Glasgow City Council

Strathclyde Pension Fund Committee

Report by Executive Director of Financial Services

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Item 3(d)

31st August 2015

Feasibility of Fossil Fuel Divestment

Purpose of Report:

To provide a response to a motion passed by Glasgow City Council at its meeting on 2nd April 2015.

Recommendation:

The Committee is asked **to AGREE** that the Fund should:

- re-state its commitment to active ownership and responsible investment;
- continue and where appropriate escalate its current responsible investment activities including engagement with companies and investment managers, and participation in LAPFF and CDP;
- continue to make appropriate investments in renewable energy and other impact areas through its New Opportunities Portfolio; and
- continue to monitor developments including the Paris climate change conference and alternative investment approaches.

Ward No(s):	Citywide: ✓
Local member(s) advised: Yes ☐ No ☐	consulted: Yes ☐ No ☐

Section 1 - Background

1.1 Background

At the 2nd April 2015 meeting of Glasgow City Council a motion was approved calling for a report to be sent to the Strathclyde Pension Fund Committee setting out the feasibility, cost and benefits of introducing partial or complete fossil fuel divestment for the Strathclyde Pension Fund. This report provides a response. The motion in full is set out in Appendix A together with some commentary on its content.

1.2 Introduction

1.2.1 Climate Change and Fossil Fuels

Climate change is a recognised environmental, social and economic risk. Groups concerned about its potential effects have been campaigning for institutional investors, such as pension funds and university endowment funds, to sell their investments in fossil fuel companies. This has gathered pace ahead of UN climate talks in Paris in December 2015. Much of the lobbying is on a purely social or environmental basis, but a number of economic and investment arguments for divestment are also promoted.

1.2.2 Stranded Assets

From an investment perspective much of the debate is focused on the risk of “stranded assets.” In broad terms these are assets that have suffered from unanticipated or premature write-downs, devaluations, or conversion to liabilities. They can be caused by a variety of risks and occur across different sectors. In the context of fossil fuels the main risk centres around future regulatory changes which could limit or curtail companies’ ability to extract and monetise their oil, gas and coal reserves.

1.2.3 Divestment

Whilst the stranded asset argument presents a case for divestment, there are a number of counter arguments. There would be costs and risks associated with divestment. These are difficult to quantify. There is no definitive list of fossil fuel investments. The nature and timing of any regulatory change is uncertain. In the meantime the price of oil and other assets is a significant variable. There are also approaches other than divestment which could have more value. A full analysis of these issues is beyond the scope of this paper which instead explores some of the main principles and issues which would need to be addressed in considering any change of policy for the Strathclyde Pension Fund.

1.3 Strathclyde Pension Fund

1.3.1 Investment Strategy

The Fund’s investment strategy is global and equity-focused. Investments are managed externally with a bias towards active management. The strategy is highly diversified by geography, sector and manager in order to reduce investment risk.

1.3.2 Fossil Fuel Exposure

The Fund’s main exposure to fossil fuels is through its listed equity portfolios which make up around two thirds of the investment strategy. There is no definitive list of fossil fuel companies but index provider MSCI compiles a market index which is based on its All Countries World Index but excludes companies that own oil, gas and coal reserves. Relative composition of the full and adjusted indices is summarised as follows.

	Total Co.s (#)	Total Value ($tr)
MSCI ACWI	**2,483**	**38**
MSCI ACWI ex Fossil Fuels	**2,353**	**34.5**
Difference	**130**	**3.5**
Difference	**5.2%**	**9.2%**

The Fund's actual exposure to fossil fuel companies will vary over time dependent on the active mangers' buy and sell decisions.

1.3.3 Responsible Investment Strategy

The Fund is a responsible investor and adopts policies and practices which acknowledge the importance of environmental, social and governance (ESG) issues. Details of the Fund's Responsible Investment strategy are set out in Appendix B. The strategy is based on active ownership and incorporating ESG issues into ownership policies and practices. It does not involve and has never involved screening out individual sectors or companies or disinvestment from particular areas.

