

**REPORT TO: SUPERANNUATION INVESTMENT SUB-COMMITTEE  
OF THE FINANCE COMMITTEE - 19 MAY 2004**

**REPORT ON: SOCIALLY RESPONSIBLE INVESTMENT - SIX MONTHLY REPORT**

**REPORT BY: DEPUTE CHIEF EXECUTIVE (FINANCE)**

**REPORT NO: 393-2004**

**1 PURPOSE OF REPORT**

This report reviews the progress by the Fund Managers regarding the positive engagement strategy approved by the Sub-Committee on 23 February 2000.

**2 RECOMMENDATIONS**

The Sub-Committee is asked to note the information contained within this report with regard to the activities of the Fund Managers during the six month period ended 31 March 2004.

**3 FINANCIAL IMPLICATIONS**

There are no financial implications.

**4 LOCAL AGENDA 21 IMPLICATIONS**

As part of the Fund's policy on Socially Responsible Investment, its investment managers are required to engage with companies on matters of social responsibility including Sustainability and the Environment.

**5 EQUAL OPPORTUNITIES IMPLICATIONS**

The Fund's Socially Responsible Investment policy requires investment managers to engage with companies regarding their performance in relation to Employee Care and Human Rights.

**6 INTRODUCTION**

On 23 February 2000 the Sub-Committee approved a report prepared by Hymans Robertson, the Fund's consultants that the Fund should adopt a strategy of positive engagement with the companies in which it invests. The four action areas were identified as Employee Care, Human Rights, Sustainability and the Environment. This report reviews how the individual Fund Managers have implemented this.

**7 ALLIANCE BERNSTEIN**

A summary of engagement activity over the last six months is shown at Appendix 1.

**8 BAILLIE GIFFORD**

Baillie Gifford are reviewing their voting procedures to ensure all votes are cast as intended. This is in response to recommendations made by Paul Myners in "Review of the impediments to voting UK shares".

A summary of recent engagement activity is shown at Appendix 2.

9 **FIDELITY**

Fidelity's policy and recent activity are shown in Appendix 3.

10 **OVERALL CONCLUSION**

The submissions by the Fund Managers continue to show that they are devoting significant resources to this area and by allowing each to use its own means of targeting companies the Fund has been able to address a wide range of issues.

The "Review of the impediments to voting UK shares" has indicated some obstacles to managers being able to ensure all their votes are cast correctly. It is expected that this will lead to improvements to ensure manager votes support their engagement activities.

11 **BACKGROUND PAPERS**

No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above Report.

**DAVID K DORWARD**  
**DEPUTE CHIEF EXECUTIVE (FINANCE)**

**12 MAY 2004**

**ALLIANCE BERNSTEIN  
ENGAGEMENT ACTIVITY**

Stocks	Meeting attended by	Subjects Discussed	Outcome
Enterprise Inns	Legal Counsel	Stakeholder Issues	Discussed steps to formalise arrangements with employees and tenants. They communicated their health and safety code, policies on equal opportunity and diversity and a code of practice that sets out the relationship between them and their tenants.
BP	Executives in Corporate Responsibility & Social Policy Department	Safety / Products	Initiated and is now implementing all 72 recommendations from action team on Alaska safety. Continuous improvements in LTI frequency over 19 years. Bernstein to receive periodic updates on specific areas e.g. BTC, Tangguh.
Rexam	Director of Corporate Communications	Environment / Human Rights / Corporate Governance	Meets the new FTSE4Good environmental and human rights requirements. Constantly reviewing their policies with regards to social, environmental and ethical issues. They are in the process of compiling a formal "Code of Conduct" under which all their policies on these issues will fall.
Unilever	Executives in the Environmental and Social Activities Department	Refrigerant Usage	Continue to progressively eliminate the use of refrigerants that cause ozone depletion or contribute to global warming. At the end of 2002, 75% of their 1.6 million cabinets were HFC based and this proportion is growing rapidly as their old ozone depleting cabinets are replaced.
Kelda Group	Kevin Whiteman (CEO)	Environment / Safety	They have reduced pollution incidents by over 85% in last five years. No environmental incidents during 2003 as of 9 December. Of the 7 incidents in 2002, 4 were caused by blocked sewers, some of which were caused by vandalism. They will continue to allocate capital in the next review period to security against vandalism.

