Leeds CITY COUNCIL

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Report of Director of Resources

Report to Executive Board

Date: 22 September 2021

Subject: West Yorkshire Pension Fund - Divestment from Fossil Fuels

Are specific electoral wards affected? If yes, name(s) of ward(s):	☐ Yes	☒ No
Has consultation been carried out?	☒ Yes	☐ No
Are there implications for equality and diversity and cohesion and integration?	☐ Yes	☒ No
Will the decision be open for call-in?	☒ Yes	☐ No
Does the report contain confidential or exempt information? If relevant, access to information procedure rule number: Appendix number:	☐ Yes	☒ No

Summary

1. Main issues

- The council declared a climate emergency in 2019 with the ambition of achieving net zero by 2030 as a city.
- As part of this declaration the Climate Emergency Advisory Committee (CEAC) was set up with the remit of providing specific recommendations to Executive Board where they considered intervention was required. This report is the direct result of a recommendation from CEAC on the divestment from fossil fuels for the West Yorkshire Pension Fund.
- The recommendation from CEAC is:

  'Following the declaration of a Climate Emergency, Leeds City Council recognises the environmental and financial risk of investing in fossil fuel companies and calls for the West Yorkshire Pension Fund to disinvest from fossil fuels in a planned way over a relatively short-period of time (not more than 3 years) and to invest this money in alternatives (such as green energy) that are expected to deliver sustainable returns over the long-term.'

- The West Yorkshire Pension Fund (WYPF) is the local government pension fund used by Leeds and other local authorities in West Yorkshire. It has circa £15 billion of assets.

- Leeds City Council has no direct decision-making powers on the WYPF. A Board of Directors comprised of Members nominated by the constituent bodies, each of which has a personal fiduciary responsibility, makes investment decisions. Bradford City Council is the administrator. However, Leeds City Council is the biggest contributor and therefore it is relevant that as a council it has a clear position on divestment from fossil fuels and the current investment strategy.
- Pension regulations require **the Board members of any pension fund to act in the best *financial* interests of the members**. It is not sufficient to choose investments which align with broader political objectives if they produce lower rates of return.
- However, as we see a rapid transition away from fossil fuels, with commitments by the government such as no new fossil fuelled cars and vans by 2030, the continued long term investment in fossil fuel carries with it some significant financial risks. It is argued that the commitment to divestment is the financially correct decision as well as being the environmentally right decision to take.
- In a speech by Mark Carney as the Head of the Bank of England, he explained that the world will face irreversible heating unless firms shift their priorities soon – suggesting that analysis shows that if you add up the policies of all the companies out there, they are consistent with warming of 3.7 to 3.8°C – significantly higher than the 1.5°C target within the Paris Agreement.
- It should, however, be noted that the fossil fuel industry employs about 30 million people globally, with over 250,000 jobs in the UK (including those in the supply chain and associated industries) dependent on the North Sea oil industry. If North Sea oil production was stopped immediately, the immediate result would be an increase in the level of imports rather than a reduction in emissions. It is therefore necessary to cut demand not just supply and to do this in a managed way to ensure a just transition for those employed in the fossil fuel industries. There are risks that a rapid divestment may not provide the level of return the Pension Fund is currently forecasting, which in turn could increase levels of contributions required from councils and scheme members.

2. Best Council Plan Implications (click here for the latest version of the Best Council Plan)

- The divestment from fossil fuels primarily supports the climate emergency pillar of the best council plan. Investment in decarbonisation initiatives will also enable greener growth, with many actions taken to reduce emissions having wider benefits that support health and wellbeing, such as improvement of air quality.

3. Resource Implications

- The WYPF provides pensions for just under 300,000 employees and therefore any decision that is taken must recognise the number of people's pensions that could be impacted.
- There is also the risk that if a lower rate of return is achieved through this policy implementation that it could result in additional costs for the council and the pension funds' members as they have to make additional contributions to counter any losses.

