Report of the Director of West Yorkshire Pension Fund to the meeting of Corporate Overview and Scrutiny Committee to be held on Wednesday 19 October 2016.

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Subject:

West Yorkshire Pension Fund Disinvestment from the Fossil Fuel Industry

Summary statement:

A review of investment in the fossil fuel sector and the implications for the West Yorkshire Pension Fund, the District and its current and retired public sector workers of any programme of disinvestment.

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1. SUMMARY

1.1 This report is a review of investment in the fossil fuel sector and the implications for the West Yorkshire Pension Fund, the District and its current and retired public sector workers of any programme of disinvestment.

2. BACKGROUND

2.1 At its meeting on Tuesday 20 October 2015, Council agreed that the Governance and Audit Committee and the Corporate Overview and Scrutiny Committee complete a joint review of investment in the fossil fuel sector and the implications for the West Yorkshire Pension Fund, the District and its current and retired public sector workers of any programme of disinvestment and report back to Council.

2.2 Climate change is widely recognised as being the result of fossil fuel consumption, and that the reduction of carbon emissions is necessary. This consensus is demonstrated by the Climate Change Act 2008, which established a target for carbon emission reductions of 80% by 2050 against 1990 levels.

2.3 A variety of campaigns seeking to influence progress towards achieving this objective are proposing a range of actions, one of which is to simply disinvest from the fossil fuel sector.

2.4 Following discussions it was decided to:

- Examine the legal position of the Pension Fund in terms of its powers to invest and dis-invest;
- Examine the financial consequences of disinvesting from the fossil fuel sector;
- Consider the risks and positive effects of fossil fuel disinvestment.

2.5 The West Yorkshire Pension Fund (WYPF), in common with most other institutional investors, has investments in a portfolio of companies within the fossil fuel sector. While the Fund does not restrict its investment managers, it actively engages with the companies it owns on issues of concern, a very long standing policy. The WYPF philosophy is that while acquiring shares in a company brings with it the rights of ownership it also brings the responsibilities, and these must be taken seriously. Therefore when the Fund owns shares in a company it needs to consider the social and environmental footprint of that company, and exercise the appropriate influence and control over management. To do otherwise, particularly where there are genuine issues to be addressed would be to abdicate its responsibility.

2.6 Among many issues, WYPF has been engaging on climate change since the early 1990s, and indeed in the recent AGM season has been a key sponsor of resolutions to companies in the sector requiring them to demonstrate how their business plan is addressing climate change and its inherent risks. The WYPF beliefs are set out in its Statement of Investment Principles (SIP), an extract is attached as Appendix 1.

3. OTHER CONSIDERATIONS

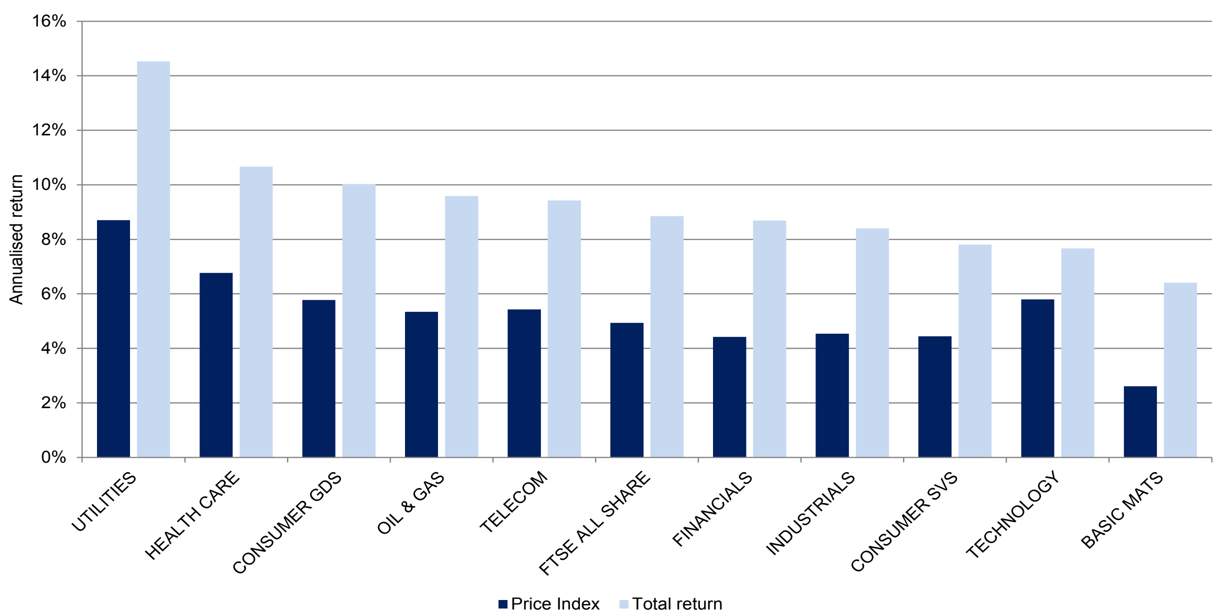
- None.