Stocks	Meeting attended by	Subjects Discussed	Outcome
Barratt Development	Management	Areas in which Barratt lagged current standards	The firm plans to: outline its bribery & corruption policy upon release of fiscal year results in a report to be entitled "Corporate Responsibility"; increase the number of non-executive and independent directors on its board (absolute numbers and percentages) but does not want to move "too quickly"; publish, for the first time, a report titled "Report on Environment, Community and the Workplace" this September 2004; and again publish its record and policies on safety standards its subcontractors have to abide by.
Pearson	CEO Marjorie Scardino and CFO Roan Fairhead	Deficiencies in the composition of their board	CEO made it very clear she considers both of Pearson's non-executive directors who have been on the board for more than ten years (Vernon Sankey and Reuben Mark) to be independent. For a start, both directors have no financial relationship with the company (beyond payments for acting as a director). Marjorie believes that the true definition of an 'independent' director encompasses this US definition, but also involves a willingness and an ability to challenge the executive directors when required. Because Vernon Sankey and Reuben Marks are viewed as willing and able to effectively challenge the executive directors when they feel it is required, both are regarded as truly "independent." Pearson has, therefore, elected not to comply with the Higgs Code on this point, but, instead, to explain its position.
Unilever	Investor Relations	Labour practices in hybrid cottonseed production in India	A report commissioned by the India Committee of the Netherlands (ICN) published in May 2003 made allegations that multinational companies, including Hindustan Lever Limited (HLL), were exploiting child labour on cottonseed farms in India. HLL views the allegations as extremely serious and substantially unfounded. HLL made clear that there is no child bonded labour in the workforce of HLL; the company observes a strict minimum working age of 18 years, well above the statutory minimum age in India, and there is no evidence whatsoever that this has been breached. HLL was adamant in its opposition to child labour and supports ILO Convention 138 on the Minimum Age for Admission to Employment.

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## Company Engagement

In addition, the company is endeavouring to set up a human rights ombudsman.

In summary, despite the recent concerns regarding the paint coating, the company appears to be managing its SEE risks effectively by working with the independent panel set up to oversee the BTC project, the Caspian Development Advisory Panel (CDAP). Also, we are encouraged by the Group CEO's reply to our letter dated 5th February 2004 in which the company outlined how it intends to respond to the CDAP's recommendations.

### Carnival

We met the joint Chairman/Chief Executive Officer (CEO), the Vice Chairman and the senior non-executive director (NED) to discuss board structure and executive remuneration. The company's board and remuneration structure is indicative of a large US company. Firstly, the company combines the chairman and CEO role. The company believes that any risk to shareholders from the combination of the two roles is offset by the Presiding Director who essentially acts as the Chairman on many issues. For example the independent NEDs annually elect and report to the Presiding Director, which provides appropriate balance. The company believes that splitting the roles can lead to uncertainty in the reporting line. Secondly, we discussed the company's current executive remuneration structure. This is a complex issue because there are both tax and pension issues to consider. The company is currently reviewing its group-wide policies. Its aim is to create a simple structure and to introduce performance targets, recognised as best practice in the UK but uncommon in the US. Thirdly, we discussed the independence of the NEDs. The company's concern is that its most experienced NEDs are now considered 'non-independent' according to the revised Combined Code in the UK

