LOTHIAN PENSION FUND

CLIMATE CHANGE POLICY

March 2025

Overarching Objective

LPF aims to deliver appropriate risk-adjusted investment returns over the long term as a responsible investor.

This policy sets out our investment beliefs on climate change, why climate change is a priority issue, our role as investors, our commitments and our approach to incorporating climate change risks and opportunities into our investment analysis and decision-making processes.

Investment beliefs on climate change

We recognise climate change as a **systemic**[1] issue posing financially material investment risks but also opportunities, which we incorporate into our investment analysis and decision-making processes.

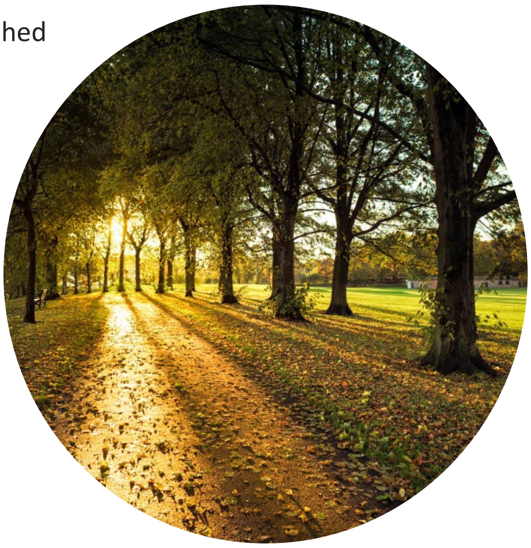
We believe **managing our exposure to financially material risks and opportunities of climate change** within our investment portfolios **is a component of our fiduciary duty** to manage risk and generate appropriate long-term investment returns.

Why climate change is a priority

The world is warming, the climate is changing, and the scientific consensus is that this is due to human activity, primarily the emissions of carbon dioxide (CO_2) and other greenhouse gases (GHG) from burning fossil fuels. This changes the world in which we live, but also the world in which we invest.

Recognising the existential threat to society that unmitigated climate change represents, in 2015, the nations of the world came together in Paris and agreed to limit global warming to 2°C and to pursue efforts to limit the temperature increase to 1.5°C. Paris Agreement[2] signatories agreed to adopt and implement nationally determined contributions (NDCs) that set out the actions they would take to reduce greenhouse gas emissions. They also committed to strengthen these efforts in the years ahead. Another key part of the Paris Agreement was an objective to make financial flows consistent with a pathway towards low GHG emissions and climate resilience. This recognises the critical role asset owners and managers play, reinforcing the need for us and our peers to drive and support the pace and scale of change required.

[1] Climate change risk is considered a systemic issue because it is not possible to mitigate it through investment diversification due to the interconnection of exposures throughout the global economy
[2] https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement



In 2018, the Intergovernmental Panel on Climate Change (IPCC) published a special report, "Global warming of 1.5°C"[3], which illustrated how critical limiting global warming to 1.5°C is: global temperature rises of 1.5-2°C above pre-industrial levels of warming are likely to have severe impacts for society and the environment due to more frequent extreme weather events and significant meteorological changes, including to rainfall patterns and sea levels. These future physical climate risks are expected to be larger if global warming exceeds 1.5°C, before then returning to that level by 2100, than if global warming gradually stabilizes at 1.5°C. If the peak temperature is higher, many of the impacts may be long-lasting and irreversible, such as the loss of ecosystems. The report found that limiting global warming to 1.5°C would require "rapid and far-reaching" transitions in land, energy, industry, buildings, transport, and cities. This includes a need for CO_2 emissions to fall by approximately 45 percent from 2010 levels by 2030, and reach 'net zero' around 2050. **We support this scientific consensus, recognising that the investments we make will be impacted by climate change and the companies/projects we invest in may impact climate change**.

Despite some progress, the Paris Agreement ambition to limit the global temperature increase to 1.5°C is in peril. Analysis by Climate Action Tracker[4] indicates that in December 2023 the world was already at approximately 1.3°C of warming above pre-industrial levels and current policies in place globally put the world on track for a central estimate of around 2.7°C warming by 2100.

