

The **co-operative**  
asset management

# Responsible Investments Quarterly Review

Spring 2011



# Section 1 Engagement Update

## Plugged in to the Great British Energy Debate

The UK Government says that in future our energy policy needs to meet three goals: security of supply, decarbonisation and affordability. We say, “Pick two.” Here, our financial analyst for utilities, Karl Green, gives an insight into our engagement with the regulators.

‘Fukushima causes surge in gas prices’  
‘Middle East/North Africa tensions drive oil to almost \$120 per barrel’  
‘Unpredictable Chinese demand raising coal price volatility’

Such headlines present a snapshot of modern day energy market globalism, highlighting the profound challenges facing the UK consumers.

Overlaying this is the urgent need to curtail greenhouse gas (GHG) emissions, whilst ensuring that the UK can continue to physically access the internationally-traded fossil fuels required to ‘keep the lights on’ for the foreseeable future. This presents politicians and appointed regulators with a tricky juggling act in terms of shaping an affordable, decarbonised energy market with adequate safeguards around security of supply.

Delivering these policy objectives will require some tough trade-offs. For example, nuclear potentially has a key role to play in decarbonising the supply of energy, but the costs of adequately safeguarding against ‘worst case’ safety breaches and decommissioning are at best uncertain and at worst prohibitive. Imported gas is relatively cheap and less carbon intensive than coal, but carries greater security of supply risk compared

to indigenous coal. The Department for Energy and Climate Change (DECC) and the energy markets regulator, the Office of the Gas and Electricity Markets (Ofgem), are working in close co-operation to determine the best blend of policy interventions.

The Co-operative Group has multiple stakeholder interests in this process. The Co-operative Asset Management invests in the energy utilities which are expected to finance and deliver the investments needed in the UK’s power generation and transmission infrastructure. The Co-operative Bank funds numerous community level renewable energy projects. Our farming business operates wind turbines and has the potential to benefit from energy from waste (EfW) opportunities.

Consequently, a cross-divisional delegation from The Co-operative was invited to attend bi-lateral discussions with senior representatives of DECC’s Energy Markets and Infrastructure Group in early February. The wide-ranging discussions we had with DECC’s policy architects highlighted the influential role that The Co-operative has to play in the re-engineering of the nation’s energy infrastructure.

From an investor’s perspective, we were keen to impress upon DECC, above all else, that risks to providers of equity and debt capital such as The Co-operative Asset Management are rising in terms of the cost of financing and operating energy infrastructure. In particular, we are concerned that technical and civil engineering risks in new nuclear, offshore renewable generation, ‘smart grid’ (including reinforcement for electric vehicle roll-out) and Carbon Capture and Storage (CCS) are substantially higher than would seem to be appreciated by civil servants.

| Energy priorities                           | How we can meet them              | The missing link                                                                                      |
|---------------------------------------------|-----------------------------------|-------------------------------------------------------------------------------------------------------|
| Security and decarbonisation                | Nuclear and renewables            | Affordability: Both these options are expensive, at least in the construction phase.                  |
| Security and affordability                  | Fossil fuels                      | Decarbonisation: CCS would mitigate some carbon but is very expensive.                                |
| Affordability and decarbonisation           | Gas (lower carbon) and renewables | Security: the UK would have to import almost all its gas as renewables cannot provide baseload power. |
| Security, decarbonisation and affordability | ?                                 | N/A                                                                                                   |

Like Ofwat for the water utilities, Ofgem determines the returns that power supply utilities are allowed to make over a 5-year period, taking into account the capital and operational expenditure these companies will need in order to meet Government's energy policy objectives. In The Co-operative Asset Management's view, the permitted returns on investment available to energy utility investors need to be adjusted on a case-by-case basis to reflect the risks associated with the required transformation of the energy infrastructure, since the Government is unwilling/unable to underwrite them owing to its own financing constraints. We have thus become increasingly concerned by the trend for 'allowed' returns on capital in the regulated energy sector to be downwardly revised at each major regulatory price control review. Whilst we recognise that debt finance costs have been falling, ultra-low interest rates will not endure indefinitely.

We have therefore separately engaged with Ofgem in its ongoing consultation into its proposals for innovation of regulation in respect of monopolistic electricity and gas transmission operators. Initial proposals released in late 2010 carried a multitude of potentially damaging financial consequences. Mercifully, the worst of these 'unintended' consequences have been scrubbed from the second draft published in March this year. Highlighting the complex compromises yet to be thrashed out, Ofgem is not expected to finalise the new regulatory regime until late in 2012.

In the meantime, The Co-operative Asset Management has mixed feelings about the prospects for the UK energy utilities. On the one hand, we are heartened by the highly consultative manner in which both DECC and Ofgem are going about their market re-design. The UK Government is acutely aware that it has to carry the private sector with it if it is to deliver on its GHG commitments, whilst keeping bills as low as possible and the lights on. However, we have deep reservations over the fragmentation of the process, unavoidable parliamentary short-termism and the raw financial capacity of current operators to deliver a doubling of energy investment over the next decade to £200bn.

As responsible investors, we wholeheartedly support the hard work being undertaken by the Government, energy companies and their multiple stakeholders to create a sustainable energy market. However, the market must evolve in a way that is both sufficiently far-sighted and economically viable. This may yet require greater degree of centralism than may traditionally be deemed ideologically acceptable to the current administration – in itself another reason to tread carefully as investors. It seems inescapable that consumers will be paying much more in any scenario. This means Ofgem's role as the consumer's friend will be increasingly difficult to maintain. As we note in our Investment Themes section on balance we believe in the end Government will have to allow UK power and grid companies to make meaningful returns on the capital expenditure they are being asked to make and those with diversified, decarbonising portfolios including renewables will enjoy a strong incumbency/first mover advantage.



