Is the Lothian Pension Fund socially responsible?
A focus on fossil fuels

Briefing for Pension Fund Committee and Lothian Pension Fund Board members

18 June 2015, Friends of the Earth Scotland (Amended)

The Lothian Pension Fund (LPF) is one of the largest of the UK's Local Government Pension Scheme (LGPS) providers with over 65,000 members from over 100 organisations.

As a whole the LGPS stewards £225 billion on behalf of its members. Its investments have a major impact on the wider economy and shape the future of our society and planet.

The LPF has stated it will “incorporate environmental, social and governance issues into investment analysis and decision-making processes”[1] and has initiated a number of schemes to consider environmental and social issues in investment decisions. Yet the fund remains deeply invested in some of the world's most irresponsible companies:

- **RioTinto** is one of the largest coal producers in the world. It is accused of anti-union behaviour, failures in worker health and safety, failure to respect indigenous peoples and numerous other violations by civil society groups including global mining union IndustrialAll.[2]
- **British American Tobacco** (BAT) was found in a BBC investigation to be marketing cigarettes to young people in Africa and is currently taking legal action against the UK Government's anti-smoking measures.[3]
- Having been found responsible for the Gulf of Mexico disaster **BP** is currently under fire for corruption and collusion with the Government of Azerbaijan, who are accused of human rights abuses.[4] In 2011 it sold its solar power business making 1,750 workers redundant.[5]

Tobacco[6]	
British American Tobacco	£22,841,896
Imperial Tobacco	£20,067,540

Oil and gas	
Royal Dutch Shell	£20,165,366
BASF	£18,859,624
Total	£15,747,011
Eni	£12,556,806
BP	£12,095,752
Statoil	£10,913,477
Husky Energy	£10,638,580

Coal	
CLP Holdings	£9,879,158
ADR Vale	£8,534,426
China Resources Power	£3,479,451
Rio Tinto	£2,973,774
Evraz Group	£2,194,920
China Shenhua Energy	£1,294,961

Arms	
Lockheed Martin	£45,693,854
United Technologies	£13,602,508
Raytheon	£10,591,118

1 'Lothian Pension Fund signs United Nations Principles of Responsible Investment', source: http://www.lpf.org.uk/lpf1/info/76/unpri

2 ‘RioTinto: The Way It Really Works’, May 2015, IndustrialALL Union, source: http://www.industriall-union.org/riotinto

3 'Japan Tobacco joins UK legal action on packaging', The Financial Times, 26 May 2015, http://www.ft.com/fastft/328863/japan-tobacco-sues-uk

4 'Azerbaijan holds activist who attacked European Games as 'BP's games'', The Guardian, 9 June 2015, source: http://www.theguardian.com/world/2015/jun/09/azerbaijan-holds-activist-who-attacked-european-games-as-bps-games

5 'BP axes solar power business', The Guardian, 21 December 2011, source: http://www.theguardian.com/environment/2011/dec/21/bp-axe-solar-power-business

6 Data from 31 March 2015 published by the Lothian Pension Fund and analysed by Friends of the Earth Scotland, source: http://www.lpf.org.uk/info/11/how_we_invest

Fossil fuels and the LPF

Fossil fuels – coal, oil and gas – are the main drivers of climate change. Fossil fuel use at its current rate will ensure a world of poorer health, increased inequality, and greater poverty.

The UN and G7, who underpin global action on climate change, have formally agreed that global warming should not exceed 2ºC from pre-industrial levels.[7] New research shows that to achieve this target more than 4/5ths of the reserves of publicly listed fossil fuel companies cannot be burnt.[8]

To contribute to the implementation of global agreements on climate change the City of Edinburgh has agreed to reduce carbon emissions by 42% by 2020, supported by its Sustainable Energy Action Plan.[9]

However climate change cannot be solved by action on emissions alone. Governments are beginning to take action on fossil fuel extraction, especially coal, in order to tackle climate change.

As a positive step the LPF has sold, or seen a reduction in value, of an estimated £240 million of fossil-fuel equities during the 2014-15 financial year. However it continues to invest in some of the biggest polluters *(see p.1)* and as of 2015 £169 million, or 3.1% of the Fund, was invested in the 200 largest coal, oil and gas companies.[10]

The carbon and coal bubbles

Government action to limit fossil fuel use is creating significant financial risks to the sector.