### BP

We met BP's Social Performance Manager, Sustainable Development Director, and Chief Executive of the Baku-Tbilisi-Ceyhan (BTC) Company to get an update on the social, ethical and environmental issues facing the BTC pipeline. The pipeline will be completed in about 12 months time with oil expected to flow through the pipeline in the first part of 2005. Firstly, we discussed the recent Sunday Times article which alleged that BP would have to dig up the pipeline, at a cost of US\$ 1 billion, because of problems with the paint coating to seal the joints. The article also accused BP of failing to disclose the safety design fault to the UK government prior to receiving a key export credit guarantee loan to underwrite the project. The CEO of the BTC Company highlighted that the safety issues alluded to by the Press related to problems with the paint curing as a result of the low temperatures in Azerbaijan and Georgia. However, the company has found a simple solution to the problem and will perform resistance testing on the pipeline before it goes into the ground and corrosion testing throughout its life. Therefore, the delays will have no impact on the timetable.

Secondly, we discussed the company's dialogue with the Non-Governmental Organisations (NGOs). The World Wildlife Fund (WWF) alleges that the company failed to consult them properly on the BTC pipeline. The company disagrees with the WWF's views and highlighted that BP's work with Amnesty International was an example of constructive engagement with an NGO. In conjunction with Amnesty International the company has amended its Host Government Agreements with Azerbaijan, Georgia and Turkey, which clarifies its position with regards to human rights issues. In

## Company Engagement

because their tenure exceeds nine years. Removing these NEDs from the board would result in the loss of experienced directors that are difficult to replace. Nevertheless, the company is searching for new NEDs who will eventually replace the existing NEDs.

In summary, this is an evolving period for the company after the completion of the merger in April 2003. Although some aspects of the company's corporate governance do not meet UK best practice, the board acknowledges that UK shareholders own 40% of the company's free float and will consider their views, including those of Baillie Gifford, in its forthcoming executive remuneration review. We believe that it would be counterproductive to vote against the re-election of the NEDs because continuity of experience from the NEDs is important for the newly combined company.

### **Pfizer (US)**

We met the company's Head of Corporate Governance and Senior Vice President of Corporate Affairs to discuss corporate governance. Like most US companies, Pfizer has a combined Chairman and Chief Executive Officer (CEO). Although the board continues to debate the pros and cons of splitting the roles, it believes that the current structure is in the best interests of shareholders. For example, Pfizer has a Presiding Director and all of its non-executive directors (NEDs) are independent. The board meet regularly with institutional shareholders without the presence of the Chairman/CEO. On measuring the performance of the NEDs, the company has a robust evaluation policy in which the nominations committee assess the contribution of the NEDs. We discussed internal controls. Under the Sarbanes-Oxley Act in the US, companies are required to establish a whistle blowing function for financial matters within the audit committee. Pfizer has had a

hot line for fifteen years and any problems are reported straight to the audit committee.

In summary, the key corporate governance issue at the company is the combined role of Chairman/CEO. Since our meeting, we have seen Disney decide to split the role following shareholder pressure and recent discussions by the Council of Institutional Investors (a US organisation of large public, labour funds and corporate pension funds) on this issue. These appear to have increased the pressure on US companies to split the roles. We will continue to monitor events in the US and at Pfizer.

## Socially Responsible Investment Policy

- ◆ Fidelity's primary objective is to produce the best financial returns for our clients.
- ◆ Fidelity recognises and supports the view that social, environmental and ethical best practice should be encouraged as long as the potential for financial return is not reduced. Fidelity believes that, over the long term, sound social, environmental and ethical policies make good business sense.
- ◆ Fidelity's investment process takes social, environmental and ethical issues into account when, in our view, these have a material impact on either investment risks or returns.
- ◆ Fidelity does not screen out companies from our investment universe purely on the grounds of poor social, environmental or ethical records. Instead, we adopt a positive engagement approach, whereby, on behalf of our clients, we discuss these issues with the management of, primarily UK, companies in which we invest, with the aim of improving procedures and attitudes.
- ◆ Fidelity has an active corporate governance policy that seeks to protect the financial interests of our clients and, for UK investments, takes into account the recommendations of the Combined Code of the Hampel Committee.

