



**Local Authority
Pension Fund
Forum**

LAPFF Annual Report of Activities 2006

Our Mission

LAPFF exists to promote the investment interests of local authority pension funds and to maximise their influence as shareholders, to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.



LAPFF Annual Report of Activities 2006

This 2006 Annual Report provides an overview of the activities of the Local Authority Pension Fund Forum during the year. It covers the Forum's various campaigns and shareholder engagement initiatives undertaken in relation to companies and the progress made on these campaigns, together with other Forum initiatives and activities.

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

2006 has been another very active and successful year for the Forum. Concerns about CG and CSR remain high on the agenda, making our role as important and relevant as ever. Public awareness of the dangers of climate change has increased dramatically; as has



Sir Nicholas Stern

the concern and debate amongst politicians of all parties. Indeed, the publication of Sir Nicholas Stern's report 'The Economics of Climate Change', commissioned by HM Treasury has been taking the headlines in all sections of the media as we go to press with this Annual Report. All of this only serves to re-enforce the importance and value of the

work we do on the need for more openness in the reporting of companies' greenhouse gas emissions.

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

The LAPFF was formed in 1990 and now has 39 local authority fund members (see appendix on page 15) with combined assets of more than £70 billion. During the year, we were joined by the London Boroughs of Harrow, Hillingdon and Hounslow, and by the Rhondda Cynon Taf Fund, the largest fund in Wales. Membership is open to all pension funds that operate under the Local Government Pension Scheme.

Executive Committee

The Forum has an Executive Committee which reports to the Forum quarterly. During 2006, membership of the Executive was as follows:



Councillor John Saunders – London Borough of Newham



Councillor Darrell Pulk – Nottinghamshire County Council



Councillor Ian Greenwood – West Yorkshire Pension Fund

Chair:
Councillor John Saunders – London Borough of Newham (until 4 May 2006)
Councillor Darrell Pulk – Nottinghamshire County Council (from 4 May 2006)

Vice Chair:
Councillor Darrell Pulk – Nottinghamshire County Council (until 4 May 2006)
Councillor Ian Greenwood (from 4 May 2006)



Councillor Don Yates – Lancashire County Pension Fund



Councillor Sue Brown – Merseyside Pension Fund



Councillor Marlene Thomas – Greater Gwent Fund



Councillor Winston Vaughan – London Borough of Newham (from 26 September 2006)



Hon Secretary: Stuart Imeson – West Yorkshire Pension Fund



Councillor Maureen Child – City of Edinburgh



Councillor Munir Malik – London Borough of Bexley (until 4 May 2006)



Councillor Adrian Hardman – Worcestershire Pension Fund



Councillor Andrew Cornwell – London Borough of Islington (from 26 September 2006)



Hon Treasurer: Brian Bailey – West Midlands Pension Fund

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

opportune time to develop the influence of local authority pension funds, and LAPFF is the perfect vehicle for this purpose. Following the Myners' Report, the Higgs and Smith Reports and the Company Law Review, and repeated

statements supporting shareholder activism from central government, we continue to operate in a very favourable climate. There has never been a better opportunity to seek improvements in CG and CSR since the Forum was formed.

Shareholder Action Engagement Projects

The Forum's outline yearly Work Plan identifies two types of shareholder engagement projects: first, those relating to CG, and second, to CSR projects, although both aspects are interlinked with the long-term sustainability of investee companies. Other matters addressed include responses to governmental consultation papers and support services.

Corporate Governance

LAPFF ALERTS

Objective 1: Review and revise the LAPFF alerts system, based on the Forum's 'Strategies for Shareholder Engagement'.

Description: LAPFF alerts are intended to help the Forum intervene more efficiently on a range of CG and CSR issues but are not binding on individual members. The Forum focuses on best practice areas, such as board composition, voting rights, compliance and internal control statements, greenhouse gas emission reporting, remuneration and audit issues. Analysis highlights particular

resolutions on the relevant company meeting agenda, a voting recommendation is made on each resolution and the alert then e-mailed to the LAPFF membership for consideration in time for the AGM.

