UNOFFICIAL ENGLISH TRANSLATION

Letter sendt to the Ministry of Finance 14 December 2021

Government pension fund global - Evaluation of the climate criterion

Evaluation of the climate criterion

The Ministry of Finance has embarked on an effort to strengthen its understanding of how climate risk should be handled in the management of Norway's Government Pension Fund Global (GPFG). In this connection, the ministry has asked a panel of experts to examine the significance of financial climate risk and climate-related investment opportunities for a fund like the GPFG. The panel's report, Climate Risk and the GPFG, was published in the third quarter of 2021. The ministry has given notice that it will include an assessment of the climate and climate risk in the management of the GPFG in its 2022 Government Pension Fund Report. The report will also describe how the coal and climate criteria in the Guidelines for Observation and Exclusion from the GPFG have been applied. In this connection, the ministry has asked the Council on Ethics to report on its experience of practising the climate criterion.

The climate criterion was introduced in 2016. In the 2019 Government Pension Fund Report, certain ambiguities in the criterion's underlying premises were clarified. In line with the expectations described, inter alia, in Meld. St. 21 (2014-2015) Report to the Storting (white paper), the Council has reviewed the GPFG's investments in several of the business sectors which produce large volumes of greenhouse gas emissions. Following the clarifications in 2019, the Council has issued a total of four recommendations that have led to the exclusion of companies engaged primarily in oil sand extraction. In its assessments, the Council has attached importance to whether the companies produce substantial greenhouse gas emissions both in absolute terms and compared with companies producing similar goods. Furthermore, the Council has attached importance to whether the companies have credible plans for reducing their emission levels to the industry average within a reasonable period of time, and, finally, to whether they are subject to the EU's regulatory framework on climate change or other similarly stringent systems.

In the Council's view, the climate criterion has had a major impact on the development of thinking about the responsibility that companies and the GPFG have in the climate field and the fund's need to manage climate risk. In recent years, Norges Bank has increasingly tended to manage climate-related issues through the exercise of shareholder influence or risk-based divestment. Norges Bank and the Council on Ethics often focus on the same companies. The situation is that the Council has devoted significant resources to assessing companies under the climate criterion without this leading to a corresponding body of recommendations to exclude companies or place them under observation. The Council therefore considers that there is reason to re-evaluate the purpose and organisation of its endeavours with respect to the climate criterion.

The ethical guidelines and the climate criterion

The original criteria for exclusion from investment by the GPFG were put forward in the Graver Commission's report NOU 2003:22 Management for the Future. It was emphasised that the basis for the criteria was that grossly unethical behaviour could lead to exclusion and that there had to be an overlapping consensus in the population about the contents of the criteria. In other words, there had to be a shared understanding and acceptance of what could lead to exclusion. In the Council's further work with respect to these criteria, it has attached considerable importance to the use of internationally accepted norms and conventions to underpin its recommendations.

In the same way as for the other criteria, it was decided that companies may be excluded from the GPFG under the climate criterion only on the grounds of grossly unethical behaviour. At the same time, no internationally recognised and generally accepted norms for companies' climate-related behaviour existed. Nor was there any overlapping consensus in the population to indicate that relatively normal industrial activities were grossly unethical and should therefore be excluded from the GPFG, even though they also resulted in greenhouse gas emissions.

Application of the climate criterion otherwise differed from the other criteria in that the companies were to be assessed at the aggregate level. This is not explicitly specified for the other criteria in the guidelines. In practice, however, a company may be excluded on the grounds of serious norm violations in an individual part of the business. The good and bad consequences of a company's operations are therefore not normally set off against each other.

Another peculiarity of the climate criterion is that almost all the information must come from the companies being assessed. The starting point for cases being assessed under other criteria is normally a censurable incident or a situation about which there is publicly available information, or which may be investigated without the company contributing all the relevant details.

International climate agreements as a guide for companies' operations

The Paris Agreement is an international agreement under the United Nations Framework Convention on Climate Change. It regulates to some extent *states*' overall greenhouse gas emissions, while permitting significant differences between states, which are in reality left to decide for themselves how much they will reduce their emissions. The Paris Agreement also allows the individual states to distribute the burden of emission reductions *unequally* between different emission sources and business sectors operating within them and thereby make different strategic choices.

As a result, an assessment of companies' behaviour does not rest on any unified standard or norm. Business sectors and companies in which certain states wish to make major emission reductions may in other states be granted concessions because the state wishes them to expand their production and emission output. It is therefore not in keeping with the Paris Agreement that all sectors and all companies must make cuts of equal size. On the contrary, it may be in keeping with the Paris Agreement for e.g. solar and hydropower producers to increase their emissions, if necessary also per kilowatt hour produced, if this simultaneously leads to significantly greater reductions in the coal-power industry.

The nature of the Climate Convention and the Paris Agreement also means that the international agreements will change over time. In the period ahead, this could make it challenging to apply the criterion as it is currently formulated and delimited.

These are issues which help to make it difficult for the Council to deduce a norm for what makes an enterprise's emissions grossly unethical.