## **Engaging for an Enhanced Understanding of Water Issues**

As reported in our Winter 2010 review, we recently wrote to ten CDP (Carbon Disclosure Project) Water Disclosure non-respondents in which we hold bonds and/or shares to initiate dialogue on water-related risks and opportunities as well as to encourage participation in this year's Water Disclosure questionnaire. Covering various sectors and geographies, these companies were Apple, BG Group, The Coca Cola Company, E.on, EDF, Lafarge, Royal Dutch Shell, Scottish & Southern Energy (SSE), Talisman and Total.

While it was disappointing to receive no response from EDF or SSE, and only a very limited acknowledgment from Apple, we were pleased at how some of the others were able to evidence different levels of integration of water issues into their businesses. We also took the opportunity to discuss the matters further in conference calls with Total and Shell. We commend Lafarge and Coca Cola for continuing to work with WWF

to improve their water management practices, with a number of others having also taken measures to identify operations most at risk and set targets for water withdrawals and the reuse and/or recycling of the scarce resources. Few, however, recognise water as a material issue or a potential business impediment, or something that cannot at least be tackled with technology. We will monitor the progress of respective companies and build on this initial engagement where appropriate.

As regards to CDP Water Disclosure, E.on and BG committed to responding to the survey in 2011, and while some companies were critical of the questionnaire itself (namely the definitions used and some of the questions asked) few ruled out responding to it in the future. What's obvious both from companies' feedback as regards the questionnaire and their responses to our enquiries, is that the lack of standardised terminology, coupled with a non-harmonised approach to measuring impacts across companies and sectors, makes it, at times, difficult for investees and investors alike to put water issues into perspective and compare performance among peers. While many businesses appear to be waking up to water risks and opportunities, the reaction to these remains relatively erratic and decentralised, with room for improvement also in linking water issues into strategy, especially in the long term.

The Co-operative Asset Management hopes that the further development of the CDP Water Disclosure and other issue-specific networks will help in bringing about improved, uniform standards as regards water management and reporting. Along with a more sophisticated understanding among our investees of impacts and opportunities beyond simple consumption and discharge numbers, this is what we will continue to campaign for.

## Gender Developments Gather Pace

We have previously espoused the benefits of a diverse board in consultation responses such as our input into the UK Corporate Governance Code, at a time when the concept was viewed as left field. Now, the EU's upcoming consultation of European wide corporate governance guidelines asks specifically for views on measures to increase the number of female directors and we look forward to making our thoughts known to the Commissioner.

Within the UK, the Department of Business, Innovation and Skills (BIS) released the conclusions of Lord Davies of Abersoch's review into gender balance in the boardroom in February.

The review began by painting a bleak picture where, at the current rate of change, it will take over 70 years to achieve gender-balanced boardrooms in the UK. The headline from the review was the decision not to recommend mandatory quotas, however that is not the end of the matter. The European Commission will publish a Green Paper on boardroom diversity this year and early indications express a preference for voluntary improvement with the implied move to quotas if there is not sufficient progress.

As part of our ongoing efforts to increase the representation of women on company boards The Co-operative Asset Management had previously fed our views to BIS. We were pleased to see the review had drawn on our 2009 study "Diversity and Gender Balance in Britain plc" in conjunction with The Observer as part of our Good Companies Guide series. (See table on next page).



One of the ten recommendations of the review was the recognition and development of the wealth of untapped female talent including entrepreneurs, academics and civil servants. In the spirit of this recommendation we raised the topic of recruitment agencies tapping into the pool of chartered company secretaries at the Institute of Chartered Secretaries and Administrators (ICSA) Corporate Governance conference. We view company secretaries as a suitable assemblage of highly skilled professionals who benefit from both a high proportion of female members and extensive board exposure, making them good candidates to consider for short-listing for board level positions.

The Financial Reporting Council (FRC) will consult on the recommendations of the Davies review this year and we will ensure our views and work in this area form part of the contributions. Shortly after the release of the Davies review we also fed our recommendations on improving gender balance into the Deloitte survey on board structure and processes.

Globally, Norway, Spain, France and Australia have taken decisive action in recognising the importance of improving the gender balance at the highest levels. As we enter the Annual General Meeting season we expect to see more shareholder resolutions in North America based on gender concerns. The first two such resolutions were lodged at the Bank of Nova Scotia and Toronto Dominion Bank and we voted in favour of both. Interestingly, Quebec has legislated on the topic of gender parity for the boards of its Crown corporations and is on track to have 50% female representation by December 2011.

Although there's still a long way to go, expectations for improved diversity are building. We will continue to engage with our investee companies to see how they handle the challenge and opportunities presented by increasing the number of women on boards and executive management in the near future.

