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Experience of the new climate and coal criteria in the Guidelines for Observation and Exclusion from the Government Pension Fund Global

In its letter of 19 October 2016, the Ministry refers to the conduct-based climate criterion and product-based coal criterion that were introduced into the Guidelines on Observation and Exclusion from the Government Pension Fund Global from 1 January and 1 February 2016 respectively. The Ministry wishes to evaluate these two new criteria and asks for Norges Bank's input. The Ministry writes that it will attach importance to the strategies and working processes established by Norges Bank and the Council on Ethics to follow up the criteria, and to how the exchange of information and coordination between the Bank and the Council are functioning in this area.

The Bank is asked to report on its experience to date from operationalising the two criteria. In the case of the coal criterion, the Ministry asks specifically for experience from the identification of mining companies and power producers, the application of the thresholds, the requirement for forward-looking assessments and the development of a chain of policy tools. The Bank is also asked to comment on how the need for transparency is met in its work on the two criteria.

The product-based coal criterion

The product-based coal criterion came about as a result of the Standing Committee on Finance and Economic Affairs' comments in Recommendation No. 290 S (2014-2015) and the consideration of the National Budget for 2016, where the Storting endorsed the Ministry's proposals for how the criterion could be operationalised. In our letter of 31 August 2015, we looked in depth at the definitions and methods for identifying companies under the criterion.

The criterion states that mining companies and power producers which themselves or through entities they control derive 30 per cent or more of their revenue from thermal coal, or base 30 percent or more of their operations on thermal coal, may be excluded from the fund.

The 30 percent threshold for revenue from thermal coal is more relevant to mining



companies than to power producers. This is because mining companies often report revenue data broken down between metallurgical and thermal coal, facilitating assessment against this criterion.

The 30 percent threshold for operations based on thermal coal necessitates an assessment of what a company *bases its operations on* and is more relevant to the assessment of power producers than mining companies. First, companies deriving 30 percent or more of their revenue from their own power production can be identified. The mix of energy sources used in these companies' power production can then be assessed. A company will be covered by the criterion if 30 percent or more of this power production measured in energy units is based on coal.

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 criterion or not. For example, integrated power companies with significant distribution or network operation activities may not be covered 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 if 30 percent or more of their operations are based on thermal coal.

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.

Besides a company's current share of revenue or operations based on thermal coal, our assessment is required to attach importance to forward-looking assessments, including any plans to reduce the share of revenue or operations based on thermal coal and/or increase the share of revenue or operations based on renewable energy sources.

Norges Bank's follow-up of the product-based coal criterion

In our work on the product-based criterion, we have established systems for sourcing and analysing company information. Information on companies' mining activities is often more readily available than information on power production. With mining companies, accounting data is often sufficient for assessing thermal coal's share of total production. With power producers, further analysis will often be needed. We have collected data from a variety of sources covering both revenue and the amount of coal used in power production.

Sourcing information of sufficient quality and detail for the operationalisation of this criterion is a challenge. In addition to a general shortage of adequate data sources, the information reported by the companies themselves is not normally detailed enough for the analyses required. We have therefore contacted multiple suppliers and data sources. While the average level of different suppliers' data points is comparable, the individual data points can vary substantially. Reporting across different time periods and metrics is a particular challenge. All of the data we use are systematically structured and stored. Our data sources



include suppliers of market data, internal analyses and selected investment banks. Information and analyses from our external managers have proven particularly useful when assessing companies in emerging markets.

In some cases, companies themselves will be the only source of relevant information on both the current situation and their plans. In the forward-looking assessment, information provided by the companies – such as plans to change their fuel mix or develop renewable energy capacity – will be particularly relevant. We have therefore also contacted companies for more information.

On the basis of this sourcing and analysis of information, we have assessed companies against the criterion and excluded those that we consider to be covered by the thresholds specified in the criterion.

The Guidelines on Observation and Exclusion state that 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”. With the product-based coal criterion, observation is a relevant option in situations where companies are considered to exceed the relevant thresholds, but where we have information on stated plans, initiatives or other material factors that make it likely that the company will fall below the thresholds within a reasonable period of time. Examples of such plans, initiatives and other factors include:

- Planned or recent purchases and sales of companies and assets (power plants)
- Publicly communicated plans to shut down, start up or alter production capacity
- Droughts, accidents and other special events that may have temporarily affected the fuel mix

During the course of 2016, we announced the exclusion of 59 companies based on the product-based coal criterion and placed a further 11 companies under observation. In line with the Guidelines for Observation and Exclusion, the grounds for these decisions were published on 14 April and 21 September 2016.

The guidelines make special provision for the treatment of green bonds, stating that a decision to exclude a company under the coal criterion does not include any green bonds issued by that company that are included in recognised indices for such bonds or verified by a recognised third party. All bonds issued by excluded companies have been screened against the universe of green bonds in the *Barclays MSCI Green Bond Index*. None of the companies excluded have issued green bonds.

We assessed relevant companies against the product-based coal criterion over the course of 2016, and exclusions under the criterion are now largely complete. We have established a systematic process for sourcing and analysing information. Its implementation has taken time and resources, but has also built on existing systems and expertise. The criterion has thus been well-suited to systematic implementation by the manager.



Going forward, we will continue our work on sourcing and analysing information. We need to follow up companies placed under observation, excluded companies and non-excluded companies alike in the light of changes material to assessment against the criterion. In our work on the criterion in 2016, we found that purchases and sales of assets and subsidiaries can greatly affect whether a company is covered by the criterion or not. We will also need to assess any new companies entering the market.

The conduct-based climate criterion

The Council on Ethics has been charged with identifying companies that may be covered by the conduct-based climate criterion, while the Bank, as with the other criteria, takes the actual decision on exclusion or observation. As yet, no companies have been excluded from the fund's investment universe under this criterion.

Exchange of information and coordination with the Council on Ethics

We presented our work on identifying companies that may be covered by the product-based coal criterion at meetings with the Council on Ethics and its secretariat during the year. The Council has been given information on how the criterion is operationalised by the Bank so that the Council's work on the conduct-based climate criterion and other areas can be appropriately aligned.

The Bank's Executive Board held a meeting with the Council on Ethics in 2016, as did the Executive Board's Ownership Committee. Norges Bank Investment Management and the Council's secretariat held four quarterly information-sharing meetings and five additional information-sharing meetings on special topics. We believe that the exchange of information and coordination with the Council on Ethics are functioning well.

Yours faithfully

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