

**REPORT TO: SUPERANNUATION INVESTMENT SUB-COMMITTEE OF THE
POLICY AND RESOURCES COMMITTEE - 19 MAY 2008**

REPORT ON: SOCIALLY RESPONSIBLE INVESTMENT - SIX MONTHLY REPORT

REPORT BY: HEAD OF FINANCE

REPORT NO: 280-2008

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 31 March 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 have specifically looked at climate change. They have identified two companies potentially affected by legislation. This 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.

6 FIDELITY

Fidelity's policy and recent engagement activity is shown at Appendix 3, together with two key issues they have identified - healthy food and black empowerment.

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.

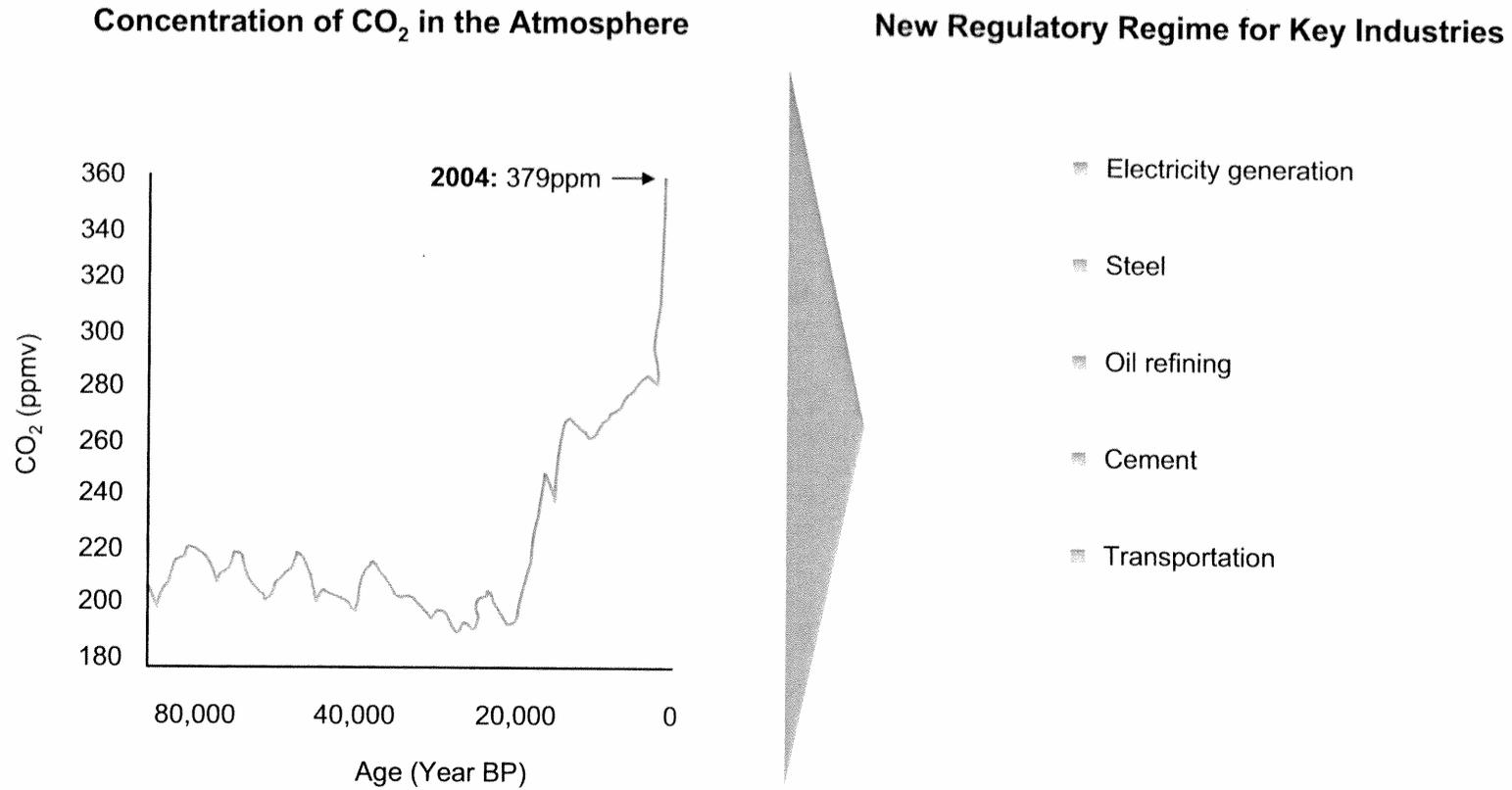
10 BACKGROUND PAPERS

None.

**MARJORY M STEWART
HEAD OF FINANCE**

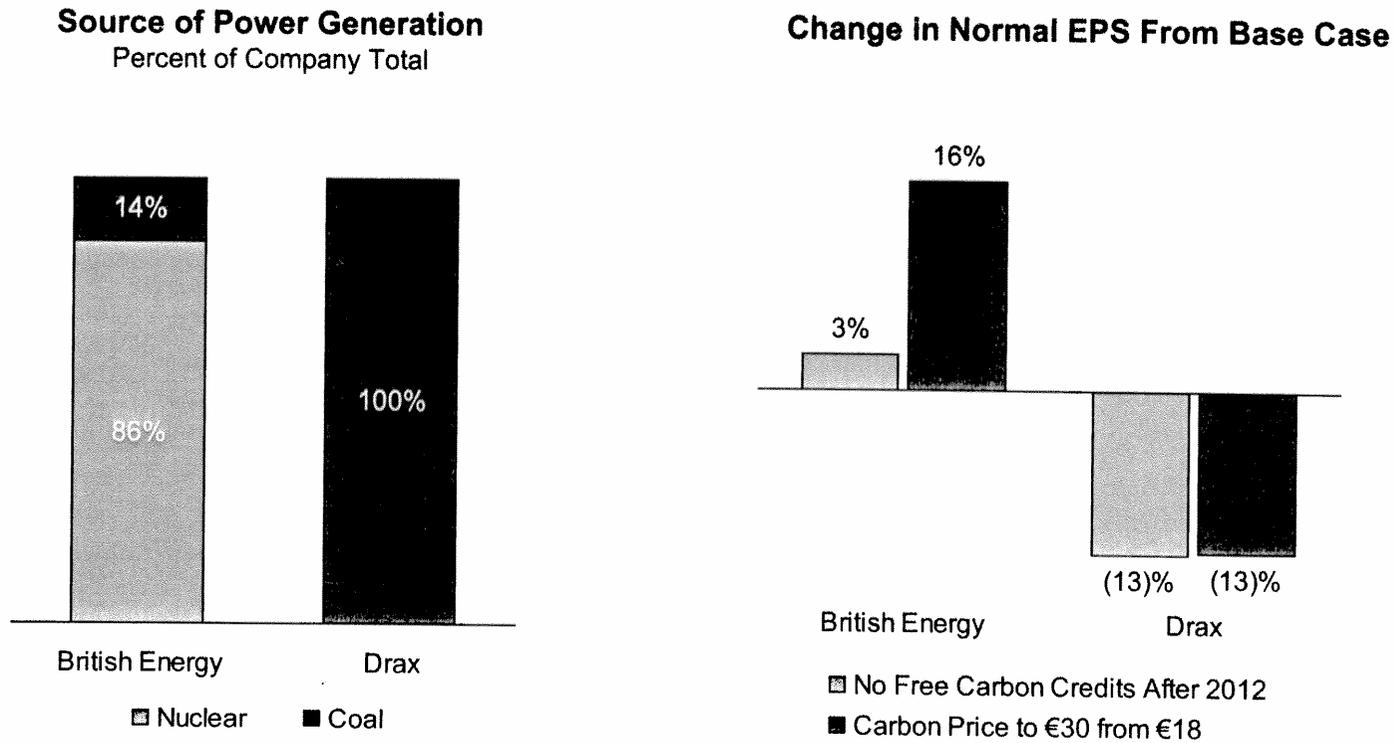
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European Utilities: Assessing the Impact of Climate Change