4. FINANCIAL & RESOURCE APPRAISAL

4.1 The sources of income for WYPF are employee contributions, employer contributions and investment returns. The employee contributions are fixed by government regulation and are a function of pay. Investment returns are what the Fund achieves on what is actually invested, hence the importance of the decisions made by the Investment Advisory Panel (IAP) consisting of elected Members from the five West Yorkshire District Councils, trade unions and scheme member representatives. Any shortfall to fully fund the scheme is made up by increasing the employer contributions, which has a direct impact on the ability of the councils to provide services to tax payers.

4.2 The financial consequences of investment decisions only become evident in the long term, which for a pension fund, which has liabilities potentially over 80 years, is obviously a period to be measured in decades.

4.3 The graph below shows the long term performance (1986 to 2015) of the subsectors within the FTSE All Share Index, which shows that three of the five outperforming sectors have been Utilities, Consumer Goods and Oils, three sectors which are dependent on fossil fuels.



4.4 During 2014 and 2015, oil and commodity prices fell from a sustained period of strong performance. This was very well publicised in the media, and has been seized on by lobby groups to push the case for disinvestment. More recently oil prices have stabilised and recovered somewhat. The low commodity prices adversely affected performance of resources stocks over the short term. However over the long term, the performance of these shares has been robust, resilient and consistently strong. This is demonstrated by the graphs in 5.3 and 5.4 below, which show the sector continues to outperform the market as a whole for the 30 years the end of September 2016.

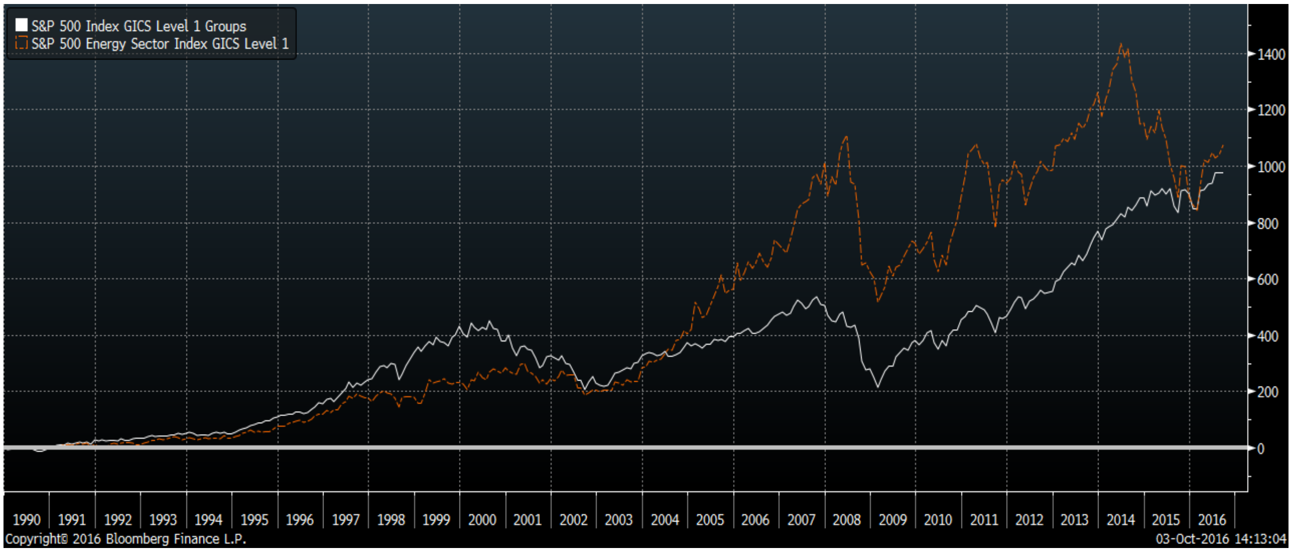
4.5 The Fund is better off as a result of holding these investments for the last 30 years by the equivalent of £4m per annum, much of which has been dividend income. To put this into context, the employers' contribution to the Fund for 2015/16 was £152m. The £4m additional return from holding the Oil and Gas sector alone is almost 3% of employer contributions, which would otherwise have been recovered from employers through a higher contribution. A 3% increase in employer contributions would be unwelcome to employers with budgets under continuing pressure.