Results: An annual review of the alerts system was reported to the October business meeting. This showed a majority of the 101 companies covered in alerts over the year had remuneration issues, followed by board issues, lack of reporting on greenhouse gas emissions and those with audit concerns. Where LAPFF policy has not been defined to cover specific issues, a case by case approach was employed, and the agreement of the



LAPFF Executive sought for the voting recommendation in each case. Remuneration issues were identified in a larger percentage of analysed companies than initially expected. To address this, a revision was agreed to incorporate the PIRC weighted rating matrix, which gives greater weight to those issues considered to have a potentially greater impact on value. It was also agreed to formally adopt the case-by-case approach to exceptional concerns. Going forward a cross-section of LAPFF members will be contacted to ascertain their views on the alerts and areas for improvement.

FUND MANAGERS AND GOOD PRACTICE IN CORPORATE GOVERNANCE

Objective 1: To engage with fund managers, using the updated LAPFF Investor Guide, on improvements to their effectiveness of engagement with investee companies and their reporting to pension fund trustees.

Description: The revised Trustee Guide is based, in part, on interviews conducted with seven of the leading fund managers of UK local authority pension funds. In these meetings, issues raised by LAPFF members were fed back to the fund managers, and the fund managers' intended use of disclosures under the planned OFR was evaluated. The repeal of the statutory OFR required a shift of emphasis in the Trustee Guide with a stronger focus on how



delegation of engagement to fund managers currently works in practice.

The guide aims to assist local authority pension fund trustees in the regular assessment of their fund managers' engagement strategies and activities. It does this by setting out assessment criteria for all aspects of delegated shareholder engagement, and integrates, in the revised version, best practice matters. The guide gives trustees an insight into the relevant issues for each aspect, and sets out pertinent questions to ask their fund managers. Members at the July business meeting approved the publication of both the revised Trustee Guide on Shareholder Engagement and also the full report 'Holding Fund Managers to Account'. This, with the accompanying press release, received good coverage in October in *FT Fund Management*.

Results: A number of issues emerged that can be considered as critical to the success of the UK's particular type of shareholder activism, much of which tends to be delegated to fund managers. Areas emphasised were the quality and persistence of engagement, the integration of CG, and CSR issues into mainstream investment processes and the transparency of fund managers' reporting. Pension fund trustees have a responsibility to ensure that their engagement activities are conducted in a way that fulfils their fiduciary responsibility towards their scheme members. The revised version of the guide aims to provide trustees with a best practice guide to initiate and continue this debate with their fund managers. Further work in this area will be to provide help for trustees in using the guide by means of practical training sessions.





Corporate Social Responsibility

OVERSEAS EMPLOYMENT STANDARDS – FOLLOW ON

Objective 2: To support the case for a statutory Operating and Financial Review (OFR) by British listed companies including directors' forward-looking statements, based on ASB Reporting Standard 1 (or equivalent), so as to assess the strategies adopted by the company and their potential to succeed.

Description: The DTI consultation on the Business Review followed the decision to abolish the statutory OFR, which took effect in January 2006. The LAPFF response to the consultation underlined the Forum's continuing commitment to the objective of improving the quality of corporate reporting and that an explicit requirement for forward-looking information and for other non-financial information, as contained in the original OFR, should be reinstated.

Results: The government statement of 3 May restored a key part of the original OFR objective, as LAPFF/PIRC had argued for, to require information to the extent necessary on 'the main trends and factors likely to affect the future development, performance and position of the company's business' to be included in the Business Review. Without this crucial addition and the concomitant enhancement of information – previously omitted – on non-financial matters, including social and community issues, and about related company policies and the effectiveness of those policies, the prospects for encouraging meaningful narrative reporting would have been much reduced.

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

Description: An interim report on the China project was published in November 2005. This interim report was then the subject of consultation with stakeholders and China experts to give their views on the Forum's findings and recommendations, particularly



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on the initial best practice guidelines. The LAPFF business meeting in October approved the publication of the final report containing the revised guidelines which took account of views expressed during the stakeholder consultation. A talk by Hilary Murdoch of Impactt, who spoke at the October meeting on labour standards in China, provided an excellent introduction to the subject for members.

Results: The revised best practice guidelines will also be published as a separate LAPFF Trustee Guide and will be used as the basis for an engagement programme with certain FTSE 100 companies in selected sectors. This would begin with those companies whose current operations appear to fall below best practice standards in China.

Objective 2: Continuing engagement with **Morrisons**, initiated in 2003/04 to address Forum concerns regarding lack of disclosure of its Code of Conduct and also corporate governance issues, which

have been accentuated by the company's acquisition of Safeway in 2004.