Since most fossil fuels need to stay in the ground to meet globally agreed climate targets, government action to limit carbon emissions will leave remaining fossil fuels as stranded assets in a “carbon bubble”.

Funds such as the LPF which continue to invest in fossil fuels can expect to suffer considerable losses when this bubble bursts.

The risk is particularly high to coal investments because of coal’s higher carbon intensity and thus greater contribution to climate change. The downturn in coal use in China has seen coal stocks plummet in value.[11] To limit this risk a number of funds have moved to exclude coal investments including the £556 billion Government Pension Fund Global in Norway, which has moved to divest from 53 coal companies[12], and the Universities of Edinburgh and Oxford.

Other funds, such as the £560 million Rockerfeller Foundation[13] along with 53 trusts and other organisations worldwide have pledged to divest from all fossil fuels. Scottish churches[14] and universities,[15] such as the University of Glasgow have taken similar action.

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7 'G7 leaders bid 'Auf Wiedersehen' to carbon fuels', Reuters, 8 June 2015, source: http://www.reuters.com/article/2015/06/08/us-g7-summit-idUSKBN0OM0I320150608

8 'Food, Fossil Fuels and Filthy Finance' Oxfam GB, 2014, source: http://policy-practice.oxfam.org.uk/publications/food-fossil-fuels-and-filthy-finance-332741

9 Sustainable Energy Action Plan (SEAP), City of Edinburgh Council website: http://www.edinburgh.gov.uk/info/20220/economic_development/544/sustainable_economy/2

10 Data from 31 March 2015 published by the Lothian Pension Fund and analysed by FoE Scotland, source: http://www.lpf.org.uk/info/11/how_we_invest

11 'China’s bursting coal bubble raises fear of stranded assets', The Telegraph, 1 March 2015, source: http://www.telegraph.co.uk/finance/newsbysector/energy/11443648/Chinas-bursting-coal-bubble-raises-fear-of-stranded-assets.html

12 'Norway's sovereign wealth fund drops over 50 coal companies', The Guardian, 16 March 2015. Source: http://www.theguardian.com/environment/2015/mar/16/norways-sovereign-wealth-fund-drops-over-50-coal-companies

13 'Heirs to Rockefeller oil fortune divest from fossil fuels over climate change', 22 September 2014. Source: http://www.theguardian.com/environment/2014/sep/22/rockefeller-heirs-divest-fossil-fuels-climate-change

14 United Reform Church Synod of Scotland divests from fossil-fuel companies', Eco-Congregations Scotland, 24 March 2015. Source: http://www.ecocongregationscotland.org/news/united-reformed-church-synod-of-scotland-divests-from-fossil-fuel-companies/

15 'SOAS to divest from fossil fuel industry', Times Higher Education, 24 April 2015. Source: http://www.timeshighereducation.co.uk/news/soas-to-divest-from-fossil-fuel-industry/2019882.article

The Bank of England is studying the risk of the carbon bubble. Paul Fisher, Deputy Head of the Prudential Regulation Authority at Bank of England warned in March 2015:

> "As the world increasingly limits carbon emissions, and moves to alternative energy sources, investments in fossil fuels – a growing financial market in recent decades – may take a huge hit."[16]

Recent analyses show that a fossil-free portfolio may give higher returns. An S&P Capital IQ study which compared the performance of equities over the last 10 years concluded that a fossil-free fund would have significantly outperformed fossil-fuel invested funds.[17] MSCI, who run global indices used by 6000 pension and hedge funds, found that investors who divested from fossil-fuel equities would have earned an average return of 13% a year since 2010, compared to the 11.8%-a-year return earned by "conventional investors."[18]

Fiduciary duties and divestment

Drawing evidence from case law and primary and secondary legislation, it is clear that when considering action on investments, board and committee members' first responsibility is to ensure the long-term interests of fund beneficiaries.

