Item 2(b)

7th September 2022

Glasgow City Council

Strathclyde Pension Fund Committee

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Direct Impact Portfolio (DIP)
Investment Proposal – NextPower UK ESG Fund

Purpose of Report:

To set out a proposal for an investment of £60m within DIP.

Recommendations:

The Committee is asked to **APPROVE** an investment of £60m in NextPower UK ESG Fund by DIP.

Ward No(s): Citywide: ✓

Local member(s) advised: Yes ☐ No ☐ consulted: Yes ☐ No ☐

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1 Background

1.1 Portfolio Establishment

In December 2009, the Strathclyde Pension Fund Committee agreed to establish a New Opportunities Portfolio (NOP) with a broad remit to invest in assets for which there was an attractive investment case but to which the current structure did not provide access.

1.2 Review

The NOP strategy has been subject to 3-yearly reviews with the name changing to the Direct Investment Portfolio in 2015. The most recent review was concluded in November 2021. This made no change to the objectives, structure, overall size parameters, risk and return parameters, or governance structure, but did result in an increase in the individual investment size parameters and a further name change to the Direct Impact Portfolio (DIP).

1.3 Implementation Framework

DIP investment proposals are assessed on their own merits within an agreed implementation framework based on SPF's overall risk-return objectives and specific DIP parameters.

The framework agreed at the 2021 review is summarised below.

Direct Impact Portfolio	
Objectives	Primary objective identical to overall SPF investment objective. Secondary objective of adding value through investments with a positive local, economic or ESG (environmental, social, governance) impact.
Strategy & Structure	In line with SPF risk-return framework but focused on the UK and the Equity, Long Term Enhanced Yield and Short Term Enhanced Yield asset categories.
Risk and Return	Portfolio benchmark return of **CPI +3% p.a.** Individual risk and return objectives for each investment.
Capacity	Target allocation of **5%** of total Fund (based on Net Asset Values). Range of **2.5**% to **7.5%** of total Fund.
Investment Size	Target: **£30m** to **£100m** Minimum: **£20m** Maximum: greater of **£250m** or **1%** of Total Fund Value
Decision Making	3 stage process with review and satisfactory due diligence by officers, followed by a presentation to the Sounding Board before a proposal is taken to Committee for approval subject to completion of legal documentation.
Monitoring	Includes individual investment reports, participation in advisory boards, and a quarterly DIP monitoring report which is reviewed by the Fund's Investment Advisory Panel.
Co-investment	Existing co-investment programme should be extended in order to maximise its effectiveness, subject to development of a detailed proposal

The following proposal has been assessed using this framework and has been reviewed by the SPF Committee Sounding Board.

2 New Investment Proposal

2.1 Key Terms

Name	NextPower UK ESG Fund
Investment vehicle	English Limited Partnership
Manager	NextEnergy Capital
Sector	Renewable Energy
Investment objective	To generate attractive, long-term, stable cashflows by creating a portfolio of contracted, utility scale, solar PV assets in the UK.
Term	10 years
Target size	£500m (Hard Cap £1bn)
Proposed DIP investment	£60m
Target return	7-9% IRR (Net) / Yield 4.5%-6.5% p.a.

2.2 Investment Summary

NextEnergy Capital (NEC) is a leading asset manager in the ground-mounted solar PV (photovoltaic) market both in the UK and also in overseas markets such as Italy, US, Spain, Portugal, India, Chile and the USA.

NEC has one of the leading solar investment teams in the UK, a tried and tested investment process and considerable experience in delivering projects that generate strong and relatively stable long-term portfolio returns. It has been investing in the UK solar market since 2011 with a current portfolio of over 90 assets mainly in the southern half of the UK, representing 830MW of installed energy generating capacity.

The NextPower UK ESG Fund (NPUK) seeks to provide attractive long term, stable, contracted cashflows to investors by constructing and managing a portfolio of new-build, utility scale, ground-mounted solar PV projects in the UK.

An investment of £60m by DIP in the NextPower UK ESG Fund is proposed.

More information on the Manager is detailed in **Schedule 1.**

2.3 Investment Rationale

2.3.1 UK Renewable Energy (RE) Requirements

In 2019 the UK Government amended the Climate Change Act 2008 to commit the UK to achieving net zero emissions by 2050. The electricity system will be the key to delivering this, both through the ongoing de-carbonisation of the current energy generation mix as well as the anticipated doubling of electricity demand by 2050.

