

PENSIONS COMMITTEE – 14 FEBRUARY 2006

LOCAL AUTHORITY PENSION FUND FORUM UPDATE

SUMMARY

This report presents a summary of the issues considered by the Local Authority Pension Fund Forum (LAPFF) over the last year.

RECOMMENDATION that

This report on the activities of the LAPFF be noted.

1. Introduction

The Committee agreed in February 2003 that the Council should become a member of LAPFF. The last report to this Committee covered issues discussed at the LAPFF's meeting in April 2005. The LAPFF continue to submit "alerts" on governance and social responsibility issues at forthcoming company AGMs to the Council. As part of the shareholder engagement strategy, those relevant to the Councils' investments are brought to the attention of our investment managers and their voting intentions obtained.

A useful summary of LAPFF's activities over the last year was presented to their AGM in November 2005 and is attached to this report. Since then there has been a further meeting of LAPFF and key items of progress are:-

- Following the Chancellor of the Exchequer's decision to abandon the idea of companies preparing an Operating and Financial Review as part of their annual report, LAPFF are to press companies to provide similar information as part of their Business Review which is to be included in the Directors' Report.
- LAPFF have selected the mining, food and beverage producers, and chemicals sectors as the next areas for engagement on greenhouse gas emissions.
- Presentations were given on carbon exposure and climate risk. It was revealed that the United Nations Environment Programme will launch their global Principles for Responsible Investment in April.
- LAPFF will hold a further four trustee seminars on various topics at venues around the country this year, following the successful pilots last November.

2. Summary of Financial Implications

The cost of membership of the LAPFF is met by the Pension Fund.

3. Summary of Other Implications

Membership of LAPFF seeks to address issues of how the Council's Pension Fund investment can take account of environmental, human rights and equal opportunities issues.

Local Government Act 1972 – section 100d

List of background documents

Contact Officer: Nigel Bate, Head of Technical Finance Ext 2647

Reporting to: David Berry, Director of Finance and Business Services



LAPFF ANNUAL REPORT OF ACTIVITIES 2005

This 2005 Annual Report provides an overview of the activities of the Local Authority Pension Fund Forum during the year. It covers the Forum's various campaigns and shareholder engagement initiatives undertaken in relation to companies and the progress made on these campaigns, together with other Forum initiatives and activities

2005 has been another very busy and successful year for the Forum. Concerns about corporate governance and corporate social responsibility remain high on the agenda making our role as important and relevant as ever. Recent events such as the hurricanes in America have certainly sharpened the focus on concerns about climate change, re-enforcing the importance and value of the work we do on the need for more openness in the reporting of companies' greenhouse gas emissions.

The Forum exists to serve the investment interests of local authority pension funds. In particular, it seeks to maximise their influence as shareholders in promoting the highest standards in corporate governance (CG) amongst the companies in which they invest and in promoting corporate social responsibility (CSR). In short, it seeks to co-ordinate shareholder activism amongst local authority pension funds.

LAPFF members believe that by actively encouraging companies to comply with best practice on corporate governance and CSR issues, shareholder value is improved over the medium and longer term. This view is increasingly supported by independent research and held by a growing band of institutional investors. It is a view also held by some of our most successful companies, by central government and by many City fund managers.

The LAPFF was formed in 1990 and now has 36 local authority fund members (see Appendix) with combined assets of more than £55 billion. Membership is open to all pension funds that operate under the Local Government Pension Scheme.

The Forum has an Executive Committee which reports to the Forum quarterly. During 2005 membership of the Executive was as follows

Chair:	Councillor John Saunders – London Borough of Newham
Vice Chair:	Councillor Darrell Pulk, Nottinghamshire County Council
Executive Members	Councillor Don Yates - Lancashire CC Councillor Maureen Child - City of Edinburgh Councillor Sue Brown – Merseyside Pension Fund Councillor Munir Malik – London Borough of Bexley Councillor Marlene Thomas – Greater Gwent Fund
Hon Secretary:	Stuart Imeson – West Yorkshire Pension Fund
Hon Treasurer:	Brian Bailey – West Midlands Pension Fund

The Executive Committee is supported by a contract with PIRC, for research and advice and we also have a contract with our Forum Officer, Keith Bray for promotional and developmental work.

