REPORT TO: **SUPERANNUATION INVESTMENT SUB-COMMITTEE OF THE POLICY AND RESOURCES COMMITTEE - 17 NOVEMBER 2008**

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

REPORT BY: **HEAD OF FINANCE**

REPORT NO: **555-2008**

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 30 September 2008.

3 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.

4 ALLIANCE BERNSTEIN

Alliance Bernstein's latest activity is shown at Appendix 1.

5 BAILLIE GIFFORD

A summary of recent engagement activity is shown at Appendix 2. This shows the wide range of topics covered and the diversity of companies approached. In addition Baillie Gifford are a signatory to the United Nations Principles for Responsible Investing and report that they are in the top 25% of investment managers in most areas.

6 FIDELITY

At Appendix 3, Fidelity have identified the specific issue of Energy Efficiency and the effect this can have on investment values.

7 OVERALL CONCLUSION

The managers have continued to demonstrate a commitment to this activity and have addressed a wide variety of issues with companies.

8 POLICY IMPLICATIONS

This Report has been screened for any policy implications in respect of Sustainability, Strategic Environmental Assessment, Anti-Poverty, Equality Impact Assessment and Risk Management.

The Fund's policy on Socially Responsible Investment requires its investment managers to engage with companies on Sustainability and the Environment and Employee Care and Human Rights.

9 CONSULTATIONS

The Chief Executive, Depute Chief Executive (Support Services) and Depute Chief Executive (Finance) have been consulted in the preparation of this report.

10 BACKGROUND PAPERS

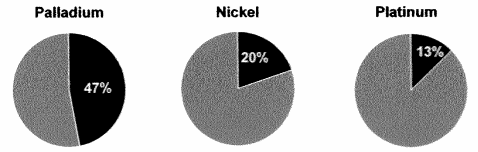
None.

MARJORY M STEWART
HEAD OF FINANCE **11 NOVEMBER 2008**

ESG Research Example: Norilsk Nickel

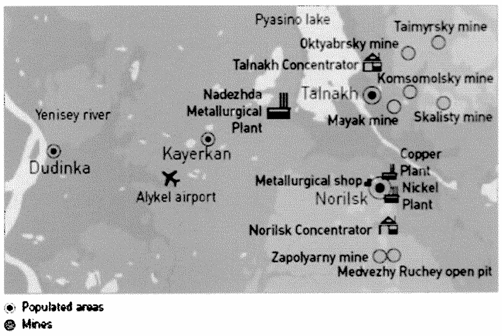
- Norilsk Nickel is a leading low-cost producer of key metals

Global Market Share: 2008E



- Its original mines and smelting operations are located in Northern Russia around the city of Norilsk

Polar Division Operations



Source: http://www.nornik.ru/en/our_products/polar_divisions/; Bernstein

ESG Research Example: Norilsk Nickel

- A legacy of Soviet-era mismanagement, the Norilsk region is one of the most polluted in the world, and Norilsk Nickel's operations have historically been a prime cause

Environmental Concerns

- Elevated contaminants in soils up to 60 km away
- Two million tons of sulphur dioxide released into the air annually
- Life expectancy of factory workers is 10 years below the Russian average

- Prior to investing, we investigated their environmental practices and concluded that the company is committed to improving its environmental performance. We have encouraged the company to continue this trend

Due Diligence

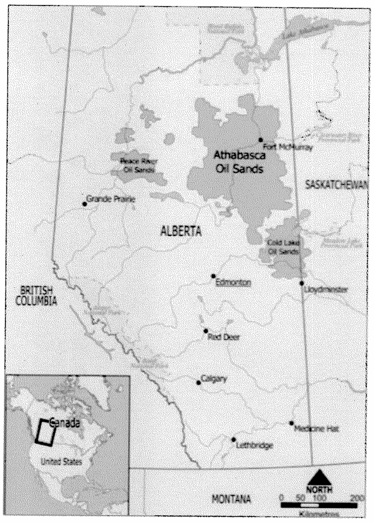
- Met Norilsk Nickel management and key shareholders
- Company is making significant efforts to reduce emissions by 2012
- Death rates are decreasing

Source: Blacksmith Institute; Bernstein

ESG Research Example: Petro Canada

- Alberta, Canada, has a large deposit of oil-rich bitumen (extremely heavy crude oil)
- The oil-sands deposits cover 54,000 square miles (141,000 square kilometres) and contain 1.7 trillion barrels of bitumen
- Surface mining could disturb wildlife habitats, leave toxic waste and, without mitigation, release carbon into the atmosphere