1.3.4 Responsible Investment Strategy and Climate Change

Climate change and its various implications have been an important strand of activity within the Fund's responsible investment strategy. Key aspects include:

- In 2014/15, **14%** of engagements by GES, the Fund's responsible investment agent, were on climate change.
- **12%** were with companies in the Energy sector.
- The Fund is a signatory to the Carbon Disclosure Project (CDP). More than **822** institutional investors representing in excess of **US$95 trillion** in assets currently support CDP in engaging with companies worldwide to disclose and ultimately manage climate change issues in order to create and sustain long term shareholder value.
- In July 2014 the Fund co-signed letters, facilitated by the PRI Clearinghouse engagement platform, to international oil and gas companies that are involved (or plan to be involved) in offshore oil exploration in the Arctic. The main objectives of this engagement are:
  - Transparency of the ESG risk-management approach of the scheduled projects.
  - Disclosure of practices to limit the environmental damage of potential oil spills.
  - Specification of risk and cost-sharing agreements in joint-ventures, particularly with Russian partners with little exploration activity.
  - Disclosure of economic viability of the project: price assumptions, rate of returns, forecasted lead time for the projects and consequent project evaluation.

Follow-up letters and engagements followed through 2014 and into 2015.

- The Fund is a member of the Local Authority Pension Fund Forum (LAPFF), a collaborative shareholder engagement group which brings together **64** local authority pension funds from across the UK with combined assets of over **£160 billion**. LAPFF strongly supports mandatory carbon emission reporting in the context of how companies are factoring the relevance of climate change into their business strategy. In particular, the Forum supports the ‘Aiming for A’ investor coalition which co-filed shareholder resolutions at the **BP** and **Shell** 2015 AGMs on behalf of **50** global investor organisations as well as individual shareholders. The resolutions asked BP and Shell to report effectively on climate related risk in their routine annual reporting. The resolutions received **98%** and **99%** shareholder support respectively. LAPFF’s policy is that robust engagement on a collective basis is preferable to placing restrictions on particular types of investment.

- Some further details on the engagement approach are set out at Appendix C.

1.3.5 New Opportunities Portfolio

The Fund’s New Opportunities Portfolio was created in 2009. In March 2015 the committee agreed to increase the capacity of the portfolio from 3% to 5% of total Fund assets. To date the portfolio has agreed to 20 separate investments with a total value of around £350m. Most of the investments in the New Opportunities Portfolio will have some positive impact beyond the financial returns which are its first priority. That impact may be local, economic, environmental or some combination of these or other factors which will give added value to the investment case. Over the last year there has been a clear emphasis on renewable energy infrastructure amongst the new investments which have included specialist onshore and offshore wind funds, the Pensions Infrastructure Platform solar UK fund and generalist renewables funds. Further details are included at Appendix D.

Section 2 – Feasibility of Disinvestment

2.1 Overview

There are some explicit legal constraints, but the Fund has a large degree of freedom as to how it arranges and manages its investments. There are few certainties and a large degree of inherent uncertainty in investing, so any investment strategy should have clear objectives and a sound rationale and should be efficient in terms of cost and benefits. These are the criteria which any decision to disinvest would need to meet.

2.2 Feasibility

2.2.1 Legal Framework

The Local Government Pension Scheme (LGPS) is a statutory scheme. It has no Trust Deed. Its rules take the form of regulations which are secondary Scottish Statutory Instruments. In addition, there is a broad acceptance that the principles of fiduciary duty apply to Scheme Managers within the LGPS.

2.2.2 Regulations

The Local Government Pension Scheme (Scotland) (Management and Investment of Funds) Regulations 2010:

- provide that an administering authority must formulate a policy for the investment of its fund money;
- provide that an administering authority may appoint investment managers instead of managing and investing fund money itself;
- include a fairly broad definition of "investment";
- add some specific exclusions and exemptions; and
- require each administering authority to publish a Statement of Investment Principles which sets out the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.

Whilst not always helpful as regards investment structures, the regulations are not unduly restrictive as regards investment strategy.

2.2.3 Fiduciary Duty

Rooted in case law rather than statute, the requirements of fiduciary duty are much less easy to define than the powers and responsibilities conferred by the scheme regulations. In broad terms fiduciary duty means that non-financial issues can only be taken into account if there is considered to be no financial disadvantage or material risk of financial disadvantage from doing so. A summary of a recent counsel's opinion on fiduciary duty is included at Appendix E.

2.3 Costs

Implementation of any investment decision entails a variety of explicit costs. These might include broker commissions, market impact, other transaction costs, taxes, advisory costs and investment management fees. Whilst not insignificant, these explicit costs are likely to be less important than the potential cost in terms of investment risk.