Description: Following a meeting in 2005 with two members of the management board, the appointment of a CSR manager and the appointment of further non-executive directors, it was considered that the company was beginning to seriously address the issues of concern. The Forum hoped it had achieved a longstanding objective of a meeting with a main board director at Morrisons when David Jones, the Senior Independent Director (SID), agreed to meet LAPFF representatives. However, the meeting with David Jones did not take place in December 2005, due to his illness and he was subsequently replaced by a new SID, Paul Manduca.

Results: A meeting has been arranged between Paul Manduca and LAPFF representatives in December 2006 to progress outstanding issues with the company.

COMPANY WORKFORCE PRACTICES

Objective 1: To develop and update the investor guide on best practice in reporting on human capital management, in the light of experience of the Forum's engagement strategy with identified company underperformers in the leisure sector and food producers' sector.



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

- to require a minimum standard of reporting on employment practices applicable to all publicly quoted companies above a certain size;
- to identify material industry-specific employment risks and opportunities;

- to seek directors' views on the materiality of employment issues in the preparation and publishing of the Operating and Financial Review or similar reports.

Results: During the year, LAPFF actively engaged with four companies in the hotels/leisure sector and one in the food producers' sector on their workforce practices. This provided comparative evidence for two contrasting approaches to engagement based on the LAPFF Trustee Guide. In June, LAPFF representatives met with **InterContinental Hotels Group**



(IHG) to discuss the implementation of their employment policies and how they are linked to business strategy. The meeting was mostly based around the IHG's OFR. In contrast an earlier meeting with Associated British Foods was mainly focused on the Forum's insistence that they comply with LAPFF's common core of indicators across the group.

Both meeting outcomes highlighted that the Forum's principle of group-wide policies and practices is unlikely to succeed unless it is adapted to fit individual business strategies.

Another finding from the meetings is that the identification of examples of industry-specific employment risks and opportunities is not straightforward and, in future, LAPFF may need to put more emphasis on company-specific risks.

Objective 2: To review the company workforce practices project and make recommendations for its further development.

Description: The Forum has established a consensus amongst its members on a set of core indicators that FTSE 100 companies should be reporting against. These indicators will continue to aid identification of underperforming companies with respect to employment standards. It is proposed that future analysis of companies' disclosures on employment practices should focus on OFRs/business reviews for the purposes of establishing an engagement strategy. Identifying industry-specific risks is difficult so a practical

way forward is proposed of taking the lists provided by the firms themselves in addition to any that LAPFF considers relevant and relying on comparisons between similar firms in the same sector to identify any material omissions. Industry-specific KPIs are useful when analysing a great number of companies. For the more focused approach proposed for the company workforce practices project, the varying situations of individual businesses should be taken into account, and issues, problems and risks discussed for the specific company.

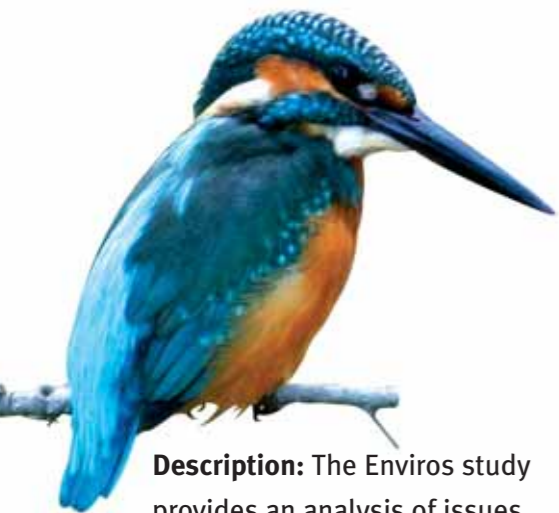
Results: Following a decision of the Forum's October business meeting, the company workforce practices' Trustee Guide is being redrafted to reflect these findings and the necessary changes made to ensure the Forum's engagement strategy on company workforce practices leads to the most appropriate and effective dialogue with companies.



In addition, on 21 August 2006, Chairman Darrell Pulk wrote to every FTSE 350 company to promote equal pay for women employees as part of the Forum's campaign to improve company workforce practices. In response to the press release, Professional Pensions and Investment & Pensions Europe (IPE.com) covered the campaign. Nearly 60 responses were received, and an analysis of the responses presented to the LAPFF Executive in November 2006.