Governments and all sectors of society (individuals, companies and investors) will need to do much more if the global temperature rise this century is to be limited to 1.5°C above pre-industrial levels. The transition to the low carbon economy calls for significant change in the shape and structure of our economy, including the rapid shift away from fossil fuels (phasing out of all unabated coal and oil power plants) [5] to achieve a Net-Zero carbon economy by 2050.

[3] Global Warming of 1.5 ºC — (ipcc.ch)
[4] https://climateactiontracker.org/
[5] https://www.iea.org/reports/net-zero-by-2050

Our role as investors

Our exposure to climate change comes predominantly from the assets that LPF manages on behalf of our employers and members. Climate change is a systemic issue which poses financially material investment risks, but also opportunities, with the potential to impact long-term shareholder value. Therefore, **we incorporate climate change into our investment analysis and decision-making processes**. We believe managing our exposure to financially material risks and opportunities of climate change within our investment portfolios is a component of our fiduciary duty to manage risk and generate appropriate long-term investment returns. Therefore, **climate change is a stewardship[6] priority for us**.

There are two types of climate risks that investors are exposed to, and both can impact society resulting in social risks:

- Physical risk due to impacts of extreme weather events (requiring adaptation of physical assets or changes to investee companies' supply chains)
- Transition risk (and opportunities) due to the realignment of economic systems towards low-carbon, climate-resilient and carbon-positive solutions (e.g. via regulations).

The transition to a low carbon economy will affect some sectors more than others, and within sectors there are likely to be winners and losers, which is why **we consider divesting from or excluding entire sectors as inappropriate**. Hard to abate sectors of the economy, such as cement – a crucial product for the building and construction sector - actively need investors' help and support to transition to a carbon neutral future. We believe that a policy of divestment passes shares to potentially less responsible and/or less active share owners, who are less likely to hold companies' managers to account on planning for and managing significant transitions in their businesses over the next decades. Abandoning these companies by divesting and/or starving them of capital or excluding them from our opportunity set achieves nothing in terms of real-world sustainability.

We actively consider how climate change, the shifting regulatory environment and potential macroeconomic impacts will affect investments, but recognise that this is a complex, multidimensional undertaking.

In addition, the transition to a low-carbon economy will affect the various stakeholders of the companies taking part in the energy transition. A ***Just Transition***[7] refers to the integration of the social dimension in the net zero transition and is part of the Paris Agreement and the guidelines adopted by United Nations' International Labour Organization (ILO) in 2015. These stakeholders include the workforce and the communities in which the companies' facilities are located.

We expect companies to consider how climate change, the shifting regulatory environment and potential macroeconomic impacts will affect their business models and to also consider potential stakeholder risks associated with their decarbonisation plans.

[6] Stewardship is defined by the Financial Reporting Council as the responsible allocation and management of capital
[7] A Just Transition seeks to ensure that the benefits of a green economy transition are shared widely, while also supporting those who stand to lose economically – be they countries, regions, industries, communities, workers or consumers (www.ebrd.com)

We believe that businesses that are governed well and managed in a sustainable way are more resilient, better able to survive shocks and have the potential to provide better financial returns over the long-term for investors. Expected returns also depend on the price of the investment and an assessment of how much risk has been factored into the price.

We recognise that investment opportunities are being created for the provision of the capital required for mitigation and for adaptation. We invest in climate solutions (e.g. renewable energy projects) however we also recognise there are large opportunities in the broader economic transition, and we aim to contribute to mitigating exposure to climate change risk through our stewardship practices:

We engage with the companies we invest in, seeking to increase management focus on resilience to regulatory and other changes that will result from climate change, thereby supporting improved company practice and performance over the longer term.
We engage with the investment managers we appoint, and support collaborative investor initiatives, to influence and encourage the broader industry to support climate resilience and adaptation.
We engage with policy makers to encourage and support them in taking action to enable the low carbon transition and effective adaptation.

