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To: Board of Administration, California Public Employees' Retirement System
cc: Ben Meng, Chief Investment Officer; Beth Richtman, Managing Investment Director for Sustainable Investments

Teachers' Retirement Board, California State Teachers' Retirement System
cc: Christopher Ailman, Chief Investment Officer; Kirsty Jenkinson, Director of Corporate Governance; Grant Boyken, Public Affairs Executive Officer

From: Tom Sanzillo, Director of Finance, Institute for Energy Economics and Financial Analysis
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Subject: Reporting on climate-related financial risk

I have reviewed the implementation memo from Fossil Free California and Environment California related to SB 964,[1] which addresses pension fund management of climate risk.

The California legislature, to its credit, has stepped up to address climate risk issues in our country's two largest pension fund portfolios, and the rest of the nation is paying close attention to California's emerging policies and actions. The broad purpose of climate legislation in California and elsewhere is necessitated by a failure in the United States to produce a coherent climate policy at the federal level.

Across the nation, however, states, cities and towns are all finding ways to contribute to solutions to our most urgent problem. California and its pension funds have been leaders in many areas of climate change policy and programs. SB 964 further advances California's commitment, as it requires that CalPERS and CalSTRS report on climate-related financial risks inherent in your investments in the oil, gas and coal sectors.

The legislation and the reports you will prepare in response acknowledge the significant contributions that fossil fuels have made, not only to the California pension funds, but also to the state and world economy. These contributions have been long-term and significant. Now, however, changes in technology, science, public opinion, politics, business, markets and finance are precipitating shifts in the energy sector, and the oil and gas industry in specific, which require enhanced diligence on the part of investors. SB 964 codifies the rationale for the additional climate-

[1] https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB964

related diligence that is essential to ensuring funds are meeting fiduciary standards and fund guidelines.

The fossil fuel sector is in financial decline. As a result, these holdings are far less relevant to California's funds and to most other major institutional investors than has been true historically. For example, at the end of 1980, the energy sector constituted 29% of the S&P 500 index. By the end of 2018, the sector accounted for only 5.3% of the index. Energy stocks led the markets for decades; they are now laggards.

Financial risk factors facing the industry loom very large as institutional investors grapple with a myriad of issues including climate risk. The Norwegian Sovereign Wealth Fund recently announced it would divest a subsector of its oil and gas holdings on financial grounds – weak returns, low prices and a volatile market. Financial challenges facing the Exploration and Production subsector were a drag on the fund's investment index. The fund will also carefully track the major oil companies that it did not divest.

California's pension funds have historically opted for a policy of responsible ownership and engagement toward its portfolio of fossil fuel companies. The need for enhanced diligence in this sector has been acknowledged implicitly by the funds' involvement in governance and public policy shareholder outreach to the companies.

The legislature's codification of the need for enhanced diligence, however, now requires a more formal, systematic treatment of climate risk.

California's pension funds are now asked to take on a complex diligence regime because the issue of climate change is complex. The new legal requirement comes during a time of broad financial changes in the fossil fuel sector. While the diligence required to comply with this statute may be seen as burdensome, this enhanced diligence, in fact, reflects the actual burden of the financial risks facing the industry. As the letter from Fossil Free California and Environment California makes clear, this is not merely a legal exercise in compliance, but a more fundamental call for an increased level of prudence and care.

Compliance may pose challenges to the staff and boards of the funds as they are currently organized. While staff and board typically handle broad financial and social policy issues across a wide expanse of issues in the global economy, the depth of diligence required to retain holdings in the fossil fuel sector, as reflected in the legislation, will most likely strain the existing professional competencies of governance and public policy staff who conduct shareholder outreach and manage shareholder relations with fossil fuel companies. The climate risk analysis will require a more specialized knowledge of industry practices and climate modeling and a deep understanding of climate risk and its impact on portfolio companies and, finally, on the Fund's specific allocations. In particular, this analysis will require a specialized knowledge of the energy sector companies in the fund's portfolio, which is typically the domain of investment staff. At a minimum, it will require knowledge of the sub-sectors within the industry and the leading companies within those sub-sectors, including their financial performance and current policy direction.

Most importantly, it will require trust and close collaboration between governance/shareholder relations staff and decision makers on the investment side. The typical cordoning off of investment policy from governance policy does not work when addressing these issues. This is resolved practically by developing working relations between investment and governance staff.

Industry experts that have conducted this kind of research for U.S. pension plans have created many tools and guides. These primers may prove useful to the staff and boards of the funds, but, of course, are not substitutes for the fund's own research. CalPERS and CalSTRS must have information tailored to their governing philosophies, current allocations and trading strategies.

Some pension funds, like those in New York City, have retained independent consultants to help them analyze their portfolio through a climate risk lens. Through their work with consultants, various stakeholders -- the New York City Comptroller as administrator of the funds, the Mayor as the Chairman of the City pension fund, board members and interested trustees – designed research that met their particular needs. Much of the work performed by consultants, though not made available to the public, proved very useful for the deliberations of New York City's pension trustees and administrative staff.

Each legislature, board and staff must develop its analysis and new allocation strategies consistent with its own history. CalPERS' and CalSTRS' respective histories however, are not insular. California's largest public pension funds have been, and I suspect in this instance will again be, highly authoritative voices in the investment community. The legislation calls for a serious and deliberate approach to climate change and investment. Your funds have the resources and your institutional position burdens you with the responsibility to get this one right.

If we can be of assistance please do not hesitate to call.