

re^o Report

F&C Investments

4th Quarter 2007



In this issue...

- 'OK before, but not anymore': Corruption scandals erupt at **BAE Systems**, **Siemens** and **Samsung**
- The UK Company Law Act: The search for 'Enlightened Shareholder Value'
- The Beijing factor: How the Olympics are putting pressure on retailers
- UK pay plans show real stretch: **Tesco**, **WH Smith** and **Unilever** lead the way
- Spotlight on biofuels:
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 - David v. Goliath: Do the oil majors hold the key?
 - Setting sensible rules: F&C engages the regulators

F&C
Investments

Expect excellence

Our philosophy

reo® stands for responsible engagement overlay

The objective of reo® is to use the influence that F&C has through the share ownership of its clients to encourage investee companies to enhance their business performance by adopting better corporate governance, social, and environmental practices. F&C believes that it can better serve its clients,

and protect the value of their shareholdings, through sustained and constructive dialogue with companies as well as the judicious and transparent use of its votes, thereby ensuring that companies respond prudently to the emerging expectations of shareholders and other stakeholders.

Why this report?

Our obligations to you

F&C represents you: we have been appointed either to manage your pensions and investments, or to represent your interests to the companies in which you are a shareholder, even if your portfolio is managed by other fund managers.

As your representative, we have important obligations to you. These are to be vigilant about how companies 1) plan their future growth with the capital you have entrusted to them; 2) manage and minimise business risks; and 3) protect financial returns over the long term.

What does this mean in practice?

This means that as your representative, we take the time to communicate our concerns to the managers of the companies in your portfolios. It also means that we expect full transparency from companies, so that we know what is being done with the money you have invested with them.

In addition, where F&C is your fund manager, this means exercising our voting rights – **your** voting

rights – at the annual and extraordinary shareholders' meetings of over 3,000 companies around the world.

Transparency: It cuts both ways

If we expect transparency from companies, you should expect no less from us: we believe that as investors, you are entitled to know what company managers are doing in your name with the money entrusted to them. At F&C, we take this responsibility very seriously. With this quarterly report, we outline how we have asked questions and spoken up in your name to ensure that companies are made aware of the concerns of their shareholders.

What could we do better?

We hope we have accurately reflected your concerns about good governance, environmental responsibility and the protection of basic employment and human rights.

Still, we want to be sure we get it right.

An electronic copy of this report can be found at: www.fandc.com/governance

Feedback: Your money listens

Your input is valuable to us. Thank you for telling us how your money should talk. Please mark your comments 'reo report feedback', and e-mail them to eve.crush@fandc.com

Or send to: Eve Crush, Governance & Sustainable Investment, F&C Management Limited, Exchange House, Primrose Street, London EC2A 2NY

reo® is operated on behalf of:



Introduction

As the year drew to a close, F&C's focus turned to four areas that are likely to see major developments in 2008: UK company reporting, Corruption, Biofuels and Labour Standards. The arrival of the UK Company Law Act heralds a new focus on so-called 'Enlightened Shareholder Value', with attention to supply chains, safety, environmental practices – and most notably of all, a clear understanding that the buck stops with the board.

2007 has also been the year of unfolding corruption scandals, as iconic names in the UK, Germany and Korea hit the headlines – and prosecutors take the gloves off on practices that would not previously have raised much of an eyebrow. So why now, and do shareholders care?

This issue also features a special report on Biofuels, an industry that has been both hailed as a saviour for climate-busting transport pollution, and condemned for disrupting food prices and destroying forests. We look behind these claims, quiz companies on their practices on the ground, and challenge governments worldwide to help make the industry perform responsibly – rather than throwing the baby out with the bathwater.

We also map out what the industry needs to do to restore confidence and improve its sustainability profile in the coming year.

Finally, we look ahead to the Beijing Olympic Games in 2008, and find that campaign groups and shoppers alike have turned up the heat on retailers, with hard questions about where the goods they purchase come from and how they are produced. As the spotlight burns brighter, we urge the industry to rise to the challenges of managing complex and remote factories, and to ensure it not only 'talks the talk' of good employment practices, but also delivers on its commitments.



Karina Litvack – Director, Head of Governance and Sustainable Investment, F&C Management Limited

They said...

“ There's got to be a way of enforcing the law while at the same time cutting a little slack to these foreign companies...”

