Fiduciary Duty in Relation to Climate Risk

DIVEST LOTHIAN

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The Climate Change and Carbon Footprinting report to the Pensions Committee, published 27th June, reveals that Lothian Pension Fund's investments have a carbon footprint of 1,292,000 tonnes CO^2e.[1] This is significantly higher than the footprint of the third largest CO^2 emitter in the country, the ExxonMobil chemical plant at Mossmorran, and close to the footprint of the second highest emitter, the Scottish Power Generator at Longannet.[2]

This high carbon footprint exposes the Fund to significant risk of devaluation, as climate legislation will increasingly restrict fossil fuel use over the coming decades. An article in scientific journal *Nature* estimates that a third of known oil reserves, half of gas reserves and more than 80% of coal reserves must remain in the ground in order to meet global temperature targets under the Paris Agreement.[3] If local and international climate legislation[4] and a market shift towards renewable energy[5] prevents these reserves from being exploited, these assets will become stranded, impacting significantly on the business activities and share prices of oil and gas extraction companies.

The Chair of Westminster's cross-party Environmental Audit Committee referred to this 'climate risk' when she stated in March that "*[f]ossil fuel companies could lose value as the world implements the Paris Agreement on climate change to keep to below 2°C...The climate change risks of tomorrow should be considered by pension funds today*."[6] The UK Government's recent consultation on trustee's investment duties agrees that "*climate change is a financially material risk to our future*".[7]

A report by Carbon Tracker Initiative calculated that in order to prevent global temperatures from rising beyond 2 degrees Celsius, $2.3 trillion of potential capital expenditure by oil and gas majors between 2017 and 2025 cannot be deployed.[8] This would affect Lothian Pension Fund's investments to varying extents; for example, Shell could not exploit 30-40% of its potential capital expenditure, ExxonMobil could not exploit 40-50%, and Apache could not exploit an alarming 60-70%.[9]

However, in the the Climate Change and Carbon Footprinting report, the Investment Strategy Panel recommend that "*there should be no explicit change to the stock selection criteria*" to include environmental, social and governance factors, including carbon. This strategy was approved by the Pensions Committee.

By failing to take appropriate action to reduce the Fund's exposure to stranded assets, the Edinburgh Council's Pensions Committee may be neglecting the legal duty of pensions committees to **make decisions in the best interest of scheme employers and members**, known as '**fiduciary duty**'.[10] Environmental law firm ClientEarth have even warned of the possibility of litigation if pension schemes fail to take climate risk seriously.[11]

The report explains that the Fund "*has for many years embraced a policy of [shareholder] engagement, rather than one of mechanistic divestment, because it believes it is not only consistent with its fiduciary duty to members and employers, but it allows it to encourage responsible behaviour by company Boards and managements on ESG issues, including climate change*".

However, the Fund does not point to any concrete reductions in fossil fuel extraction and production resulting from their engagement activities. Of the "engagement case studies" highlighted on the Fund's website, only one is about engaging with a fossil fuel extraction and production company: Shell.[12] It reveals that Shell has not taken any action to reduce its fossil fuel operations, despite many years of engagement and pressure from shareholder coalitions. Hermes EOS, one of the companies contracted by Lothian Pension Fund to carry out its engagement, states that "*we remain concerned that the company [Shell] has not fully taken into account the potential impact of a sustained period of reduced global demand for oil, which could result in a structural change to the nature of supply of oil, leading to a permanently lower global oil price*".