*Source: Sir David King (Chief Scientific Advisor to the UK Government), University of Berne, National Oceanic and Atmospheric Administration

The Regulatory Impact of Climate Change Can be Profound



Source: AllianceBernstein, company reports

Company Engagement

Bunzl

Bunzl is specialist distribution company with operations across the Americas, Europe and Australasia servicing customers across several market sectors including catering, contract cleaning, safety, retail, healthcare and vending. It is part of the supply chain for many customer facing businesses. Being confident the company has considered the business risks and is taking advantage of the opportunities presented to it as a result of the increasing awareness and environmental expectations is a relevant consideration during the investment decision making process. We met the Chairman and Corporate Responsibility Manager to discuss these issues.

Environmental, social and governance (ESG) risks are relevant to Bunzl's operations firstly in its own operations, and secondly in the products it supplies to its customers. It is very conscious of ensuring the ESG risks associated with its own business are well managed, this is important because of the global nature of its business and because it grows primarily by acquisition rather than organically. We are confident the company has the appropriate management practices in place to manage any concerns.

With regards to its customers, Bunzl supplies the products they want to buy and providing a 'green' product range is a new niche market which it expects to continue growing for the foreseeable future

Cairn Energy

Cairn Energy is an UK listed oil and gas exploration and production company which has operations (primarily) in India, Bangladesh and Nepal, although it is extending its operations into Greenland and

Tunisia. In addition it is a 69% shareholder in Cairn India which it successfully floated in January 2007.

Cairn Energy has a very stable Board with a number of directors having been together for more than 9 years. From Baillie Gifford's perspective this is extremely positive; they are the personnel who have built the company into a FTSE 100 company and have had some significant exploration and production successes. The one governance concern however was whether there is a succession plan in place. We had a meeting with the Company Secretary and Corporate Responsibility Manager to discuss this and other Environmental, Social and Governance (ESG) issues. The company has good ESG management practices which are particularly important when entering a new country for exploration. Without a good history of ESG performance a host government is less likely to issue an operating licence. We have however suggested that the company consider a succession plan and will follow this point up at future meetings.

Hon Hai Precision Industry Company

Hon Hai Precision, a Taiwanese firm, is one of the largest manufacturers of electronics and computer components worldwide and mainly manufactures on contract to other companies. Among other products it produces the iPod and iPhone for Apple Computer; various orders for Dell and Hewlett Packard; PlayStation 3 for Sony; the Wii for Nintendo; and the Xbox 360 for Microsoft.

The company discloses no information about its environmental or employee policies and management practices but given that they are a design manufacturer for large global companies we believed there were likely to be significant expectations from their clients for good environmental and employee management systems. In

Company Engagement

addition, the clients listed above carry out unannounced audits of supplier manufacturing sites and non-compliance with environmental or employee management practices can influence future business decisions and relationships. It was therefore important for us to understand the company's approach to the management of these issues.

The company confirmed that it is a member of Electronic Industry Code of Conduct (EICC); does integrate the ROHS requirements (the restriction of the use of certain hazardous substances in electrical and electronic equipment); ensures products are recyclable, reusable and recoverable; and does consider its social responsibility very important. We have asked for an increase in disclosure on these issues and will continue to monitor its progress.

Microsoft Corporation

For a company such as Microsoft whose growth markets are in the emerging economies, there are significant pressures to ensure growth does not happen at the expense of good business practice. This is particularly relevant given Microsoft's history of competition enquiries from countries and regions as diverse as US, EC and South Korea.

