RESPONSIBLE INVESTMENT FOR A JUST TRANSITION: AN INQUIRY BY THE ALL-PARTY PARLIAMENTARY GROUP FOR LOCAL AUTHORITY PENSIONS

Consultation Response from LGPS Central Limited

Patrick O'Hara

Investment Director – Responsible Investment and Engagement

CONTENTS

INTRODUCTION

Background

LGPS Central Limited is one of eight Pool companies formed in response to HM Government's call in 2015 for LGPS funds across England and Wales to pool their investment assets with the aims of:

1. Reducing investment management costs through economies of scale.
2. Improving access to alternative asset classes.
3. Strengthening governance and decision-making across the scheme.

LGPS Central Limited was established to manage the pooled investment assets of nine Local Government Pension Schemes (LGPS) across the centre of England: Cheshire, Derbyshire, Leicestershire, Nottinghamshire, Shropshire, Staffordshire, West Midlands, the West Midlands Integrated Transport Authority (ITA) and Worcestershire, together our "Partner Funds". The company launched on 1st April 2018 and is being built so that it will ultimately have the capability to manage over £45 billion of assets on behalf of almost one million LGPS members and some 2,000 participating employers.

LGPS Central Limited is jointly-owned by its Partner Funds[1] and is authorised and regulated by the Financial Conduct Authority (the FCA).

OVERALL VIEW OF LGPS Central

LGPS Central Limited is of the opinion that investors have an important to role to play in bringing about a just transition through both engagement with the corporations and assets in which we invest and through financing the transition itself.

We are of the opinion that the just transition must be recognised as a global challenge as communities that stand to be impacted the most by climate change are often situated in developing countries. We consider that COVID19 illustrates that global challenges require global solutions if they are addressed permanently.

Government has an important role to play in encouraging supporting innovation by sending strong signals to investors in terms policies, subsidies, and taxes. For example, decisive carbon pricing and robust regulation around carbon off-setting.

A just transition requires consistent and holistic long-term strategy and collaboration between the private and public sector.

[1] The West Midlands ITA does not have an ownership interest in LGPS Central Limited

LGPS CENTRAL RESPONSE TO SPECIFIC QUESTIONS

Individual comments are made below relating to specific questions raised by the enquiry. These are generally made with reference to the common shared objectives of LGPS Central Limited and our Pool members.

LGPS Central Limited agrees with those guidance points where no specific comments are made.

1) *What are the main barriers for investors and companies?*

The conflict between economic development and the environment is at the heart of the sustainable development challenge. It is a tension that has existed since the dawn of the industrial age. The Just Transition is a contemporary manifestation of this challenge. How can we realise the maximum benefits to the planet through decarbonisation whilst minimising the negative impact on society and, those members of society most vulnerable to the impacts of economic disruption and industrial transition?

There was a perception amongst some investors that the Just Transition was an issue for governments to address rather than investors. However, COVID19 provided a further illustration of the important role that investors need to play in ensuring that management of corporations take a long-term view of their businesses. They also need to recognise the interests of a broad set of stakeholders when making both tactical and strategic decisions. During the pandemic investors generally recognised that the cancellation of dividends was an appropriate and necessary response to the immediate and unavoidable disruption caused by COVID19 and the ensuing lockdowns. It also became obvious that the remuneration packages of senior management should be reflective of the dividend cuts and the hardship being felt by displaced and furloughed employees and the efforts being made by taxpayers via their governments to soften the blow.

A similar level of forward thinking and recognition of the greater good is needed if corporations and investors are to play a full part in the Just Transition.

Markets have traditionally demanded that corporations act in the best interests of shareholders and have not necessarily rewarded longer term thinking. As such, it is perhaps no surprise that operational efficiency and cost minimisation has been driving factors in corporate decision making. This has not always resulted in the best outcomes for employees, customers, local communities and even governments.

There needs to be a change in priorities for the Just Transition to be at the forefront of corporate decision making and a recognition that the protection of shareholder value is a long-term consideration. Government policy around support for renewables, phasing out of fossil fuels, transport and energy also need to be coordinated. A lack of co-ordination can make strategic planning more challenging.