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## Socially Responsible Investment

Fidelity pursues an active policy of dialogue with UK companies on social, environmental and ethical issues. Our research is supported by independent research from EIRIS (Ethical Investment Research Service). Fidelity seeks to contact companies when there are concerns relating to SRI. We ask them a range of questions relating to these matters. We recently contacted GlaxoSmithKline and BP. Details of some of the feedback that we obtained from each is outlined below.

### GlaxoSmithKline (GSK)

GSK is a world leading research-based pharmaceutical company. We wanted to gain a more detailed understanding of GSK's approach to environment, health and safety (EHS) issues. Our findings are detailed on page 37.

### BP

The firm is the largest non-OPEC oil producer in the world. We met with the company with regards to the following two major projects it was undertaking:

#### **Baku-Ceyhan-Tibilisi (BTC) pipeline**

- ◆ New oil and gas fields in the Caspian region contain significant reserves. BP as part of a consortium is constructing a pipeline to carry oil and another to carry gas from Azerbaijan (Baku) to Turkey (Ceyhan) via Georgia (Tibilisi). From Turkey, tankers will carry the oil to international markets bypassing the congested Bosphorus sea. At the time we saw BP the oil pipeline was 56% complete in terms of the overall work plan.

#### **Tangguh Liquefied Natural Gas (LNG) project**

- ◆ Berau-Bintuni Bay, West Papua, is one of Asia's largest untapped natural gas fields. BP is a majority stakeholder in the Tangguh liquefied natural gas (LNG) project in the bay area. This enterprise involves tapping the Tangguh fields, processing the gas into liquefied natural gas (LNG) and loading it for shipment primarily to East Asian markets.
- ◆ Papua is a location that sets demanding challenges in terms of social and environmental responsibility. It is remote, under-developed and rich in cultural and ecological diversity. Although political tensions appear to be receding, the recent past has witnessed some severe abuses of human rights. Within the Berau/Bintuni vicinity, many people depend on local natural resources like shrimp, fish and sago for their income. A number of companies are already active in the area, and the region has been significantly impacted by their operations.

## Socially Responsible Investment: GlaxoSmithKline

### Environment Health & Safety (EHS) policies and management

The company as a whole has set overall EHS improvements, and then asked individual business divisions what they can do to achieve these aims, rather than imposing top-down targets. So, for example, in trying to reach the overall energy efficiency goals, each site might agree a different target for which they are ultimately responsible. The company has set up a specialised intranet facility that allows individual sites to manage their objectives and provides for the data to be collated at group level. In addition, the system is used to conduct audits. From audit scores, GSK have found that sites with the highest risk profile are the best at managing their targets, while those at the lowest end of the scale have the worst results.

In 2003, the reduction of key EHS risks was a major focal point. Specific objectives included a driver safety programme (a high proportion of lost time injuries are caused by vehicle accidents); the development of tools to manage stress and ergonomics; the assessment of occupational chemical exposure; ensuring site emergency plans are in place and the provision of tools for new product development.

### Products – pharmaceuticals in the environment

Historically, the company has recently addressed the issue of waste disposal from R&D and manufacturing. However, it is now starting to focus on the products themselves as well. This issue is being addressed as a result of concerns that active ingredients, which are not fully consumed and subsequently excreted could build up in the environment. Some of the substances are removed during waste water treatment. However, GSK is looking into this area to see the extent that waste water treatment effectively removes these substances. GSK is also providing related data to authorities in the US and Europe. Pharmaceuticals are not the only manufactured goods to be found in waste water. However, they are easier to target than, for example, nicotine and caffeine as different medications are based on very specific molecules. So far this form of waste water pollution has not been a major issue for GSK. However, management feel that there could be increasing pressure on firms to pay for the costs of removal of toxins from waste water in the future.

