Pensions Committee

1.30pm, Tuesday, 5 December 2023

Holdings Report

Item number 6.5

1. Recommendations

The Pensions Committee (Committee) is requested to:

1.1 note the report.

Bruce Miller

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Holdings Report

2. Executive Summary

2.1 At its 27 September 2023 meeting, the Pensions Committee requested "a report to the next meeting detailing all investments currently held by Lothian Pension Fund in companies whose principal business is fossil fuels". This report responds to that request by providing a table identifying / isolating those companies.

2.2 For many years, fund officers have supported transparency by publishing all holdings on the website. As well as highlighting the fossil fuel producers owned by the fund, the report presents broader context for the fund's investments to inform members and employers about the balance between fossil fuels and renewables in the portfolio and in the real economy. This is important because returns are generated from the real world not an ideal world.

2.3 The context for these comments is that the Pensions Committee has always been advised by fund officers and independent advisers against excluding types of investments from the universe of potential investments because imposing constraints leads to sub-optimal outcomes. That is not to say that the fund invests in the whole universe, but where it does and doesn't invest is determined for investment reasons by the investment managers charged to do this, rather than for purely non-financial reasons.

2.4 It is through analysis rather than advocacy that the fund determines a mix of investments with which to fund its pensions, and that mix changes over time. The change of fossil fuel producers over the last three years is shown in the report as requested. It's also worth remembering that the investment returns achieved directly impact employers' contribution rates.

2.5 It is critical to understand that both renewable energy companies and fossil fuel producers are legitimate entities that deliver essential energy for today's economy and society to function. Derivatives of fossil fuels also have essential uses in the modern world, from pharmaceuticals to fertilisers and sterile medical devices. To exclude fossil fuel producers would be to ignore their portfolio attributes, which are derived from their importance to the economy. These attributes have been in evidence over the last three years, supporting their inclusion in the investment universe. The performance of listed renewables and fossil fuels are shown in the report.

2.6 As we strive to fund pensions and keep employer contributions as low as possible, officers and advisers reiterate the advice to maintain the widest possible universe. LPF officers are committed to support the goal of transitioning the real economy to net zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5 degrees Celsius by 2100. To achieve this goal, a massive transition in the energy industry has to take place - this transition has started, but the economy has been built on fossil fuels and there will still be a role for oil and gas for many decades. Even in a declining industry, companies that are generating cash flows that will be paid to their shareholders (including pension funds), can be financially attractive investments. It therefore remains appropriate to consider the merits of owning them. Furthermore, we aim to engage with these companies to support implementation of just transition plans and will hold directors to account through our voting.

3. Background

3.1 The Pensions Committee supported a motion by Councillor Burgess requesting a report narrowly focused on companies whose principal business is in fossil fuels. This paper provides the information requested.

3.2 The fund has, for many years, provided transparency about all its holdings, which are published on its website. In view of the request to provide data on a narrow group of stocks within the fund and the emotive nature of climate change and the impact of fossil fuels on it, the report provides some context.

3.3 The fund continues to invest in a range of companies delivering energy that provide essential products to humanity. According to the Energy Institute, 82% of primary energy was derived from fossil fuels in 2022 and 7% from renewables, excluding hydroelectricity (also 7%). The outlook for continued growth in renewables is strong, while the outlook for growth in fossil fuels is weaker. But not all fossil fuels are equal and both renewables and fossil fuels are valued differently by investors. Value is important and almost always ignored by divestment lobbyists.

Primary Energy

Consumption (Exajoules)	Oil	Natural Gas	Coal	Nuclear Energy	Hydro-electricity	Renewables	Total
Total World	191	142	161	24	41	45	604
	32%	23%	27%	4%	7%	7%	100%
OECD	88	65	29	16	13	24	234
	38%	28%	12%	7%	6%	10%	100%
Non-OECD	103	77	133	8	27	22	370
	28%	21%	36%	2%	7%	6%	100%

Source: 2023 / 72nd edition, Statistical Review of World Energy, Energy Institute

3.4 Some people invoke a moral case for not owning fossil fuel related companies (climate change) while others invoke a moral case for owning them (they are inputs that provide economic essentials, such as fertilisers that feed the world). The fund tries to stay clear of moral judgements, which are personal, and focuses on the investment merits (including an assessment of material financial ESG risks) of the fossil fuel, renewable and other companies that populate its portfolio.

3.5 Renewables are not without ESG risk: the solar photovoltaic supply chain is heavily concentrated in China, which creates geo-political and human rights risks; there are environmental concerns specific to each new renewable project development; and the electrification of transport requires significantly more mining of the metals required for EV batteries causing environmental and potentially also social issues.