North West Territories: Oil-Sands Deposit

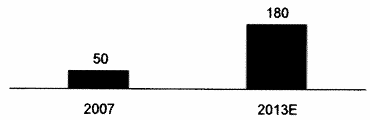


Source: Bernstein

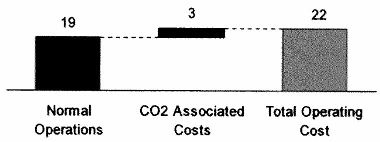
ESG Research Example: Petro Canada

- Petro Canada* is well positioned to exploit Canadian oil sands
- We have assessed current and expected regulatory impacts and the resulting CO_2 mitigation costs
- Petro Canada remains attractive when mitigation costs are included

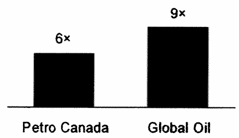
Petro Canada Oil Sands Production:
Thousands of Barrels per Day After Royalty



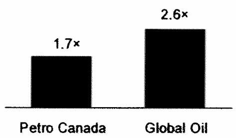
Operating Expense per Barrel: In US$**



2008 Price/Earnings***



2008 Price/Book***



*Includes Syncrude
**Excluding natural gas costs; real dollars
***July 25, 2008
Source: Bernstein

Aggreko

Aggreko is a power rental business which provides solutions to customers who need power, temperature control, or oil-free compressed air, either very quickly, or for a short period of time. We met the CEO in August and discussed the company's nomination and succession planning processes. While the business is headquartered in Glasgow and its finance function is based there, it operates from many locations globally. The CEO talked us through the nomination process that the company used recently in the search for two new independent non-executive directors; one has been the group financial director at WS Atkins for a number of years, and is a chartered accountant, while the other is the Chairman and CEO of Akzo Nobel and ICI, respectively. Both directors have substantial experience gained through working in global companies similar to Aggreko. We are reassured by the company's nomination procedures as they have recruited the non-executive directors with relevant skills and experience, which is particularly important as the company grows.

Brambles Limited

Brambles is an industrial services company with operations in Australia, Europe and North America. For growth businesses like Brambles, implementing incentive schemes which reward management for achieving sustainable profit growth is vital. We had a conference call with the Chairman of the Remuneration Committee (Remcom) to discuss the company's revised remuneration schemes. We reiterated our concerns to the Remcom about the problems associated with incentivising management to increase revenue growth at the expense of capital efficiency. This was a significant problem 6 or 7 years ago when management within CHEP Europe's pallet business were incentivised to run the business inefficiently by building new pallets to boost revenue instead of repairing old pallets. However, since then a new Chief Executive and management team have been appointed which has helped to turn the business around. As part of the remuneration proposals, the Remcom has incorporated the Brambles Value Added hurdle, which is their capital performance measure, into the long term incentive schemes. This ensures that management will only be rewarded for top line revenue growth which exceeds a capital performance hurdle. We welcome the remuneration proposals: it supports the company's accelerating growth strategy and its recent board and business restructuring, increases the focus and line of sight for executives, and is better aligned with shareholder interests.

GlaxoSmithKline

We attended a meeting with the Head of Corporate Responsibility as part of the company's annual corporate responsibility (CR) discussion with investors. We had already met GSK several times and consider them to be aligned with best practice in the pharmaceutical sector. However, this was an interesting meeting because it was our first opportunity to discuss the impact the CEO, appointed in October 2007, is having on the business and specifically CR activities. A new CEO often provides a renewed focus or a change of priorities. At GSK, he has made a commitment to improve transparency with regard to business processes, strategy and corporate policies with the expectation that this will create greater trust between the company and its stakeholders, including shareholders. We are currently at an early point in the process but we are keen to measure the impact this change of focus will have over the medium term.

Keppel Corporation

Keppel Corporation is a Singaporean company with operations in the real property investment, offshore and marine, and infrastructure sectors. We had a conference call to discuss its approach to corporate governance and environmental and social issues. We were keen to have the discussion because its governance structures are equivalent to western governance practices. Although there are no publicly available social or environmental policies, we were impressed by the company's documents which show the degree to which environmental concerns appear to be integrated into its current and future growth plans.

