context of the current stage of the transition where company valuations (for example in relation to oil and gas reserves) do not yet appear to fully reflect the impact of the move away from a carbon based economy. This presents a challenge for investors (and investment managers) who might, all other things being equal, wish to not invest in such companies but cannot make a financial case for doing so.
- The fact that such a great proportion of carbon positive investment options are in private markets which some, particularly smaller, funds find it difficult to access, although this is an area where pooling should be able to achieve a positive benefit. Even allowing for this, though no investor can afford to tie up too great a proportion of their portfolio in illiquid assets of this type, placing an effective ceiling on investments in private markets which can support the transition.
- The focus on a simplistic and time consuming debate over exclusion. The stores of capital represented by large companies such as BP and Shell will have to be a fundamental part of financing the transition and if that transition is not to negatively impact communities that are hugely dependent on these major employers then engagement and influence from investors, particularly those with a stake in a place like LGPS will be crucial. Failure to re-purpose these stores of capital makes the risk of an "unjust" transition even greater.

From the point of view of companies the key issues would appear to be:

- Realism as to timescales. In an ideal world it would be possible to switch off carbon intensive industries and processes and instantly replace them with low or no carbon alternatives, and from the point of view of companies this is what many lobby groups are seeking. Instant change is more likely to see the sort of negative effects caused by the closure of the coal industry, like the rapid withdrawal of major employers from communities. Companies need to be given time to adapt, however, in exchange for this there needs to be an open commitment to their transition plan signed off by shareholders following appropriate consultation with affected communities.
- The scale and nature of investment required, particularly where new technologies are required, for example in industries like steel making. While some competitors are still using older technologies or not transitioning away from carbon, companies that are doing so can find themselves at a competitive disadvantgage which is not in the interests of shareholders. Clearly this can impact decision making by companies.

2. **How might government and those responsible investors signed up to a just transition raise awareness and stress the importance of a just shift to net zero, including throughout the investment community and across government?**

The last 12 months have seen a sea change in the way in which investors view ESG issues and risks. This is precisely the moment to capitalise on the holding of CoP26 in Glasgow and move the debate forward. The increasing use of the UN Sustainable Development Goals (SDG's) as a framework for understanding the wider impact of investments is potentially a key lever in changing understanding and gaining support for the Just Transition.

There are already a wide range of channels and organisations through which such information can be disseminated across the whole investment community and subsets of it such as LGPS, ranging from the Institutional Investors Group on Climate Change (IIGCC) to the Local Authority Pension Fund Forum (LAPFF), and it would not be helpful to create further organisations in an already crowded space. Government and leading investors can work through these organisations to promote best practice, while investors signed up to the idea of a Just Transition can publicly report on the impact of their investment decisions which will help create a wider understanding of the opportunities available in this space and encourage others. The creation of the perception that full recognition of climate and transition risk "is the way to do investment strategy" through means such as this will create a positive momentum in the industry, as has been seen in relation to the broader sweep of ESG issues during the Covid-19 pandemic.

The prominence given to the consideration of transition risk by this sort of process will transmit itself to investee companies who will recognise the need to address these investor concerns, particularly where this is supported by effective engagement activity.

Government specificlally can either through regulation or guidance encourage investors, and particularly asset owners such as pension funds, to pay more than lip service to climate change and the wider responsible investment agenda. Progress is already being made in this direction through the proposal to require reporting in line with the TCFD, but this could perhaps go further by the mandating of stewardship code compliance (currently only a "should" for LGPS funds). Government could also consider providing more active support for the Net Zero Asset Owner movement given that the goal of Net Zero by 2050 is written into UK law.

3. How can investors assess and report the level of risk of not considering a just transition? And what support and regulations are needed from government?

This is a very difficult area and while data and measurement are important it is vital that progress is not delayed waiting for the perfect data set. The move to make reporting in line with the requirements of TCFD mandatory will be helpful but this focuses on climate risk and the move to net zero. Important though this is it is only half the story and the wider impacts of the transition are not an area of focus. The wider understanding of the impact of the transition will only come through some wider reporting of the impact of all elements of an investment portfolio. The latest version of the UK Stewardship code indirectly moves investors in the direction of reporting in this way, however, adoption is not mandatory across the industry (although within the statutory guidance for LGPS funds it is something funds "should" do) and the level of commitment to fully meeting the requirements of the Code is likely to be patchy in these early years, and there is currently no standardized framework for understanding these wider impacts, although there is a clear trend to the use of the SDG's in this space.