- Had WYPF not invested in the fossil fuel sector, the return achieved by the pension fund would have reduced by circa £30 million and this would leave LCC with an approximate additional annual liability of £7.5 million.

Recommendations

Executive Board is recommended to request that the West Yorkshire Pension Fund:

a. be explicit about acknowledging the climate emergency and the need to divest from fossil fuels.

b. actively look to divest into alternative, cleaner investments with comparable returns.

c. report annually against the progress on divestment, specifically against the region's declared net zero target.

1. Purpose of this report

1.1 To present the CEAC committee's case for supporting divestment from fossil fuels for the West Yorkshire Pension Fund as well as outlining the potential risks with this strategy

2. Background information

2.1 The West Yorkshire Pension Fund (WYPF) is the local government pension fund that Leeds and other local authorities in West Yorkshire use to provide pension benefits through.

2.2 Pension regulations require **the Board members to act in the best *financial* interests of the members**. This means that including other considerations is difficult. A redirection of investment will need to demonstrate that changes are of financial benefit to the scheme's 294,447 members from 451 employers across the UK.

2.3 The 'administrating authority' of the WYPF is Bradford. That said Leeds City Council is the biggest contributor and therefore able to influence.

2.4 WYPF is a longstanding member of the Local Authority Pension Fund Forum, which carries out engagement with companies regarding climate change, corporate governance, and social issues. The fund continues to exercise its vote at shareholder meetings and will act as co-signatory to shareholder resolutions where required to encourage companies to meet the expected standards of corporate governance, climate risk and social responsibility.

2.5 Although low carbon investments remain a relatively small market segment, WYPF has been able to build up its portfolio to over £700m, with a further £260m committed to future projects.

2.6 WYPF is also a member of the Institutional Investors Group on Climate Change (IIGCC). The IIGCC seeks to promote a better understanding of the implications of climate change amongst its members and other institutional investors, and to encourage companies and markets in which its members invest to address any material risks and opportunities to their businesses associated with climate change and a shift to a lower carbon economy.

2.7 In 2017 WYPF signed Climate Action 100+ This group of global institutional investors, with $33.6 trillion of assets under management, have come together on a collective basis to carry out engagement with the top greenhouse gas emitting companies (globally). The initial 'focus' list for engagement comprised 100 companies but has since been extended to include an additional 61 companies. During the first year of operation, the project reported successful engagement with a number of large companies, notably Royal Dutch Shell, BP and Glencore, with companies announcing significant carbon emission reduction targets in order to align their businesses with the goals of the Paris Agreement.

2.8 Just one hundred companies are responsible for 71% of global emissions with many of these companies being listed on the stock exchange.

3. Main issues – the argument for divestment

3.1 The most basic financial arguments for divestment are based around a concept called the carbon bubble. The fossil fuel companies own much more coal, oil and gas than we can ever use if we are to meet the terms of the Paris Agreement and ensure that temperatures rise by no more than 1.5°C.

3.2 Road transport consumed more than 40% of oil demand in 2019. Yet, many major auto manufacturers have outlined roadmaps to end the sale of fossil-fuel vehicles, some ahead of legal cut off dates. These include Volvo, Volkswagen, General Motors, Jaguar, Honda and Jaguar Land Rover. The move to electric will increase demand for generation and although the UK has made significant in-roads into decarbonising its grid, this is not true across the globe so many electric vehicles will continue to be powered indiriectly by fossil fuels.

3.3 The low carbon energy transition that is already underway makes it very likely that the carbon bubble will burst – that fossil fuel assets will drop permanently in value or become 'stranded assets'. Mercure et al have calculated that the loss of value due to stranded fossil fuel assets could be in the trillions. This paper also found that even in the absence of new, tougher climate policies, fossil fuel asset stranding would still occur due to the challenge posed by renewable energy, energy efficiency and battery storage.

