Climate risk and our investments

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John Pearce
Chief Investment Officer

Message from the Chief Investment Officer

Welcome to the sixth edition of
Climate risk and our investments.

The race to net-zero continues apace with governments, particularly in developed countries, strengthening their resolve to make good on their commitments. Australia, not long ago tagged as a climate pariah, is now firmly in the race. Headlining our position is the targeting of a 43% reduction in emissions by 2030. As lofty an ambition as it is, underpinning the goal is an even loftier goal to power the electricity grid with 83% renewable energy in the same time frame. Most importantly, policies and mechanisms are being put in place to ensure that there are incentives (and penalties) to support achievement of the goal. The Safeguard Mechanism, in particular, is as close to a price on carbon that we can achieve given the political settings. Granted it may not be perfect in the eyes of some, but we can't let the pursuit of perfection result in nothing being done.

While the developed countries in Europe and Asia are also setting ambitious goals, and implementing appropriate policies, this is all being dwarfed by the United States (US). The (misleadingly labelled) Inflation Reduction Act (IRA) is estimated to provide total incentives in the vicinity of $1.5 trillion to corporates that invest in the US energy transition. The IRA has been described as the equivalent of Roosevelt's New Deal in terms of its broader impact on the US economy; there is even talk about the re-industrialisation of the US. Hyperbole or not, the current reality is that the IRA has already attracted (and diverted) investment. It is also a political master stroke, with quite a number of Republican states already benefiting from increased investment and jobs. Therefore, ongoing political support for key components of the IRA is likely to be bipartisan.

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There are two ways to look at the implications of the IRA. The US is arguably the only scale player in the world that can do this, so the world will be better off because of it. The downside is that other countries now find themselves competing with a dominant player for people, equipment, and capital. Nevertheless, with Australia’s endowment of resources essential for the transition, we need to find a way to ensure developments in the US turn out to be a net opportunity rather than a risk.

The overarching aim of this report is to provide our members with a level of comfort that we are on top of the opportunities and risks in a world that has to, and is, decarbonising. The report has four key areas, and to assist with navigation, the following is a brief summary of the key points and messages.

PATHWAY TO NET ZERO

UniSuper endorses the goals of the Paris Agreement on climate change and we intend to play a part as Australia fulfils its commitment as a signatory. We believe that UniSuper's investment-related activities, when viewed in aggregate, will assist in achieving the goals of the Paris Agreement and provide for greater retirement outcomes through: (i) our governance structure (ii) investment activities (iii) using our position as an owner to engage with the corporate sector (iv) collaborating with like-minded investors and advocating for policies and mechanisms necessary to effect a just and orderly transition. Our pathway to net zero is covered in pages 6 to 17.

Key points include:

- Achieving net zero emissions requires a fully integrated approach with the goals and tone set by our Board and incorporated into management performance frameworks.
- While the ultimate objective is to achieve a net-zero status by 2050, we need to align with Australia’s goals by contributing to a 43% reduction in emissions by 2030.
- Where achievement of net zero is practically and financially possible before 2050, every effort needs to be made to do so. To reflect this, we have established asset specific targets for our unlisted property and infrastructure, see page 10.
- We have invested billions of dollars in companies directly involved or instrumental in the energy transition. On top of the more obvious ‘green themed’ investments (e.g., renewables, EVs, batteries) we also have significant investments in companies that develop the critical resources required to transition (see pages 11 and 12).
- There is a growing awareness that the energy transition needs to be just and orderly. A just transition implies that less developed countries and certain segments of society are not unfairly bearing the cost of the transition. An orderly transition, in simple terms, means that we must get the sequencing right. We simply can’t risk losing the mainstream support needed to effect the transition. An excellent case study of a just and orderly transition is BHP’s exit of its thermal coal assets at Mt Arthur (page 15).

This document is an extract from our annual climate risk report, *Climate risk and our investments*.
Read the full report at **unisuper.com.au/climateriskreport**.

VIEWING PROGRESS THROUGH THE LENS OF OUR TRAFFIC LIGHT REPORT

Our traffic light report (pages 22 to 23) is a proprietary initiative focusing on our 50 largest Australian investments. These companies constitute over 65% of our Australian investments. They are the companies that we have direct access to, engage with most, and with which we can wield the greatest influence.