| <b>Our recommendations</b>                                                                                                                                       | <b>Lord Davies's review conclusions</b>                                                                                                                                                                                                                                                                                                                                                                                                                 |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Improved disclosure of gender balance in company management hierarchies and specifically at the two levels below the board.                                      | Quoted companies should be required to disclose each year the proportion of women on the board, women in senior executive positions and female employees in the whole organisation.                                                                                                                                                                                                                                                                     |
| Clarification of the legality of women-only executive searches.                                                                                                  | Executive search firms should draw up a Voluntary Code of Conduct addressing gender diversity and best practice which covers the relevant search criteria and processes relating to FTSE 350 board level appointments.                                                                                                                                                                                                                                  |
| Enhanced guidance should be prepared for chairmen on differences in communication styles between women and men.                                                  | This does not appear in the review but we will continue to discuss the issue as part of our engagement with investee companies.                                                                                                                                                                                                                                                                                                                         |
| Better dissemination of the business case for improved gender balance.                                                                                           | The review itself brought together the most business-relevant studies whilst generating a significant amount of debate on the topic. However, this should only be considered the starting point for information dissemination.                                                                                                                                                                                                                          |
| Requirements for boards to consider gender balance within the UK Corporate Governance Code should be strengthened, with increased focus on implementation.       | The FRC should amend the UK Corporate Governance Code to require listed companies to establish a policy concerning boardroom diversity, including measurable objectives for implementing the policy, and disclose annually a summary of the policy and the progress made in achieving the objectives.                                                                                                                                                   |
| Steps should be taken to improve dialogue and transparency over board nominations processes, particularly with an increase in prior consultation with investors. | In line with the UK Corporate Governance Code provision B2.4 "A separate section of the annual report should describe the work of the nomination committee, including the process it has used in relation to board appointments". Chairmen should disclose meaningful information about the company's appointment process and how it addresses diversity in the company's annual report, including a description of the search and nominations process. |
| Legislation requiring companies to implement flexible working should be introduced.                                                                              | The solutions offered by the review highlight flexible working as a means to encourage women to serve on boards, having gained experience, expertise and profile.                                                                                                                                                                                                                                                                                       |



### No Trip-ups in the Dash for Gas

The Co-operative Asset Management co-edited a scientific report by The Tyndall Centre for Climate Change Research (and sponsored by The Co-operative Group) which sought to measure the environmental impacts of shale gas extraction. Shale gas, which is extracted by hydraulically fracturing ('fracking') shales underground to release gas molecules, now supplies one third of US gas demand. This dash for gas has the potential to transform the US fuel economy and other countries including China and Poland are looking to exploit their reserves. The chief environmental concern, the Tyndall Report details, is groundwater pollution, an issue that has attracted much attention in the US and is currently the subject of review by the Environmental Protection Agency with federal legislation expected by Q1 2012. The report's analysis suggested shale gas production is only marginally more CO<sub>2</sub> intensive than conventional gas though more study is needed.

The Co-operative Asset Management believes that shale gas may have a role to play in the shift to a low carbon economy but only in the presence of strong regulation that confers an economic value to its carbon profile, which is currently only the case in Europe. The technology will also have to demonstrate that it can operate safely with no meaningful risk to drinking water if it is to prosper.

Companies involved in fracking have declined to or said they are unable to disclose the hundreds of chemicals used in the fluids needed to maintain the complex drilling equipment but it is the composition and potential toxicity of some of these constituents, as well as the potential for leakage of gas into aquifers, that gives rise to concerns.

We signed an investor letter led by SHARE, a Canadian investment coalition, to EnCana, a Canadian energy company heavily involved in fracking in North America. The letter commended the company's recent disclosures on the subject but pointed out that it still appeared not to know what exactly were the constituents of the fluids it was being supplied with and didn't appear to have systems for testing groundwater.

We will be approaching a number of investees with exposure to shale gas this year to ask them how they are preparing for likely regulation and minimising risk to drinking water.

### Guiding Principles for Business and Human Rights

While businesses have started to appreciate that addressing environmental issues is not only the right thing to do but often also has material business benefits, it has been more difficult to demonstrate where companies' responsibilities lie when it comes to human rights. This is something that Professor John Ruggie, the UN Secretary General's Special Representative on Business & Human Rights, has worked on over the past six years, with his efforts likely to culminate in human rights issues becoming a central consideration for businesses by this summer. Professor Ruggie's mandate was to identify and clarify, and subsequently operationalise, standards and practices as regards respect for human rights in business context. The Special Representative developed a framework consisting of three interrelated pillars: the states' duty to protect against human rights abuses by third parties, the corporate responsibility to respect human rights and better access to remedies for victims (the 'Protect, Respect, Remedy' Framework).

The last phase of Professor Ruggie's mandate brings it to the practical level through concrete, workable recommendations for the framework's implementation, drawing from extensive consultations with numerous stakeholders. In January, The Co-operative Asset Management was part of a small investor group which met with Professor Ruggie, feeding back on the usefulness of his work for responsible investors and seeking further guidance on companies' responsibilities in certain situations.

Professor Ruggie has since presented the final Guiding Principles to be voted on by the UN Human Rights Council this June. The process has been broadly endorsed by governments and non-governmental actors alike; a commendable achievement considering the contentious and potentially emotive nature of the subject matter. We were among investors issuing a statement in support of Professor Ruggie's final report in February and consider widely agreed, formalised, and practical guidelines to companies on managing human rights issues to be long overdue. We envisage these to be valuable for both our engagement efforts and the assessment of our investees' handling of related risks, not least as regards operations in controversial circumstances (see Section 3).

If approved, the Guiding Principles will provide companies clarity on their responsibilities along with guidance for managing human rights risks and impacts of business activities. Furthermore, as an UN-backed mechanism the principles will serve as an authoritative set of expectations for appropriate behaviour for multinational companies.

## Section 2 **Corporate Governance**

### Reflections on Active Ownership in 2010

We consider it imperative that, in a situation where we feel we cannot vote in favour of a resolution due to environmental, social or governance (ESG) concerns, we inform the company in question why we have arrived at that conclusion. This opens the door to, or builds upon, ongoing dialogue and ultimately enhances our view of how well an investee company puts good governance into practice.

In 2010, 203 letters were sent to company secretaries detailing an intention to vote against, or to abstain on, a management resolution, or to support or abstain on a shareholder resolution. This is broadly similar to 2009 where we sent 207 letters.

We were pleased, but not altogether surprised, to see the response rate from companies increase by more than threefold from 2009. The importance of proactive dialogue with shareholders has been hammered home on two fronts. Companies now know that stonewalling investors over ESG matters has no place in today's environment. This is underlined by the changes in the UK Corporate Governance Code. Equally, now the Financial Reporting Council's (FRC) Stewardship Code has been introduced, there is an increased onus on institutional investors to devote resource to engage with companies on ESG and wider matters.