Bloomberg, 'US expands bribery probes, targeting Nigeria and Kazakhstan', 19 December 2007, quoting Stanley Sporkin, former federal judge and co-author of the US Foreign Corrupt Practices Act, currently representing Prince Bandar bin Sultan of Saudi Arabia in connection with the investigation of BAE Systems

Engagement programmes

Corporate Governance



Focus on the United Kingdom **6-7**

Social



Focus on Labour Standards **10-11**

Sector Focus



Focus on Bribery & Corruption **8-9**



Biofuels **12-15**

Companies featured in this report

Corporate Governance & Voting

pages 6-7

Company	Countries	Company	Countries	Company	Countries	Company	Countries
BP	UK	HSBC	UK	Photo-Me	UK	Tesco	UK
Cable & Wireless	UK	Lloyds	UK	Provident Financial	UK	Unilever	NL
First Group	UK	Morrison	UK	Royal Bank of Scotland	UK	Vodafone	UK
HBOS	UK	Munich Re	DE	RSA	UK	WH Smith	UK

Governance Bribery & Corruption

pages 8-9

Company	Countries	Company	Countries	Company	Countries	Company	Countries
ABB	CH	Cobham	UK	Petrobras	BR	Samsung	KR
BAE Systems	UK	CNOOC	CN	Petrochina	CN	Siemens	DE
Balfour Beatty	UK	ExxonMobil	US	Rolls Royce	UK	StatoilHydro	NO
Boeing	US	Monsanto	US	Royal Dutch Shell	UK	Thales	FR
BP	UK	ONGC	IN	RWE	DE		

Social Labour Standards

pages 10-11

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Apple	US	Hennes & Mauritz	SE	Nokia	FI	Ted Baker	UK
Carrefour	FR	Hermès International	FR	Olam International	SG	Tesco	UK
Financière Richemont	CH	Marks & Spencer	UK	Primark	UK	Wal-Mart	US
GAP	US	Nike	US	Seven & I Holdings	JP	Woolworths	UK

Sector Biofuels

pages 12-15

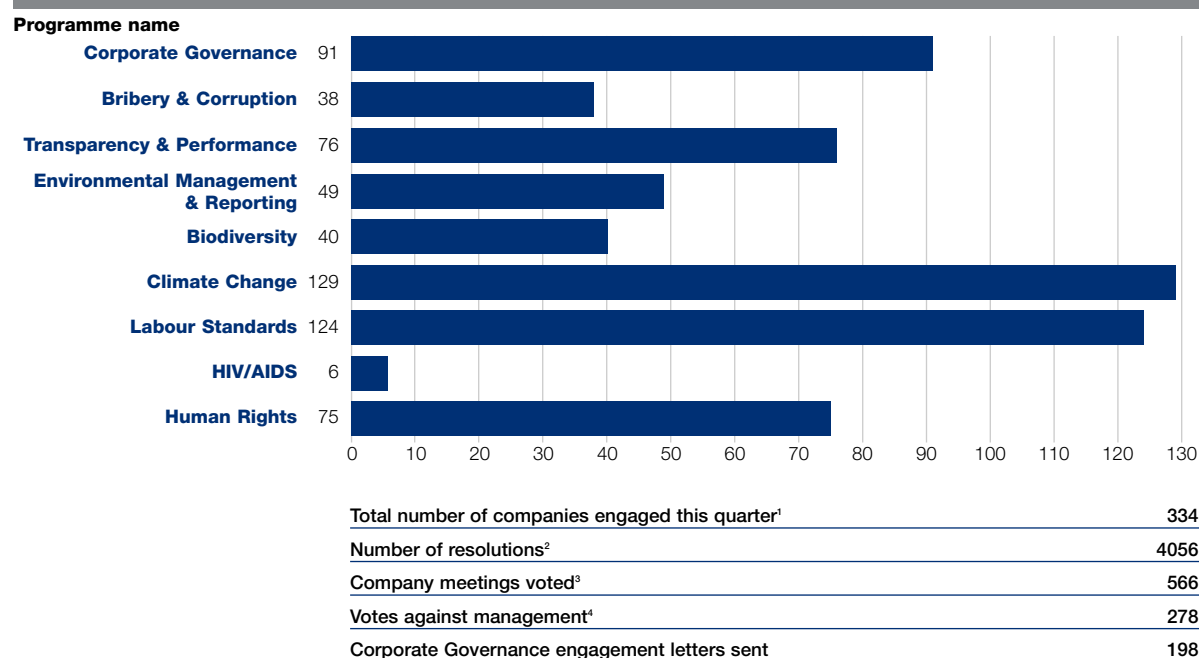
Company	Countries	Company	Countries	Company	Countries	Company	Countries
Archers Daniel Midland	US	Clean Energy Brazil	BR	Marks & Spencer	UK	Shell	UK
Argent Energy	UK	CNOOC	CN	Marathon Oil	US	Statoil	FI
Aventine Renewable Energy	US	D1 Oils	UK	Metabolix	US	Tesco	UK
Brasil Ecodiesel	BR	Dupont	US	Neste Oil	FI	Tesoro	US
BP	UK	Eni	IT	Pacific Ethanol	US	Total	FR
Bunge Ltd	US	Ensus	UK	Petrobras	BR	Verasun Energy	US
Chevron	US	ExxonMobil	US	Petrotec	DE	Verbio AG	DE
China Sun Bio-Chem Technology	CN	Global Ethanol	US	Potash Corporation	US		