5. RISK MANAGEMENT AND GOVERNANCE ISSUES

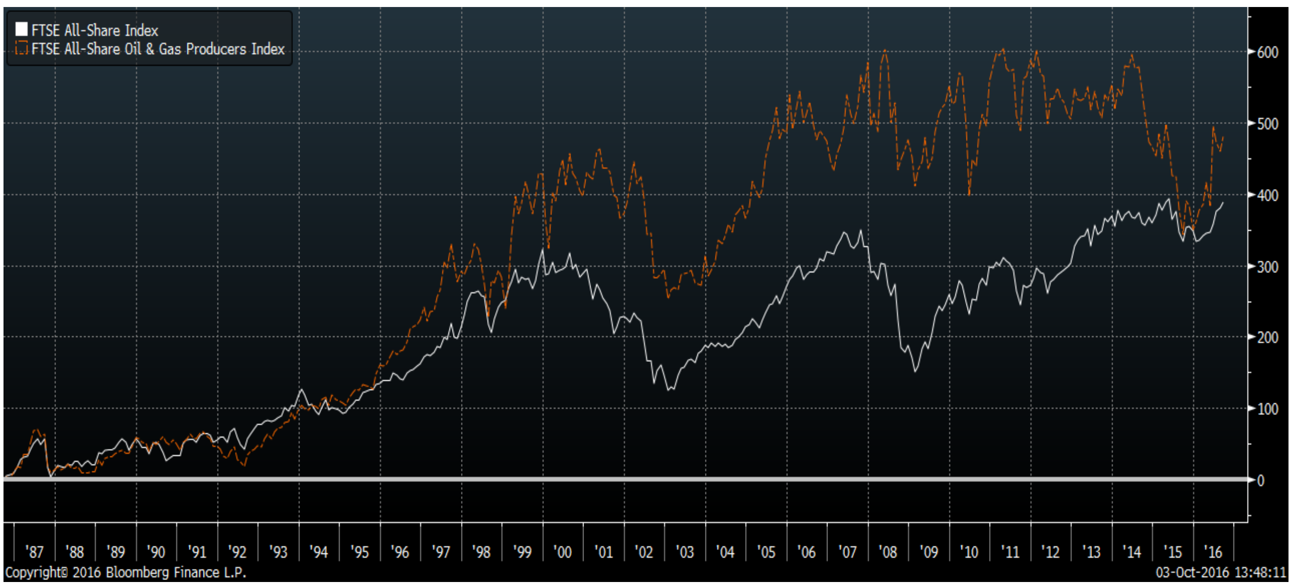
5.1 The IAP, as part of its fiduciary duty, has a responsibility to ensure the portfolio is balanced and not taking undue risks against the index. Excluding fossil fuels would result in a significant divergence from the index, introducing a risk into the portfolio, as it represents 11.2% of the index at 30 September 2016. (Oil and Gas, Mining and Utilities sectors together make up almost a fifth of the market). If this decision is made on the grounds of the pressure groups who are lobbying for fossil fuel disinvestment, then there is the consequent risk that other pressure groups lobbying on obesity or public health will expect similar consideration, and very quickly the portfolio would not measure up against the fiduciary duty which is covered in more detail in paragraph 6 of this report.