More recently, a shareholder resolution brought to Shell's 2018 AGM urged Shell to set targets to limit its greenhouse gas emissions in line with the Paris Agreement. Hermes EOS recommended that its clients, including Lothian Pension Fund, vote **against** the resolution - which did not pass.[13]

Apart from the unsuccessful engagement with Shell outlined above, it appears that the Fund is not prioritising engagement with fossil fuel companies about the key issue of reducing fossil fuel extraction. In February 2018 Divest Lothian submitted a Freedom of Information request to the Edinburgh Council, seeking information about any instructions given by the Council to Hermes on shareholder engagement concerning financial risks associated with climate change. The response included the statement "Hermes EOS does not provide a service to manage financial risks associated with climate change".[14]

Further, the results of the carbon footprinting study have focussed the Fund's engagement strategy away from the crucial Energy sector. This is because the data used in the carbon footprinting study do not include all 'Scope 3 emissions' (those produced by actually burning fossil fuels, e.g. for heating or driving). As the report explains, "*the exclusion of Scope 3 emissions...produces… counter-intuitive results. For example,...oil producers appear to have relatively low carbon footprints*". Consequently, the Fund's investments in the Utilities sector appear to have the highest carbon footprints, and the Fund's engagement seems to be directed towards this sector, as illustrated by the case studies in Appendix 3 of the report.[15]

Therefore, the Fund is neglecting to take meaningful action to safeguard its investments from the risk of stranded assets. Even if Hermes began to engage with fossil fuel companies on this issue, calling for a managed decline in production and a halt to new investment in fossil fuels, it would be extremely unlikely to have the desired effect. The business plans of both Shell and BP, in both of whom the Fund invests, are still based on global temperatures rising by 3-5C or more (despite both companies publicly endorsing the Paris Agreement's cap at 2C).[16] The Financial Times writes that "*expecting engagement to change the fossil fuel industry ignores decades of evidence to the contrary*"[17], and the Pensions Committee itself has asserted that engagement is "*unlikely to effect change" when the issue discussed "is a core part of a company's product/service*".[18]

Instead, Divest Lothian are calling on Lothian Pension Fund to divest, meaning to remove its investments, from fossil fuel extraction and production companies over five years. This would minimise the Fund's exposure to stranded assets and unexploitable capital expenditure, and would be in keeping with the legal duties of pensions committees. A report for the Scottish Local Government Pension Scheme (LGPS) clarifies that: "*investment options may be restricted where the investment returns to the fund may be negatively impacted by such environmental, social or governance factors*."[19] This would also comply with advice recently issued by Mercer, financial advisor to 18 LGPSs. Their report on climate risk advises funds to "*reduce risk exposure*" and "*allocate to new opportunities*".[20]

Six local government pension funds in the UK have already committed to divest or tilt their investment portfolio away from fossil fuels. Fiona Colley, who Chaired Southwark Pension Fund when it committed in January to divest its £1.2bn fund, stated that "*This was a decision based not just on our political and ethical concerns, but primarily on our belief that climate change and significant investments in fossil fuels present a long term financial risk to our fund*."[21]

Divest Lothian suggest that divested funds be invested in renewable energy companies and other sustainable businesses which could benefit the local community and are not exposed to risk of devaluation as fossil fuel demand falls.[22]

This document was produced by the Divest Lothian campaign:
https://www.facebook.com/divestlothian/

More information can also be found at: [*www.foe.scot/divestment/local-government*](www.foe.scot/divestment/local-government)

Notes and References

[1] Appendix 2 of the report states that the Fund's footprint is 152 tonnes CO^{2}e / $ million invested. The fund is valued at GBP£6.6 billion (at today's rates US$8.5 billion or US$8,500 million). http://www.edinburgh.gov.uk/download/meetings/id/57587/item_57_-_climate_change_risk_and_carbon_footprinting

[2] The Scottish Environment Protection Agency's 'pollutant release inventory' lists the top polluters in Scotland and provides their carbon footprint in kg (0.001 of a tonne): https://bit.ly/2LhdsuZ

[3] Nature (2015): https://www.nature.com/articles/nature14016

[4] Examples of climate legislation are:

- The Scottish Government aims for economy to be carbon neutral by the middle of the century, has banned fracking, and is phasing out fossil fuel-powered cars by 2032.
- The UK has committed to phase coal out of electricity generation by 2025: https://ind.pn/2IzLeep
- Norway will phase out petrol and diesel cars by 2025, France by 2040, and India is aiming to only sell electric models by 2030: https://bit.ly/2tVg4v2
- The Scottish Parliament recently banned plastic straws (https://bit.ly/2w6cyg7), and Westminster is considering a "latte levy" on plastic coffee cups and a ban on plastic straws, stirrers and cotton buds (https://bit.ly/2Bl0ZGS). BP admits that plastic bans around the world will dent oil demand growth, and that oil demand will peak in the 2030s: https://bit.ly/2okh8CU.