2.3.1 Risk

Investment risk includes:

- absolute risk – loss of capital;

- relative risk – inferior returns to an alternative decision; and
- volatility – variability of returns.

These risks are acknowledged in the Fund's Statement of Investment Principles (SIP). The SIP also describes the Fund's approach to risk management.

2.3.2 Risk Management

The Fund pursues a policy of lowering risk through diversification of investments by asset class, manager and geography. Risk is also controlled by setting appropriate benchmarks and investment guidelines and maintaining a robust investment monitoring regime.

2.3.3 Impact of Divestment

By definition, exclusion of any sector or class of investment reduces the potential for diversification. That does not inevitably mean that it increases risk as this is also dependent on other factors including correlation between different investment sectors or classes, but it does concentrate the risk in a smaller investment universe.

2.3.4 Non-Financial

It is accepted that fossil fuel is a very significant contributor to climate change and that carbon reduction would be a universal benefit, indeed a necessity. It is less clear whether divestment by the Strathclyde Pension Fund from fossil fuels would help to achieve that. It is unlikely that such a move would have any impact on global supply and demand of fossil fuels. Divestment could provide a signal that the Fund is taking a stance on the issue of fossil fuels and global warming, but once the assets are sold the Fund would have no further influence in what happens in these companies and within the national and international energy sectors. Divestment would be achieved by selling the shares to other investors who may be unconcerned about climate change and less inclined to engage with management to change company behaviour.

2.3.5 Financial

The principal financial impact of divestment would be on investment returns. It is not possible to predict with any certainty what that impact would be. Performance of the full and adjusted indices to 30 June 2015 was as follows.

	1 Year (%)	**3 Year (% p.a.)**
MSCI ACWI ex Fossil Fuels	**13.25**	**15.01**
MSCI ACWI	**10.06**	**13.51**

The adjusted index has outperformed by a significant margin but this says little or nothing about future performance. Advocates of the stranded assets argument in respect of fossil fuels would suggest that long term performance will be inferior to other investments. This is by no means certain and the timing of any devaluation is even less so. One counter argument is that the price of oil dropped sharply towards the end of 2014 and is currently at or around a multi-year low. Whilst it could drop further there is also a strong case for it rising back to previous levels or higher and for associated investments to respond similarly. Any adverse impact on investment returns from excluding fossil fuel investments would be a financial burden on employers through their pension fund contributions.

Section 3 – Practical Considerations

3.1 Role of Investment Managers

Since its establishment the Fund has adopted an outsourced investment management model. It retains a varying number of external investment managers and spends a significant sum annually on investment management fees. The role of investment managers is to make decisions on the purchase, retention or sale of investments. Managers employ significant research, resource and analytical expertise in this process. Key factors in their analysis will include current valuation and forward-looking prospects of any investment. Environmental, social and governance factors will also be considered. This will allow the manager to take a fully informed view on the risk and return characteristics of each prospective investment. That forms the basis of investment decision-making. It is not clear why the Fund would superimpose a view on that model by excluding any particular sector from the investment universe.

3.2 Investment Indices

Choice of the investment index used as a benchmark for any portfolio is, in large part, a strategic decision and therefore a Fund decision. For actively managed portfolios the choice of index will have an influence on the ultimate shape of the portfolio. However, the Fund's approach to mandate construction is largely "unconstrained" – the Fund does not impose maximum or minimum sector limits. So investment managers already have this freedom in investment decision-making.

3.3 Passive Portfolios

Index selection will absolutely dictate the shape of a passive portfolio. A partial allocation to an ex fossil fuel index could be considered but there would need to be a very clear rationale for this. No such rationale has yet been established.

3.4 Formulation of Policy

Divestment is a very blunt tool particularly if complete divestment were contemplated. It makes no differentiation between companies, for instance identifying separately those who own fossil fuel deposits but are also developing significant renewable energy capabilities and capacity.

3.5 Precedent

Any action agreed in respect of fossil fuel investments will inevitably lead to calls for similar action in respect of other sectors or individual investments.

3.6 Governance

Fiduciary duty implies that, to justify fossil fuel divestment the committee would need to be satisfied that there would be no adverse financial implications from such a course of action.

Section 4 – Conclusions and Recommendations

4 Conclusions

4.1 Divestment Activity

There has been some limited and partial divestment by pension funds and others from fossil fuels. Restricting investments has never been the Strathclyde Pension Fund's policy.