In 2010, The Co-operative Asset Management attended five annual general meetings (AGMs). In terms of UK voting figures, we abstained or voted against 10% of resolutions, slightly down on the 11% of 2009. However, engagement with companies prior to the AGM has increased, leading to commitments from companies on the issues causing concern. In such instances we normally relax our voting stance but monitor progress closely.

These figures confirm our status as one of the most active and assertive institutional investors in the UK, with the major areas of opposition being executive remuneration, executive incentives and board independence.

### New Year Brings Signs of Improved Governance Dialogue

As the new UK Corporate Governance Code bedded in, becoming effective at the turn of the year, an unprecedented amount of companies sought out investors' feedback on proposals that would form part of upcoming Annual Reports. With circa 150 institutional investors signed up to the Stewardship Code at last count, there was clearly a sense of shared responsibility for shareholders to contribute effectively through the various consultation processes.

ITV, a company in the midst of transformation, took a particularly candid approach to proposing changes to executive pay arrangements and we certainly welcome their openness to dialogue. While we had various reservations on elements of the proposal we were largely satisfied by the blank-canvas approach ITV had taken to the review. We particularly commend the tight alignment of pay to current strategic imperatives, such as a focus on share of viewing and growth in non-advertising revenues & increased internal supply of programme content. It was

encouraging that one of our focal engagement objectives - that ITV improve disclosure of the annual bonus framework - was taken up by the company and we are satisfied by the improvement presented in the 2010/11 Annual Report.

Carrying on with the theme of companies reviewing executive pay to achieve a tighter fit to strategy, we were also encouraged by the result of an investor consultation process with InterContinental Hotels Group (IHG). Following the remuneration committee review and shareholder feedback it was concluded that net rooms growth and like-for-like revenue per available room growth are both integral drivers of profitability and central to the current strategy. Therefore it was agreed that the measures should form part of the Long-term Incentive Plan (LTIP) where performance is measured over three years, necessitating sustained out-performance. As a long-term investor in IHG we are encouraged that healthy two-way dialogue has led to steady improvements in the company's corporate governance.

Having been unable to support the remuneration report for 2009/10 at regeneration specialist St Modwen Properties we took very seriously our stewardship role as an investor participant in their remuneration review consultation. Having narrowly avoided the admonishment of having the remuneration report voted down by shareholders the non executive directors took the reform agenda seriously. Following a healthy degree of dialogue we are pleased to report that overall St Modwen took a significant step in the right direction. Among the notable improvements was the introduction of a formal bonus claw-back provision, a more definitive graduated scale for each of the performance metrics, a bonus deferral system and a commitment to improve disclosure.

More recently we have been actively involved in discussions with Tesco (as previously reported) and a prominent FTSE 100 bank; however, as dialogue is ongoing, we will update you on our progress when we can.

Finally, carrying on with the positive theme, ongoing engagement with Amec, the global engineering consultancy, has led to the introduction of a formal bonus deferral and claw-back system, a more prudent approach to maximum bonus pay unless more stretching performance conditions are achieved, and an increased share-ownership requirement for executive directors.

So far we have been buoyed by the sense of re-invigoration the new year has brought to company engagement, allowing for a much more inclusive approach to corporate governance reforms. We hope this continues as we move into the busier AGM season and, importantly, maintain our momentum of realising reforms at investee companies. In all, a positive start for stewardship in 2011.

## One Share, One Vote

The principle of one share one vote underpins good governance practices. This principle is seriously diluted when, at a general meeting, the chairman counts only the votes of those shareholders present and not the vast majority of shareholders who have cast their vote using a proxy form (known as poll voting). Imagine a situation where a clear majority of all shareholders had posted in their votes against a resolution but more than half of a handful of investors who had attended the AGM voted in favour, meaning that the resolution was carried!

In 2005 Lord Myners highlighted the erosion of democracy caused by counting the votes using a “show of hands” to the Shareholder Voting Working Group. He made it clear that the use of poll voting demonstrates best practice. Fast forward to 2011 and we are pleased to see that 90% of the FTSE 100 companies have voluntarily adopted the counting of votes by poll, rather than a show of hands. However, the battle is not yet won and to this end we have supported two initiatives addressing investor concerns. One called for the remaining 10% of FTSE 100 companies to address their laggard status, while the same point of concern was also raised to Singaporean companies listed on the Straits Times Index.

## Say on Pay Gains Traction in Switzerland

This was our third year of campaigning for shareholders to have a “say on pay” in Switzerland. Say on pay is a key shareholder right and one which comes with significant responsibilities. Presently, there is no legal obligation on companies to put their remuneration report to the shareholder vote, however we are delighted to see positive momentum building in Switzerland with companies acting ahead of potential legislation to make a vote compulsory. For instance, 33% of the top 100 Swiss companies by market cap are giving their shareholders a vote on director pay packages in 2011, up from 20% in 2010. Those who have introduced the vote include well-known names such as Swiss Re, Nestlé, UBS and Novartis.

### Novartis

Novartis introduced an advisory vote on its remuneration in 2010, however this resolution will only appear at the AGM every three years. We, alongside many other responsible investors, prefer annual opportunities to feedback to the company given the ever-changing nature of remuneration. Significantly, Novartis is the only Swiss company recommending a vote every three years.

Given that at their AGM in February 39% of shareholders voted against Novartis’ remuneration report we feel it is imperative that investors are granted an annual opportunity to raise concerns.