This fiduciary duty, to act not in one's own interests, but to put the interests of beneficiaries first, has been affirmed by case law on pension funds:

- In *Cowan v Scargill* [1985] Ch 270 it was found that divesting from competitors to English coal was against the best interests of their retired members.
- In *Martin v City of Edinburgh District Council* [1989] Pens LR 9 the Council was found to have acted improperly because it divested from companies linked to apartheid South Africa in order to *first* carry out council policy on South African funds, and did not properly consider the best interests of the beneficiaries.

In the current legal framework the City of Edinburgh Council must always first consider its fiduciary duty to scheme employers and scheme members, and must act in the best long-term interests of fund members.[19]

However, this approach does not preclude taking action on irresponsible companies. With this caveat in mind the law on "divestment" has been clarified in recent years by UK institutions which, although not binding, have "persuasive value" in Scotland[20]:

- A Local Government Association (LGA) legal opinion concluded that as long as the authority's powers are used only for investment purposes "the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that that does not risk material financial detriment to the fund."[21]
- A wider review of fiduciary duties was produced by the Law Commission (England & Wales) who stated that "the primary aim of an investment strategy is therefore to secure the best realistic return *over the long term, given the need to control for risks*"[22], giving examples such as "environmental degradation", "poor safety record", and "risks to a company's long-term sustainability."[23] The Law Commission

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16 'Bank of England warns of financial risk from fossil fuel investments', The Guardian, 3 March 2015. Source: http://www.theguardian.com/environment/2015/mar/03/bank-of-england-warns-of-financial-risk-from-fossil-fuel-investments

17 'Fossil Fuel Divestment: Smart Bet or Losing Strategy?' Forbes, 10 February 2015. Source: http://www.forbes.com/sites/tomzeller/2015/02/10/fossil-fuel-divestment-smart-bet-or-losing-strategy/

18 'Fossil fuel-free funds outperformed conventional ones, analysis shows', The Guardian, 10 April 2015. Source: http://www.theguardian.com/environment/2015/apr/10/fossil-fuel-free-funds-out-performed-conventional-ones-analysis-shows

19 'In the matter of the Local Government Association and in the matter of administering authorities under the local government pension scheme; Opinion', p. 2, Nigel Giffin QC, 11 King's Bench Walk, Temple, London, Commissioned by the Local Government Association. Available on request.

20 'Fiduciary Duties of Investment Intermediaries. Consultation Paper No. 215', The Law Commission. p. 88, 2013.

21 ibid. p.11

22 'Is it always about the money? Pension Trustees' duties when setting an investment strategy: guidance from the Law Commission', p. 2, The Law Commission, 1 July 2014.

23 ibid. p. 3.

concluded “there is no impediment to trustees taking account of environmental, social or governance factors where they are or may be, financially material.”[24]

- The Law Commission and the LGA both found that environmental concerns may also be taken into account as a non-financial factor so long as there is there is no “significant impact on returns” and “trustees have a good reason to think that scheme members would share the concern.”[25]
- The UK Government has agreed to implement the recommendations of the Law Commission: “Fiduciaries such as pension scheme trustees have a duty to consider any factors which are, or may be, financially material to the performance of an investment ... this should include taking into account environmental and social, and corporate governance factors and wider macroeconomic considerations, where trustees think these may be financially material.”[26]

Legal precedent also tells us what proportion of investments might be excluded. In *Harries v The Church Commissioners for England* [1992] 1 WLR 1241 a view was reached that “excluding 13% of the market would be acceptable, while excluding 37% would not be.”[27]

As we have seen, a number of pension funds have taken action on responsible investment within the existing legal framework. In 2014 Croydon Council adopted an exclusion policy by divesting its entire LGPS fund from tobacco[28], citing health risks. Funds across the UK are under pressure to take similar steps for coal and other fossil fuels.

Responsible investment policy at the LPF

The LPF is a signatory to the United Nations Principles for Responsible Investment,[29] whose first principle is to “incorporate ESG issues into investment analysis and decision-making processes” and the LPF Statement of Investment Principles says the fund “has a responsibility to take environmental, social and governance issues seriously and where appropriate, to act upon them.”

These commitments underpin investor engagement on climate change, with one manager, Hermes EOS, engaging on 28 climate change issues in 2014.