[5] The Financial Times writes that the shift to clean power is disrupting the fossil fuel industry, and asks whether the 21st century will be their last: https://on.ft.com/2rhMz4o

[6] MPs seek answers from pension funds on climate risk: https://bit.ly/2wmbMec

[7] UK Government's June 2018 consultation on clarifying trustee's investment duties: https://bit.ly/2t8EHSc

[8] Carbon Tracker Initiative (2017), p. 5: https://bit.ly/2wlq8vz

[9] We checked Lothian Pension Fund's investments in fossil fuel companies, listed in the Divest / Reinvest Scotland 2017 report (https://foe.scot/resource/divest-reinvest-councils-report/), against the list of companies' potential upstream capital expenditure outside the 2D budget in the Carbon Tracker Initiative report (pp. 7-8; link provided above).

[10] The Scottish Local Government Pension Scheme Advisory Board (SAB) issued a legal opinion from Pinsent Masons, stating that: "any decision (investment or otherwise) made by a Pensions Committee which may affect a party to whom the fiduciary duty is owed, should be made having regard to the best interests of that party (our boldface)." Fiduciary duty is owed to scheme employers and scheme members. Pinsent Masons (2016), p. 2: https://bit.ly/2N9krrl

[11] ClientEarth (2018): https://www.clientearth.org/top-uk-pension-funds-put-on-notice-over-climate-risk/

[12] Engagement Case Studies on Lothian Pension Fund website: https://bit.ly/2BCN4fl
Shell case study: http://www.lpf.org.uk/downloads/file/819/royal_dutch_shell_plc_uk-holland_case_study

[13] Hermes urged Shell to publish targets for its decarbonisation strategy, but did not vote for the 'Follow This' shareholder resolution: https://bit.ly/2xrVPal

[14] Results of the Freedom of Information Request into 'Relationship between Hermes Equity Ownership Services (EOS) and the City of Edinburgh Council': https://bit.ly/2OTNHTC

[15] Lothian Pension Fund's Employer Finance Briefing from June 2018 includes a chart showing that the Utilities sector have a higher carbon footprint than the Energy sector (because the data did not include all Scope 3 emissions): https://bit.ly/2OXeI8U

[16] ShareAction's reports show that both BP and Shell's 'base case' in their business plans are consistent with 3–5°C+ of global warming. BP: https://bit.ly/2w4Rir4 (page 8); Shell: https://bit.ly/2z6GrA0 (page 8).

[17] Sanzillo, T. (2018). *Financial Times*. https://on.ft.com/2IbDhwh

[18] This statement is from Alasdair Rankin's (Convenor of the Pensions Committee) response to the 2017 deputation about divestment from the arms industry: https://bit.ly/2NeTO4s

[19] Pinsent Masons (2016): https://bit.ly/2MGS7jx

[20] Mercer (2015): https://bit.ly/2o0eTEZ

[21] Statement by Southwark Pension Fund's former Chair about their reasons for divesting: http://www.southwark.gov.uk/news/2018/jan/council-commits-to-low-carbon-investment

[22] More detail about alternative, sustainable investments is provided in this report: https://foe.scot/wp-content/uploads/2017/08/Divest-and-Reinvest-Scotland-2017-Printable-1.pdf
As a concrete example, Southwark Pension Fund are moving their investments into at least three low carbon funds: BlackRock Low Carbon Target Index Fund, Legal and General Investment Management Low Carbon Target Index Fund and Glenmont Clean Energy Fund Europe III.
https://www.southwark.gov.uk/assets/attach/7000/Draft%20March%2018%20PAP%20minutes.docx

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