It is difficult for investors to model the impacts and the timeframes of the transition. There remains uncertainty about policy interventions and technological evolution. This in itself presents an obstacle to analysing and preparing for a Just Transition.

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?

Investors can coalesce around collaborative engagements organised by organisations such as the IIGCC, the PRI, the Investor Forum and the Investment Association. Investors should embrace the Just Transition in their engagements with corporates and make it clear in these engagements that a Just Transition is a priority. It is well documented that during the COVID19 crisis the "S" of ESG became more prominent in discussions between investors and investee companies. This momentum needs to be maintained and this will happen only if it is recognised that climate change is a social issue as well as an environmental issue. It is relatively straightforward to measure a company's progress in terms of decarbonisation of their emissions (Scope 1 and Scope 2). It is less straightforward measuring the performance of a company in terms of its social impacts and planning. It is also less straightforward in terms of setting targets.

Government can assist by providing strong policy support requiring transparency from corporations and by providing support for communities impacted by the transition. It is encouraging to see Government embracing mandatory TCFD reporting and perhaps additional reporting requirements around social impact and the Just Transition can be mandated.

Any transition has the potential to create winners and losers and government must ensure that the benefits are widely distributed with no groups or communities left behind. COVID19 illustrated that groups and communities are affected by a crisis in different ways. The burden is not evenly spread, and this is likely to be case with the transition to a lower carbon economy.

As discussed above climate change is a social as well as an environmental issue, and as such it is a multi-departmental issue. All government departments should set a strategy for delivering a Just Transition. It may be advisable to appoint a Minister for Just Transition to co-ordinate efforts across Whitehall. It may be difficult to achieve consistency and coherence over multiple decades in the absence of cross-party consensus. The climate crisis is an issue that transcends party politics and will cut across multiple administrations.

The government can provide additional support for affected communities and those business attempting to take a longer-term view. Senior management and investors in large corporations are not always incentivised to take a long-term view of the business. Longer-term projects that might not provide attractive risk/ return ratio's compared to shorter term projects are often not prioritised. An example of this, is the mining industries failure to invest in tailings dam management or the fashion industries failure to address issues in supply chains. Similar shorter-term pressures can prevent investment in climate change mitigation and resilience beyond the immediate "low hanging" energy efficiency type projects.   These longer-term projects can create positive regional economic impacts if undertaken.

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?

Through engagement with corporations, investors are in a privileged and unique position to gather information on corporate attitudes and behaviour. This provides investors with an opportunity to understand a corporation's approach to managing the transition and their willingness to embrace their broader role in society. Corporations that understand and have enunciated their broader purpose are arguably more likely to recognise their role in a Just Transition.

However, it is difficult to model the downside risks associated with an unjust transition. Many investors conduct scenario analysis and stress testing to assess the implications and impacts of climate change and the transition to a lower carbon economy on their portfolios. This analysis shows that an orderly transition is favourable to a disorderly one. However, in our experience these scenario analysis tools stop short of modelling the broader social impacts of climate change such as social unrest, involuntary migration, inequality, and social exclusion. The underlying data and sophistication of this analysis is evolving and it may be possible to model the implications of an unjust transition on portfolio's in the future. There have been several economic/ industrial transitions both managed and unmanaged upon which analysis could be based. However, investors are largely reliant on third party providers for this analysis.

It is difficult to benchmark companies in terms of the Just Transition, although we know what the challenged sectors are.

Pension funds require healthy vibrant companies in which to invest over decades and therefore a long-term view of investment returns and fiduciary responsibility should be encouraged. A long-term view that allows investors to behave like owners of the companies they hold rather than speculators in the share price. This also affords shareholders the opportunity to take the interests of other stakeholders of the company into consideration when forming views on management and strategy. A long-term view also enables shareholders to evaluate the difficult decisions that management might need to make to secure the longer-term success of the business. A long-term view requires investors to look beyond quarterly returns and consider the structural challenges facing a business and its ability to deliver its core objectives and strategy.