During discussions with the Group Controller, we discovered that, in the offshore and marine business, the company works with its customers to incorporate environmental and safety features into its designs. This helps to reduce energy use and emissions from the platforms and minimise the risk of injuries and oil or chemical spills. The property and infrastructure businesses are involved in several projects which should contribute to their long term sustainability from a financial rather than solely a corporate reputational perspective. The company is responding to developing environmental themes by focusing on creating more energy efficient buildings - both residential and commercial. It is also enhancing skills and resources in the water reuse and waste management sectors; water recycling and reuse being important in water-scarce regions and waste as an input for either fertilisers or incineration for electricity generation. In addition, it is involved in a joint venture to build an Eco-City in China which should provide valuable lessons for the business which will be beneficial for future projects, particularly if we assume improved energy and resource efficiency is likely to become increasingly important in the emerging as well as developed markets.

Lonmin

Lonmin, a South African platinum mining company, has had a number of operational difficulties which have resulted in production downgrades and two profits warnings in the last 12 months. In addition to the discussions the UK investment team were having with the management, the Corporate Governance team met the company to discuss corporate governance, environmental and social (ESG) management structures. Particularly relevant for mining companies is the ability to effectively manage the wide range of ESG issues considered important for sustaining a competitive advantage as environmental and social regulations are strengthened and media and NGO scrutiny increases.

One of our concerns is the fact that the company has its head office in London although its operations are in South Africa. In addition, there has been significant turnover of middle management in the last couple of years and levels of absenteeism are higher than industry averages. However, environmental, health and safety performance indicators are currently on a par with industry peers and continuing to improve.

We had wide ranging discussions with representatives from the London and South African offices. In addition to recruiting new senior employees, the company is implementing management policies and procedures which should be positive for operational performance. We acknowledge these steps which ought to lead to some improvement, and will continue to review delivery.

Orascom Construction Industries

Based in Egypt, Orascom Construction Industries is one of the leading construction companies in the Middle East and has recently moved part of its business from cement production to fertiliser manufacturing. As it has significant subsidiaries in the US and Europe and aspirations to be classed as a leading global operator, we were interested to learn more about the company's management of environmental, social and governance (ESG) risks. There are greater ESG expectations associated with being a global operator as opposed to an emerging market operator.

In a detailed conversation with an Investor Relations manager it quickly became clear that this is a company that is highly regarded on home ground with leading employee scholarship and training programmes that are emulated by other companies. This is most encouraging given that recruiting and retaining skilled engineers is one of the key risks to the business. We encouraged the company to increase the detail in its disclosure of ESG management to substantiate the currently implied high standards of safety and environmental performance. With the previous CFO now championing corporate responsibility activities within the company, we will monitor with interest the anticipated progress as Orascom develops its ESG processes and reporting.

Petrobras

Petrobras is a Brazilian based oil & gas company, considered to be a world leader in the development of advanced technology from deepwater and ultra-deepwater oil production. As it is one of the largest companies in the world, we expect Petrobras to have comprehensive systems in place to manage its wide range of social and environmental impacts. Following a meeting with a co-ordinator for sustainability issues, investor relations and a representative from the Health, Safety and Environment team, we were impressed with the proactive approach the company is taking. The company has an established comprehensive management system and already reports on environmental and social issues, meaning it is able to focus its energy on forward looking strategies. These include extracting value from technologies and R&D, developing the employee skills base and transferring knowledge, as well as assessing carbon risks and becoming a world class oil & gas operator. We continue to have some concerns regarding the health and safety performance of contractors working for Petrobras and encouraged the company to tackle this more vigorously.

From a governance perspective, a board evaluation committee has recently been set up to 'evaluate performance in a more objective way' and focus on succession planning. However, perhaps not surprisingly, investor relations were unable to elaborate on the results of the board evaluation. Nevertheless, board members, who include ministers of state and well known executives from the private sector, do have international experience which is important in light of the company's long term strategic plan.

Overall, Petrobras appears well governed and, on environmental, social and governance issues, is transparent and willing to engage openly with foreign investors.

Rolls-Royce Group

Corporate governance and environmental considerations are integral components of Rolls Royce's business. We met the Company Secretary to discuss two key points.

Firstly, because the company is central to the UK's national defence, there is a limit on the size of holding a foreign shareholder can have. In addition, the UK Government has a Special Share which allows it to have a say on disposals as well as on the nationality of directors. This is obviously not a usual arrangement for a UK listed company.