ENVIRONMENT – GREENHOUSE GAS EMISSIONS

Objective 1: To engage with companies based initially on the Enviro's study, concerning the likely impacts of climate change on industry sectors and companies with long-term research and development programmes and consequent risk to shareholder value. This would be supported by additional engagement on greenhouse gas emissions and waste disclosures in annual reports.



Description: The Enviro study provides an analysis of issues common to companies in each sector. Dialogue with particular companies would be around the range of climate change management issues identified by the study, which apply particularly to the sector.

The Forum initially wrote to all FTSE 350 companies in the oil and gas sector in October 2005. This contained details of the initial LAPFF assessment of how each company was addressing the impact of climate change, based on publicly available information and the framework proposed in the Enviro report. In May 2006, the Executive considered the response from six companies to their climate change disclosure profiles and selected three companies for further engagement. This decision was based on a number of criteria, including size of LAPFF investment and quality of response. The three companies chosen were **Royal Dutch Shell, BG Group** and **Dana Petroleum**.



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Results: The Forum is arranging meetings with the identified oil & gas companies to seek certain commitments for improvement in the way they are addressing climate change. Where possible this is being co-ordinated with other investors. In January 2006, further sectors were identified for engagement by the LAPFF Executive, which were chemicals, food and drinks and mining and work was undertaken to identify appropriate companies for engagement. This is likely to be taken forward in 2007.

Objective 2: To review latest developments in climate change policy, as well as mechanisms and technology for emissions reduction, particularly in the light of the outcomes of the December 2005 Montreal Climate Conference, with a view to informing trustees and to identifying opportunities for local authority pension funds to take action against climate change.

Description: The Forum recognised that in order for trustees to make informed

investment decisions or to opt for activism on climate change where this would enhance value, they will need to be aware of and understand the relevance of the latest major developments in the area of climate change policy. The briefing, which LAPFF commissioned from PIRC, covers The Kyoto Protocol and its mechanisms, the EU Emissions Trading Scheme and developments in emissions trading, UK Government policy on climate change, and the implications of the Energy Review and ongoing shareholder initiatives in the area of climate change.

Results: The briefing seeks to identify relevant debates and challenges for investors in each of the identified areas, as well as opportunities for local authority pension funds to take action on climate change. Action can be undertaken by individual funds or by way of joint action with other investors. Implications for investors as outlined in the briefing will be taken into consideration in LAPFF's ongoing engagement programme with companies both in selecting particular companies for engagement and for assessing the risks and opportunities faced by

companies in the chosen sector.

STUDY ON MERGERS AND ACQUISITIONS



Objective: To develop guidance, published as a LAPFF Investor Guide, on strategic and other issues to be considered by pension fund trustees when assessing M&A offer documents, with particular emphasis on CG and CSR aspects that are most commonly cited as reasons for failure of these transactions, and including recommendations on circumstances leading to intervention. Guidance is to extend to accountability requirements for private equity transactions.





Description: A review of the statutory and regulatory framework of M&As in the UK was undertaken, with particular reference to points of intervention for pension fund trustees in the run-up to such transactions. LAPFF engaged an external consultant to identify relevant strategic fit and implementation issues, and to develop an M&A disclosure framework. The framework formed the basis for the compilation of a draft Trustee Guide on M&A by PIRC which is to be submitted to the LAPFF Executive for consideration.

Results: The draft Trustee Guide included a proposal on how information obtained from the questions set out in the guide should contribute to the overall decision on whether or not to support a deal. The next stage would be to pilot the Trustee Guide, by applying it to completed and/or current examples of agreed and hostile takeovers.



RESPONSES TO CONSULTATION PAPERS, DOCUMENTS AND RELATED ISSUES

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

Description: The DTI consultation on the Business Review, following the decision to abolish the statutory OFR, was referred to previously. In addition, the Forum has progressed matters in the following areas:

- **Audit**
LAPFF was involved in the Audit Quality Forum, as part of the Forum's role in the ongoing work to improve the audit process in the UK. This included attending a working group meeting in May on 'audit purpose'. LAPFF submitted its own paper on stakeholder interests in company reporting to this meeting.