Some of the metrics collected by the ESG rating agencies could be used as a proxy for a company's willingness and ability to contribute to a Just Transition. They consider the treatment of workers and the management of community impacts when researching companies and compiling their ratings. Governance and corporate culture are also indicators. There is more scope to analyse the behaviour of individual companies in this regard , but it is difficult to quantify in financial terms the reputational implication of a corporation's failure to manage their transition in a just manner, taking into consideration the interests of a broad set of stakeholders.

Further research could be carried out in this regard.

The COVID19 crisis provided responsible investors with an opportunity to assess the behaviour of investee companies during the crisis and the treatment of workers and other stakeholders. This provided evidence that the reputation of a corporation can be damaged if they fail to act equitably and for the long-term. It is difficult to quantify reputational damage, but this may also evolve.

COVID19 proved the case for government intervention during a time of crisis. It was proven that this would be tolerated by business and society.

We consider that in terms of ESG matters, transparency and disclosure help drive performance and behaviours. No corporation wants to provide unfavourable performance numbers to stakeholders.

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?***

We consider that government has a role to play in creating opportunities for all pension funds (both public and private) to participate in the Just Transition.

Large pensions funds tend to be global investors/universal owners of stock markets. Maintaining portfolio diversification is a risk management imperative. Pension funds can invest in companies and assets that are managing the transition responsibly and contributing to just outcomes if those companies also present attractive opportunities in terms risk-based returns.

Pension funds can invest in infrastructure projects and governments can assist in creating attractive opportunities through fiscal policies that reward and incentivise positive behaviours and impacts through the transition.

As discussed above, transparency and disclosure will be required to allow investors to identify those companies that are contributing positively to the Just Transition.

The internalisation of externalities and the recognition of the criticality of natural capital through government policy provides the right incentives for a Just Transition and has the potential to reward long-term thinking. The burden of bio-diversity loss and plastic pollution does not fall evenly on communities across the globe. Putting a higher economic value on the carbon storage capacity of carbon sinks will help to ensure they continue to exist in the future.

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

It is important that ESG considerations are integrated into the regular conversations held between investors and corporations. Investors can speak with one voice through collaborative engagement programmes organised by investor groups. At a global level dialogue between responsible investors and local communities is also important and is already being organised with the assistance of labour representatives, NGO's and organisations such as LAPFF. It is important that investors recognise and understand the needs of other stakeholders. It is also important that any conversation between investors and corporations around climate change are holistic and recognise the social implications of the transition to a low carbon economy.

It is essential that the Just Transition is recognised by asset owners in their procurement of investment services and forms part of their due diligence when selecting asset managers.

These engagements should also include active AGM voting, if a company's disclosure is inadequate or it fails to engage with investors then this should be reflected in the vote. Shareholder resolutions are not the only way for investors to show dissatisfaction. Voting against the report & accounts, specific directors or the chair is also appropriate.

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 must play a critical role in helping support innovation at a local level and supporting communities in transition. Displaced workers will need to develop new skills required by the transition to a low carbon economy and the private sector will not be able to deliver this on its own. A Just Transition will need to be co-ordinated and will require forward planning.

The government can play an important role in incentivising longer-term corporate thinking and by internalising externalities that perhaps create short-term incentives that mitigate against long-term thinking. This can apply to negative externalities whereby the impacts arising out of the emission of greenhouse gases are borne by society as a whole and positive externalities - those developing new technologies and networks bear the cost of the research and development but other players benefit from the results. Government can stimulate innovation and create incentives through the removal of subsidies from high emitting sectors and subsidising innovation in low carbon technologies to spread the risk associated with unproven innovation.

Government can play a central role in risk sharing which could help to encourage the flow of investment into new technology. During the COVID19 crises the government agreed to underwrite trade credit insurance, introduced a mortgage guarantee scheme, introduced the risks protection scheme for schools. These policies are examples of the types of risk sharing initiatives that could help early stage industries/businesses during the transition. They could also help to overcome some investors concerns around fiduciary responsibility.