Following our meeting last year (Q1 2007) with the Director of Corporate Citizenship, we had a conference call to follow-up on a number of points; primarily the implementation of corporate responsibility strategy throughout the global network, and the progress made on the Principles addressing free expression and privacy.

Microsoft's country managers are expected to comply with the company's Strategic Overview in these areas, so we asked to see examples of different country plans in order to assess differences in

priorities between countries. The Principles addressing free expression and privacy are currently being finalised and should be publicly available by June 2008. We have asked to be kept informed about their publication date as they will provide an important structure for future matters related to freedom of expression and information.

Provident Financial

Provident Financial is the market leader in home credit in the UK and Ireland. Lending money to those whom high street banks regard as being too risky is a highly sensitive and sometimes controversial business. Provident has to balance the provision of credit at affordable prices to those who need it with the need to lend responsibly and not to encourage clients to take on more debt than they can manage.

The business operates via local agents who deliver the money to their customers' homes and call every week to collect repayments, there is an up front fixed charge with no default or penalty charges. The main risks are agent security, customer satisfaction, reputation and perceived value for money, and compliance and fraud. Problems in any of these areas would impact the financial strength of the business. We met the Managing Director of the Consumer Credit Division who gave a comprehensive overview of the business, focussing on their risk management and mitigation measures. We are confident that the business has considered and manages all of its significant and material risks.

Reed Elsevier (UK)

This is an international publisher of information for professional users. The business is divided into three operating divisions:

Company Engagement

Science and Medical, Legal, and Business. From an environmental perspective, the business is in a low impact sector. Two areas they are looking at however are their paper sourcing (they are becoming FSC (Forest Stewardship Council) compliant) and energy usage at data centres. This should ensure they are fully prepared for any future increased environmental expectations of them from customers or governments.

From a governance perspective, the company has operations globally and is listed on the United Kingdom, Dutch and US stock exchanges. In order to fulfil the corporate governance requirements of all three exchanges, the company has comprehensive disclosure. In addition, for its activities in China, a 'China Chairman' has been appointed who is responsible for the Chinese business and communicating with the Chinese government. This should help ensure Reed Elsevier understands the different risks and expectations of operating in the Chinese market and minimise any political risk associated with its publishing operations.

Reed Elsevier has significant governance environmental and social policies which are forward thinking and in accordance with best practice.

Rosneft

Rosneft is a Russian energy company, with oil & gas projects in the South, North and far East of Russia and Siberia, as well as in Kazakhstan and Algeria. We invested in the company because of its significant access to resources and despite its poor corporate governance arrangements. The Russian Government is the majority shareholder and the Head of Investor Relations confirmed both that the Government makes the majority of decisions with regards to Rosneft and that within the Articles of Association there is no mechanism to protect minority shareholders. The company did go

on to state that as over 156,000 Russian individuals are shareholders, the majority of whom are public sector employees or retired, we should be assured that the company's share price, dividend policy, production and growth expectations are aligned with our own - the government would not want to 'hurt' this sensitive group. In addition we discussed the company's environmental, health and safety policies which appear to be closer to expected practice although we have encouraged the company to increase its disclosure in 2008.

Appendix Corporate Social Responsibility Report - Q1 2008

Fidelity's policy on Corporate Social Responsibility

- Fidelity believes that high standards of corporate social responsibility (CSR) make good business sense and have the potential to protect and enhance investment returns. Consequently, our investment process takes social, environmental and ethical issues into account when, in our view, these have a material impact on either investment risk or return.
- We recognise and support the view that social, environmental and ethical best practice should be encouraged as long as the potential for financial return is not reduced. We favour companies committed to high standards of CSR and to the principles of sustainable development.
- We do not screen out companies from our investment universe purely on the grounds of poor social, environmental or ethical performance. Instead, we adopt a positive engagement approach whereby we discuss these issues with the management of the companies in which we invest on behalf of our clients. We use the information gathered during these meetings both to inform our investment decisions and also to encourage company management to improve procedures and attitudes. We strongly believe that this is the most effective way to improve the attitude of business towards CSR.