### REACH (Registration, Evaluation and Authorisation of Chemicals) regulatory framework

A new EU regulatory framework for chemicals known as REACH (Registration, Evaluation and Authorisation of Chemicals) has been proposed. The rules aim to improve the protection of human health and the environment by putting greater responsibility on industry to manage the risks from chemicals and to provide safety information on the substances. Pharmaceutical compounds themselves are exempt from this. However, as a result of REACH, some substances might have to be withdrawn, including product inputs. This could have a significant effect on the pharmaceutical industry, as drug approvals are based on the manufacturing process as well as the compound itself, and any changes to the method by which a medication is made would need to be re-approved. GSK said that this is a general concern and that no particular product has been highlighted at present. When designing medication, the company currently uses an eco-design process, which it hopes should avoid the use of the more dangerous substances that REACH is seeking to regulate. During GSK's eco-design process, raw inputs such as acids, alkalis etc are colour coded (red, amber, green) depending on their EHS impact, and those carrying the highest potential repercussions (red) are avoided where possible.

## Socially Responsible Investment: BP

### Baku-Ceyhan-Tibilisi (BTC) pipeline

The pipeline is being built by different contractors in each country. The contractor in Azerbaijan, is Consolidated Contractors International Company (CCIC), in Georgia, it is Spie Petrofac JV and in Turkey it is the state pipeline building company, BOTAS. BOTAS has been hired as a contractor on a fixed-price lump sum contract and has sub-contracted the work to four Turkish contractors.

BTC recognise that the resulting health, safety and environmental (HSE) requirements its contractors must meet are numerous and wide ranging and that it is often difficult to disseminate this information to field operations. Consequently, BTC has been obliged to undertake a higher level of supervision than originally thought and has had to stop work several times to ensure compliance with procedures including HSE requirements.

The company has an external panel of four experts: The Caspian Development Advisory Panel (CDAP), which looks at economic, environment and social factors. In its December 2003 report on Turkey, the panel praised BP's efforts to introduce the 'highest international standards' but raised a number of criticisms, particularly with regard to the Turkish contractor BOTAS. These included the unwillingness of BOTAS to implement required standards. The Turkish government also voiced complaints to the panel about BP's insistence on maintaining its environmental, health, and safety standards, suggesting that a relaxation of these would better enable BOTAS to complete construction on time and under budget.

### Tangguh Liquefied Natural Gas (LNG) project

BP was working on the pre-construction phase of this project. The company outlined a number of key issues for the scheme.

**Security and human rights:** There have been a number of human rights violations in the area. This has influenced, BP's decision to set up a community-based security guard firm. At the time we saw BP, they had recruited 110 security guards from the region, 50 from the bay itself. These recruits were being trained in technical aspects as well as issues like human rights.

**Prospect of migrants to the area:** The influx of people to the region, is an area of concern and BP are taking a number of measures to mitigate this. Recruitment is all being undertaken at other locations to try and prevent people travelling to the area to look for a job. Remuneration will be made in local towns rather than on site. Workers will undertake 2-3 week shifts, and will not be allowed to bring their families with them. General site access will also be limited.

**Environment, health and safety:** Although the fields are mainly gas, there are specific safety issues relating to liquidification. In terms of the environment, water quality and the impact on the mangroves are key issues. One of the other challenges is the need to manage any adverse effect on the local fishing industry.

**Social impacts:** BTC is looking at a number of areas in order to address its social impacts. These include undertaking community development programs, setting up a bay community forum, the provision of community-based security and helping to manage its fiscal impact. One of the local villages, Tanah Merah, was being relocated to allow the LNG plant to be built. The new site chosen by the villagers, is only 3km away from its current location and within the same tribal area. The building was done by BP contractors, who have trained some local people in areas such as electric and maintenance as well as general training on areas such as use of latrines and power. In line with BP's policy, the villagers will be better off financially than they were at the old site. BP conducts community workshops year with each village directly affected by its operations. Four villages are also receiving \$50,000 each year for local improvements, of their choice.

TAYSIDE SUPERANNUATION FUND

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