Activity report

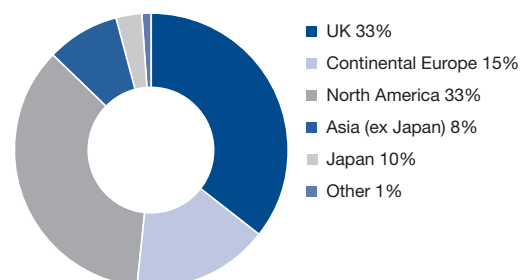
F&C's responsible engagement overlay is exceptional in the depth and breadth of its engagement, as the quarterly statistics below demonstrate. Key features are:

- A 15-person team of Governance & Sustainable Investment specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary
- Global engagement – in all markets
- Comprehensive voting – F&C votes all of its clients' shares worldwide, as well as publishing the voting record each month.

Number of companies engaged this quarter

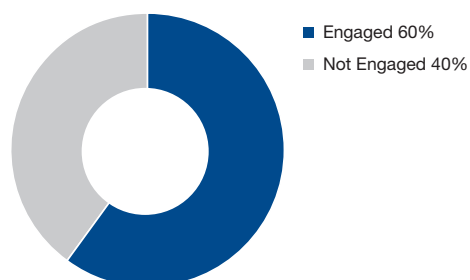


Geographical spread



This table shows the domicile of companies that have been engaged by F&C in the last quarter.

Engagement of FTSE-350 companies⁵



This table shows the proportion of the FTSE-350 Index, by market capitalisation, engaged by F&C in the last quarter.

1 Companies may have been engaged on more than one issue
 2 Companies may have been engaged on more than one issue
 3 i.e. company meetings for which F&C has issued voting instructions
 4 Votes against management or abstentions
 5 by market capitalisation



Corporate Governance: Focus on the United Kingdom

Our objectives

- Ensure high standards of corporate governance in line with F&C Corporate Governance Guidelines with a focus on:
 - Board structure and composition
 - Remuneration
 - Appropriate internal controls and risk management systems
- Issue voting instruction on 100% of shares held.

Voting activity report

This table sets out the scale of voting for the past quarter. It is important to note that several votes in favour of management mask detailed dialogue, where, following compromise or mutual persuasion, we elected to support management.

Voting to date	Number	%
Total number of Meetings	566	
Number of countries in which we voted	42	
Number of resolutions	4056	
Total votes for management	2849	70%
Votes against management	278	7%
Abstentions	832	20.5%
No vote	97	2.3%

Analysis of votes

Issue	Number	% for	% against	% abstain	% no vote
Routine business	745	83	8	4	5
Directors and governance structure	1851	76	8	15	1
Capital	418	84	10	2	4
Mergers/reorg	174	61	2	30	7
Remuneration	393	77	13	8	2
Anti take-over	7	57	43	0	0
Others	265	81	6	8	5

Shareholder resolutions number of votes for or against management

	for	against	abstain
	39	66	8

Engagement by F&C

Introduction: the advent of the Company Act

The key development in the United Kingdom in 2007 was the introduction of the Company Law Act, which will radically change the way companies assess risks and shape and execute their long-term strategy. Although the complete Act will not formally come into effect until October 2008, its provisions have already begun to send ripples through the corporate and investor communities.

Shining the spotlight on the board

In the first – and certainly most dramatic – ripple this year, public attention has zoomed in on the competence of the board of directors and its ability to develop and realise a strong, sustainable long-term company strategy. This was helped by the Act's expansion of directors' duties, which now include a clear requirement to consider all factors when deciding on what is best for the company, rather than merely 'acting in good faith' as previously. Encouraged by

this new emphasis on 'enlightened shareholder value' – a new term coined by the Act – shareholders have looked for evidence of the value-added by the board of directors – and taken action where this evidence was found wanting!