## US Update: Investors Call for More Company Outreach

Following our last post on the US market, implementation of the biggest regulatory overhaul since Glass-Steagall has continued, as the Dodd-Frank Act becomes a reality for companies. It is helpful at this stage to summarise some of the changes that may alter our approach as institutional investors in the region.

Firstly, corporate governance responsibilities have increased substantially for both issuers and owners. Investors have been particularly empowered by the advent of further engagement tools more commonly enjoyed in other markets like the UK:

- Shareholders now have the opportunity to vote on say on pay and to determine the frequency of such votes. Encouragingly, many companies have plumped straight for an annual vote in line with a clear investor preference.
- Although delayed due to a legal challenge from the Chamber of Commerce, proxy access rules are to be significantly modified to make it easier for investors to nominate directors to the board in an inexpensive way. This acts to make directors much more accountable to shareholders.
- The closing of the broker discretionary voting loophole, which allowed all unassigned votes to be automatically voted in favour of director election and compensation, has resulted in magnified value for institutional shareholder votes. As a consequence, institutional investors will be required to disclose their voting decisions on such resolutions.

This all provides a much improved framework for a more prominent stewardship role for institutional investors and underlines the need for enhanced dialogue between investors and companies. Traditionally such discourse has been very limited in the US resulting in a bigger emphasis on shareholder resolutions as a means to catalyse genuine communication.

Armed with further tools to channel engagements and with a need to increase dialogue The Co-operative Asset Management has joined with other international investors with combined AUM of \$1.84 trillion in calling for a dedicated conference call for institutional investors focused exclusively on corporate governance matters as reflected in the annual proxy statement.

We believe this “Fifth Analyst Call” is a hugely timely initiative and if implemented successfully would augment a step-change in the quantity and quality of dialogue between investors and companies. Improved communications would also serve to enhance our understanding of a company’s governance so that we are more able to reflect positives or negatives in our investment appraisals. We are encouraged by early signs of traction in discussions with companies and remain hopeful that they will see the benefit of more informed proxy voting by investors.

We are currently leading the investment group’s engagement at healthcare company McKesson Corporation and will report on our progress in the Summer 2011 review.



# Section 3

# **Business Operations in the Occupied Palestinian Territories**

At The Co-operative Asset Management the selection of suitable companies for our Sustainable Funds is far from straightforward and often the subject of vigorous debate. We consider various negative and positive criteria that investees must pass in order for them to be acceptable for investment. It often happens that a company has obvious benefits to society on one hand, with negative – or else controversial – aspects elsewhere, making it a delicate balancing act. Our guiding principle is that a company should produce a clear net benefit for the environment or society (some best-in-class companies are also allowed). A recent case in point was companies with activities in the Occupied Palestinian Territories (OPT), with the question being whether companies providing products and/or services to the Israeli authorities, or otherwise doing business in the contested areas, could be included in the investable universe. The OPT is perhaps the most contentious geo-political question of our time. Corporate involvement accordingly is something many of our customers may be uncomfortable with.

## **International Law and Principles**

While Israel insists that the West Bank, Gaza, Golan Heights and East Jerusalem are ‘disputed’ rather than ‘occupied’ territories, the latter description is accepted by both the UN Security Council and General Assembly (which has further adopted resolutions stating its concern about the continuing violation of the human rights and the economic and social hardship of the Palestinian people), the International Court of Justice, and indeed also by the Israeli High Court of Justice. As such, the fourth Geneva Convention applies and Israel continues to have the status of ‘occupying Power’. The Geneva Convention hence prohibits Israel from establishing settlements in the occupied territory but it

also means that the country has certain responsibilities, including that:

- The occupying power must take measures to restore and ensure, as far as possible, public order and safety.
- To the fullest extent of the means available to it, the occupying power must ensure sufficient hygiene and public health standards, as well as the provision of food and medical care to the population under occupation.

While the law and statements are less clear on acceptable/unacceptable behaviour of companies and other non-state actors in such context, it is safe to say that Israel's position is widely condemned by the international community and companies perceived as facilitating or supporting the continued occupation, thereby contributing to the violation of human rights, risk significant reputational damage. Israeli and multinational corporations lead real estate deals; develop the Israeli infrastructure and settlements in OPT; and contribute to the construction and operation of an ethnic separation system, including checkpoints, walls and roads, as well as design and supply equipment and tools used in the control and repression of the civilian population under occupation.

Professor Ruggie's proposed Guiding Principles on Business and Human Rights (see Section 1) state that “in situations of armed conflict enterprises should respect the standards of international humanitarian law” for which Geneva Conventions set the standards. They go further, suggesting that a company may also be responsible for the negative impacts of third parties (such as suppliers and joint venture partners) with complicity having both legal and non-legal implications.

It is suggested that if the company is unable to prevent or mitigate such impacts it should consider ending the relationship. Furthermore, Professor Ruggie stresses that in gauging human rights risks, companies should pay special attention “to any particular human rights impacts on individuals from groups or populations that may be at heightened risk of vulnerability or marginalization”. Operations in locations such as OPT are therefore far from business as usual, and require special caution and due diligence.

However, as the Geneva Convention also stipulates that Israel has the responsibility to ensure public order, safety and hygiene standards, as well as the sufficient provision of food and medical care, within the occupied territories, it is not unreasonable to expect international companies to become involved in such activities. Indeed, notwithstanding the illegality of the occupation, the Palestinian people have the right to live as normal a life as possible under the circumstances and to outright deprive them of services that those in less challenging locations take for granted could be seen as only making the situation worse.

### Assessing Companies with a Palestinian Presence

The Co-operative Asset Management benefits from an advisory committee comprising independent experts drawn from business, the non-profit sector and academia. Its main function is to offer guidance on the suitability of potential investments in terms of meeting the environmental, social and governance criteria. The panel also acts as a source of expertise and an independent perspective on policy matters such as our approach to OPT, and accordingly we recently sought their views on the suitability for Sustainable Funds of specific companies operating in the area.