Fidelity's four-stage process for CSR analysis & engagement

1. The CSR Analyst identifies engagement priorities, typically focusing on companies where we perceive that environmental, social and ethical issues could have a material impact on shareholder value. These engagement priorities are discussed with the relevant research analysts.
2. Background research is undertaken on specific issues through dialogue with brokers and other interested parties (such as non-governmental organisations).
3. CSR Analyst holds dedicated CSR meetings with companies.
4. The findings from the meeting are reviewed by the CSR Analyst and research analyst and future engagement objectives agreed.

Recent company engagement

Note: We have been in contact with the companies listed below to discuss environmental, social and ethical issues, either through face-to-face meetings, by teleconference or in writing.

Company	Country	Corporate Responsibility Strategy	Environmental Management & Climate Change	Responsible Product Stewardship	Workplace	Human Rights	Company	Country	Corporate Responsibility Strategy	Environmental Management & Climate Change	Responsible Product Stewardship	Workplace	Human Rights
Alstom	France		•	•			Royal Bank of Scotland	UK	•	•	•	•	
Camco International	UK		•	•			RWE	Germany	•	•	•	•	
Canelour	France	•	•	•	•		Saft Groupe SA	France		•	•		
Danisco	Denmark		•	•			Tesco	UK	•	•	•	•	
Danone	France	•	•	•	•		Unilever	UK	•	•	•	•	
Enova Systems	USA		•	•			Valeo	France		•	•		
Nestlé	Switz	•	•	•	•		Vivendi	France	•	•	•	•	
Renault	France	•	•	•	•								

Appendix Corporate Social Responsibility Report - Q1 2008

Issue: Healthy Food, Healthy Growth

Background: An ongoing area within our CSR research & engagement is to encourage companies in the food sector to adopt effective responses to the issues of consumer health and obesity. Food companies that take action can help to offset the prospect of costly and time-consuming regulation, while at the same time benefiting from an increasing interest among consumer groups in the health benefits of good nutrition. On the latter we have seen evidence that the science is moving from everyday foods that are good for you, towards concepts of 'positive' or 'optimal' nutrition. The absence of negative characteristics in food products (sugar, fat, salt, cholesterol) adds 1 or 2 percentage points to the usual growth pattern experienced by the basic food products. While adding a positive functionality (such as probiotics, extra calcium), boosts growth prospects by another 5 or 6 percentage points. Our research objective this quarter was to identify the key players that are well positioned in this latter, dynamic food segment.

Company Engagement: New products are emerging that increase or incorporate beneficial ingredients into our food, for example biologically active components with the potential to improve physical and mental health. This is being accompanied by an ongoing shift in the business model of food companies. An insufficient scientific basis for health food claims and over-use of the health/well-being argument in product offerings in the past, has created doubts and mistrust on the part of consumers. As a result, key players in this industry have recognised that it is crucial to provide proof of health claims through clinical tests. Protection of innovations through patents and the development of considerable technological know-how is also key to differentiation, while ensuring barriers to entry from competitors. **Danone** holds the leading position in this business model as a unique 'pure play' on the healthy food market, its in-house Research & Development (R&D) department consists of 700 scientific experts and, in 2006 alone, 30 patents were filed by Danone Research. **Nestle** is lagging behind Danone, despite continuous efforts to improve the nutritional profiles of its products with interesting innovations, while **Unilever** – which entered this business too late – is struggling to catch up with these two key competitors. Although **Unilever** has been elected the sustainability leader in the Food & Beverage sector in the Dow Jones Sustainability Index for 9 years in a row, the specific focus on food & health has gained more emphasis since 2004. Another competitive parameter of this business is leading-edge industrial processes that enable compounds to be incorporated into foods without detracting from their taste or texture. It is reasonable to expect that suppliers assisting food companies in addressing consumer health & wellness will also benefit from the growth trend. **Danisco** outlined to us its range of technological ingredients that enable manufacturing of healthy wellness will also benefit from the growth trend. The need for greater R&D, whether to develop new products or to support health claims solutions with 'no compromise on taste', a strong differentiating factor for industry leaders such as Danone, notably with respect to retailers' private labels which have greater difficulty copying these health food products. In France, **Carrefour** joined forces with pharmaceutical company, **Forbes Medi-Tech**, to launch a product speciality line with the cholesterol-lowering sterol ingredient **Reducool**. However, the private label business model is not adapted to finance long-term research programmes. Despite a European sterol/stanol foods market estimated to be worth more than EUR 600m, most private label offerings have sold only at niche level, often despite severe price discounting. Other private label under-performers include a **Tesco** yoghurt and margarine range in the UK.