This remains a particularly opportune time to develop the influence of local authority pension funds and LAPFF is the perfect vehicle for this purpose. Following the Myners Report, the Higgs and Smith Reports and the Company Law Review, and statements supporting shareholder activism from the Office of the Deputy Prime Minister (ODPM) and the Department for Works and Pensions (DWP), we continue to operate in a very favourable climate. There has never been a better opportunity to seek improvements in corporate governance and CSR since the Forum was formed.

Research and Engagement:

The shareholder engagement projects in the Forum's outline Work Plan for 2005/06 relate, first, to corporate governance, and, secondly, to corporate social responsibility although both aspects are interlinked with the long term sustainability of investee companies. Finally, other matters include: responses to governmental consultation papers; and support services.

Corporate Governance

- **Strategies for Shareholder Engagement**

Primary Objective: Implement an expanded LAPFF Alerts system by the start of the 2005 proxy season, based on the Forum's 'Strategies for Shareholder Engagement' which was approved by the business meeting on 2 July 2004.

Description: This new framework is intended to help the Forum intervene more efficiently on a range of governance and CSR issues but it is not binding on individual members. The priorities for intervention in companies are in the areas of:

- (i) board structures;
- (ii) remuneration;
- (iii) shareholder rights;
- (iv) separation of audit and non-audit work; and
- (v) environmental/sustainability/greenhouse gas emissions.

Results: The expanded LAPFF Alerts system was implemented in April 2005. Members' feedback is being sought during the current quarter and a more formal review is envisaged ahead of the 2006 proxy season.

- **Fund Managers and Good Practice in Corporate Governance**

Primary Objective: To update, particularly in anticipation of the forthcoming statutory Operating and Financial Review, the LAPFF investor guide on issues to be considered by pension fund trustees when reviewing compliance of their Fund Managers with the principles of engagement as outlined by the Institutional Shareholder Committee's statement [reviewed in 2005].

Description: Following the completion of the first phase of this project last year the LAPFF best practice guidelines have been published as an 'Investor Guide' and circulated to the officers responsible for investment panels (or equivalent) of the Forum members. The officer responsible at each Fund was invited to circulate the Guide to every trustee of the investment panel for use in applying the Myners or ISC Principles to the regular (usually quarterly) reports received from fund

managers. A data base is being prepared so that the Guide can be circulated to non-members of LAPFF via their chairmen of trustees and finance directors in order to create a wider awareness of the Forum's engagement activities.

As a consequence of the Forum's submission to H.M. Treasury's review of the Myners Principles a meeting was held with two senior HMT officials on 25 April 2005 who listened carefully to the views of LAPFF representatives on shareholder engagement. HMT also reconsidered the question of LAPFF involvement in the FRAG Working Group and subsequently invited the Forum's Hon Treasurer to join the working party. John Kingman, Director, Head of Enterprise and Growth Unit at HM Treasury, gave an interesting talk at the July business meeting on the progress with the Myners Review and discussed the Forum's concern that the Myners principle on activism be retained.

The steps to develop the Investor Guide, as approved at the July 2005 business meeting, are well underway. Meetings with six Fund Managers who agreed in principle to be interviewed as part of the 2004 LAPFF survey on compliance with the ISC Principles are taking place in October/November. A seventh Fund Manager is currently considering involvement in the process. The interviews are providing feedback to the Managers on the views of Funds about issues raised in the 2004 survey and enabling questions to be asked about Fund Manager application of the ISC Principles and how they intend to make use of the company disclosures under the OFR. Initial findings will be presented to a workshop at the LAPFF Conference in December and a full report will be ready for the business meeting early in 2006.

Results: The project has illustrated the link between in-depth research and successful engagement in the form of the progress the Forum has made in putting itself on the map with H.M. Treasury. Additionally the update of the LAPFF Investor Guide is on schedule for completion by the end of the 2005/06 financial year.

Secondary Objective: To research any link between good practice in corporate governance and enhanced company financial performance in order to ascertain what contribution, if any, the Forum can make to disseminating studies with relevant evidence and cases on best practice.

Result: While no opportunity has yet arisen to develop this as a pilot project it will be kept in mind with respect to LAPFF analysis of statutory OFRs, which is currently being developed.