We asked the committee whether they would deem presence in OPT in itself reason enough for exclusion, or whether the nature of activities would make a difference to whether a company is acceptable for investment. Extending the question to similar considerations in other contentious locations (e.g. Burma, Sudan), we wanted advice on the general approach to the proximity to human rights violations we should take on screening companies for the funds.

Two companies presented to the committee as potential investments were Veolia Environnement – the largest water and wastewater company in the world – and Alstom – an engineering company focussed on power generation, public transport and grid – both of which possess positive characteristics in the areas of energy efficiency, decarbonisation, clean tech and other environmental services. However, they are both also involved in the Jerusalem Light Rail Transit connecting Western and Eastern Jerusalem, thereby also serving Palestinian areas. The contracts are not financially material to either business, however this is neither an excuse to overlook them nor reason in itself to ask companies to divest when important principles are at stake.

The Co-operative Asset Management suggested to the advisory committee that there are at least two plausible moral arguments here. The ‘absolutist’ one is that any activity that normalises the permanency of the OPT is underwriting a de jure illegal occupation, making a bilateral two-state solution, seen by most observers as the only fair solution, increasingly distant. The ‘pragmatist’ argument posits that it is unacceptable to hold the Arab populations of the OPT hostage to a

higher principle when a negotiated solution is not on the horizon and that services that do not oppress but assist Palestinians should not be denied to them, even if the services are inevitably bound up in the normalisation process. Public transport non-discriminatorily serving also the Arab neighbourhoods could be seen as benefiting the oppressed by creating amenity for residents.

The advisory committee deliberated both sides of the argument and conceded that the issue was very complex and sensitive, with the best interest of the oppressed having to be the key consideration in any analysis. They agreed that companies can play an important role in bringing living standards of the Palestinian people up to something resembling normality and as a consequence certain humanitarian reasons may justify corporate presence in an area otherwise plagued by activities not in line with the spirit and purpose of the Sustainable Funds. Infrastructure benefiting the occupied people was generally perceived by the committee as positive, however they stressed that it was essential that such projects *clearly, significantly and genuinely* benefit *all* residents.

Overall, the committee was inclined to judge operations in OPT objectionable, but reserved the right to approve companies on an exception basis where positive impact on the Palestinians is unequivocal and where the company's operations more broadly have a net benefit to society. As regards Veolia Environnement and Alstom, and taking into account their respective portfolios of environmentally friendly offerings globally, the committee's advice was that these companies could be invested in as the benefits of the light rail project are real and it appears to have the support of the communities affected.

### G4S Exits Contracts amid Human Rights Concerns

As reported in our Winter 2010 review, we have been engaging with G4S over its operations in the West Bank. We advised the company that proximity to human rights violations deems it unacceptable for our Sustainable Funds and asked G4S to demonstrate how activities in OPT could be justified both against its own human rights policies and the norms endorsed by the UN, particularly considering the nature of the business. We urged G4S to assess and monitor its impacts in order to ensure its presence in the area does not contribute to the oppression, either directly or indirectly. We also referenced the case of G4S to our advisory committee as being involved in activities that could tangibly be linked to more incendiary aspects of the occupation, such as prisons and checkpoints. As such, it is an example of a company that would have been excluded according to the reasoning endorsed by the committee had it been put forward.

We are pleased to report that G4S took our and others' concerns seriously and after reviewing its activities in the West Bank against its own Business Ethics Policy has decided to exit from certain contracts involving checkpoints, prisons and police stations in the area. Although the company retains a number of private contracts which it considers as conducive to the safety and security of the general public in OPT, The Co-operative Asset Management commends G4S' willingness to enter into dialogue with concerned stakeholders and review its activities in response. We welcome the company's decision to withdraw from its most contentious contracts in the region and have encouraged it to further develop its human rights policies and practice to avoid contributing to oppression or violations anywhere in the world.

# Section 4

## Recent Developments

### What Fukushima Means for the Future of Nuclear

Few could fail to be moved by the images of surreal devastation visited upon Japan, the tens of thousands dead and unaccounted for made more harrowing by having to contend at the same time with a volatile old foe: the threat of nuclear radiation.

In a world seized with anxiety over the energy gap, climate change and political turmoil we were supposed to be embarking on a nuclear renaissance. We have 100 years of uranium stocks in mostly friendly countries, nuclear is low carbon and fission technology is relatively mature. But the crisis in Japan has caused ripples across energy policy the developed world over. Most countries with nuclear ambitions, including China, have announced that nuclear plans are suspended pending reviews of safety standards. Has Fukushima buried nuclear power for the foreseeable?

#### The Co-operative Asset Management's connections to nuclear energy

The Co-operative Asset Management has never had significant investments in the nuclear industry and was unlikely to even before Fukushima, mostly owing to the uncertainty of its future and the difficulty for equity and corporate bond investors to assess the risk versus return. Since launch, our Sustainable Trusts have not been permitted to invest in companies whose business is to generate nuclear power nor may they invest in any company with exposure to the industry of more than 10% of revenues; however companies that offer safety and decommissioning services are acceptable.

Nevertheless, the question of what role nuclear is allowed to play in the global energy mix has significant ramifications for other parts of the economy.

#### How representative of industry risk is Fukushima?

Alarming as it is, there are many factors about the Fukushima event that mean a direct read-across to all nuclear stations is not appropriate:

- The problem was caused by the failure in back-up diesel power supply to the cooling systems: arguably something that should have been a predictable and manageable risk;
- The reactors are in some of the most seismically active areas on the planet and the breakdown was the result of a concatenation of risks that would be even less likely in any other major user of nuclear;
- The reactors depend on active safety measures, i.e. human intervention, whereas modern plant uses passive systems like convection to automatically kick in, which can then be modified by human intervention.