3.6 Investment managers deploy the fund's capital (employer and employee contributions) to provide a financial return. They aim to own assets with cash flows that are undervalued by the market and avoid assets that are overvalued within a portfolio that is diversified to reflect the considerable uncertainties about the future. They do so to fulfil their fiduciary duty to members and employers.

3.7 The risk of this report is that by isolating and highlighting a group of companies that some see as pariahs, it creates a false impression of the fund by diverting attention from the fund's investments in other sectors, including renewables, potentially resulting in politics taking precedence over fiduciary duty. This is important because Principle 1 of the fund's Statement of Investment Principles states that "Committee believes that their decisions, and those of officers, must give precedence to the fiduciary duty owed to members and employers".

3.8 Lothian Pension Fund presents itself as neither ethical nor unethical. This is because it represents a very large number of stakeholders, including over 90,000 members and over 60 employers. It is impossible to satisfy all stakeholders on all ethical issues. What it does do, is invest on the basis of analysis rather than advocacy.

3.9 The request for a paper detailing fossil fuel companies must be put in context. The consequences of selling shares that provide a useful role in a diversified portfolio of assets is poorer investment outcomes, which impacts employers in the first case. It also achieves nothing towards climate change or energy transition goals, both of which the Fund seeks to support.

3.10 The gross domestic product of world economies is enabled by fossil fuels. There is an energy transition underway, and governments have enacted policies to support growth in renewables. Fossil fuels will retain a critical role in the global economy for many years, indeed decades, to come. Their production impacts the environment, and they emit greenhouse gas emissions when burnt, but they continue to support human life and human living standards.

3.11 While scientists and technologists seek ways to replace fossil fuels, their use is expected to continue for several decades. There are no easy solutions, and stopping production of fossil fuels without sufficient alternatives is not a sensible option. Within its SRIP, LPF is clear that it is committing not to provide new capital to fossil fuel companies, and the only exception would be where the provision of new capital supported implementation of a transition plan which would result in the company aligning with the aims of the Paris Agreement.

3.12 Finally, the Committee should remember that buying and selling of shares does nothing to impact the production of fossil fuels.

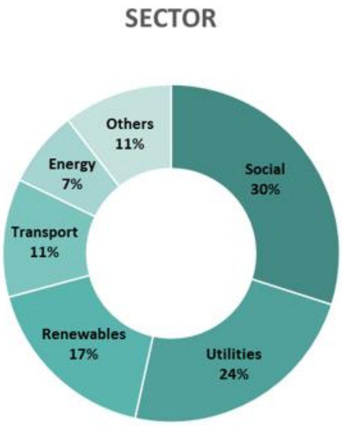
4. Main Report

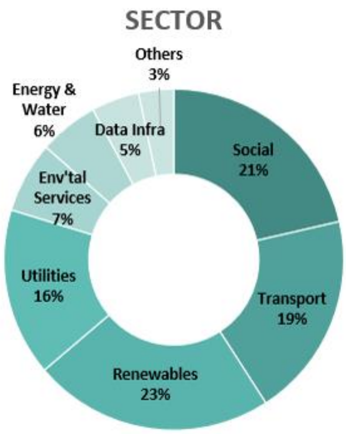
Holdings

4.1 The following table shows the value of the shares of the fossil fuel producers currently owned by the fund (end September 2023), and the changes over the prior three years. They represent approximately 2% of the total fund value.

Energy Sector Investments	30/09/20 (£m)	30/09/23 (£m)	Change in shares (09/20 - 09/23)
BP PLC	7.9	18.6	0
CHEVRON CORP	3.0	7.4	0
CONOCOPHILLIPS	2.4	8.0	-11,947
ENEOS HOLDINGS INC	0.0	18.1	5,601,600
ENERGEAN PLC	0.0	4.1	355,000
ENI SPA	6.8	14.8	0
EQUINOR ASA	10.8	26.6	0
EXXON MOBIL CORP	12.5	40.1	-55,308
GULF KEYSTONE PETROLEUM LTD	0.0	0.5	500,000
HESS CORP	2.9	8.3	-26,274
I3 ENERGY PLC	0.0	0.5	3,500,000
PETROTAL CORP	0.0	0.5	1,000,000
RELIANCE INDS-SPONS GDR 144A	2.1	4.0	41,445
SAVANNAH ENERGY PLC	0.0	0.6	2,458,000
SERICA ENERGY PLC	0.0	1.2	500,000
SHELL PLC	7.0	18.9	0
TOTALENERGIES SE	13.6	27.8	0
WOODSIDE ENERGY GROUP LTD	0.0	0.5	25,770
TOTAL VALUE	**73.4**	**200.5**	

4.2 The following pie charts show the fund's infrastructure portfolios at end September 2020 and end March 2023. Within the portfolio, there are several investments in renewables. The fund has invested £154m in renewables over the 2.5 years to end September 2023, including investments in a hydroelectric plant, two offshore wind farms and a portfolio of bioenergy assets. Over £100m was invested in renewables within FY 22/23. Renewables in this portfolio alone represent approximately 3% of total fund value.