3.4 Energy transition is being driven by several factors:

- the necessity of limiting both climate change (due to the potential devastating impacts temperatures rises over 1.5C will have internationally) and air pollution (the cause of huge health problems).
- the introduction of policy – international agreements like the Paris climate agreement are driving governments to set stricter climate policies, emission reductions policies, policies to phase out fossil fuel subsidies or to enforce minimum efficiency targets etc.
- the divestment movement has also mobilised new capital – i.e. money to drive decarbonisation and greater investment in renewable energy.
- Development of new technology - huge progress in renewables in the last decade – the cost of generating power using renewable energy has plummeted. There has also been rapid progress in energy storage using batteries – like lithium ion batteries.

3.5 Importantly the costs of solar PV, wind and battery storage are still falling rapidly, and they are now able to compete with fossil fuels without subsidies. In some parts of the world solar power is now the cheapest source of electricity in history according to the International Energy Agency. In most countries, it is cheaper to build solar farms than coal or gas fired power plants.

3.6 Big transitions from one major technology to another typically reach a tipping point, around peak demand for the incumbent where change happens very rapidly–and investors in the old incumbent technology who don't get out in time lose money just as peak demand for the incumbent happens. Some energy strategists are now warning that we have come very close to peak demand for fossil fuels. A group of energy strategists in London called Carbon Tracker have done a lot of modelling and analysis to predict when fossil fuel demand is likely to peak. Their report "2020 Vision" warns that fossil fuel demand is most likely to peak in 2023 and at this point investors who still have investments in fossil fuel companies will foot huge losses.

3.7 Even China, a country with a 2060 net zero target that is later than most, has committed to reaching peak emissions by 2030 and will thereafter decarbonise their economy. Decarbonisation is inevitably linked to a reduced demand for fossil fuels.

3.8 In 2015 (just 12 to 18 months after coal had peaked) the share price for coal dropped very quickly with some Local Pension Funds losing up to £638 million as they hadn't anticipated how quick the decline would be. The West Yorkshire Pension Fund was not impacted, having exited before the price declined

3.9 One concern is that if fossil fuel divestment happens too quickly is that major international companies who employ huge numbers globally will be left without the required investment to transition their business models and that this could impact the rapid transition required. From the extract below from the Financial Times (October 2020), the industry is not taking the action required to meet the Paris Agreement:

"No major oil, gas or coal company is on track to align their business with the Paris climate goal of limiting the global temperature rise to well below 2°C by 2050, new research shows, despite net-zero emissions pledges. A partnership between London School of Economics academics and investors that manage $21tn in funds, called the Transition Pathway Initiative, assessed 125 oil and gas producers, coal miners and electricity groups on their preparedness for a lower-carbon economy."

3.10 It is also interesting to note that in 2018 in Shell's annual report the trend for divestment is listed as a material risk – "*Additionally, some groups are pressuring certain investors to divest their investments in fossil fuel companies. If this were to continue, it could have a material adverse effect on the price of our securities and our ability to access equity capital markets."*

3.11 In May 2020 new research was released by Imperial College of London and the International Energy Agency, which analysed stock market data to determine the rate of return on energy investment over a 5 and 10 year period. The research found that in the U.K., also over five years, investments in green energy generated returns of 75.4% compared to just 8.8% for fossil fuels. Green energy stocks were also less volatile across the board than fossil fuels, with such portfolios holding up well during the turmoil caused by the pandemic, while oil and gas collapsed. [1]

3.12 Returns on green energy have now stabilised and are more in the region of 4 to 8% but it remains a small sector of the overall investment market.

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[1] Just How Good An Investment Is Renewable Energy? New Study Reveals All (forbes.com)

3.13 Charles Donovan, director of the Centre for Climate Finance and Investment at Imperial College and the report's lead author, said that "even before the coronavirus, global investment in green energy was falling well short of that necessary to hit the Paris Agreement target of limiting global warming to within 2 degrees Celsius by 2100. In order to achieve that, countries will need to at least double their annual investment in renewables compared to current levels, from around $310 billion to more than $660 billion, according to the International Renewable Energy Agency." [2]

3.14 Investment in renewables remains relatively low despite the high returns, in part as the renewables market is still relatively young. [3]

4. The Argument Against Rapid Divestment

4.1 Given the fiduciary duties of Directors to ensure that the best return is made to the pension fund, it is important to separate legitimate political aspirations which may cloud that judgement. Members will need to be satisfied that alternative investments will generate equivalent or better returns. There are two principal issues to consider.