None of this is to say that it's not an objectively serious incident and it is of no consolation to anyone directly affected by it. Neither can human error ever be eliminated, nor is it possible to design a 100% safe nuclear plant.

#### What have been the observable health impacts of nuclear disasters?

That has to be answered in two parts:

1) effects during the life of the plant  
Until Fukushima there were two major incidents in the world since the first civil programmes began in the 50s: Three Mile Island (TMI) and of course Chernobyl. At TMI in 1979 there was a partial meltdown of the reactor because operator error compounded the loss of coolant. Though radiation was released and much studied, it is accepted there is no evidence to show anyone died prematurely because of it. Chernobyl was by several orders of magnitude more serious: 400 cases of thyroid cancer, at least dozens killed and several hundred thousand exposed to above average radiation level. The personnel involved in clean-up activities

at Chernobyl were exposed to around 100 mSv of radiation – the lowest level at which an increase in cancers can be detected. To put this in the context of an extremely lethal case, the dose that Alexander Litvinenko, the Russian dissident, received when he was poisoned in London in 2006 and which killed him in days was in the order of 10,000 mSv. Though there have been dozens of incidents of radiative leaks in the world since the 1950s TMI and Chernobyl have been the benchmarks of severity.

## 2) effects in the afterlife – what to do with the waste

Though 95% of enriched uranium used in reactors can be reprocessed to be used again, nuclear fission still produces waste that takes longer than 10,000 years to go back to the radiation levels the uranium emitted before mined and has to be stored in deep geological formations. This is actually where the greatest concern should lie given the intergenerational responsibility of ensuring safe storage. The finding and approval of suitable geological sites has lagged way behind plans for development.

Newer generation plants are supposed to produce less waste and it is hoped fusion (which is still many decades away) will produce none.

## Putting the risk in context

The respected Pew Centre for the Environment in a recent study noted:

“Coal-fired power plants remain among the top contributors to fine particle pollution, particularly SO<sub>2</sub> and NO<sub>x</sub>, in the U.S. This pollution is expected to cause over 13,000 premature deaths in 2010, as well as almost 10,000 hospitalizations and more than 20,000 heart attacks per year.”

Put simply, the rate at which we burn coal causes more premature deaths than nuclear energy ever has or likely ever would, based on current growth projections. However, mortality is only one factor in how humans respond to perceived threat: one reason why nuclear's image suffers particularly is the vulnerability of children to radiation poisoning.

### Key figures about nuclear

- Globally, there are 439 nuclear power plants in operation in 29 countries, with a capacity of 373GW
- Nuclear energy accounts for around 17% of global power generation. 32% of European electricity, 30% of Japan's, 80% of France's, and 22% of US
- Countries like Ghana, Congo, Vietnam and Columbia have operated research reactors since the 1960s
- 100GW of nuclear in China planned in next 10 years equals half of all new global plants
- Germany had planned to close all 17 reactors by 2022 but India has ten planned and 15 proposed
- Globally there are 43 plants under construction and well over 100 planned with a further 270 proposed
- The average age of a reactor is about 25 years with reactors having a optimal life of 40 years. The US, despite being the largest nuclear power in the world with 100 reactors, has not completed a single reactor since 1974 and has only one under construction
- The UK has recently granted approval for new nuclear plant at 8 sites, which it says it expects the private sector to fund entirely

## Nuclear supply gap

A Chatham House study in 2005 estimated that perhaps 70% of global nuclear capacity is to leave the system if we include 10-year extensions to the life of existing plant with only 20% new supply to come on stream by 2030. Proponents of nuclear say that it is essential to satisfying the expected doubling in demand for electricity by 2050 in view of the expansion of emerging markets coupled with population growth.

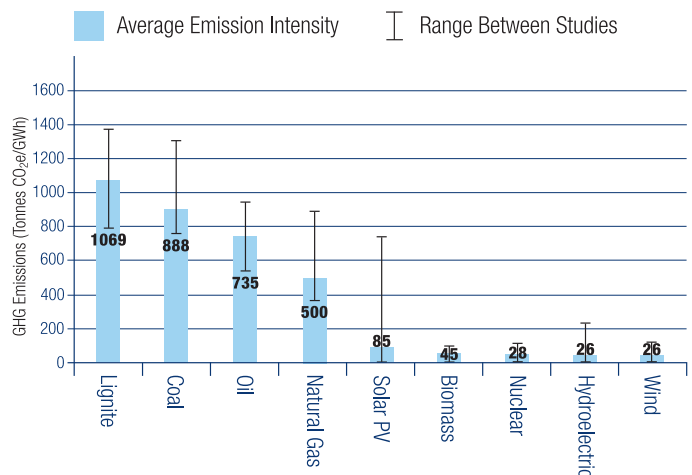
## How does nuclear compare on cost?

Research from Goldman Sachs estimates that the current third generation nuclear reactors can generate electricity at a cost somewhat below oil and gas, however this is not the full picture. The extremely high capital expenditure required to build the stations with a long pay-back period is the greatest barrier to private sector investment while the quoted cost of generation does not include the long-term costs of decommissioning and waste storage. This is why nuclear started and probably needs to remain a government-financed activity in public hands and viewed as both a strategic asset and liability.

## So is nuclear really low carbon?

The following is a metastudy of peer reviewed academic, government and 3rd party audited industry figures, and shows nuclear is indeed a very low carbon means of power generation:

### Lifestyle GHG Emission Intensity of Electricity Generation Methods



Source: Cameco, Lifecycle GHG Emissions, October 2010.

