



The next big thing

Summary

- Interest in the renewables market is increasing rapidly, whilst the market itself is maturing and becoming more attractive for pension schemes.
- Further investment is still needed to support broader climate commitments, but renewable investments can be a great starting point for ESG considerations, including social.
- Regulatory changes will be needed to encourage investment in some aspects of the renewables market, and the government is already considering solutions.

Amid increasing investor interest, Sophie Smith explores what opportunities the renewable energy market could hold for pension schemes, and the key challenges still to overcome

Interest in the renewables market has been growing for some time, with research from Octopus Renewables revealing that the vast majority (92 per cent) of pension schemes are planning to increase their allocations to renewables over the next three to five years, with 46 per cent expecting

renewables to become the most attractive investment amid the pandemic.

Indeed, Octopus Renewables co-head, Alex Brierley, emphasises that there has “absolutely” been increased interest in the market, with new investors making their first steps into the market almost every week. This may be unsurprising, as

Alpha Real Capital head of renewables, Will Morgan, describes the renewables market as being attractive for pension schemes for several reasons, stating: “Renewable energy infrastructure is an attractive secure income real asset with predictable cashflows, significant inflation linkage and good duration.”

Octopus Renewables’ research finds that 91 per cent of pension schemes cited the prevailing low interest rate environment and volatility in equity markets as pushing them to seek uncorrelated sources of higher yield, whilst just under half (46 per cent) were looking for ‘stable and predictable’ cash flow from renewables.

Renewables are not only an opportunity from an investment perspective, however, as Brierley says that there is also the benefit of the responsible investment story, with a further 76 per cent of pension schemes pointing to pressure from millennials as causing a boost in demand for renewables.

Renewed market interest

“From a member engagement

perspective, environmental concerns have been moving up the list of concerns for everyone, but we have seen more from younger people, and generally more publicity on the impact of climate change in the past few years,” adds Redington investment consulting team managing director, Carolyn Schuster-Woldan, arguing that demonstrating how a DC member’s benefits are helping towards the energy transition may also encourage greater engagement levels.

More broadly, Schuster-Woldan points to pension schemes as having an important part to play in the energy revolution needed to meet the countries net-zero commitments. Agreeing, Renewity head of research, Stephan Breban argues that “UK pension plans can be a significant player in providing the necessary capital to help transform not just UK, but global, energy provision to greener, carbon-neutral solutions, displacing the existing ageing, dirty, fossil fuel-based generation”.

Indeed, Alpha Real Capital’s research previously found that 64 per cent of pension schemes expect institutional investors to increasingly divest their portfolios of companies in fossil fuel industries over the next three years, with 56 per cent doing so because they believe returns from traditional energy companies will fall and become ‘riskier’ amid the transition to cleaner energy.

And these considerations may be particularly important amid the pandemic, as Octopus Renewable’s research found that Covid-19 has significantly slowed the pace of divestment from fossil fuels, with institutional investors, on average, divesting just 1.9 per cent of their overall portfolio in 2020, compared to the 5.7 per cent forecast.

Alongside this, the pandemic has demonstrated the role of renewable markets as a “safe haven”, with Glenmont Partners co-founder, Peter Dickson, predicting a growing number of opportunities in the renewable markets for pension schemes, arguing that these

offer stability and certainty, unlike carbon-intensive industries that are at risk of becoming stranded assets. “In times of volatility like we have seen in the pandemic recently, anything that gives security of pricing will have added attractiveness for groups such as pension schemes,” he says.

Navigating the market

Yet despite the positives, obstacles remain. “From a DC perspective, liquidity (or the lack of it) remains the largest challenge, alongside scale of investment, fees and the interaction with the DC charge cap,” says Schuster-Woldan. “These can only be addressed by further changes in regulation to promote longer-term, less liquid funds in DC accounts.”

Breban, however, highlights the portrayal of liquidity as a significant obstacle as a “red herring”, arguing that pension funds have very predictable cash outflows and should be planning to meet these with corresponding cash inflows.

“Resorting to selling assets to meet liability payment is a symptom of poor planning,” he continues. “Pension plans need cashflows far more than they need liquidity.” Adding to this, Brierley argues that these are “relatively illiquid assets”, explaining that there is a huge amount of interest in the market, which means there are liquidity options, given three to six months to find a buyer.

Furthermore, whilst he acknowledges that there are investor concerns around merchant price power risk, he emphasises that there are solutions, such as the creation of diversified portfolios that are not all exposed to the same part of merchant risks or the use of hedging structures to mitigate risk.

Scale, on the other hand, remains a critical challenge. “Only scale can deliver for investors sufficient country, technology and investing stage diversification,” Breban argues, stating that in the UK, even the largest specialist renewables managers might struggle to deploy over £200-300 million into

the market in a year, regularly, without materially affecting market or at least asset pricing. “If we are to expand the deployed renewable energy capacity at the speed we need,” he argues, “then something has to change.”

In particular, Breban suggests that trustees seek solutions that are themselves structurally scalable at speed and of scale in terms of their nature. Multi-manager platforms, for instance, he says can fit the bill and provide the earliest and broadest deployment across multiple managers, spreading execution risk and delivering the earliest return on capital and greatest stakeholder impact.