This is partly a result of the fast-increasing market share of electric vehicles as well as the increasing electrification of other sectors such as general transport, industry, property and housing. This is in addition to the increased demand

resulting from population and economic growth and RE will require to supply 80% of the *increased* level of demand to meet the net zero target. To keep on track for 2050, the UK's existing wind and solar generating capacity requires to double in size by 2030.

The rate of development and construction of new RE generating projects suffered a material decline following the ending of the Renewable Obligations subsidy scheme in 2017 for onshore wind and solar assets. New RE projects however are now economically viable without subsidies due to several factors:

- the expansion of the Contracts for Difference (CfD) pricing support and scheme and its availability to onshore wind and solar projects again;
- falling technology costs for solar, wind and battery projects;
- wind and solar now having the lowest unit cost of energy;
- carbon prices rising & fossil fuel generation becoming less competitive;
- increased preference of users for energy from renewable sources; and
- the growing public support for RE.

2.3.2 Fund Strategy

Solar generated electricity offers a reliable and predictable source of power due to the abundant nature and high predictability of annual solar radiation. Its increased prominence in recent years has been a consequence of reduced costs, with the levelised cost of solar energy having reduced by more than 90% since 2009, allowing the sector to mature from a commercial perspective.

NPUK will be launched with 2 operational seed assets located at i) Llanwern (near Newport), currently the largest operational solar farm in the UK with an installed capacity of 75MW; and ii) Strensham (Worcs / 40MW). Both assets will be transferred by NEC into NPUK on its launch at a 15% discount to their respective (and independently validated) market values. These two cornerstone assets will serve to generate immediate cash yield and thereafter the fund will construct a series of fully consented solar projects also acquired from NEC at a discount to their independently appraised market value.

NEC has secured exclusive rights over a sizeable pipeline of projects representing c.1.2GW of capacity (sufficient to employ the fund's £500m target size) with a further 2.1GW of projects under negotiation. The fund will have the ability to invest up to 5% of total assets in the development phase.

The NPUK fund has secured a commitment of up to £250m from the UK Infrastructure Bank (UKIB) on a matched funding basis and has very recently secured a 1st close in the amount of £327m, from the UKIB as well as 4 other institutional investors (3 of which are other LGPS funds/pools).

2.4 Risks

The main risks of the proposed investment in the fund are considered to be:

- Origination Risk
- Development Risk
- Construction Risk
- Price Risk

A summary of investment specific risks and key mitigants is contained in **Schedule 2**.

2.5 Projected Return

The fund is targeting a return of 7%-9% IRR (Net) with an investment yield of between 4.5% and 6.5% p.a. This is considered attractive for a fund seeking to construct and operate solar projects as this segment of the RE sector is generally considered to be at the lower risk/lower return end of the spectrum.

A relatively strong case has been made by NEC to support the achievement of the targeted return. This is based on their highly selective investment diligence process and the track record of outperformance of WiseEnergy (WE), NEC's inhouse asset management division.

WE use technical optimisation; the securing of Power Purchase Agreements (PPAs) with robust counterparties; private wires connecting power generating assets directly with large users (i.e., bypassing the grid); battery storage; asset life extensions; operating cost efficiencies; asset repowering etc. to achieve outperformance. WE have a strong track record in respect of the asset portfolios under their management.

2.6 Exit

NPUT will have a basic term of 10 years comprising a 4-year Investment Period (IP), followed by a holding period of 6 years with up to 3x1 year extensions. Repayment of capital and investment returns are expected from asset sales when they have developed operating track records and have the benefit of long term PPA's.

2.7 Fees

The Management Fee is in line with DIP's current portfolio of RE investments and also of DIP's experience of the current market. The fee will be calculated on total commitments during the IP and thereafter on the invested capital, which is in line with market practice. SPF will benefit from a modest discount in the management fee based on the amount (>£50m) of the proposed investment.

Carried interest provisions also apply. These are structured such that NextEnergy, as manager require to perform strongly before they benefit under these provisions.

The fee structure for the NPUK fund is in line with DIP's experience for a fund of this nature in the RE sector and is therefore considered acceptable.