4.2 Responsible Investment Strategy

The Fund's Responsible Investment strategy is based on active ownership and incorporating ESG issues into ownership policies and practices.

4.3 Active Ownership

The Fund participates in LAPFF (representing **£160 billion** of local government assets) and Carbon Disclosure project (representing **US$95 trillion** of global assets). Both of these organisations strongly endorse active ownership in respect of fossil fuel investments and climate change.

4.4 Active Investment

The Fund is also an active investor in the renewable energy sector.

4.5 Performance

Recent performance of the fossil fuel excluded index has been better than that of the full index but it is impossible to predict future performance with any certainty.

4.6 Investment Restrictions

Restricting investment opportunity will tend to increase volatility and may impair investment returns. It also reduces investor ability to engage and influence.

4.7 Active Management

The Fund's investment arrangements involve the appointment of external investment managers to make the vast majority of investment decisions. Their research and analytical resources equip them to make decisions on investment value and to incorporate environmental, social and governance considerations. The Fund's active managers continue to make selective fossil fuel related investments.

4.8 Fiduciary Duty

Fiduciary duty implies that, to justify fossil fuel divestment the committee would need to be satisfied that there would be no adverse financial implications from such a course of action. On the evidence available, the benefits of divestment are questionable, there would definitely be a cost and the overall impact in terms of investment returns could be significant. This course of action is therefore not recommended.

5 Policy and Resource Implications

Resource Implications:

Section 4 – Conclusions and Recommendations

Financial:	No issues
Legal:	No issues
Personnel:	No issues
Council Strategic Plan:	Not applicable

Equality Impacts:

EQIA carried out:	N/a
Outcome:	N/a

Sustainability Impacts:

Environmental:	Recognising environmental, social and governance issues is fundamental to the Fund's responsible investment policy.
Social:	Recognising environmental, social and governance issues is fundamental to the Fund's responsible investment policy.
Economic:	Recognising environmental, social and governance issues is fundamental to the Fund's responsible investment policy.

6. Recommendation

The Committee is asked **to agree** that the Fund should:

- re-state its commitment to active ownership and responsible investment;
- continue and where appropriate escalate its current responsible investment activities including engagement with companies and investment managers, and participation in LAPFF and CDP;
- continue to make appropriate investments in renewable energy and other impact areas through its New Opportunities Portfolio; and
- continue to monitor developments including the Paris climate change conference and alternative investment approaches;

Appendix A

Motion to Council

1. <u>Full text of Motion</u>

By Councillor Kieran Wild:-

Notes the decisions by the City of Oslo, Edinburgh City Council, Oxford City Council, Dunedin City Council in New Zealand and the University of Glasgow, to agree to partially or completely divest their pension funds from companies whose main purpose is extracting fossil fuels.

Notes the Council's fiduciary duty must be paramount in all decision making around pension funds.

Notes that recent studies, including the Impex Asset Management, have found that fossil fuel-based funds which exclude fossil fuels, and further notes reports including from business leadership think-tank Ceres which identify unreported risks in fossil fuel funds, which suggest the fiduciary duty may be best served by divestment from fossil fuels.

Notes recent clarification from Cabinet Secretary for Finance John Swinney MSP that local authorities may decide that fulfilment of their Public Bodies Duties under the Climate Change (Scotland) Act 2009 requires them to reduce the carbon emissions associated with their funds and investments.

Calls for a report to be sent to the relevant Committee setting out the feasibility, cost and benefits of introducing partial or complete fossil fuel divestment for the Strathclyde Pension Fund."

2. Commentary on Motion

2.1 Other Funds

From published reports the position of the other fund mentions appears to be as follows.

- **City of Oslo** committed to selling its pension fund investments in coal companies. The Norwegian government pension fund remains invested.
- **Oxford City Council** pledged to make no direct investments in fossil fuel companies for ethical reasons. The Committee determined that there was no clear financial justification for divesting from fossil fuel companies. The Oxfordshire Pension Fund has rejected disinvestment.
- **Dunedin City Council** in New Zealand voted not to invest in fossil fuel extraction companies as part of an ethical policy that also excludes munitions, tobacco, gambling and pornography industries. It committed to divest the £37m Waipori Fund, a Council fund, of any such investments within two years.
- **The University of Glasgow** has committed to fully disinvesting from fossil fuel industry companies over a 10 year period, subject to reassurance that the financial impact for the University is acceptable. This decision relates to endowment funds, not pension funds.