## So why can't we just develop renewables instead?

Unfortunately it's not that simple. Nuclear is an effective means of delivering predictable baseload power whereas favoured renewables technologies like wind and solar are intermittent: they work when the wind blows and the sun shines and therefore are best suited for supplementing baseload power. With much of the coal, oil and nuclear plant that provides our baseload power in the developed world needing replacing soon as they reach their end of life, only a percentage of this gap could be filled by renewables. Developing countries like China and India also realise that relying completely on fossil fuels is not a long-term strategy. The reason why nuclear has been receiving positive reappraisal from the energy policy world was because it was argued to be low carbon, less reliant on politically unstable regions and have low correlation to fossil fuel markets, making the cost of supply, once operational, less volatile.

### Conclusion

Proponents of nuclear energy, even arch-environmentalist George Monbiot, have exhorted the public to look at the risk/reward from nuclear in a rational way, arguing that all sources of energy have their risks and weaknesses but that nuclear, on the basis of sheer hard numbers of people injured and killed, doesn't deserve the bad press it gets. Yet the proponents acknowledge that more has to be done to satisfy legitimate safety and storage concerns. Long-time opponents of nuclear, such as Greenpeace, argue that we need to re-direct investment to revolutionise green, safe energy, pointing out fairly that the industry suffers from a trust deficit.

At The Co-operative Asset Management, we believe that the Fukushima event may delay the building of new nuclear power plants by a couple of years in emerging markets and up to a decade in developed economies unless the crisis is brought under control soon. As a result, the coming electricity supply crunch in some countries, including the UK, could force a number of scenarios: an abrupt decision to allow and extend the life of fossil fuel-based stations, such as Drax; the rapid deployment of scaleable renewables such as off-shore wind; or the conversion of current coal and oil plant to modern, less emitting natural gas – or most likely some combination of these scenarios. Carbon Capture and Storage may also play a role in making a continued fossil energy economy acceptable though it is extremely expensive.

A strictly utilitarian approach to the energy security/climate change problem would predict that people overcome their distrust of nuclear conditional on higher safety standards because there is no alternative except energy insecurity or dangerous climate change. But the history of public perception of nuclear in trying to predict the repercussions of Fukushima should not be underestimated. National culture and perceived risk has proven to be more influential in determining nuclear's fortune than bloodless rational calculations. In our view, while it is too early to dismiss nuclear power in a world distinctly short on ideal options it would be naïve to imagine that Fukushima hasn't made a difficult argument that much harder. One thing remains certain whatever the outcome: electricity bills will go up.

### Investment themes

Due to rising levels of inflation in economies like India and China, The Co-operative Asset Management has slightly reduced large holdings in some emerging market plays including SAB Miller. Agricultural commodity price increases are the primary driver of this surge and, as we know from our recent in-depth study of the sustainability of the food system, the world may be embarking on a period of long-term structural food price inflation. Though this is an issue also in developed countries, food accounts for a larger proportion of non-discretionary spend in emerging market household budgets, suggesting overall inflation levels are likely to remain high. Some companies will be able to manage this better than others. One such example is Unilever which has developed skills in adapting global brands to local markets in a way that remove inefficiencies in its production, consistent with the company's sustainability goal of making its products less resource intensive. Our holdings in Unilever were increased in the period.

The Sustainable Funds in particular were buyers of telecoms companies like BT and Vodafone, underpinned by a general belief that next-generation technologies such as ultra-fast broadband will unveil novel business applications that the market hasn't priced in yet, as well as the proliferation of somewhat older but more affordable technologies to new demographics. We believe Vodafone, for example, can benefit from the rapidly increasing affordability and accessibility of smartphones; many users in India may have a budget smartphone as their first computer rather than a laptop which still requires the laying of copper wire landline infrastructure for high-speed broadband. This leapfrogging of technology – and the associated efficiencies this brings – is a strong sustainable investment theme for the Funds.

Though recent increases in holdings of Scottish and Southern Energy and National Grid reflect expectation of stronger returns from higher power prices because of the surge in the oil price, utilities are favoured long-term because of their centrality to achieving national policy, such as the Government's Energy Market Reform's goals of security of supply, decarbonisation and affordability. Admittedly there is a tension between the returns the regulators will allow regulated assets to earn and the sweet spot they enjoy as incumbents with extremely high barriers to entry. Ultimately we believe the two sides will have to reach a workable agreement because policy failure is in no one's interest.

### Ethical Operating Plan

The Co-operative Financial Services (CFS) is part of The Co-operative Group, the UK's largest mutual retail business with around five million members, more than £14 billion turnover and core business interests in food, financial services, travel, pharmacy and funeral care. As the asset management arm of CFS, we are committed to the same co-operative values as our parent and benefit from The Group's strong expertise and heritage in helping to build a more sustainable society.

In February, The Co-operative launched a groundbreaking Ethical Operating Plan; a three-year rolling programme entailing various radical and ambitious pledges aimed at raising the bar across areas such as environment, ethical finance, global poverty, animal welfare, social fairness, health and community enterprise. As the largest co-operative in Europe, The Group is well positioned to lead the way in the pursuit of sustainable and just economic development; something we contribute to through our responsible investment practices.

The Ethical Operating Plan spells out specific activities where The Co-operative Asset Management plays an important role in pushing for social and environmental improvements in the corporate world. Namely, we will extend ethical screening to the investments underlying The Co-operative's key general insurance products and, where screening is not feasible owing to our fiduciary duties, we will ensure that our engagement is the most active, assertive and transparent of UK institutional investors. The outcomes of such engagements continue to be reported in our quarterly and annual reviews, in line with our commitment to transparency and accountability.

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