Secondly, as a provider of power systems and services for use on land, at sea and in the air, operating in four global markets (civil aerospace, defence aerospace, marine and energy), environmental performance including fuel efficiency, noise pollution, and exhaust emissions generally, are priorities for its customers.

We have been aware of the governance matter for some time and accept that it is a consequence of what the company is and does. We do not believe there are any negative consequences and understand the rationale for the Special Share.

Although the environmental performance of the company and the integration of environmental criteria into R&D and technology development is a 'must have' for its customers, we were still very impressed with the commitment and level of disclosure offered by the company. Environmental performance of its products will continue to receive increased scrutiny. We believe that as a high-technology company, it is well positioned to respond as environmental expectations and pressures increase and diversify.

Sina Corp

There are occasions when we speak to a company before its AGM either because we have concerns about a resolution or because the company wants to articulate its position in regard to a resolution. Sina Corp at its AGM in October 2008 had a resolution on the agenda to approve amendments to the Articles of Association. A number of the amendments were purely technical in nature and therefore neutral in terms of impact, although some were positive for shareholder rights and two combined to be an anti-takeover device. Anti-takeover devices effectively act to the advantage of management and not in the best interests of shareholders in a hostile takeover situation.

Sina Corp is a company which has exposure to the Chinese IT market and so the potential for it to become an acquisition target is relatively high and significant to the investment case. The company was unable to provide a satisfactory explanation for this request and so, despite some positive amendments to the Articles of Association, we opposed the resolution to approve the changes. Our engagement with the company will continue, in order to encourage improved shareholder protection and a move towards best practice.

Vodafone Group

As a high profile FTSE 100 company, Vodafone is expected to have good quality corporate responsibility (CR). Following a review of the most recent corporate reports, we felt there was a lack of consistency in the messages being given to investors and other stakeholders on issues such as gaining customers trust, climate change and the growth of business in emerging markets. At a meeting with the Director of CR, the Head of CR Performance and Reporting, and investor relations, it became clear that there had been a lapse in the co-ordination of the reporting rather than a failure to integrate CR activities into the business, as Vodafone claims. Indeed, Vodafone appears to have a good understanding of how various environmental, social and governance issues can impact the business and was able to demonstrate how short-term commercial gains had been sacrificed in favour of the long-term sustainability of the company. Examples of this include developing relationships with landlords rather than seeking short-term cost savings by outsourcing the location of masts, and the decision to withdraw from a high revenue generating gambling service on Vodafone Live in Greece in favour of preserving the reputation of the brand as a responsible operator.

We think the investments Vodafone has made in recent years in developing its CR activities will support the success of the business over the long term. We will continue to monitor the company's performance in this area, in particular its communication of the value of its CR management.

Appendix Corporate Social Responsibility Report - Q3 2008

Issue: Energy Efficiency (EE) – The Invisible Powerhouse

Overview:

This quarter our CSR Analyst undertook an in-depth look at Energy Efficiency (EE). The output of this work was an Industry Review (IR) on cross-sectoral investment opportunities in EE, which was presented to Fidelity's investment teams in Europe and North America. The IR was led by our CSR Analyst, but included input from Fidelity's Equity Analysts covering Steel, Oil, Autos & Parts, Chemicals, Industrials and Capital Goods.

Industry Review (IR):

Unless there is a concerted shift in energy policy and consumption, global energy demand is set to double over the next 20 years. This will not only make efforts to combat Climate Change even more challenging but also impose significant costs on the world economy, businesses and consumers in an era of historically high energy prices. Accelerating energy efficiency improvements is a crucial challenge for Energy and Climate Change policies.

Our analysis shows there is substantial scope for improving energy efficiency (EE) based on existing technology and in a cost-effective way that offers investors attractive returns. EE is the most cost-effective way to reduce global greenhouse gas emissions (GHG). Moreover, it can help avoid investment in energy infrastructure that would otherwise be needed to keep pace with accelerating demand. The International Energy Agency (IEA) estimates that on average, an additional $1 spent on more efficient electrical equipment, appliances and buildings avoids more than $2 in investment in electricity supply.