The furlough scheme also provides an example of where government can support displaced labour during periods of transition.

Responsible investors are looking for attractive investment opportunities of an appropriate size that create positive social and environmental impacts and competitive investment returns. Government policy around climate change and the transition can create strong signals and clearer timeframes around the role-out of these technologies. The commitment to change regulations around carbon emissions such as mandating electric boilers, support for hydrogen as a fuel, carbon capture and storage and other fledgling technologies will help to create investable opportunities in the future.

We consider that a realistic price on carbon and the implementation of a robust and transparent system governing carbon-offsets would be transformative in terms of accelerating the transition to a lower carbon economy and allowing investors to price carbon emissions into their investment processes. This would also help to create a more realistic valuation of natural capital and the services provided, such as the carbon storage potential of forests.

It would help investors better assess the risks faced by higher emitting industries and the potential opportunities open to lower emitting sectors and companies providing solutions addressing the carbon crisis.

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?***

Whilst the transition to a lower carbon economy will be wide-sweeping and is urgent, there is an opportunity for it to be managed. An orderly transition will have fewer negative impacts than a disorderly transition.

Allowing people to participate in the process of regeneration, forward planning and co-ordination between different governmental departments are all essential. Germany's management of its transition away from coal provides an example of a managed transition.

Technical assistance as well as financial assistance is needed. In some cases, skills from challenged sectors can be repurposed such as project management skills that exist within the fossil fuel industry. This sort of collaboration can be co-ordinated.

Industrial transition in the past has led to uneven economic development and a sense of social injustice that has taken many years to overcome. The transition to a lower carbon economy presents many opportunities to the UK, and it is important that the government, through regional economic support, helps to ensure that challenged areas are not left behind in terms of economic development.

It is essential that consideration is given to the wider impacts on supply chains as well directly impacted industries. An abrupt transition will accentuate these impacts.

As discussed above, Scenario Analysis suggests that an orderly transition, coordinated through a coherent policy framework is less impactful than a disorderly transition. This will help to make the transition more just. Identifying impacted sectors and regions and responding early to the risk of economic decline will also help to reduce the impacts. Investment in infrastructure can help to lessen the impact on effected areas and prepare for a Net Zero economy. The reports of the National Infrastructure Commission provide a useful resource for this work.

It is important that the UK workforce has the right skills to prosper in 2050 and beyond. A review of the national curriculum and higher education may be required to ensure that the skills of the next generation of school leavers and graduates are equipped for a career in the net zero economy.

The Just Transition is a global issue even if the impacts are localised. Government policy and action will need to consider the negative impacts of the Just Transition on developing economies. The sharing of technology and knowledge is going to be critical if developing countries are to realise their transitional ambitions and to ensure that the carbon emissions reductions required are realised at a global scale.

There remains the risk that if the transition is perceived to be something feared rather than embraced. This could encourage resistance rather support and action may be delayed.

It is also important that the transition to a low carbon economy is part of a broader conversation around how we can create, a more sustainable economy where patterns of consumption are more sustainable, where waste is reduced, where plastic packaging is less common, where less meat is consumed and where natural capital and bio-diversity is valued.

Much of the debate has been around the supply side of the challenge i.e the transition of the fossil fuel industry for example, there needs to be renewed focus on demand as it is a fall in demand for these products that will bring about a transition and a reallocation of capital.

DISCLAIMER

Important information:

This document has been produced by LGPS Central Limited and is intended solely for information purposes. Any opinions, forecasts or estimates herein constitute a judgement, as at the date of this report, that is subject to change without notice.

Any information and analysis contained in this publication has been compiled or arrived at from sources believed to be reliable, but LGPS Central Limited does not make any representation as to their accuracy or completeness and does not accept any liability from loss arising from the use thereof.

All information is prepared as of 04/05/2021.

LGPS Central Limited is authorised and regulated by the Financial Conduct Authority. Registered in England Registered No: 10425159. Registered Office: Mander House, Mander Centre, Wolverhampton, WV1