The Traffic Light report can be viewed as a 'ready reckoner' with respect to a company's commitment to: (i) achieving net zero by 2050 (ii) setting ambitious shorter-term targets and (iii) tangible evidence of an action plan. Based on our assessment, green, amber and red lights are assigned to each category. The report also serves to inform us on potential areas for further engagement, particularly where companies are falling short of our expectations. The 50 companies involved receive a letter from UniSuper detailing the outcome of our assessment. Suffice to say that a negative assessment typically leads to a robust follow-up discussion between UniSuper and the company.

Partly in response to feedback received from a number of our engaged members, this report has two important additions. First, we have made an attempt to reconcile our assessment of 'net zero readiness' with science-based assessments. In particular, we refer to the analysis conducted by two highly reputable institutions, SBTi and Climateworks.

While our conclusions are broadly consistent with the science-based assessments, in some instances we differ. A key point of difference, in principle, is that UniSuper applies a pragmatic overlay. The crux of the overlay is based on our acceptance that the path to net zero will be non-linear. The analysis is introduced on page 24, and a full listing of the results is contained in the appendix on pages 81 to 86.

This report also attempts to add more colour to our engagement activities by including overviews of the nature of our engagement with three companies—Rio Tinto, Cleanaway, and BlueScope.

Case studies are also used to better illustrate why we voted in favour of APA's climate report and against resolutions at Woodside's AGM.

UNDERSTANDING OUR KEY RISKS

Pages 34 to 47 deal with our key risks, which can be broadly grouped as physical or transition. Physical risks do not vary much from year to year, although a better understanding of them should lead to constantly improving mitigation strategies. In this edition, we use a case study example of a timber asset (HVP Plantations), as an example of how climate risk is impacting strategy.

Transition risk refers to the disruption a company may endure when being forced to adjust to a decarbonising economy. At one extreme this may result in assets becoming 'stranded' (meaning zero economic value), and the most likely candidates are companies directly involved in the fossil fuel industry. We therefore include our 'look-through' exposure to companies with reported revenue from fossil fuels which aims to capture the component of a company's revenues that is related to fossil fuel extraction, production (page 42 and 43), or generation. See page 42 for the methodology on how fossil fuel exposure is calculated.

We estimate that our look-through exposure to fossil fuels is approximately 2.34% of the total Fund, which is down from 2.80% in the previous year. As has been the case over the past few years, our exposure is dominated by our holding in gas-pipeline company APA which is largely held by the defined benefit portfolio.

While we all accept the need for the world to ultimately wean itself off fossil fuels, there is growing acceptance that gas has a fundamental role to play in the transition. A section on the role of gas (page 44 and 45) is in the report. The section refers to research published by the Net Zero Australia Project (a partnership between the Universities of Melbourne and Queensland) which concludes that gas capacity would actually need to increase for firming, while operating at low capacity. Suffice to say that we do not envisage APA's gas pipelines are at risk of becoming a stranded asset for a very long time.

ESTIMATING OUR CARBON FOOTPRINT

The final section of the report contains information on individual investment options, including estimates of their carbon footprints. The section is included in the interests of full transparency, although it's caveated with the clear message that there are (potentially significant) limitations given that the source data is far from complete or uniform. Bear in mind that funds represent an aggregation of the equity and debt being held in companies. UniSuper has holdings in over 3000 companies. We expect that over time, adoption of standard reporting will be compulsory for companies, thus enabling a comprehensive and robust set of reporting standards for funds.

As with our previous reports, this edition of our *Climate risk and our investments report* demonstrates our efforts to continually improve our climate risk assessments and reporting.

In relation to the carbon footprint, whichever way one looks at it, there is obviously a very long way to go in order to achieve net zero. So how can we still be confident that we will get there? The two key reasons are: (i) it is a 2050 target and progress is likely to be in quantum steps—not linear, and (ii) companies representing over 80% of the Fund (by look-through value) have already set a net zero target, and a further 7% have committed to material reductions. Furthermore, over time (but before 2050) we have the option of avoiding or divesting any company that we believe is not on the path to net zero. The bottom line is that we remain confident that we will be able to construct a suitably diversified fund with a net zero profile before 2050.

John Pearce
Chief Investment Officer

Image: Basic Oxygen Steelmaking Facility at Port Kembla Steelworks Australia. A crucial piece of BlueScope's manufacturing infrastructure in Australia which converts liquid iron and scrap into steel. | Source: BlueScope Steel

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