However, years of investor engagement with the fossil fuel industry have not delivered a sustainable energy industry, and many companies' environmental performance has worsened.

Drax Plc. is listed as an example of successful shareholder engagement on the LPF website. However the company's Drax Power Station remains the biggest emitter in the UK. Earlier this month the Norwegian Sovereign Wealth Fund concluded time was up for Drax and announced divestment.[30]

Engagement has most impact when a timed threat of divestment or exclusion is given. However the LPF has no policy provision to exclude irresponsible companies or industries. Although the recent reduction in investments in fossil fuels is welcome, companies must know that exclusion is an option if engagement is to have a major effect.

Furthermore, for oil, gas and coal companies fossil fuel extraction is their core business and are unlikely to be encouraged to change their whole business model. Investor engagement also fails to insulate the LPF from the risks of the carbon bubble.

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24 ibid. p. 3.
25 ibid. p. 4.
26 'Building a culture of long-term equity investment. Implementation of the Kay Review: Progress Report', p. 27, Department for Business, Innovation and Skills, October 2014.
27 ibid. p. 5.
28 'Croydon Council Announces Move to Ethical Pension Funds', 16 July 2014. Source: http://blueandgreentomorrow.com/2014/07/16/croydon-council-announces-move-to-ethical-pension-funds/
29 United Nationals Principles for Responsible Investment website: http://www.unpri.org/
30 'Norway confirms $900bn sovereign wealth fund's major coal divestment', The Guardian, 5 June 2015, source: http://www.theguardian.com/environment/2015/jun/05/norways-pension-fund-to-divest-8bn-from-coal-a-new-analysis-shows

Recommendations

The Lothian Pension Fund should take a number of steps to respond to climate change risks and exclude investments in irresponsible companies. The LPF should:

1. Fully respond to the risk of the carbon bubble by publicly excluding fossil fuel equities, **beginning with high risk coal mining** companies such as RioTinto. The recent sale of fossil fuel equities like BHP Billiton is encouraging. Such a step would cement this progress and highlight the fund's continuing commitment to responsible investment.
2. **Consult fund beneficiaries** on environmental, social and governance standards and incorporate their views into a revised Statement of Investment Principles in 2016. These standards should be used to improve the effectiveness of the existing ESG engagement policy by enabling the eventual **exclusion of companies which do not meet minimum standards** (for example this approach could enable divestment from profitable yet irresponsible industries such as tobacco).
3. Investigate options for fund managers who offer low or zero-carbon products and publish details of the Fund's investments in **local, sustainable infrastructure** to promote good practice in the sector. This would follow Falkirk Pension Fund's announcement that they had invested £30 million in social housing[31] and Strathclyde Pension Fund's £10 million investment in renewable energy.[32]
4. **Regularly report on the climate change** impact of its investments and the risk to the fund posed by the high-carbon investments. This would contribute to the City of Edinburgh Council's annual reporting under the public bodies duties of the Climate Change (Scotland) Act[33] and respond to the public service pensions Code of Practice which requires "risk assessments, risk management and risk register policies."[34]

● *Friends of the Earth Scotland is campaigning for sustainable pensions with trade unions and civil society in the Green Light Coalition[35] and the Fossil Free UK campaign.[36]*

Up-to-date information can be found at http://www.foe-scotland.org.uk/fossilfree.

This document was produced for Friends of the Earth Scotland by Ric Lander with additional legal research by Gill Davies.

31 'Fund will invest in 300 new houses', Sunday Herald, 13 Apr 2014. Source: http://www.heraldscotland.com/business/company-news/fund-will-invest-in-300-new-houses.23945768

32 'Smaller renewable energy projects enjoy £60 m funding boost', STV, 17 February 2015. Source: http://news.stv.tv/scotland/310579-smaller-renewable-energy-projects-to-enjoy-60m-funding-boost/

33 Letter from John Swinney MSP to Alison Johnstone MSP, March 2015. Available on request.

34 Code of Practice 14, "Governance and administration of public service pension schemes", the Pensions Regulator, April 2015, p.13.

35 Share Action's 'Green Light' coalition website: http://greenlightcampaign.org.uk/

36 Fossil Free UK campaign website: http://gofossilfree.org/uk/