The ideal situation would be for all investors and asset owners to be required to publicly report on the impact of their portfolios in the widest sense using a common framework of the SDG's. This would allow the identification of issues such as where a positive impact on climate has a negative effect on fair work which would imply an "unjust" transition. To achieve this would require statutory backing for the Stewardship Code and also some additional refinement to the Code, although such refinements would very much be with the grain of the new Code.

4. How can local authority pension funds, whilst exercising their fiduciary duties, invest in a just transition and the opportunities created? And what role is there for government to create and support new opportunities?

The opportunities in the transition to a low carbon economy are clear, as a society we will need to create new industries to replace those that have no future and fundamentally change industries that will need to continue (such as steel and cement making) so that they can operate in a post transition economy. Businesses will need to raise capital for their adaptation process, but will only be able to do so where there is a commercial case and LGPS will only be able to invest where the return from that commercial case is enough to meet the return target which allows them to meet their liabilities. But we also need to be reasonable in the expectations we set around this. It would not be appropriate for example for the climate transition to be the only investment theme reflected in a portfolio as large as SYPA's and while absolute limits would be impractical and counterproductive creating a climate where the climate transition should be a part of the opportunity set examined by investors is an important signal.

The key challenge is how to bring viable opportunities and investors together at sufficient scale for larger investors such as LGPS to be able to participate in the transition process, much of which is currently being financed in the less liquid private markets. Some of this will happen through fund managers who are already operating in the market place, and the climate transition is a significant investment theme across private markets both in the UK and globally. But some businesses and some localities (certainly in the UK) find it difficult to attract fund managers interest regardless of the quality of the opportunity. There may well be a role here for LGPS funds to work together to commission specific funds or add targeted sleeves to managers funds, both ideas which have already been tried on a small scale by a small number of funds and fund managers.

There is a challenge around mindset, if investors go out positively looking for opportunities to invest in things that support the transition, or any other specific characteristic, and which deliver their required return and risk characteristics they will find them, as we have demonstrated with our portfolio of local development loans. Too often fiduciary duty is used as an excuse for lack of imagination and/or effort in finding the right opportunities. This can be addressed through the sharing of good practice between funds, while the greater resources available within a number of the pool companies will, in time, be able to support a more active search for opportunities.

The structure of some of the opportunities that present themselves in this area may also be a challenge for individual LGPS funds, for example involving direct lending, which funds may not feel equipped to undertake. Again the greater resources available in the pools may be able to assist in addressing this.

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There is also a challenge in terms of a mismatch in scale. As a pension fund we are often approached by local organisations seeking to raise finance for initiatives that would support the climate transition but which are too small for us to engage with. The total sums involved mean that the due diligence costs could not be justified however appealing the investment might appear in headline terms. This is an ongoing challenge as so many of the opportunities that have made a real difference in terms of the transition have grown organically from small local initiatives and do not have the institutional scale or infrastructure for institutions like SYPA to deal with them easily. This seems to point to the need for some additional form of aggregator in the marketplace to raise finance for the many small initiatives that will form part of the transition.

5. How can investors best engage not only with investee companies but also with stakeholders locally, nationally and internationally about the risks and opportunities?

From the investee company point of view engagement is likely to be more productive if undertaken collectively with a significant weight of shareholder funds behind any engagement. The success of Climate Action 100+ in moving the dial on the climate transition with so many companies shows the benefits of this approach. This approach also needs to be given time to have an impact. It will, though, be necessary to broaden the scope of engagement around climate issues so that it addresses the potential wider impacts of the transition on both businesses and the communities in which business operates, to appropriately emphasise the Just Transition.

Similar approaches may work in other areas, for example internationally an investor coalition with a significant weight of assets behind it may find it easier to engage with governments, as has been the case in the engagement over deforestation with the government of Brazil. Collaborative engagement would certainly be our preference in most areas as this allows a greater level of resource and expertise to be brought to bear on the exercise.

The one group of stakeholders glossed over in the question is scheme members (or beneficiaries). It is incredibly important that as the stewards of their pension fund we explain to them why we regard climate risk as the most significant risk we face in terms of the Fund's investments, and why managing a Just Transition from a "brown" to a "green" economy is central to our thinking. There are clearly a wide range of ways of doing this, but creating a strong dialogue with scheme members enables us to understand their views on the climate transition and other issues and weigh them in the decision making process as appropriate in line with the views expressed by the Law Commission on fiduciary duty. This is, obviously, something that can only effectively be done on a fund by fund basis, although the sharing of good practice through groups like the Scheme Advisory Board, will be beneficial in improving the quality of such engagement across the board.