2.8 ESG and Impact

DIP's RE investments make a positive impact by generating significant amounts of clean energy and thus reducing carbon emissions. RE is a key element in the transition to a low carbon economy and DIP is an important part of SPF's climate change strategy.

NPUK is expected to provide between 1GW and 2GW of generating capacity. Much of the portfolio pipeline is already secured.

In addition, NEC's investment appraisal and asset management processes are heavily influenced by consideration of ESG factors, biodiversity and community engagement under the responsibility of Giulio Guidi, NEC's Group Head of ESG and who will sit on NPUK's Investment Committee.

More information on the Manager's approach to ESG and Impact is included in **Schedule 3.**

2.9 Investment Size and Cash Requirements

SPF Fund value at 30th June 2022	£26,818m
DIP allocation (target 5% of main fund) NAV	£ 1,341m
Current DIP NAV	£ 1,219m
Headroom v NAV	**£ 122m**

2.10 Investment Strategy

The proposed investment falls within the Infrastructure / Renewable Energy sector and therefore the Fund's long term enhanced yield allocation (LTEY).

Allocations following this investment, based on Fund values at 30th June 2022 and total DIP commitments to LTEY, would be as follows:

Infrastructure / Renewable Energy, £ in DIP	£1,072m
Infrastructure / Renewable Energy, % in DIP	59%
Infrastructure / Renewable Energy, % of Total Fund	4.0%
LTEY, % Total Fund (target 20%)	19.2%

3 Policy and Resource Implications

Resource Implications:

Financial: Investment of £60m to be drawn as required. Fee structure is in line with market.

Legal: The investment will be subject to satisfactory completion of due diligence, including review and execution of appropriate legal documentation.

Personnel: None.

Procurement: None.

Council Strategic Plan: Strathclyde Pension Fund aligns with the theme of a well governed city.

Equality and Socio-Economic Impacts:

Does the proposal support the Council's Equality Outcomes 2021-25? Please specify.	Equalities issues are addressed in the Fund's responsible investment policy.
What are the potential equality impacts as a result of this report?	No specific impact from this proposal.
Please highlight if the policy/proposal will help address socio-economic disadvantage.	No specific impact from this proposal.

Climate Impacts:

Does the proposal support any Climate Plan actions? Please specify:	NextEnergy has been a signatory to the PRI (UN-supported Principles for Responsible Investment) since 2016. This is consistent with Strathclyde Pension Fund's Climate Change strategy, which is being developed in line with Item 34 of the Council's Climate Action Plan.
What are the potential climate impacts as a result of this proposal?	A meaningful contribution to the additional RE generating capacity required for the UK to become net zero by 2050.
Will the proposal contribute to Glasgow's net zero carbon target?	Yes, through the development and construction of 1GW to 2GW of additional RE generating capacity across the UK, including potentially in Scotland.
Privacy and Data Protection Impacts:	To be fully provided for in the legal documentation for the proposed investment.

4 Recommendations

The Committee is asked to **APPROVE** an investment of £60m in NextPower UK ESG Fund by the Direct Impact Portfolio.

Schedule 1

Investment Manager: NextEnergy Capital

Founded in 2007 by current CEO Michael Bonte-Friedheim, the NextEnergy Capital Group (NEC) is a leading international investment and asset manager exclusively focused on the solar PV sector. It has 200 employees spread across 6 locations in London, Milan, Hyderabad, Madrid, USA and Chile.

Since its inception NEC has developed or acquired c.325 solar assets and currently manages c.US$3.2bn in assets under management (AUM), representing over 2.4GW of total generating capacity across its private and public institutional funds.

NEC is the investment manager of NextEnergy Solar Fund (NESF) which is listed on the London Stock Exchange. NESF is one of the largest listed solar infrastructure companies in the world with 99 operational assets, all but 8 of which are located in the UK (the remainder are in Italy) and net assets of £615m (Dec 2021). The 91 UK assets represent 865MW of installed capacity, including 280MW in the post-subsidy era.

NEC was the manager for the €232m private solar fund, NextPower II which sought to consolidate and optimize the highly fragmented Italian solar market, becoming one of the 10 largest solar asset owners in Italy with 105 operating solar assets (149MW) at the time of the portfolio's disposal in January 2022.