Motion to Council

2.2 Scottish Government

The motion notes recent clarification by John Swinney MSP around local authorities' fulfilment of their Public Bodies Duties under the Climate Change (Scotland) Act 2009. However, to date no change has been made to the guidance provided by Scottish Ministers to Public Bodies under the Climate Change (Scotland) Act 2009.

2.3 Studies

The motion notes recent studies and reports by parties including Impax Asset Management and business leadership think-tank Ceres. However, neither of these reports could be viewed as independent, authoritative, or impartial:

Impax Asset Management describe themselves as "…a leading investment manager dedicated to investing in the opportunities created by the scarcity of natural resources and the growing demand for cleaner, more efficient products and services, through both listed and private equity strategies."

Heavily invested in renewables and fossil fuel 'clean-up', they have a clear business interest in fossil fuel disinvestment.

Ceres is an advocacy organisation promoting sustainability.

Appendix B

Responsible Investment Policy

1. Background

The importance of corporate governance and social and environmental considerations to shareholder value has long been recognised by Strathclyde Pension Fund.

In January 2008, the Fund became a signatory to the United Nations Principles for Responsible Investment (UNPRI). A key feature of the principles is that they encompass environmental, social and governance (ESG) issues. After a review of its adherence to UNPRI during 2008, the Fund combined its existing corporate governance and Socially Responsible Investment policies into a single Responsible Investment policy following the framework of the principles.

2. Activity

Responsible Investment activity is carried out by:

- the Fund's investment managers who are required to exercise the Fund's voting rights, to incorporate analysis of ESG issues into their investment analysis and expected to engage on these issues with the companies in which they invest;
- Global Engagement Services (GES), a specialist responsible investment engagement overlay provider appointed by the Fund in 2012 and again in 2014; and
- the Fund itself through direct engagement and collaboration with other investors including the Local Authority Pension Fund Forum, Shareaction, Carbon Action and other ad hoc alliances.

A quarterly report on Responsible Investment activity is considered by the Strathclyde Pension Fund Committee and published on the Fund's website at: www.spfo.org.uk

3. The Principles for Responsible Investing

The text of the Principles is as follows.

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. *We will incorporate ESG issues into investment analysis and decision-making processes.*
2. *We will be active owners and incorporate ESG issues into our ownership policies and practices.*
3. *We will seek appropriate disclosure on ESG issues by the entities in which we invest.*
4. *We will promote acceptance and implementation of the Principles within the investment industry.*
5. *We will work together to enhance our effectiveness in implementing the Principles.*
6. *We will each report on our activities and progress towards implementing the Principles.*

Appendix C

New Opportunities Portfolio

SEP Environmental Capital Fund	
Total fund size:	**£89m**
NOP investment:	**£5m**
Net return:	**N/d**

This fund was established with two distinct investments strands – the acquisition of a utility connections business and a 4 year pipeline of similar investment stock, together with an ongoing investment programme into smaller scale renewables assets, such as energy efficiency, district heating etc. The total fund size is £79m, with total funding of £117m being available for investment after accounting for the borrowing facilities in respect of the connections business acquisition. The commitment approved was £7.5m but all parties had to accept scaling back due to significant demand and NOP's share was reduced to £5m

Albion Community Power PLC	
Total fund size:	**£100m**
NOP investment:	**£10m**
Target return:	**11% IRR**

ACP has been set up to build, own and operate small-scale renewable energy plants across the UK. An investment of £10m has been made through the NOP alongside £25m from the Green Investment Bank, which is providing further match funding to a total of £50m overall as further investors come through. The company operates at the smaller end of the market, where competition tends to be lower and will focus on single wind turbines in industrial locations, "run of the river" hydro schemes and AD plants.

Now that the first round of funding has been completed, work has begun on the pipeline and initial drawdowns have been made in respect of 3 hydro schemes and 1 wind scheme which will all be operational next year.

Iona Environmental Infrastructure LP	
Total fund size:	**£70m**
NOP investment:	**£10m**
Target return:	**12% IRR**

This is an investment into a fund which develops and runs Anaerobic Digestion ("AD") plants across the UK. The AD process involves breaking down organic product of varying types (farm waste, silage, commercial food waste etc.) through a digestive process in tanks, with the main eventual output being methane, which can either be injected directly to grid or used to generate electricity. Iona have established a number of plants of varying levels – some farm scale and some linked to commercial waste agreements or with local councils

Appendix C

New Opportunities Portfolio

The fund is now closed and over the next year or so the remaining developments will be completed and our commitment drawn in full. Distributions will commence soon and the indications from the operational assets so far are that the target levels of return will be achieved.

