



NORGES BANK

Ministry of Finance
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Your ref.:
Our ref.:

Government Pension Fund Global

We refer to the Ministry's letter of 25 June 2015 on the Government Pension Fund Global (GPFG) and investments in, and policy tools for, coal companies etc. The Ministry's letter to some extent follows up the discussion in Recommendation 290S (2014-2015): The Standing Committee on Finance and Economic Affairs' Recommendation on Report to the Storting No. 21 (2014-2015) "The Management of the Government Pension Fund in 2014".

In its letter, the Ministry writes that the purpose of the ethically motivated criteria for exclusion must still be to reduce the risk of the fund being invested in companies that are complicit in, or themselves responsible for, gross breaches of norms. It also writes that there is to be a new product-based criterion for coal-based activities in addition to the new conduct-based climate criterion which is not restricted to specific sectors or types of greenhouse gas. Norges Bank understands that the conduct-based criterion is to be viewed in combination with the new product-based criterion. The letter asks Norges Bank for advice and assessments regarding the new product-based criterion for coal-based activities.

Norges Bank understands that it is to perform a specific risk assessment of companies in the portfolio "whose involvement in coal extraction, coal power generation or coal-based energy conversion represents a significant part of their business". Norges Bank has begun such a process and will come back to this analysis.

Background

In its recommendation, the Standing Committee on Finance and Economic Affairs writes that there are ethical issues associated with the activities of a number of coal companies in both mining and power production. For this reason, the Committee considers it appropriate for

there to be a separate product-based criterion in the Guidelines for Observation and Exclusion covering such companies. In its recommendation, the Committee writes:

“The criterion should in the first instance cover mining companies and power producers where a significant part of their business is related to coal used for energy purposes. [...] Coal power companies and mining companies which themselves, or through entities they control, base 30 percent or more of their activities on coal and/or derive 30 percent or more of their income from coal, should as a rule be included under the definition of ‘significant’.”

The Guidelines for Observation and Exclusion laid down by the Ministry now differentiate between product-based and conduct-based criteria. In its recommendation, the Committee writes:

“A chain of policy tools should also be established for the new product-based criterion, something which has not been the case for the existing product-related criteria concerning weapons and tobacco. This means, for example, that importance should be attached to forward-looking assessments with respect to the new product-based criterion, including any plans a company may have that will change the share of its business based on coal and the share of its business based on renewable energy sources.”

The criterion proposed here differs from the other criteria currently found in the Guidelines. To date, the product-based criteria have been absolute and not linked to production exceeding a certain share or value. The new criterion is also presented in such a way that the specified thresholds may be overridden in the light of forward-looking assessments. With the conduct-based criteria, one key element is forward-looking assessments and consideration of whether the use of other measures might be more appropriate, but such assessments do not apply to the existing product-based criteria.

In the following, we comment on the matters on which the Ministry requests input in its letter of 25 June 2015.

Terminology and operationalisation

The Ministry asks for Norges Bank’s view of whether the terminology used is sufficiently clear for the operationalisation of the criterion. The Bank believes that the way the criterion is formulated raises a number of significant issues in terms of both scope and definitions. Norges Bank nevertheless believes that the terminology used can form a basis for operationalisation. For the criterion to be applied in a clear, predictable and consistent manner, further clarification is needed at both a general and an operational level. We believe that the formulations “base [...] of their business on coal” and “coal used for energy purposes” require closer definition and practical interpretation. In the following sections, we highlight various issues and comment on the priorities and demarcations it would be natural to consider ahead of the operationalisation of the criterion.

Terminology

Recommendation 290S (2014-2015) refers to companies that base 30 percent or more of their business on coal used for energy purposes and/or derive 30 percent or more of their



income from such activities. The Standing Committee talks of “mining companies” and “power producers”. For the criterion to be operationalised, a clearer understanding needs to be established of what these terms refer to. The Bank’s interpretation is that it is actual production that is covered, corresponding to the approach under the existing tobacco criterion in the Guidelines on Observation and Exclusion. Buying and selling coal, or transporting coal, will not, therefore, be included. Similarly, power distribution and power trading will fall outside the definition.

The main type of coal used in the production of electricity is known as thermal coal. Coal for steel production is known as metallurgical coal. Norges Bank assumes that the operationalisation of the criterion will limit “coal used for energy purposes” to thermal coal. We also assume that the word “income” can be understood as revenue or sales.

Sectors

We note that an assessment is proposed of a specific type of activity’s share of each individual company’s overall business. Such an assessment will be more straightforward for pure mining companies or power producers than for conglomerates with multiple business lines. One natural operational starting point for this work would be the Industry Classification Benchmark (ICB). Mining companies will come under the ICB’s coal, general mining and nonferrous metals sectors, while power producers will mainly fall into its conventional electricity and multi-utilities sectors. Companies in the multi-utilities sector are often also involved in power distribution, power network operation and the supply of gas and water.

Thresholds

The Standing Committee proposes two thresholds for identifying whether a company’s coal business is sufficiently significant to be covered by the criterion. One is the share of income from coal, and the other is the share of the business based on coal.

Norges Bank assumes that the income threshold entails an assessment of mining or power companies that derive 30 percent or more of their revenue from the production of thermal coal or from the production of power from coal.

The second threshold entails an assessment of what a company bases its business on. This threshold is more relevant to companies in the power sector than to mining companies. As an example, companies deriving 30 percent or more of their revenue from power production can be identified. The mix of energy sources used in these companies’ power production can then be assessed. If 30 percent or more of a company’s aggregate power production measured in energy units is based on coal, it will be covered by the criterion.