NextPower III ESG is a private solar infrastructure fund which has raised US$896m for investment in the international solar sector, mainly to fund the construction and long-term ownership of solar projects. This fund has acquired 42 assets mainly in OECD countries with 852MW of installed capacity.

NEC's asset portfolio benefit from its inhouse asset management arm, WiseEnergy (WE) which provides asset management services in respect of both NEC's assets as well as to third party asset owners. WE has a strong track record of operational outperformance in respect of the assets it manages (c.1,300 solar projects with a total capacity of c.2.2GW and estimated value of c.€4bn).

WE oversees all aspects of the life of the asset from construction to the operational phase from a technical, commercial and financial perspective. It seeks to enhance asset performance through technical improvements, operating cost reductions, asset life extensions, a commitment to innovation and a proprietary technology platform which generates high quality data remotely.

Finally, NEC's project development division, Starlight, focuses on the development phase of solar and battery projects. Through Starlight, the NEC group has developed over 100 utility scale projects both within the UK and internationally and continues to progress a strong pipeline of development projects.

Schedule 2

Investment Specific Risks

Origination Risk
NextEnergy are highly experienced investors in the solar PV sector, with a long track record of operating in the UK market. They currently have secured off-market access to sufficient numbers of opportunities to deploy approximately the entire target fund size, with numerous earlier stage opportunities in negotiation behind these.

As is natural in these situations, some of these opportunities will fall by the wayside, however the strength of their investment pipeline is such that the origination risk is considered to be relatively low.

Development Risk
This is the risk that the contracts, planning and permit/licensing approvals required for a project to proceed are not obtained or are subject to conditions which make the project unviable. This could include planning, grid connection or lease issues.

The fund will be restricted to a maximum of 5% of commitments being exposed to development risk and this, together with NEC's experience in developing asset opportunities means that the development risk is also considered relatively low.

Construction Risk
Construction risk is the risk that projects will be subject to cost overruns or delays in the construction phase of projects. NEC will seek to ensure that all construction contracts are fixed price (or capped) in order to pass the majority of the risk to the contractor and they have an extensive track record of successfully managing construction projects.

Price Risk
NEC have a dedicated team focusing on ensuring that the electricity generated by their managed solar assets is subject to robust, long term, fixed price and/or index linked PPAs (Power Purchase Agreements or contracts to supply the electricity generated) with strong counterparties (i.e. electricity users/buyers).

These PPAs provide increased security and stability of revenue for the fund from corporate or power sector utility buyers (or "offtakers") which is expected to reduce the potential volatility of energy prices (and therefore fund revenues), as currently seen in the general market and over the past couple of years.

Schedule 3

ESG and Impact

NEC believes that identifying and accounting for ESG performance improves the risk characteristics of its assets and its longer-term investment returns, making ESG integration a source of innovation and competitive advantage for its core business. It is committed to generating economic value in a way that also benefits society, by both addressing its challenges and safeguarding and accelerating the transition to a low carbon economy.

NEC's Sustainable Investment Policy defines its approach to ESG risk, the principles and standards it abides by and the process by which ESG factors are integrated into its investment and asset management processes, from the initial investment screening stage, through negotiation and monitoring over the life cycle of the asset. The policy is available on NEC's website and is reviewed regularly by the Head of ESG (Giulia Guidi) and the firm's leadership team.

NEC is committed to measuring, managing and reporting its contribution to sustainable development in general and to the UN Sustainable Development Goals in particular in terms of land use and management, the protection of biodiversity and ecosystems and respect for human rights across the value chain.

The Green Investment Group, an independent ESG consultant will be appointed to provide transparency and investor reporting on NPUK's investment activities.

NEC has been a signatory of the UN PRI (Principles of Responsible Investment) since July 2016, is a member of the Institutional Investors Group on Climate Change (IIGCC) and has adopted the recommendations of the Task Force on Climate Related Financial Disclosures (TCFD).

Finally, NEC is the founder and principal funder of the NextEnergy Foundation, an international charity which acts to provide energy and light from RE sources to underserved regions, and to benefit the local communities in which it is present. NEC pledges at least 5% of its net profits to the Foundation annually and grants totalling c.£715,000 have to date been awarded to projects in 26 countries.