Resonance British Wind Energy Limited

Total fund size:	**£100m**
NOP investment:	**£10m**
Target return:	**10% IRR**

Resonance is an established Fund which invests in existing operational small scale onshore wind assets. Again, we were the final Investor to complete the fund which is now closed at £100m, with most of that fund now invested in 7 operational wind farms across the UK. These are now generating a cash yield as part of the overall return and we shall receive our first distribution from the fund shortly, as our investment was drawn down in early April. Performance over the portfolio as a whole generally is in line with expectations.

Terra Firma Infrastructure Fund for Global Renewable Energy

Total fund size:	**US $ 500m**
NOP investment:	**US $ 50m**
Target return:	**10% IRR**

The fund will be run by Terra Firma, which has been a significant operator in the Renewable Energy space in recent years. This will be their first fund focussing solely on Renewables but they have been active investors through their general funds and were recently ranked by Bloomberg as the no.1 investor in Renewable Energy, having completed 20 clean energy transactions with an installed capacity of 1.7 GW.

The fund will invest in a mix of renewable power generation assets, some brownfield and some construction ready, so no planning and development risk will be taken. The portfolio is expected to be distributed across the OECD. Terra Firma will put up a cornerstone investment of US £100m. This is currently in commercial diligence.

Temporis Onshore Wind Fund LP

Total fund size:	**£75m**
NOP investment:	**£30m**
Target return:	**net IRR 10%**

Appendix C

New Opportunities Portfolio

Temporis is an asset manager which focuses on the renewables sector in a variety of ways. They manage assets for a number of VCTs ("Venture Capital Trusts"), principally onshore wind and small hydro, and recently were appointed the manager for a £200m debt fund for renewables projects, funded equally by the Green Investment Bank and KKR. They also operate their own wind consultancy business, which adds to their significant direct experience. This fund will bring together a club of investors to invest in onshore wind development projects.

UK GIB Offshore Wind Fund LP	
Total fund size:	**£1 billion**
NOP investment:	**£50m**
Target return:	**gross yield 9-11%**

The Green Investment Bank ("GIB") was established by the government to act as a catalyst in the Renewables sector and to help the flow of private finance into areas of the sector which would not otherwise receive it. It is currently raising £1bn for an operational offshore wind fund, buying equity stakes in developments where the GIB is already a partner with the likes of RWE and Statkraft. The rationale for the fund is that it will allow development capital to be released from operational assets and recycled for further development.

Aviva Investors PiP Solar PV Fund	
Total fund size:	**£250m**
NOP investment:	**£20m**
Target return:	**RPI + 2-5%**

Strathclyde Pension Fund is a founder investor in the Pensions Infrastructure Platform (PiP), an innovative investment vehicle created "by pension funds for pension funds".

For this, the second PiP fund, Aviva Investors have been selected as the preferred provider for a £250m tranche of investment, into UK private and social residential solar PV rooftop installations. The Aviva fund will purchase portfolios of installed/ operating assets, with lease of rooftop space and revenue provided from the Feed-in Tariff regime. Revenue is RPI linked, with payments continuing for 20-25 years post installation. At lease expiry, panels revert to homeowners.

Appendix D

Further Details of Engagement Approach

1. Principles of Engagement

Engagement is based on a belief in active rather than passive ownership. The European model of active engaged ownership contrasts with the Asian/Middle Eastern Sovereign Wealth Fund holding model. The European model of ownership facilitates engagement on the full span of ESG issues. Absent this concern and pressure, corporate behaviour would deteriorate across the ESG spectrum and risk to investment value would increase. Ironically the less responsible investors there are in a sector the more chance of negative ESG outcomes not just for markets but also for society and the environment. Active ownership improves accountability both in the investor and in the process of holding corporate entities to account.

The easier option is to be a passive disinterested holder. It can be argued that disinvesting/excluding undermines claims of being a 'responsible' investor.]

A collaborative approach to engagement facilitates peer group co-operation on other issues, sharing of ideas and best practice outside of Responsible Investment. Engagement collaboration on extractives facilitates the Fund's compliance with its PRI signatory obligations. Engagement on 'difficult' cases requires external service provider co-operation and input. It facilitates the diligence/governance process with these external providers.