5.2 Following a similar campaign to exclude tobacco stocks, Norfolk Pension Fund commissioned a report on the impact of excluding the Tobacco sector. The report (see Appendix 2) concluded that a portfolio would have been 6% worse off over 10 years.

5.3 In the US, the Energy sector index has outperformed the 'Eco' sector index (an index which is designed to represent the economy as a whole) by 0.34% per annum from the beginning of 1990 to 30 September 2016 as the following chart shows, giving a return of 9.63% p.a., even after the significant falls which were a consequence of the drop in oil prices in 2014/15.



5.4 This is not dissimilar from the relative performance of the UK Oil Sector against the FT All Share index, where it has outperformed by 0.63% p.a. giving a return of 4.97%.



5.5 Divesting of all fossil fuels would mean selling a significant portion of the WYPF global equity portfolio. In the UK alone, selling Oil and Mining stocks would mean sales of over £635 million. The transaction costs of selling almost two thirds of a billion pounds worth of stock would be £1.25 million, while reinvesting the money would be even more costly due to stamp duty at the rate of 0.5% in addition to the commission, money that would be lost to the Fund forever.

5.6 Selling significant shareholdings (such as the 38 million BP shares held by WYPF) would push the share price down. Being a 'forced' seller would mean having to accept lower prices in order to complete the sale. So the initial £635m resources market value is likely to be worth considerably less due to an oversupply of stock in the market. There is also an additional risk that if other funds become forced sellers, through a divestment policy, that share prices will fall even further.

5.7 The 7.26% yield on the Oil sector is currently the highest in the FTSE All Share. This is partly due to share price falls as a result of the lower oil price, but also the major oil companies are maintaining or increasing dividends. If fossil fuel divestment were pursued as a policy, then WYPF dividend income would fall by a significant amount. In 2015/16, dividend income to the fund from UK oil and mining and companies was £33 million. The yield on the wider FTSE All Share index was significantly lower, equivalent to £18.6 million. This would be a 44% reduction in income and cash flow, cash flow that will be required to pay pensions in due course.

5.8 There are reasons to consider carefully before simply parting company with the sector, even from an environmental perspective. Much of the leading edge research into solar and battery technology is being undertaken or funded by these companies.

5.9 A strong argument put forward for disinvestment is what has become known as 'stranded assets', that oil in reserves which could never be burned without exceeding agreed climate change targets. However, this takes little account of the fact that close to 75% of reserves are owned by states or state owned oil companies, and not the investable oil companies, and the 'stranded assets' will be those which have not been acquired by investors.

5.10 The reality is that the switch from oil and gas to alternative energy sources will take several decades, and that energy companies should be taking account of this in their business plans. Impax Asset Management, a specialist in sustainable investment, in its report 'carbon risk for investors: Building a "Smart Carbon" portfolio puts forward the view that 'climate change risk and policy responses are likely to evolve considerably in the next five to ten years,' confirming the WYPF view that the changes are long term in nature, and that any changes to the portfolio should be implemented gradually over time. They also suggest engagement with companies, seeking further information, which will enable ever better monitoring of the risk, and any mitigating action that may be required, which may indeed include reducing sector exposure. They believe that risk needs to be assessed at the individual asset level, as put forward in a paper from the Smith School of Enterprise and the Environment, but the detailed information required to do this is not presently available.

5.11 They also state that 'At its heart, carbon risk focuses on the potential for consumption of fossil fuels to be materially lower than is implied by today's prices.' There is as yet little evidence that this is a likely short term reality, as demand continues to grow in developing countries. Investment timing is key to success, and the current evidence supports regular review and gradual change in portfolio construction, through the sector changing its business plan or investment in the developing energy efficiency and green energy sectors, as WYPF is doing.

5.12 For the reasons above WYPF believes engagement is likely to be far more effective than disinvestment. By requiring the management of the fossil fuel (and mining) companies to present business plans that take account of the international agreements on climate change, by pushing resolutions through company AGMs, WYPF can ensure action is taken. Simply divesting of these stocks would allow those who have no such concern for the environment to acquire the shares at a lower price, and take the pressure off management to respond positively to this issue.