One stark example of this is the attack against **Vodafone** launched by activist investor Efficient Capital Structure, which filed four shareholder proposals calling for the disposal of the company's US-based **Verizon** assets and an overhaul of its capital structure. Meanwhile, fellow activist investor Knight Vinke turned its fire on **HSBC** criticising its corporate governance and demanding a strategic review of the bank's operations. Finally, Principal Capital raised the alarm on the struggling **Photo-Me**, attempted to block the sale of one of its divisions and called for a summary dismissal of the board. In all instances, F&C has welcomed investors taking an active interest in company performance, but has kept its own counsel on whether or not to support them. We reviewed

carefully the proposals and even, in the case of **HSBC**, raised a number of its own concerns about strategy with the “world’s local bank”, largely relating to the management and governance of its US operations after an unprecedented profit warning.

Remuneration and strategy: connecting the dots

In line with the Act’s focus on challenging boards and broadening the definition of responsibility, shareholders have also turned their attention to remuneration, expecting to see a clear fit between how much and when senior executives get paid and the strategy of the company. Some companies have already begun to respond: the 2007 proxy season saw several long-term incentive plans jump from a three-year to as much as a seven-year duration: indeed, both **Tesco** and **WHSmith** set performance targets so stretching that even the threshold levels (i.e. performance needed to trigger the first tranche of the award) exceeded market expectations.

Companies have also boosted transparency of performance targets and better explained how they support the overall strategy: for instance, following extensive dialogue with F&C, **Unilever** disclosed sales growth and free cash flow targets, which exceeded market expectations and allowed F&C both to support the proposal and upgrade its view of the company. Similarly, **Cable & Wireless** introduced a scheme with clear financial metrics that would make the company a more attractive acquisition target – part of its declared strategy. F&C welcomes these moves and believes greater transparency of performance targets will help strengthen accountability and improve performance. Conversely, where progress has stalled, i.e. performance conditions remain unclear or alignment between strategy and remuneration is missing, such as at **Royal Bank of Scotland** and **Provident Financial**, F&C will oppose the schemes.

One company that has led the way in ensuring its pay is fully aligned with all aspects of its strategy is **BP**, which has allocated 30% of annual bonuses to non-financial metrics, such as health, safety, environmental performance and reputation. However, when the company this year cut executive bonuses by 50% to reflect the impact of the Texas City and Alaska incidents on the share price, many investors, including F&C, did not feel this was enough. As a result, the remuneration scheme met with opposition from nearly 20% of shareholders. Since then, the company has responded to investor and public criticism, and the new CEO is restructuring the business to achieve more consistent standards.

... and integrating sustainability concerns

The heightened sensitivity to non-financial risks, such as safety, is symptomatic of the ripples caused by another key feature of the new Act: the requirement for companies to include within their annual report a specific review of all risks arising from the company’s environmental, community or supply chain impacts.

“For the first time, the Bill... enshrines in statute what the law review called ‘enlightened shareholder value’. [...] Directors will be required to promote the success of the company in the collective best interest of the shareholders, but in doing so they will have to have regard to a wider range of factors, including the interests of employee and the environment.”

Alastair Darling, Commons Second Reading, 6 June 2006

The inclusion of the new beefed-up business review means that the buck now stops with top management when it comes to non-financial risk management. Indeed, change is already apparent, as senior executives and shareholders alike demonstrate growing awareness of risks that were once the preserve of niche specialists and investors. Thus, shareholder proposals were filed at **First Group** and **Tesco**, questioning these companies’ approach to labour standards and calling for the adoption of more stringent policies. At both companies, F&C met with management and facilitated meetings with shareholders filing the proposals. In the case of **First Group**, these meetings led to a decision by the company to make such significant commitments in this area that F&C was able to support management on the proposal. **Tesco** has also taken steps in this area, particularly with regard to its reporting, enabling F&C to abstain on the proposal⁶.

As investors increasingly press for better management of non-financial risks, senior company executives are also demonstrating a better understanding of the links between environmental, social and governance risks and company performance. Following the devastating summer floods in central and southern England, senior executives at large UK and international insurance companies such as **RSA**, **HBOS**, the syndicates of **Lloyds**, and **Munich Re** committed to addressing climate change by launching the **Climatewise** Principles, of which F&C was a founding signatory⁷. We were also delighted to see the new CEO of UK supermarket chain **Morrison** adopt a three-year sustainability strategy (the first for the company!), which incorporated many of the suggestions made by F&C, especially in the areas of health and nutrition. The fact that neither of these developments are a result of highly visible shareholder pressure illustrates how awareness of the new ‘enlightened shareholder value’ approach enshrined in the Company Act has begun to seep into the fabric of company management.