Future Engagement Objectives: Nutrition (Wellness & Obesity), a continuing research theme.

Issue: Black Empowerment

Background: South Africa's Black Economic Empowerment (BEE) policy came into force in 1997 with the creation of the BEE Commission. The policy's objective is to allow the 'historically disadvantaged' black majority 'meaningful participation' in the country's economy. Several pieces of complex legislation and codes are now in the statutory books and the aim is to achieve substantial changes to the racial composition of ownership and management structures of businesses. Companies bidding for government contracts have to comply with new regulations and satisfy the regulators that they have attained BEE status. This bold experiment is part of the distinctive challenges that face companies in the extractive industry. The resources they mine are non-renewable natural capital, so communities expect tangible and human capital benefits in return for their exploitation. It is also part of a wider global issue of how countries with natural resources can manage the commercialisation of these, while sharing the benefits with the wider society so as to ensure ongoing socio-economic development and in order to prevent social unrest. This BEE issue was identified as material to the performance of platinum companies by Fidelity's natural resources equity analyst team, who requested that the CSR analyst undertake research to help them gain a more in-depth understanding of this complex area. It demonstrates that our CSR research is gathering momentum as our equity analysts increasingly understand the impact of CSR issues.

Company Engagement: There are growing calls on the South African government to review the BEE policy and simplify the complex regulations that are in place, which are causing headaches for policy makers and business alike. Significant scandals have emerged about 'BEE-fronting', when **VerifySolutions** revealed in 2005 (after a two-year study) that 15 companies have fraudulently presented their BEE status to win government contracts. Experts say that there are many types of BEE-fronting, but the most common is that of companies listing fictitious black shareholders, who are often unaware and receive no benefits. At the same time, a whole service industry has grown around the BEE policy, with consultants and compliance experts advising business on how to navigate the complex legislation. BEE is also the object of an ideological tussle within South African politics. Archbishop Desmond Tutu has spoken strongly about what is seen as 'black oligarchs' that have benefited while doing little to tackle the country's serious wealth inequality. A study by the International Monetary Fund (IMF – a non-governmental organisation) also expressed concern over this, calling for safeguards to limit the concentration of wealth, while there is growing awareness among the government that innovative measures need to be introduced to make the BEE policy more 'broad-based' and 'expand the pool of beneficiaries'. The initial focus of markets was on the equity participation element of BEE (15% within 5 years and 26% within 10 years). Going forward we will look at relevant companies under our coverage exposed to the BEE to assess their progress against all 10 provisions of the 'scorecard', including human resource development, employment equity, community and rural development. Failure to make sufficient progress could result in the loss of mining rights, so our CSR Analyst will be working with the equity team on an assessment of performance in relation to BEE. In this review we will include input from the **International Council on Mining & Metals (ICMM)** which has been running a project designed to distil the key learnings from those countries that have made a success of developing their resource base, with the aim of sharing good practice among its members.