In pursuing this approach, we recognise that just because a company is engaged in a carbon-intensive industry that the management and strategy of such companies may still be aligned (or have the potential to align) with the goal to transition to net zero. We should not assume that such companies are “bad” simply because of their carbon intensive legacies. It is important that we also recognise that in the real world such transitions are complex and require capital and time to set in motion and for progress to be achieved. We need to be patient and understanding while continuing to assess what is genuine progress and what is intransigence.

Our climate change commitments

1. **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°C by 2100, primarily through collaborative engagement with companies and policymakers.

    - **Policy engagement and advocacy:** We encourage policy makers, regulators and standard setters to establish comprehensive and robust climate change policy frameworks to facilitate investment in the net zero transition by supporting long-term investment returns
    - **Stewardship activities (engagement and voting):** We challenge and encourage companies and other entities in which we invest and contract with to support the transition to the low carbon economy, to adapt and articulate their climate strategy to enable them to be prepared for and resilient to the impacts of climate change, and to improve their performance on alignment criteria and climate solutions activities
    - **Collaboration:** By collaborating with like-minded investors, we amplify our influence. We participate in Climate Action 100+ and use data from the Transition Pathway Initiative (TPI) to identify climate leaders and laggards and to engage with and encourage companies to adopt business plans that are in line with the aims of the Paris Agreement.

2. **To promote a managed decline for the fossil fuel sector**

    - We undertake policy engagement and advocacy
    - We identify and engage with climate laggards with a **presumption against continued investment in laggard[8] oil & gas companies**, given our recognition of the need for the world to phase out the vast majority of fossil fuel use by 2050
    - We undertake additional due diligence, recognising that expected returns from investments in fossil fuel companies depend on how much of the climate transition risk has been factored into their stock prices and whether the market is over- or under-estimating the speed of the transition.

[8]Definition of laggard oil & gas companies: For companies in the oil & gas sector, that have been subject to years of engagement through Climate Action 100+, we consider a TPI Management Quality assessment at <4 to indicate a laggard oil & gas company. Note that the TPI considers companies that are assessed at <3 (out of a maximum of 5) on Management Quality to be laggard companies.

3. To report annually in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)

- We **measure and report** annually on the carbon intensity of our equity and corporate bond portfolios and the progression of this metric over time
  - **Our ambition is to expand our reporting of carbon metrics across all asset classes** (supported by external managers and using estimates if necessary) over time
  - Carbon metrics are an output of our investment process, not an input. We continue to assess the metrics and targets used as data and industry standards develop; there is a risk of just focusing on emissions, a backwards looking metric, and it is important to ensure that metrics we use reflect the expected future state and transition plans that companies have in place or under development.
- **Scenario analysis**: We use third-party scenario analysis tools to assess and report on the potential impact of several climate scenarios on the likelihood of success of our funding strategy (which incorporates the potential impact on both our assets and liabilities) on at least a triennial basis.
  - We note that climate scenario analysis is continuing to develop, with services and products evolving as data quality and disclosure from companies continues to improve.

"Deny debt, engage equity"

While the trading of equities (shares) may not in itself affect the capital position of a company, subscribing to new bonds and new equity does provide companies with funding. Within our equity portfolio we engage with our holdings, and that engagement includes using the tools and strategies we have at our disposal to influence companies to commit to align with the goals of the Paris Agreement. In our debt portfolios, we aim to deny funding to those non-aligned companies. Where material risks remain following engagement activity, we retain the ability to divest.

4. **To develop a climate action plan** to underpin our adoption of best practice climate risk management **to support the resilience of our investment strategy to climate change.**

Identification and assessment of climate risks at an asset level: We consider climate-related risks and opportunities within our investment decision making processes.