- **Study on Mergers and Acquisitions (M&As)**

Description: As this is a pilot study, at this stage no formal objective has been adopted by the Forum. However, the aim is to examine the corporate governance and CSR aspects of takeovers and mergers, especially in the light of evidence that many such M&As do not yield the benefits originally expected. A literature review conducted in April led the LAPFF Executive to decide that a full proposal, with external assistance as required, was needed to provide a simple framework to assess M&A deals being proposed by companies. A case study approach was thought to be relevant especially in the light of well publicised post-mergers problems, such as at Morrisons. On the other hand, private equity has provided examples of M&As that were successfully implemented. A full proposal is under development with the assistance of academic experts and the results will be presented to the Executive early in the New Year.

Corporate Social Responsibility

- **Overseas Employment Standards**

Objective 1: Development of an engagement programme on overseas employment standards focused on UK FTSE 100 companies, particularly those operating in China.

Description: The interim report of the China project with initial best practice guidelines was approved for publication by the October business meeting. Profiles of current practice by HSBC and Standard Chartered in the banking sector, AstraZeneca and Glaxosmithkline in the pharmaceutical sector and an unnamed chemicals firm reveal a generally encouraging picture of good practice by UK listed companies operating in China. The interim report will be the subject of consultation with stakeholders and China experts before a final report and a separate Investor Guide are published next year. A helpful response was received from Teresa Fabian and Caroline Hill of PricewaterhouseCoopers (PwC) as part of their talk to the October meeting on CSR and the ethical supply chain in relation to China.

Results: The Forum now has the knowledge base to undertake an engagement programme with the companies in our study or other firms. A delay in the publication of the China project report has occurred, due to the belated agreement of a sixth company in the LAPFF sample to be interviewed, which it was considered important to incorporate. This would begin with those FTSE100 companies whose current operations appear to fall below best practice standards in China and (as envisaged in the provisional 2006/07 Work Plan) in other developing countries.

Objective 2: Continuing engagement with Morrisons, initiated in 2003/04 to address Forum concerns regarding lack of disclosure of its Code of Conduct and also corporate governance issues, which have been accentuated by the company's acquisition of Safeway in 2004.

Description: A further meeting was held with two members of the management board of Morrisons on 25 January 2005. Overall the LAPFF representatives came away feeling quite positive about the outcome. The impending appointment of a CSR manager was seen as a real breakthrough and evidence that these issues were being taken seriously. On the other hand, though, the company did not appear to have moved on corporate governance since last year. This latter concern was also expressed at the company AGM in May, which LAPFF representatives attended. Since then the company has made progress on corporate governance particularly in appointing further non-executive directors.

Results: The Forum has recently achieved a longstanding objective of a meeting with a main board director at Morrisons and following correspondence with the Chair a meeting is to take place with David Jones, the senior independent director. Morrisons has also recently informed the Forum that a CSR manager was appointed at the end of the summer. This development is a further indication that the Forum's encouragement of a favourable environment for CSR has helped achieve a positive outcome here.'

• **Company Workforce Practices**

Primary Objective: To implement the engagement strategy, based on the Forum's investor guide on best practice in reporting on human capital management, with identified company under-performers in the Leisure sector and Food Producers sector.

Secondary Objective: To develop and update the investor guide on best practice in reporting on human capital management, in the light of experience of the Forum's engagement strategy and in discussion with leading employers and trade union organisations in this area.

Description: The Forum has developed a three-fold approach to engagement:

- Require a minimum standard of reporting on employment practices applicable to all publicly quoted companies above a certain size;
- Identify material industry-specific employment risks and opportunities;
- Seek directors' views on the materiality of employment issues in the preparation and publishing of the Operating and Financial Review or similar reports.

Following submission of the Forum's response to the Accounting Standards Board's Exposure Draft on the OFR Reporting Standard the remaining sections of the Investor Guide, on industry-specific employment risks and the OFR, could be drafted. The Guide was then ready to be used as the basis of the engagement programme.

The Executive agreed that four companies in the Leisure sector and one company in the Food Producers sector had not made sufficient progress since 2003 in improving their reporting on employment policies and practice. Consequently engagement with these companies began. While the response to letters and profiles sent to each company by LAPFF has been slow one meeting has been arranged for November and there is the prospect of meetings with the other two companies with which discussions have been sought. A written response is being requested from the remaining companies.