And whilst renewable energy can offer help in terms of carbon considerations, Schuster-Woldan is keen to stress that carbon commitments are only one facet of ESG investing. “We expect more pension fund trustees to focus on the social impact of their investments as more data and approaches become available,” she says, highlighting this as especially pertinent following the Covid-19 pandemic, which has seen inequalities in society brought to light.

Creating an impact

“When capital flows into the sector, it’s not just on the decarbonisation benefits,” Brierley emphasises however, explaining that renewable energy can also have a positive impact on communities around assets, the biodiversity of the region, and act as a creator for jobs. Agreeing, Breban argues that renewable energy is a perfect fit for ESG. “It ticks all the boxes,” he says. “It creates jobs, it is supporting dynamic research and development in the sector, it improves health by reducing pollution, it reduces climate displacement.”

Although Dickson acknowledges that each project should be considered on its individual merits, clarifying that not every project is equal, he adds that, unlike other areas of ESG investing, renewable energies are one that face no threat of greenwashing. “For renewable funds like ourselves,” says Dickson, “there is no ambiguity about the sustainability

of Glennmont's clean energy funds and there is no possibility of being accused of green-washing when your assets are 100 per cent renewable energy."

"For some clients," Morgan adds, "it may also be about contributing towards national infrastructure policy, namely the net-zero target by 2050, and the 10-point plan for a 'green industrial revolution.'"

Indeed, the government recently launched a consultation on the DC charge cap as part of its 'build back better' plan, in an effort to smooth performance fees and facilitate investment in broader areas, including green infrastructure. Speaking to *Pensions Age*, Pensions Minister, Guy Opperman, says: "One way pension scheme trustees can

manage climate risk is to positively invest in climate-related opportunities including renewable energy firms and infrastructure, which stand to

benefit from the urgent transition to net zero.

"I am committed to encouraging pension schemes to think about the benefits of renewable energy investment without diluting member protections or reducing returns, not only by legislating to require that trustees take action on climate risk, but also by driving DC consolidation, and making clear that costs related to holding infrastructure assets do not contribute to the DC charge cap."

A growing movement

Campaign groups have also been supportive of the trend towards renewables, with Make My Money Matter CEO, Tony Burdon, arguing that all pension schemes should explore the possibility of investing in renewable energy. "Not only is this good for our planet, but for member returns too, as we expect the green economy to grow significantly over the coming decade,"

he says, calling on schemes to follow the example of Nest ahead of COP26.

These hopes may soon be fulfilled, as Morgan predicts a "healthy increase" in the level of investing from pension funds in renewables, noting that the renewables market more broadly is growing rapidly and providing more investment opportunities for investors.

"It is also maturing rapidly, making it more appealing for pension funds," he adds. This is echoed by Dickson, who explains that the deep market potential and balance of yields and turn provided by the asset has prompted it to mature significantly.

Furthermore, whilst Brierley notes that there has been a consistent fall in returns from renewable assets over the course of the past 15 years, he clarifies this should not be seen as a negative. "This is a maturing market, and it should be expected", he says, emphasising that increasing interest has prompted greater competition, with oil majors also being bought into the market via low-carbon strategies.

Despite the fall in yields, Breban argues that they have nonetheless been consistently very attractive compared to corporate debt, particularly on a risk-adjusted basis.

"The combination of good margin yields from income over long durations gives a strong uplift for pension plan cashflows and funding levels, whilst lowering risk," he says. And although he acknowledges the market's relative immaturity, he highlights this as a significant benefit, stating that there are still significant opportunities to further improve the technology, and enhance returns in future.

"Advances in technology should make it cheaper and easier to create renewable power," adds Schuster-Woldan, agreeing that further developments for storage technologies in particular are essential to enable the next phase of the energy transition.

Written by Sophie Smith

Getting the turbine spinning

Nest has appointed Octopus Renewables to boost its investment in clean energy infrastructure, with £250 million expected to be committed this year in the UK and Europe, as part of a potential £1.4 billion investment by the end of the decade. The mandate will target deployment into renewable energy projects and the associated infrastructure, predominantly in the UK and Europe, to support the transition to a net-zero economy. As part of this, Octopus Renewables will arrange investment deals directly with the owners of renewable infrastructure projects, negotiating bespoke deals to ensure members are "suitably rewarded" for injecting new funding.

Nest chief investment officer, Mark Fawcett, highlighted investing in renewable infrastructure as a "win-win for all involved", emphasising that the "strong foundations" of this kind of investment should help achieve "great returns" as well as acting as a direct investment in the future of the planet.

"Anecdotally, the reaction we've had from speaking to members, including over social media, has been extremely positive," a Nest spokesperson adds, emphasising that many members welcome the chance to use their pension to help reduce the impact of climate change.

They also explain that whilst there are barriers for DC pension schemes accessing assets like unlisted infrastructure equity, such as fees, Nest's scale puts it in a very privileged negotiating position, stating: "Octopus Renewables have been able to present a solution which matches our needs – they'll create a diversified portfolio for Nest of infrastructure projects in the UK and Europe, focusing primarily on solar and offshore wind farms. We are also about to appoint two further infrastructure equity mandates who will also include some exposure to renewable assets, as they aim to be diversified across all the major sub-sectors of the infra market."