It is a valid strategy with active investment management to hold companies that require ESG improvements to extract value. The market will readily discount poor ESG practices, a discount that can be closed by positive intervention on ESG issues through engagement and voting.

2. Strathclyde Pension Fund Case Studies

The Fund is a signatory to Carbon Action. Carbon Action is a CDP initiative which works with investors and corporations to encourage companies to take action to reduce their Green House Gas emissions by making investments in emissions reduction activities that have a satisfactory financial return. In 2013 300 companies targeted in heavy emitting industries, $33bn invested in emissions reduction activities with 1,050 reported projects and reduced emissions of 169 million metric tonnes CO_2e (110 million metric tonnes CO_2e in 2012).

History has shown that a lack of oversight in the extractive sector leads to major incidents with loss of life and serious environmental damage. Responsible/active investors are critical to this oversight. SPF examples of this positive influence are:

> **GES** has been engaging with **BP** since the Gulf of Mexico incident in 2010. The company prepared and published its incident report within a reasonable timeframe following the incident, and committed to improving the management of health, safety and environment (HSE) company-wide. This included the creation of an internal Safety and Operational Risk function to supervise all operations, a new internal Global Wells organisation to oversee oil and gas well standards and practices, redoubled efforts to roll out the company's

Further Details of Engagement Approach

Operational Management System globally, and changes to key staff including replacing both the head of exploration and company CEO.

At the company's annual sustainability day in London, attended by GES at the end of 2014, BP communicated that 97 per cent of the incident report recommendation tasks were complete. The remaining work is being executed as planned, with full completion expected in early 2016.

GES has been in regular dialogue with **Anadarko** since the Gulf of Mexico incident in 2010. The company initially stated that the Macondo blowout was caused by gross negligence on the part of BP, and maintained that the project was a routine one and that the blowout could have been prevented if good oilfield practice had been followed. Anadarko also stated that it is normal practice for non-operating partners to be uninvolved in operational matters. The company did however contribute numerous staff, vessels and equipment to the spill clean-up, and pledged that any money earned from sale of recovered oil would be donated to local causes. In the last two years, Anadarko has significantly strengthened its sustainability and health, safety & environment work, including the setting of new corporate standards endorsed by the CEO. In 2013, the company committed to making significant improvements to sustainability management, including establishing a CSR committee and engaging consultants to evaluate performance and design a pathway to improvement. In addition, a new Manager of Corporate Responsibility role was created and a program of health, safety and environmental management system improvements initiated. This new approach is published on the company website and GES has received copies of other internal procedures which verify that improved standards and routines are in place.

On behalf of clients GES attended the Royal Dutch Shell sustainability day in London in April 2014. The event was attended by the CEO and other key members of senior management, allowing management a first-hand chance to hear and respond to investor concerns. Sessions and key topics covered included an opening overview by the new CEO, carbon management, North American operations including oil sands, Nigeria, and HSE performance. Many questions were fielded on company-wide carbon emissions and management of oil sands impacts (carbon, water, physical impacts). During the session on Nigeria GES questioned the company’s due diligence in regard to its recent divestment out of several onshore oil blocks. GES also followed up on Shell’s planning and implementation of the Ogoniland pollution remediation, as well as communication on progress, which is currently sub-standard.

Appendix E

Counsel's Opinion on Fiduciary Duty

1. **Local Government Association "the LGA Opinion"**
During 2014 the Local Government Association on behalf of the LGPS Shadow Scheme Advisory Board in England & Wales instructed Mr Nigel Giffin QC in the matter of:

    I. Does an LGPS administering authority owe a fiduciary duty and if so to whom it is owed?

    II. How should the wider functions, aims or objectives of the administering authority influence the discharge of its LGPS investment duties

    His conclusions were:

    CONCLUSIONS

    i. In managing an LGPS fund, the administering authority has both fiduciary duties and public law duties (which are in practice likely to come to much the same thing).

    ii. The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way).

    iii. However, so long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such considerations, the administering authority may not prefer its own particular interests to those of other scheme employers, and should not seek to impose its particular views where those would not be widely shared by scheme employers and members (nor may other scheme employers impose their views upon the administering authority).

2. **Scottish Scheme Advisory Board**
The Scottish Scheme Advisory Board established in 2015 has included fiduciary duty in its initial first workplan and may take a separate Scots law counsel's opinion.