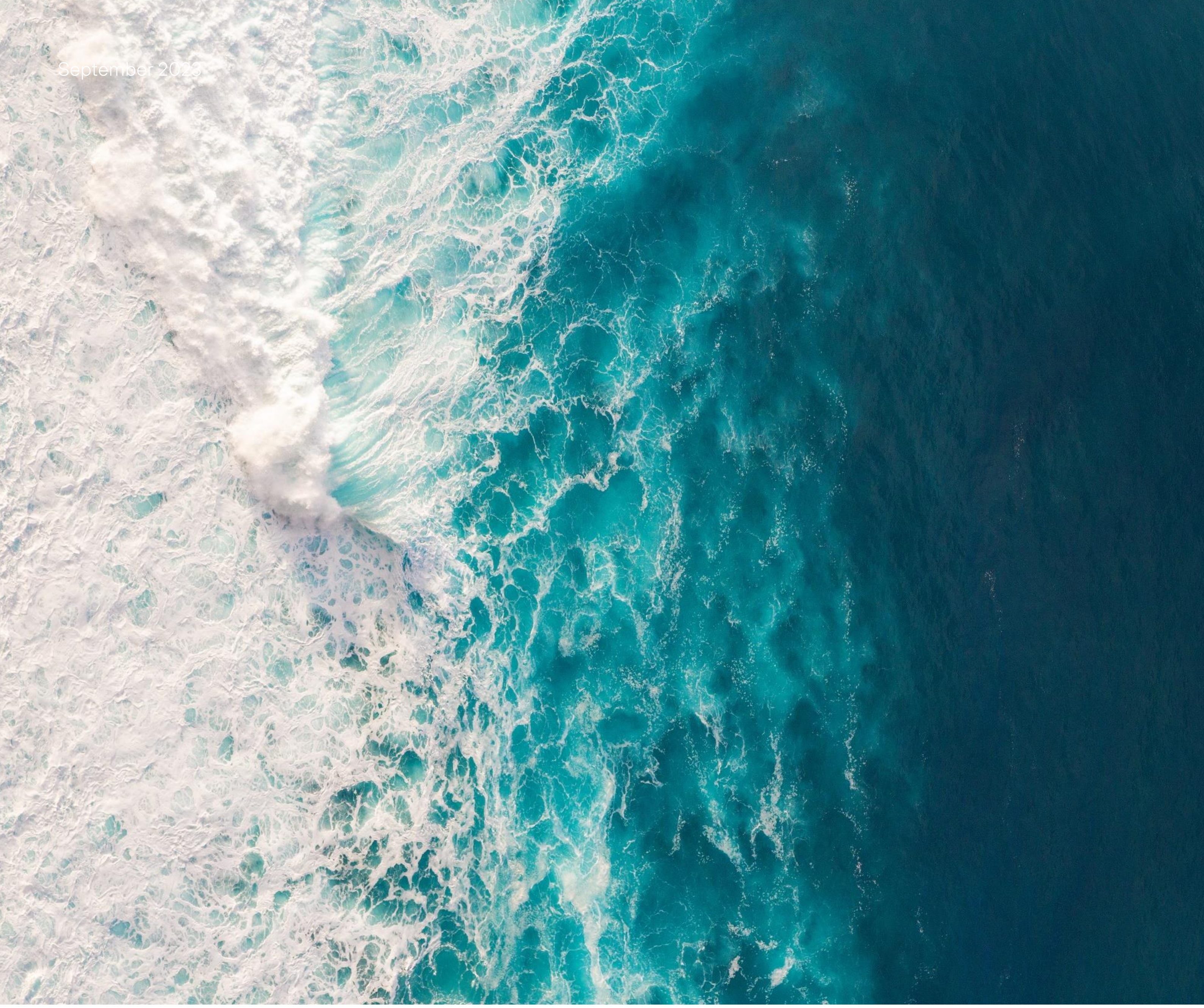


# East Sussex Pension Fund

# Background paper: Definitions

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# Definitions

We set out below an overview of the definitions used in our analysis of pursuing an engagement or divestment approach in relation to fossil fuel exposure. Unfortunately, there are few investment industry standard definitions of many of these terms.

## Fossil Fuel Exposure

There is no single definition of fossil fuel exposure. Throughout this work, we have defined this according to recognised external industry frameworks, as follows.