4.2 Although the medium-term argument is strong that there will be a shift away from carbon and ultimately a loss in value, being able to predict that moment in advance is very difficult. Committing to divestment on principle within three years, rather than judging the time as events unfold, could lead to an unfavourable investment position affecting the pensions of Members and the financial contributions of councils.

4.3 The Financial Times (11 August 2021) reported that Market Forces, a shareholder activist group, submitted a resolution to BHP urging it to run down its fossil fuel assets rather than divest to meet the Paris Agreement goals. This highlights a shift in strategy by activists and campaigners who are growing increasingly concerned that the sale of fossil assets to smaller operators or state-backed companies could lead to increased production and therefore pollution.

4.4 A further argument against divestment is the positive role that investors can play in influencing the direction that companies take. The largest carbon based companies are also potentially those with some of the greatest investment capability in renewables. By withdrawing funding from the companies, there is the danger that this hampers the managed transition to zero carbon alternatives, which also offer good returns.

4.5 FT 3 August 2021: Bernard Looney, chief executive (of BP), who has started to pivot the business over the long-term towards renewable energy since taking the helm last year, said the company was raising its dividend 4 per cent and would have the "capacity" to increase it by a similar amount each year to 2025.

4.6 The company is still reliant on oil and gas revenues for the vast majority of its earnings, with higher prices giving it the opportunity to funnel more cash to shareholders as well as investments such as offshore wind, solar and hydrogen.

4.7 Investors across the sector have demanded fatter returns, putting pressure on executives given the long-term uncertainty over the future of oil and gas, and the potential for companies to transform themselves into renewable energy giants.

4.8 An alternative strategy in consequence would be twofold: to improve WYPF awareness of the renewables market, encouraging them to switch investments from fossil fuels on commercial lines when the time is right; to press fossil fuel companies to utilise their

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[2] Just How Good An Investment Is Renewable Energy? New Study Reveals All (forbes.com)
[3] Just How Good An Investment Is Renewable Energy? New Study Reveals All (forbes.com)

investment strength and expertise in the rapid development of alternative energy sources.

5. Corporate considerations

5.1 Consultation and engagement

5.1.1 The subject of fossil fuel divestment was discussed at the Climate Emergency Advisory Commitment and members were asked to support the following statement:

'Following the declaration of a Climate Emergency, Leeds City Council recognises the moral and financial risk of investing in fossil fuel companies and calls for the West Yorkshire Pension Fund to disinvest from fossil fuels in a planned way over a relatively short-period of time (not more than 3 years) and to invest this money in alternatives (such as green energy) that are expected to deliver sustainable returns over the long-term.'

5.1.2 The following was noted in the minutes:

- That the Committee's support for the position statement as set out above be noted;
- That the matter be referred to the Executive Members to adopt as formal council position;
- That the Chair write to the Chair of the Green Economy Panel at the West Yorkshire Combined Authority to request that this matter be discussed at a future meeting.

5.1.3 Following the CEAC meeting, the West Yorkshire Pension Fund were approached to comment on the recommendation and to set out their current position to enable a balanced review to be undertaken prior to the report being presented to Executive Board. CEAC members had not been made aware of the potential financial impact to the Council of a very rapid withdrawal when they agreed the original recommendation.

5.2 Equality and diversity / cohesion and integration

5.2.1 An equality, diversity, cohesion and integration screening form was completed and is attached as Appendix 1. The screening concluded that there were no equality impacts of this report.

5.3 Council policies and the Best Council Plan

5.3.1 The divestment from fossil fuels primarily supports the climate emergency pillar of the best council plan, however it will also enable greener growth and many actions taken to reduce emissions have co benefits that support health and wellbeing such as improvement of air quality, reduction in fuel poverty etc.