The Council's review of selected business sectors

The Council on Ethics has assessed companies in several of the sectors with the greatest greenhouse gas emissions, such as the production of oil, steel and cement, and to some extent international shipping. For all these sectors, we have also commissioned sectoral analyses and assessments from consultants with considerable expertise in the field. On the whole, the challenges are the same: it is difficult to obtain data that is representative for the company's operations and easily comparable between companies.

For example, it is possible to compare emissions per tonne produced by two different steelworks, but if they use different raw materials in different processes and produce different qualities of steel based on the input of energy from different sources, the matter becomes significantly more complicated. Even though it is possible to find that one of the companies is apparently systematically better than the other at using the latest and most climate-friendly technology, the absence of behavioural norms nevertheless makes it difficult to determine what is unacceptable in any case. The lack of norms can also cause the Council's investigations to focus on companies capable of comparison rather than the companies that are potentially the 'worst offenders'.

Another experience has been that the Council on Ethics and Norges Bank have to some extent focused on the same sectors. This is to be expected if both the exercise of shareholder influence and the act of exclusion are intended to address companies' contribution to climate change. In that case, both institutions will focus on major emissions and emissions that are unnecessarily large. An example of this is that several of the companies which the Council has worked with have disappeared from the GPFG before the Council has finished its assessment. At the same time, climate risk is the reason given by Norges Bank for many risk-based divestments.

Possible changes in the GPFG's management of climate risk

In its political platform, the government has said that the GPFG shall work on the basis of a long-term goal of zero emissions from the companies in which it has invested.

The panel of experts which advised on the GPFG's management of risk relating to climate change and the green transition found that climate risk is a relevant and potentially material risk for the fund. The panel of experts considers that the exercise of shareholder influence should be a key tool in the management of climate risk, and points out that a framework for companies' reporting of climate-related risks has been developed and is steadily expanding in scope.

Such a focus on the exercise of shareholder influence, climate risk and reporting will make it easier for Norges Bank to establish a dialogue with companies whose climate-related behaviour is non-conformant and, if appropriate, facilitate the divestment of investments therein.

EU's activities with respect to sustainable finance

The EU is continuing to work on a taxonomy for economic activity, which has been described as the fundament on which the EU's action plan for sustainable finance is built. The taxonomy is a classification system for economic activities that are sustainable in relation to defined environmental goals and in accordance with defined requirements for economic sectors and underlying activities.

This system encompasses significantly more than company emissions alone, and could provide a broader and more detailed picture of where a company stands in relation to the climate and sustainability in general. Going forward, such systems will probably be a useful tool for banks and financial institutions when they wish to assess companies' climate and sustainability behaviour more broadly than simply looking at their greenhouse gas emissions. The actual action plan involves a requirement to report on sustainability, regulations concerning the banking and finance sector's sustainability-related fund and risk management, and the above-mentioned system for the classification of what constitutes sustainability (taxonomy). The objective has thus primarily been to ensure that banks and financial institutions gain access to companies' climate and sustainability data and not to separate out or identify companies that are lagging behind.

The Council's assessment

The government's goals for the GPFG's climate profile, the attention paid to anthropogenic climate change and the world's views on companies' responsibility for it, as well as data collection and reporting systems to document the role of companies in a climate context, have changed substantially since 2016 when the climate criterion came into effect. The changes are so substantial that the Council considers that the purpose and organisation of its endeavours relating to the climate criterion should be re-evaluated.

Firstly, setting a goal of climate neutrality will over time probably lead to significant changes in the GPFG's climate profile, both because companies change their behaviour and because the portfolio changes its composition. It should be possible to formulate the climate criterion so that it contributes to this process. It is therefore not given that the currently established 'pegs' should form the basis for exclusion if we are working towards such a long-term objective. The criterion's formulation should reflect this new situation and that future need.

Secondly, such a change in the investment mandate will require a further build-up of activity and competence on the part of Norges Bank. Due to the way the climate criterion is framed, the Council and Norges Bank will to an even greater extent than today request information from the same companies and establish dialogues with the companies on the same issues. This will not be a particularly efficient use of resources, nor is it likely to instil confidence in the companies concerned.

With the resources the Council has at its disposal, combined with the build-up of capacity on the part of Norges Bank, it is not very likely that the Council's work under the climate criterion going forward will produce significant results in the form of the exclusion or observation of companies. Norges Bank will probably pick up on the same companies as the Council and deal with them through the exercise of shareholder influence or risk-based divestment.

The Council on Ethics is therefore of the opinion that the Ministry of Finance should consider solutions to give Norges Bank responsibility in the climate field, which also includes the assessment of companies under the climate criterion. Today, Norges Bank can exclude companies under the coal criterion without a recommendation from the Council on Ethics. Nevertheless, a brief explanation is still given for why the company is being excluded or placed under observation. Under this arrangement, responsibility for the coal criterion is, in principle, divided between Norges Bank and the Council, with the primary responsibility lying with Norges Bank. The Council may, at its own initiative, recommend exclusion or observation under the criterion. Such an arrangement should also be workable for the climate criterion.

Yours sincerely,

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