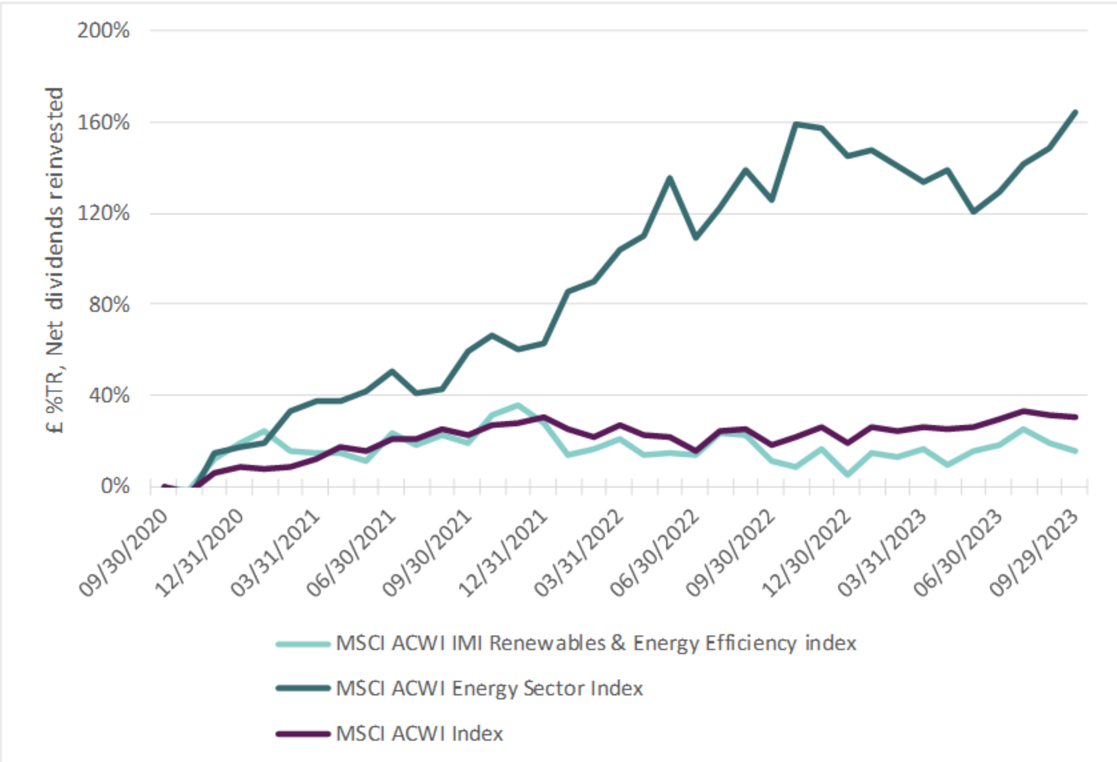




Infra portfolio £0.86bn as at 30/09/2020
Renewables: £146m

Infra portfolio £1.3bn as at 31/03/2023
Renewables: £300m

4.3 Whilst the fund has invested significant sums into renewable energy, it is worth highlighting why it continues to invest in fossil fuel producers. The last three years provide evidence that we need to be careful about excluding them as financial returns can be significant and significantly higher than those from renewables. The chart below shows the returns over that period for the MSCI Renewables & Energy Efficiency Index +15%, MSCI All World Index +31% and MSCI World Energy Index +165%.



5. Financial impact

5.1 The investments highlighted in this report will contribute to the performance of the fund, which will impact the funding costs borne by employers of the fund.

6. Stakeholder/Regulatory Impact

6.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the fund and they are invited to comment on the relevant matters at Committee meetings.

6.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report. However, an exclusion policy would need to be justified as not being in breach of fiduciary duty, which would likely require it to be justifiable on investment grounds. The Committee agrees, as set out in the SIP, that it is the responsibility of professional investment managers and not the Committee to take investment decisions.

6.3 The introduction of an exclusion policy, whether fossil fuels or any other specific sector would raise risks including investment performance, people risk, risks to the strategic collaboration with Fife and Falkirk pension funds and impact the externally managed portfolios of LPF.

7. Background reading/external references

7.1 The fund's list of investment holdings is published on its website:

Investments | LothianPensionFund (lpf.org.uk)

7.2 The fund's Statement of Responsible Investment Principles (SRIP) is published on its website. The revised version has been tabled for approval by the Pensions Committee on 6 December 2023 (item 6.4 Appendix)

Responsible Investment | LothianPensionFund (lpf.org.uk)

8. Appendices

None.