<u>Climate Emergency</u>

5.3.2 Reducing greenhouse gas emissions is a primary focus of this paper.

5.4 Resources, procurement and value for money

5.4.1 As explained in the main issues section, there is a financial risk associated with the continued investment of pension funds in fossil fuels, so it is important that the

WYPF starts to develop its exit strategy. While it is an extreme example, it is worth noting that demand reduction saw the price of oil plummet globally in April 2020, including to negative levels in the US market.

5.4.2 As the WYPF is responsible for the pensions of circa 300,000 employees, it is important that due consideration of policy changes is given to the financial impact of investment decisions on individuals' pensions.

5.4.3 If the policy change resulted in a drop in the fund's value, the council and individual members could have to increase their contributions to counter the reduction in value. This could equate to £7.5 million for LCC's members alone.

5.5 Legal implications, access to information, and call-in

5.5.1 The Council has the legal power to recommend a divestment of fossil funds to the Pension fund, however as set out in the report, it is unable to set specific policies for the Pension Fund itself.

5.5.2 The Council cannot fetter the position of any appointed Members of the Council who are trustees of the Fund/Pension Board and must ensure that any of the recommendations set out above do not obstruct their individual fiduciary duty to the Fund in their decision making capacity.

5.6 Risk management

5.6.1 It is important that a pension fund balances its risk across a wide portfolio of investments. However, it also needs to be aware of future trends and take action to derisk its portfolio of investments to avoid the scenario that was described in section 3.7 related to coal.

5.6.2 Although no one can argue that the demand for fossil fuels will diminish alongside the current level of financial return, determining the timing of making the decision to disinvest is less clear. As is shown with the coal example, the decline happens post peak emissions and peak emissions will occur at different times around the globe.

5.6.3 One of the ways that pension funds balance their risks is to spread the risk over a wide range of sectors and companies. As a result, energy firms make up part of most individual and institutional investment portfolios as they constitute about 7.5% of the market value of the MSCI World Index.[4] As the WYPF has nearly £15bn of assets and naturally wants to spread risk over a large number of companies, it is practically more difficult if a large proportion of investable companies are out of bounds.

6. Conclusions

6.1 Given the council's declaration of a climate emergency and its commitment to net zero, it is important that it tries to use all policies and levers at its disposal to support the transition to net zero.

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[4] *The Financial Impact of Divestment from Fossil Fuels – research by Auke Plantinga and Bert Scholtens*

6.2 Although the council is not the decision maker in relation to the West Yorkshire Pension Fund, it makes a significant contribution and therefore can use its influence to encourage the adoption of divestment of fossil fuels as a policy.

6.3 There is no doubt that divestment from fossil fuels must happen for both environmental and financial reasons As we see the call to action strengthening and with COP26 on the horizon, it is likely that the current 70% of the world's economies by GDP that have already set net zero targets will only increase and targets are likely to tighten as they already have in the UK, speeding up decarbonisation and reducing demand for fossil fuels.

6.4 However the more challenging question is the timing of when that action should be implemented to ensure that the WYPF doesn't suffer detrimental losses by either acting too soon or conversely by leaving it too late and being left with investment in stranded assets.

6.5 Divestment from fossil fuels is still seen as a key step required in order to deliver the net zero goal. Our advice is to support a progressive, more transparent divestment rather than impose a three year absolute deadline.

7. Recommendations

7.1 Executive Board is recommended to request that the West Yorkshire Pension Fund:

a. be explicit about acknowledging the climate emergency and the need to divest from fossil fuels.

b. actively look to divest into alternative, cleaner investments with comparable returns.

c. report annually against the progress on divestment, specifically against the region's declared net zero target.

8. Background documents[5]

8.1 None

[5] The background documents listed in this section are available to download from the council's website, unless they contain confidential or exempt information. The list of background documents does not include published works.