**Fossil fuel exposure**: is defined in line with the European Union Sustainable Finance Disclosures Regulation (EU SFDR) principal adverse indicators, as follows:[1]

- The company exposure definition is focused on share of revenues: "companies active in the fossil fuel sector' [and] means (i) companies that derive any revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite; (ii) companies that derive any revenues from the exploration, extraction, distribution (including transportation, storage and trade) or refining of liquid fossil fuels; and (iii) companies that derive any revenues from exploring and extracting fossil gaseous fuels or from their dedicated distribution (including transportation, storage and trade)".
- The real asset exposure definition is focused on share of investments: the "share of investments in real estate assets involved in the extraction, storage, transport or manufacture of fossil fuels".

**Materiality of exposures**: we must also define the point at which fossil fuel exposures become material. We have aligned this definition with the Institutional Consultant Sustainability Working Group (ICSWG), a group of nineteen investment consultants (including Isio), who reached a consensus on this matter, and we take this to represent the broad UK industry view on fossil fuel exposure. This is deemed to be those companies with at least ten percent of revenues exposed to fossil fuel exploration, extraction, processing, refinement and transport activities, as well as products and services that support the exploration, extraction or processing of fossil fuels.[2] This could also be applied to the real assets' definition as at least ten percent of investments involved in the aforementioned activities.

For completeness on what is included within the definition, and what is excluded, we set out the following notes on the definitions adopted (as clarified with the investment managers):

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[1] European Securities and Markets Authority, European Banking Authority, European Insurance and Occupational Pensions Authority and Joint Committee of the European Supervisory Authorities. (2021) *Final Report on Draft Regulatory Technical Standards.* jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf (europa.eu)
[2] Institutional Consultant Sustainability Working Group (ICSWG). (2021) *ESG Metrics – November 2021.* PowerPoint Presentation (icswg-uk.org)

- We have defined fossil fuel exposure to include utilities, such as power generation from natural gas or coal sources.
- We note that the ICSWG definition includes the "products and services that support the exploration, extraction or processing of fossil fuels", beyond direct fossil fuel exposures.[3]
- We have adopted a production-orientated approach, in focusing on the production (rather than the consumption) of fossil fuels.

We note that different investment managers adopt different definitions of fossil fuel exposure (including different thresholds for setting exclusions) and many of the existing systems make it challenging for them to report against different definitions. We have sought to identify each instance of this with your managers to better align data with the definitions set out above.

Many energy and transport companies are in the process of transitioning to a lower carbon economy.  This should result in a significant shift from high to low carbon goods and services over time, and therefore requires regular monitoring of classifications. The transition in companies is important in reducing overall carbon emissions.

[3] Institutional Consultant Sustainability Working Group (ICSWG). (2021) *ESG Metrics – November 2021*. PowerPoint Presentation (icswg-uk.org)

## Fossil Fuel Exclusion

We adopt the following definitions in relation to fossil fuel exclusions. These seek, to differentiate between the driving forces that bring about an absence of investment in fossil fuels within a portfolio. Again, there is no industry standard definition of these terms.

**Divestment:** Divestment is defined as a situation where the owner of assets commits to a blanket removal of a specific investment class from the investable universe.

This can include the complete removal of a set of companies, sectors or regions with the intention to fully remove exposure from the undesired risk, (in this case fossil fuel exposure). This ensures no material exposure will be permitted within the portfolio, either on a temporary or long-term basis.

The divestment of the specific investment class is often undertaken to demonstrate adherence to sustainable finance practices and climate risk management.

**Disinvestment**: The specific investment class remains part of the investable universe, but an active decision is taken to completely sell down or reduce exposure for financial reasons. For example, the asset owner may disinvest from a company deemed to have an inadequate approach to managing climate risk – whilst this is removed from the portfolio, it remains in the investable universe, such that if climate risk management is improved in future, the asset owner could choose to invest again.

Disinvestment may remove fossil fuel exposure through engagement escalation, to (at least temporarily) sell out from a particular name, should engagements with the company not yield the required outcome from an engagement perspective.

**Exclusions:** Fossil fuel exclusions are defined similarly to divestment. Exclusions are often (but do not need to be) more granular than a blanket fossil fuel sector divestment.