- **Collaboration with Carbon Disclosure Project (CDP)**
Following on from a meeting with CDP in December 2005, the Executive Committee agreed to engage in an informal arrangement with CDP, whereby the CDP questionnaire was included in the Forum's initial letters to FTSE 350 companies, as part of the LAPFF Climate Change project. LAPFF continues to be a signatory to the CDP questionnaire to companies, now in its fifth year, and which now also covers the FTSE350. Input was provided to the draft questionnaire seeking information from companies on the potential commercial risks and opportunities relating to climate change.

CONTINUING LAPFF SUPPORT FROM PIRC

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

Description: This is carried out by a number of means including lobbying, press releases, liaison with officers, regular meetings with Forum officers, attendance at Forum's executive meetings, maintaining networks, monitoring press activity, investment manager developments, government policy developments, NGO policy developments and overseas investor developments.

Results: A position paper is being drafted on obesity and the food and drinks sector. This covered the current range of SEE (social, ethical and environmental) risks the industry faces, brief coverage of related studies on these issues, and the potential for investor involvement. Further work is planned on a tobacco industry position paper and a briefing on the UK defence industry. In October, a briefing on the health and safety crisis at BP was provided and it was agreed to engage with the company to obtain reassurances that investor concerns would be addressed.

Various speakers have attended LAPFF business meetings throughout the year, to present on matters relating to areas of work or interest to members. These included Henderson Global Investors on 'Carbon Trends and Carbon Governance', 'A Trustee Guide To Understanding and Addressing Climate Risk' by Mercer Investment Consulting, and 'The Development of the Corporate Health and Safety Performance Index' by the Chairman of the Health and Safety Commission.

LAPFF has agreed a process for creating a mechanism to enable the Forum to participate with other investors in various shareholder initiatives that arise from time to time on matters of CG and CSR, which meet the broad policy goals of the Forum. LAPFF continues to be represented in various fora, including the Responsible Investors' Network.

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

Description: Organisation of seminars and conferences, including regional initiatives.

Results: Two trustee training seminars were held during the year. The first was in Manchester in June and was entitled 'Mergers and Acquisitions'. The second was in September in Birmingham and was on hedge funds.

The 11th Annual Conference will be held at Bournemouth in December 2006. The theme is *Investor Governance and Stakeholder Engagement, Pension Fund Activism in an Era of Accountability*. Speakers at the Conference include Phil Woolas, Minister for Local Government & Community Cohesion, and Paul Myners, ex-Chairman of Marks and Spencer plc and the author of the Myners' Review of Institutional investment in the UK.



Phil Woolas



Paul Myners

Other Activities

During the year, the Forum conducted a survey to establish the fund governance arrangement adopted by its members. The Chairman and officers met with Terry Crossley, Head of Local Government Pensions at the Department for Communities and Local Government (DCLG), to compare the findings of this survey with surveys undertaken by DCLG. The Forum subsequently responded to the DCLG

consultation paper on the governance of funds, giving its support to the Department's proposed 'light touch' approach aimed at promoting best practice.

Looking ahead into 2007, we are introducing a 'networking initiative' with short presentations from members to facilitate the exchange of experiences on topical and practical matters of interest.

This will commence in January with a presentation on the approach taken to currency management by the London Borough of Brent.

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

Appendix

LAPFF Membership as at 30 September 2006

- Avon Pension Fund
- City of Edinburgh Council
- Clwyd Pension Fund
- Derbyshire County Council
- Devon County Council
- Dyfed Pension Fund
- Greater Gwent Fund
- Greater Manchester Pension Fund
- Lancashire County Pension Fund
- London Borough of Brent
- London Borough of Camden
- London Borough of Croydon
- London Borough of Hackney
- London Borough of Hammersmith & Fulham
- London Borough of Harrow
- London Borough of Hillingdon
- London Borough of Hounslow
- London Borough of Islington
- London Borough of Newham
- London Borough of Southwark
- Lincolnshire County Council
- London Pension Fund Authority
- Merseyside Pension Fund
- Norfolk Pension Fund
- Northamptonshire County Council
- North Yorkshire County Council
- Nottinghamshire County Council
- Rhondda Cynon Taf Pension Fund
- Shropshire County Council
- Somerset County Council
- South Yorkshire Pensions Authority
- South Yorkshire Passenger Transport Authority
- Teeside Pension Fund
- Tyne and Wear Pension Fund
- West Midlands Pension Fund
- West Midlands PTA Pension Fund
- West Yorkshire Pension Fund
- Wiltshire County Council
- Worcestershire County Council



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