5.13 Obtaining such a positive response from management will be absolutely key to allowing the world economy to continue functioning during the transition to a low carbon economy, as decisions on which reserves are developed can have a significant impact on the carbon footprint. There can be a difference of over 80% in the emissions per barrel between the lowest and highest types of oil.

5.14 As part of its engagement through the Local Authority Pension Fund Forum (LAPFF) WYPF continues to seek action from the companies with which it engages. To this end on 21 July the LAPFF and the Carbon Tracker Initiative (CTI) are launched a new report 'Engaging for a Low Carbon Transition' which sets out why a 2°C business model for Oil and Gas companies can be less risky than 'business-as-usual'. By putting this report, backed up by professional research, in front of the boards of the major oil companies WYPF expects to achieve real change.

5.15 Individual actions to address climate change can demonstrate leadership, but will not provide a total solution. Institutional investors by collaborating can influence their companies to adapt and prepare for a lower carbon future, and engage with policy makers. While this may have short term negative consequences this is ultimately in their long term best interests. This is a collective problem which requires government and international action to achieve a solution.

6. LEGAL APPRAISAL

6.1 As a local authority pension fund, the WYPF has a duty to invest contributions from its members in a way which gives the highest return possible for an acceptable level of risk. Members of the Investment Advisory Panel (IAP), representatives from the five West Yorkshire district employers, union representatives and scheme member representatives are charged with overseeing the function of the Investments department of the WYPF.

6.2 The fiduciary duty of the Panel is to maximise returns for the fund, as advised in a Counsels Opinion to the National LGPS Advisory Board in March 2014, which states that maximising fund returns must be the primary motive of LGPS investments, and that the member authorities should not seek to influence the investment process of the funds for any other purpose.

6.3 The conclusions of Nigel Giffin QC are:-

- In managing an LGPS fund, the administering authority has both fiduciary duties and public law duties (which are in practice likely to come to much the same thing).

- The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way).

- However, so long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such considerations, the administering authority may not prefer its own particular interests to those of other scheme employers, and should not seek to impose its particular views where those would not be widely shared by scheme employers and members (nor may other scheme employers impose their views upon the administering authority).

The opinion is available at
http://www.lgpsboard.org/images/PDF/Publications/QCOpinionApril2014

6.4 In summary, after these duties have been discharged it is possible to take other factors into account when making investment decisions. The proviso is that taking other factors into account should not prejudice the expected return, nor increase risk.

7. OTHER IMPLICATIONS

- None.

8. EQUALITY & DIVERSITY

- None.

9. SUSTAINABILITY IMPLICATIONS

- The sustainability implications are set out in paragraph 5, and will be positive if the recommendations are followed.

10. GREENHOUSE GAS EMISSIONS IMPACTS

- The greenhouse gas emissions impacts are set out in paragraph 5, and will be positive if the recommendations are followed.

11. COMMUNITY SAFETY IMPLICATIONS

- None.

12. HUMAN RIGHTS ACT

- None.

13. TRADE UNION

- None.

14. WARD IMPLICATIONS

- None

15. NOT FOR PUBLICATION DOCUMENTS

- None.

10. OPTIONS

- None.

11. RECOMMENDATION

Recommended -

That the Committee:-

- *Notes that WYPF investment decisions are made by the Investment Advisory Panel which includes representatives of all West Yorkshire Districts as well as other interested parties, and not Bradford alone,*
- *Notes that the Investment Advisory Panel considers the annual report of the Local Authority Pension Fund Forum which includes engagement activities with fossil fuel companies,*
- *Agrees with the policy of positive engagement set by the Investment Advisory Panel,*
- *Welcomes the progress achieved towards ensuring that the fossil fuel companies revise their business plans to take account of the COP21 agreement,*
- *Welcomes continuing investment in green energy technology and production as the industry develops.*

11. APPENDICES

- WYPF SIP extract – Appendix 1
- Extract from Norfolk Pension Fund Report – Appendix 2

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12. BACKGROUND DOCUMENTS

- Background documents are documents relating to the subject matter of the report which disclose any facts or matters on which the report or an important part of the report is based, and have been relied on to a material extent in preparing the report.

Published works are not included.

- All documents referred to in the report must be listed, including exempt documents.
- All documents used in the compilation of the report but not specifically referred to, must be listed.