For example, investors could opt to exclude just *select* fossil fuel companies, such as thermal coal companies, or those fossil fuel companies which undertake unconventional fossil fuel exploration, extraction and production (e.g. from oil sands or the arctic region).

## Stewardship Definitions

We defined the stewardship terms used in the Fund's divestment versus engagement papers, as follows.

**Active Ownership:** the use of the rights and position of ownership (either via debt or equity investments) to influence the activities or behaviour of investee companies. Whilst active ownership can be applied in each asset class, the avenues to do so will differ. For example, in listed equities, it includes engagement and voting activities, whilst for debt the focus is on engagement.[4]

**Engagement:** is a "purposeful, targeted communication with an entity (e.g. company, government, industry body, regulator) with the goal of encouraging change at an individual issuer [level] and/or the goal of addressing a market-wide or system risk (such as climate)"[5] via a range of approaches and methods. This definition is taken from the ICSWG definition, where the focus is on climate change engagement. Regular communication to gain information as part of ongoing research, however, is not considered as engagement (although it is worth noting some managers would classify this as such).

**Escalation:** Investment managers typically have stewardship escalation processes in place, including on climate change matters. This is a process: starting from voting activities, to bring about changes in investee firms for which they own equity holdings; to engagement activities, including the setting of specific engagement key performance indicators (KPIs) to measure progress. Many investment managers may use the threat of disinvestment as part of their escalation process if companies are not engaging with them.

**Stewardship:** We define stewardship as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society", in line with the definition provided by the Financial Reporting Council's 2020 UK Stewardship Code.[6]

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[4] Principles for Responsible Investment. (2018) *Introduction to active ownership in listed equity.* Introduction to active ownership in listed equity | Technical guide | PRI (unpri.org)
[5] ICSWG. (2021) *ICSWG Engagement Reporting Guide Version 2: introductory guidance*. Firm-level questions. b25a61_2f1090f92f30484590358785cd7a3a34.xlsx (live.com)
[6] Financial Reporting Council. (2020) *UK Stewardship Code*. Stewardship-Code_Dec-19-Final-Corrected.pdf (frc.org.uk)

## Other Definitions

Other key definitions used in the Fund's divestment versus engagement paper series include:

**Fossil fuels:** Fossil fuels result from decomposing animal and plant matter. Fossil fuels include coal, oil and gas fuels. Coal is the most carbon intensive fossil fuel, upon burning, whilst natural gas is the least carbon intensive.[7]

**Just transition:** The just transition is a process of greening the economy, in a way that is fair and inclusive, with respect to everyone concerned, creating decent work opportunities, and leaving no one behind.[8]

**Greenhouse Gas (GHG) emissions**: GHG emissions are released into the atmosphere as a result of the burning of fossil fuels, primarily from energy, transport and industrial or manufacturing processes.

**Low carbon transition risk**: Low carbon transition risk arises from companies realigning themselves from high to low carbon goods and services. Risks arising from the transition include climate-related regulatory developments, market trends and decarbonisation action.

**Net zero emissions**: A state where the GHG emissions released into the atmosphere are balanced out by the removal of GHG emissions back out the atmosphere (e.g. using nature-based approaches, such as reforestation, or man-made technologies, such as carbon capture usage and storage).

**Stranded assets:** Stranded assets will no longer be able to generate an economic return (before the end of their economic life) due to changes in market preferences (e.g. falling costs of low carbon technology) and regulatory environment (e.g. decarbonisation policy and carbon pricing).[9] Whilst partial stranding is where assets will start to generate returns below anticipated levels. They will result in unanticipated devaluations or conversions into liabilities.[10]

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[7] ClientEarth. (2022) *Fossil fuels and climate change: The facts*. Fossil fuels and climate change: the facts | ClientEarth

[8] International Labour Organisation. (2023) *Climate change and financing a just transition*. Climate change and financing a just transition (ilo.org)

[9] Carbon Tracker Initiative. (2017) *Stranded Assets*. Stranded Assets - Carbon Tracker Initiative

[10] Caldecott, B., Tilbury, J. and Carey, C. (2014) *Stranded Assets and Scenarios*. Microsoft Word - Stranded Assets and Scenarios - Discussion Paper - 27.01.14.docx (ox.ac.uk)