Results: The engagement strategy is being implemented as planned and it is envisaged that any updating of the Investor Guide would be carried out before the end of this financial year, provided more company meetings can be arranged to gain a sufficient base of experience.

- **Environment – Greenhouse Gas Emissions**

Objective: To engage with companies based initially on the Enviro study, concerning the likely impacts of climate change on industry sectors and companies with long-term research and development programmes and consequent risk to shareholder value. This would be supported by additional engagement on greenhouse gas emissions and waste disclosures in annual reports. Emphasis now is on positive dialogue with companies, moving away from the previous focus on poor disclosers.

Description: Following the delivery of the Enviro report in January 2005 LAPFF decided at its April business meeting to engage with companies based on its research into the long-term implications of climate change for shareholder value. The Enviro study provides an analysis of issues common to companies in each sector and within this there is a section entitled 'implications for shareholder engagement'. Dialogue with particular companies would be around the range of climate change management issues identified by Enviro, which apply particularly to the sector. The aim of the engagement process with companies is to have a greater impact than that created by focussing purely on disclosure of direct emissions.

The LAPFF Executive agreed that the initial approach, as a pilot study, would take the FTSE 350 companies in the Oil and Gas sector. The FTSE definition of the oil and gas industry covers all stages in the supply chain from exploration and production through to refining activities and marketing and retail. Of FTSE 350 companies in the oil and gas sector, there are four FTSE 100 companies; and seven mid-cap companies (as taken from PIRC's universe on 7 June 2005). It should be noted that the FTSE index also defines the type of company: the FTSE 100 companies being more integrated companies; the mid-caps being primarily exploration and production.

Letters were sent to all the oil and gas companies in October containing details of the initial LAPFF assessment of how each company was addressing the impact of climate change, based on publicly available information and the framework proposed in the Enviro report. BP was the only exception in that its excellent disclosure would be praised but no further engagement sought. Three companies are to be selected for further engagement, once their responses have been assessed, which would take the form of meetings to seek certain commitments for improvement in the way they are addressing climate change.

Once analysis has been undertaken in the oil and gas sector and dialogue undertaken with appropriate companies, further sectors can be tackled. The order of priority will be set after consultation with LAPFF members.

Results: This project is progressing largely as planned although, in the light of non-disclosure on climate change by most oil exploration and production companies, the emphasis has been continued on engaging with poor disclosers, albeit balanced by recognition of good disclosure in other cases, even where further progress is sought.

Other Matters

- **Responses to Consultation Papers, Documents and Related Issues**

Objective: Provide analysis and draft response for LAPFF agreement on relevant consultation papers, documents and related issues arising in the year.

Description: Apart from the responses to H.M. Treasury and ASB consultation papers mentioned previously, the Forum responded to the DEFRA consultation on Environmental Key Performance Indicators in September 2005 and, the following month, to the DTI consultation on the final clauses of the Company Law Reform process concerning voting at AGMs. In its response to the DEFRA consultation the Forum drew on its own experience and technical support from Enviro to generally affirm the government's approach but suggest some areas for improvement in their environmental reporting guidelines for UK business. The LAPFF response to the DTI consultation on the CLR process argued, inter alia, that all voting at AGMs should be by poll and that shareholders acting in a fiduciary capacity should be required to disclose how they exercised their voting rights.

In addition the Forum has progressed matters in three important areas:

- **Audit.** Representatives of LAPFF met with Deborah Chaplin of the Audit Quality Forum in July and discussed the Forum's involvement in some aspects of its work.
- **Remuneration.** A meeting was held with the Group Secretary and Head of Board on Shareholder Services of the Royal Bank of Scotland in August mainly to express Forum concerns over the Bank's lack of transparency over the current and proposed incentive plans for its Chief Executive.
- **Collaboration on Climate Change.** A meeting in July between Forum representatives and Peter Scales, Chair of the Institutional Investor Group on Climate Change (IIGCC), which is currently going into partnership with the Climate Group, concluded that future engagement could be on a joint basis but would have to wait until organisational changes at IIGCC were complete.

- **Continuing LAPFF Support from PIRC**

Objective 1: To provide support to LAPFF, LAPFF officers and Forum Officer. Maintain market intelligence on issues relating to LAPFF mission statement and areas of interest.