As the world economy has shifted away from industry and toward less energy-intensive service industries, consumers are increasingly the driving force of energy consumption. Standards and labelling requirements introduced by Governments have been shown to be an effective, low-cost way to coordinate a consumer transition to more efficient appliances. It is difficult to quantify market size because it is in its infancy, but clearly there is an upside for capital goods companies that are developing many of the energy efficiency solutions. Philips was highlighted as a company that will benefit from the move in Europe and elsewhere towards mandatory lighting efficiency standards. Another factor affecting energy consumption is automobile usage. The use of cars in developing countries is expected to increase as they move up the economic growth curve. This will put significant strain on worldwide petroleum supplies. The short-term focus is expected to result in the development of economy standards to reduce demand, which will benefit auto suppliers with solutions in this area, such as Continental, Elringklinger, Valeo, Michelin and GKN. We can also expect to see significant investment in railroad infrastructure around the globe, presenting attractive revenue growth prospects for Delachaux, Faiveley, Ansaldo and Vossloh.

There is a pressing need to find ways to decouple energy use and CO2 emissions from economic growth. The rapid acceleration of economic growth in developing countries is estimated to be one of the major causes of increased energy demand over the next 15 years. The world's leading CO2 emitters are currently the US and Europe. However by 2010, (indeed many have argued it has already occurred), China will have overtaken both as the world's leading CO2 emitter and by 2020 will account for 24 percent of global CO2 emissions. At the same time, global CO2 emissions will grow more quickly than global energy demand because of a shift to a more CO2-intensive fuel mix, notably coal-intensive power generation in these developing economies. The story is, however, quite different in per-capita terms. China will emit around 6 metric tonnes per inhabitant by 2020, compared with 20 metric tonnes in the US – so the effort must be a global one.

Nevertheless, our review highlighted that developing regions can contribute more to improving energy productivity, largely because they tend to start from a much lower base, grow more rapidly than developed economies, and thus can adopt the latest technologies for new capital at a lower cost. Their faster growth also creates opportunities to adopt latest, energy-efficient technologies in a cost-effective way. The choices they make will therefore be critical to the future trajectory of energy demand growth. During our review, we were interested by China's 11th Five Year Plan to 2010, which is focused on energy intensity. It presents attractive growth drivers for companies such as Alstom and Siemens in relation to their 'clean coal' technology solutions, and for ABB and Siemens in terms of their power transmission technologies. Power transmission technologies enhance transmission capacity by 20-40%, as well as offering better grid stability which in turn facilitates new forms of electricity generation (e.g. wind and solar).

According to the McKinsey Global Institute, the industrial sector offers significant potential for efficiency gains, with developing regions representing 80% of this opportunity. Replacing old, inefficient plants or production lines with newer ones is often a major opportunity, and our review highlighted the efforts of the Chinese Government to drive momentum towards consolidation and elimination of inefficient steel production capacity. This initiative will encourage faster production responses in China when demand is slow, which has bullish implications for steel prices globally for the medium to long-term. The initiative will also have an impact on European steelmakers such as Voestalpine AG, Thyssen Krupp AG and Saltzgitter AG. Similarly, our analysis highlighted that China's coal-based processes for ammonia fertiliser production typically use 70% more energy than gas-based processes (the primary method used around the world), which led the Chinese Government to put in place export tariffs on this high-energy-consuming product earlier this summer. This has created a market distortion (oversupply China/undersupply world), which has driven up prices and profitability for European ammonia producers such as Yara Intl.

Finally, with the long life of buildings, the energy efficiency of structures built over the next ten years – in particular the rapidly growing building stock in developing regions – will impact energy demand for many decades afterwards. It is during the construction of buildings when the economics of energy efficiency are most attractive. There is therefore a very strong case for ensuring that, globally, both new construction and building remodels in the residential and commercial sector are carried out at optimal energy productivity levels. The public and private sectors are increasingly working together to help provide capital to finance upfront investment in energy-efficient construction. China has set up a $1billion energy efficiency fund to spend on energy-efficient products such as new light bulbs, funded with resources earned from the sale of carbon credits. Under the Clinton Global Climate Initiative, building-controls companies and financial institutions have teamed up to increase the energy efficiency of city buildings around the world, through retrofitting. Some $5 billion of loans from five major financial institutions are available to facilitate economically viable efficiency solutions. Siemens and Schneider Electric are part of this initiative, and should benefit from growth in demand for Energy Efficiency Systems for Commercial Buildings including enabling products (e.g. dimmers, timers, presence sensors) and management systems (e.g. power monitoring, remote control).