- We recognise that assessing and monitoring climate risk is under constant development, and that tools and underlying data are developing rapidly
- We use indicators of climate risk management and net zero alignment (from a variety of data sources, including TPI) to identify asset specific climate-related risks (and opportunities) and to assess the net zero alignment of the companies we invest in, to **identify climate leaders and laggards**. We note that carbon-equivalent footprints are backwards-looking metrics, and that progress needs to be tracked over time
- **We engage with climate laggards with a presumption against continued investment in *laggard oil & gas companies*[8]**, given our recognition of the need for the world to phase out the vast majority of fossil fuel use by 2050. We note that expected returns from investments in fossil fuel companies depend on how much of the climate transition risk has been factored into their stock prices and whether the market is over- or under-estimating the speed of the transition
- **We avoid subscribing to new equity and fixed income issuance from companies whose business plans are assessed as incompatible with the aims of the Paris Agreement** because we recognise that primary market issuances are more associated with new production capacity assess
- We expect our appointed managers to demonstrate how they incorporate climate risks into their ownership policies and practices, and material misalignment from our approach will lead to review.

Portfolio Alignment: We focus our efforts on engagement and advocacy (financing reduced emissions) to drive real world decarbonisation rather than simply reducing financed emissions.

- We support our investee companies to improve their performance against relevant net zero pathways and encourage them to adopt business models and strategies that are in line with the aims of the Paris Agreement
- We regularly review the investment case for identified climate laggards within our portfolio, and escalate engagement through voting, which may include:
    - Voting against the reappointment of relevant directors
    - Voting against management climate strategies/progress reports
    - Voting against remuneration policies that appear misaligned to incentivising transition
    - Filing/co-filing or voting for shareholder resolutions that call for robust target-setting, and a clear and credible strategy in place to achieve the stated targets
    - Voting against the financial report & accounts.
- **Our ambition is that over the next five years (i.e. by end 2029) we will increase the alignment of our investee companies[9] to a future low carbon world.** We focus on holdings in sectors which are currently a significant source of global greenhouse gas emissions as this is where transition is critical to achieving net zero.

Capital Allocation: We measure and report on the percentage of our assets allocated to climate solutions.

- **We aim to position the Fund to benefit from the energy transition by having more exposure (across the Fund) to *climate solutions*[10] than in companies whose primary business is related to fossil fuels**
- Asset and portfolio level assessments: We use data sources (such as MSCI for listed markets and manager reporting for private market investments) to identify and classify activities, products and services that contribute to emissions reductions using net zero scenarios and/or local taxonomies and to calculate our allocation to climate solutions
- We continue to research and support the deployment of new capital into projects set to benefit from the transition to a low carbon economy.

[9] Initially our scope will be limited to listed companies on the Climate Action 100+ focus list where alignment progress can be assessed using the NZIF2.0 framework alignment criteria
[10] Climate solutions refer to investments in renewables, energy efficiency, climate adaptation & resilience as well as in enabling technologies and nature-based solutions

Conclusion

Our approach supports the transition of the real economy and is compatible with being a responsible investor as well as the objectives of the 2015 Paris Agreement. By that, we mean taking climate action in the context of other environmental and social objectives. We acknowledge other systemic risks and stresses that interconnect with climate action and are part of our wider approach to Responsible Investment.

We consider our best contribution to supporting the climate transition involves remaining engaged with companies (including fossil fuel companies), rather than implementing a blanket divestment policy. Through engagement with companies and policymakers we can advocate for these fuels to be produced and consumed as responsibly as possible, while promoting a manged decline. As the transition proceeds, we expect substitutability of fossil fuels by other energy sources to increase, particularly in developed markets, with the potential for technological, economic, or political tipping points to accelerate the phase out of the most carbon intensive or costly fossil fuels. In line with our approach to risk management we will continue to monitor the fossil fuel transition closely to factor such developments into our investment decision-making. This may result in extension of our current policies over time.

We also accept that there are limitations to what engagement can achieve. In part this may be because government policy is not developing fast enough to create the incentives for companies and investors to drive towards the goals of the Paris agreement. In other cases, it may be because companies themselves are not doing enough to respond to a progressively decarbonising world. We have therefore strengthened our climate risk assessment and escalation processes. Where we assess material financial risks to investment returns, we expect to divest on a case-by-case basis.

Our Climate Change Policy will guide our work on climate change for the remainder of the decade, and we will regularly monitor its implementation and publicly report on its effectiveness.