The selection criteria described above may mean that the way a company chooses to organise its activities could play an important role in whether the company is covered by the criteria or not. For example, integrated power companies with significant distribution or network operation activities may not be included even if coal accounts for a significant share of their power production in isolation. At the same time, companies deriving less than 30 percent of their revenue from coal-based power production may be covered by the threshold referred to in the previous paragraph, right down towards 9 percent in the example above.

The criterion focuses on coal. This means that renewable energy cannot be offset against power production from coal when assessing the thresholds in isolation. As a result, the criterion could, for example, capture companies deriving 30 percent of their revenue from coal-based power production and 70 percent from renewable energy. The Bank notes, however, that the Committee considers the share of renewable energy production to be relevant in the forward-looking assessment.

Corporate structure

The Ministry also asks for Norges Bank's view of the implications of the formulation "through entities they control". Controlling companies in group structures could be covered by the criterion. Revenue consolidated at group level based on published financial statements would be the starting point in Norges Bank's view. The Bank also considers that there is no basis for excluding subsidiaries that do not themselves have sufficient coal-based activities.

Green bonds

Under the Guidelines, exclusion decisions apply to both equity and fixed-income instruments in the GPFG's portfolio. Norges Bank proposes that so-called green bonds are not covered if they are recognised through inclusion in specific indices for such bonds or verified by a recognised third party.

Access to information

In practice, it will probably be a challenge to obtain good information on revenue and production at a sufficiently detailed level for all potentially relevant companies. Reporting on these variables varies from company to company and from market to market. There will often be a need for additional processing and quality assurance of revenue and production data.

Wording of the Guidelines

The Ministry asks whether it would be appropriate to have a different formulation to "shall not be invested in". Norges Bank recommends that the new criterion is included in a separate section as a "may" rule. Other sections of the Guidelines might then also need to be reviewed.

Observation as a policy tool

The Ministry asks whether observation should be considered as a possible policy tool in respect of this criterion. Under the Guidelines, observation may be decided on "when there is doubt as to whether the conditions for exclusion are met or as to future developments, or where observation is deemed appropriate for other reasons". Norges Bank believes that observation may be a relevant tool under a new coal criterion in situations where companies have concrete, time-limited plans that suggest that their activities will fall below the relevant thresholds. An appropriate time horizon for forward-looking assessments will vary, and it may be difficult to establish a general rule for how long this horizon should be. Observation may also be relevant where there is uncertainty about the underlying information.

Division of responsibility between the Council on Ethics and Norges Bank

The Ministry asks whether the most efficient and appropriate division of responsibility between the Council on Ethics and Norges Bank for this product criterion will differ from that



established for the existing criteria. The Ministry also asks for the exchange of information and co-ordination between the Council on Ethics and Norges Bank on the new criterion, and dialogue with companies assessed against the criterion.

Work on observation and exclusion under the new criterion will require good access to data, good systems and methods for processing data from different sources, and a detailed knowledge of sectors and individual companies.

Norges Bank has gradually expanded its capacity for fundamental company analysis, and we believe that the operationalisation of the new coal criterion could draw on this capacity. This is particularly relevant given the proposal for forward-looking assessments of a company's development and strategic plans, which will, in practice, often include restructuring of assets, investments in renewable energy, emission reduction technologies or other technological advances.

Against this background, and in the light of the significant demands the criterion makes in areas such as analysis, Norges Bank could take on the role of operationalising the new product criterion for coal-based activities. In this case, the Executive Board would ask Norges Bank Investment Management to identify companies, conduct forward-looking assessments and make recommendations on observation and exclusion for decision by the Executive Board. The reasoning for the decisions would be published in line with the other criteria. Norges Bank Investment Management would make contact with companies on threshold values and forward-looking assessments. At the same time, the Council on Ethics could assess and recommend exclusion of individual companies on an independent basis.

Financial consequences

Finally, the Ministry asks about the financial consequences. With the threshold values above, the criterion could cover some 120 companies with a combined market value of around 55 billion kroner. The direct transaction costs of excluding this number of companies can be estimated at around 400 million kroner. Given the size of the fund, transactions of this kind in individual stocks will lead to large trades that will to some extent be predictable for other market players, making the costs difficult to gauge.

The new criterion may alter the fund's portfolio characteristics to a degree. Utilities companies often have a more stable revenue profile than companies in the fund's other sectors. Over time, the exclusion of such companies could give the portfolio a different risk/return profile.

Shares of production and revenue will vary over time. One topical example is the decline in coal prices in recent years. There is a risk of Norges Bank excluding a number of companies that will not be covered by the new criterion in the longer term. These considerations may warrant building a certain margin into the threshold values specified above.

Closing remarks

Norges Bank notes that the Standing Committee writes that the application of the criterion will evolve over time, for example as a result of changes in energy production or



technological advances. In time, for example, increased use of carbon capture technologies could give grounds for a separate assessment of power production using these technologies.

Norges Bank also assumes that the operationalisation of the criterion will need to be carried out over a period of time. Some companies will remain in the portfolio for further dialogue and clarification before any decision is taken. In practice, most relevant companies ought to be assessed by the end of 2016.

The Bank assumes that decisions on exclusion will not be published until divestment has taken place. As with the other exclusion criteria, the criterion will be managed continuously and the portfolio will be monitored accordingly. No guarantee can ever be given that there will not be companies in the portfolio that could be viewed as breaching the exclusion criterion. Norges Bank would attach importance to external stakeholders being able to contribute relevant information for capturing companies that may be a case for observation or exclusion.

Norges Bank has already divested from a number of companies that are involved in coal mining and/or use coal as an input, based on a general financial assessment. Some of these companies will be covered by the new coal criterion. The Bank recommends that these companies, which are included in the GPF's benchmark index, are also formally excluded from the fund.

Yours faithfully

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