Description: During the year PIRC suggested a change in business meeting procedure, approved by the Executive, such that external speakers would be invited to give talks on subjects relating to LAPFF projects that have reached a critical stage in their development, e.g. the PwC speakers referred to previously in relation to publication of the China project interim report. This is intended to stimulate interest and generate debate on the issues concerned. For the same reasons, full reports are no longer provided on every LAPFF project to each business meeting. Rather an expanded Summary Report, with a two-year planning horizon, brings members up to date on progress in the last quarter and intentions for the next while full business meeting reports are reserved for projects that have reached a key stage. Background papers are also available on

each project in the members' section of the LAPFF web site. This may be of special relevance to new members.

Results: Although it is too soon to assess the benefits of the new approach initial indications, in terms of member involvement at meetings, appear positive.

Objective 2: To develop a trustee training programme for LAPFF members and, possibly, others with a focus on CG and CSR issues.

Description: Following detailed consideration by the Executive and business meetings in January 2005 the first LAPFF trustee training seminars were held on 2 and 4 November in Sheffield and London respectively.

We continue to develop our relationship with the Institute of Directors with regard to the IoD's Chartered Director qualification which seeks to improve the competencies and skills of directors on company boards. At the April 2004 meeting the Forum had agreed to give full support to this initiative which has the backing of the DTI, CBI, NAPF and CIS and we have continued to liaise with the Institute regarding areas where we believe we can contribute to the syllabus for the qualification.

A further example of how the LAPFF has collaborated with another national body is in connection with the Freedom of Information Act. Following the introduction of the Act in January 2005, LAPFF has linked up with the CIPFA Pensions Panel in producing a joint guidance note for use by local authority pension funds to assist them in dealing with requests for information under the Act.

Membership of the LAPFF affords funds the opportunity to join with a large group of local authority pension funds in developing their policies in a coherent and effective way. The effectiveness of individual funds engaging in shareholder activism alone must surely be questionable. By taking a co-ordinated approach with other local authority funds their level of effectiveness is increased and improved beyond measure. At the same time membership of the Forum does not in any way impede their ability to act unilaterally whenever they think it appropriate to do so in the interests of their own Fund. Our membership includes funds from all parts of the UK, and represents all types of administering authorities under the political control of all the major parties. During 2005 we were joined by the Avon Pension Fund, the London Borough of Southwark and by Devon County Council and most recently by the Lincolnshire Pension Fund.

The Forum hopes that others will follow - we are certainly very eager to maintain a dialogue with all LGPS funds over the months ahead. In this context our 10th Annual Conference will be held at Bournemouth in December 2005. The theme is '15 Years of Shareholder Activism – Results and Prospects'

The Conference will be addressed (amongst others) by the Minister of State for Pensions , Stephen Timms MP, Paul Myners, Chairman of Marks and Spencer plc and the author of the Myners Review of Institutional investment in the UK and Terry Crossley Head of Pensions at the Office of The Deputy Prime Minister . As usual the aim will be to explore all the major governance and corporate social responsibility issues that remain at the heart of current debates on how governance adds value to company operations leading to improved financial returns for shareholders

Anyone wanting more information about any aspect of the LAPFF's activity's can visit our website at www.lapfforum.org or contact Forum Officer, Keith Bray at postmaster@keithbray.plus.com

November 2005

APPENDIX

LAPFF membership as at 1 November 2005

Avon Pension Fund
City of Edinburgh Council
Clwyd Pension Fund
Derbyshire CC
Devon CC
Dyfed Pension Fund
Greater Gwent Fund
Greater Manchester Pension Fund
Lancashire County Pension Fund
Lincolnshire CC
LB Bexley
LB Brent
LB Camden
LB Croydon
LB Hackney
LB Hammersmith & Fulham
LB Islington
LB Newham
LB Southwark
London Pension Fund Authority
Merseyside Pension Fund
Norfolk Pension Fund
Northamptonshire CC
North Yorkshire CC
Nottinghamshire CC
Shropshire CC
Somerset CC
South Yorkshire Pension Fund
South Yorkshire PTE Pension Fund
Teeside Pension Fund
Tyne and Wear Pension Fund
West Midlands Pension Fund
West Midlands PTA Pension Fund
West Yorkshire Pension Fund
Wiltshire CC
Worcestershire CC