6. **What role is there for government to support a just transition (skills, active labour market policies, economic development, infrastructure investment, investment in communities) and how could investors be part of that process?**

Government (local and national) must work with industry to identify those places at risk in the transition to a low carbon economy. In the UK some of these places are likely to be places that are already in some way "left behind". Government's role must be to fund those things which the market cannot, which might include skills and other labour market issues but also items such as transport infrastructure where in many cases there is no obvious income stream for investors or where government can borrow money more cheaply than the market. These forms of intervention will support the creation of investable places where business will want to develop the new green facilities that will replace the core of the existing "brown" economy.

Investors can support this process in various ways, for example through supporting commercial development to exploit the investment in infrastructure, a small proportion of which could be speculative. This is the core premise of our local development loan portfolio and of the Lancashire Pension Fund's allocation to the Preston, South Ribble and Lancashire City Deal area, and of some of the local investment work done by the Greater Manchester fund so there are models which can easily be followed.

On a different tack the development of a programme of "retro-fitting" the housing stock in order to achieve carbon neutrality or reduction will create investment opportunities both in the production and fitting sectors. Such a programme will require government subsidy, or it will not gain sufficient traction to assist in meeting the 2050 goal, but again offers the opportunity to redeploy resources from "brown" to "green" sectors within the economy on a very significant scale given the volume of work that will be required.

Probably the most important role for Government, though, is the atmosphere it creates. If Government solely focuses on the transition regardless of the conseqnuences then we will see a situation analogous to the decline of coal in the 80's. However if Government sets out an ambition for the transition that "no place will be left behind" and backs that with a framework of interventions which address key blockages to investment in the green ecomomy in particular places then business will get the message and buy in to a just transition, because it will become the way in which transition is done.

7. What lessons can be learnt (both successes and failures) from the UK and abroad about previous initiatives to support people and places as their economy has experienced industrial change? And what initiatives are already underway that can be drawn on?

In the Authority's view there are a number of crucial lessons that need to be learnt from the transition away from coal which impacted our place from the early '80's onwards the scars of which our communities are still dealing with.

Firstly transition needs to be planned and managed. This means that companies and government need to share information about those industries and facilities that ultimately will have no place in a net zero economy, and come to an agreement about what will replace those industries and facilities. For example if an oil company is closing a refinery but making a move into being an energy producing and distributing company will the site of the refinery be useable for producing elements of what the reconfigured business requires. Without action of this sort the places affected by this latest round of changes will become "left behind" in the same way as so many mining communities were in the 1980's. Planning and management of this sort needs to be locally led and nationally supported rather than nationally driven in some sort of latter day 5 year plan. Equally though it requires government to set out an ambition that "no place will be left behind" in the transition, something that President Biden has begun to articulate in the US.

Secondly companies, investors and the wider public sector need to accept clearly defined roles in such plans. Investors like LGPS can help companies finance the investment they need to make in, for example new production facilities, while investment from the wider public sector can be targeted to support re-skilling and the development of alternative sources of employment. For investors such as LGPS it is vital that the defined role fully respects the prime importance of their duty to ensure that they make a return sufficient to meet their liabilities when due.

Thirdly local communities need to be engaged and involved in the transition, rather than it being something done to them by outside forces, whether that be the forces of capital in terms of industry or the forces of the state in terms of government. If people are engaged in and understand the change that is occurring they will be much more prepared to support the change that is necessary even if it does result in some short or medium term difficulties. This reinforces the need for such change processes to be locally led, and accountable.

Finally the approach must be timely. Specific efforts by national government in the UK to address the aftermath of the closure of the mines were too late. The sorts of intervention discussed above, if they are to have impact need to happen alongside, and preferably ahead of the transition from "brown" to "green".

What we are suggesting requires a genuinely joined up response focused on individual places harnessing both state and non-state actors. As far as we are aware this is not something that is being proactively considered in the UK, but there do seem to be some examples in Germany, where the refocussing of RWE's business presents similar challenges for some communities to those faced by British mining communities in the 1980's, and which will no doubt be faced as the oil industry winds down some of its larger scale operations in the coming years.

Conclusion

In conclusion the Authority believes that LGPS funds can play a specific positive role in the transition to a low carbon economy reflecting their unique connection to specific places, while still maintaining the entirely appropriate primary focus on ensuring that funds are available to pay pensions when they become due.

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