As UK companies adapt to the reforms brought on by the Company Law Act, F&C will continue to press for a clear alignment between governance practices and company strategy. In particular, companies need to demonstrate a clear understanding of the full range of factors that make up a successful and sustainable strategy, including environmental, employee, community and supply chain impacts.

⁶ Please refer to pp. 10-11 for a more detailed discussion of this engagement.

⁷ Please refer to pp. 8-9 of Q3:07 reo⁷ report for further details and www.climatewise.org.uk for information on the Principles. Please also see www.fandc.com/insurancereport for a report detailing F&C’s views on the risks facing the insurance sector from climate change.



Focus on Bribery & Corruption

Our objectives

- Ensure that companies have effective anti-bribery and corruption policies and systems with a specific focus on: agents, intermediaries and third parties; payments transparency; whistleblowing; political influence; facilitation payments.

How corruption costs money for shareholders

In a 2002 report entitled *'The Governance of Bribery & Corruption'*, F&C highlighted how bribery and corruption presented a significant investment risk, yet few companies were well-equipped to deal with it. Since 2002, many companies have improved their management systems, supplier contracts, training and corporate culture, amidst tightened enforcement in the wake of September 11th and increased government scrutiny of hidden transactions. However, a series of recent incidents has demonstrated how vulnerable companies remain – particularly when they have business relations with the United States, where prosecution under the Foreign & Corrupt Practices Act (FCPA) can lead to heavy fines and other painful sanctions. The picture for shareholders is complicated, because the value of new contracts won can often far outweigh the costs of fines for past misdemeanours; as a result, a rise in share price related to new contracts might accompany the announcement of a significant fine – which gives the perverse impression that shareholders do not regard corruption as important.

A short-term share price rise can mask the long-term damage that a reputation for corruption can have with potential customers and regulatory authorities – to say nothing of the hidden costs of cooperating with complex investigations. Most disruptive is the management change that can result: two companies embroiled in scandals this year, **BAE Systems** and **Siemens**, have lost their CEOs, and seen major restructuring of key divisions.

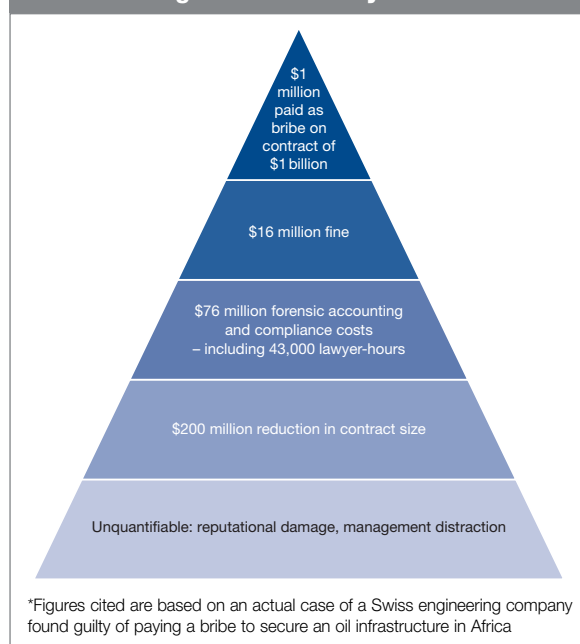
The hidden costs of corruption that play out over the medium to longer term include:

- Diversion of management time to deal with investigations
- Disruption caused by senior executive changes, including those at board level
- Legal and forensic accounting fees
- The cost of appointing external an compliance officer - often imposed on companies as a condition of reaching a settlement and generating additional demands on staff time and procedures
- Loss of key clients not wishing to be associated with a corrupt company
- Temporary or permanent blacklisting by lenders and key customers, such as governments or multilateral development agencies

- Effects on employee morale and recruitment
- Business disruption as relevant units are restructured and processes overhauled
- Corrosive effect on corporate culture: a company that tolerates bribes is less likely to object to other forms of misbehaviour, including defrauding shareholders.

Over and above the effects on individual companies, shareholders also suffer as corruption penalises non-corrupt companies, distorts competition and ultimately undermines the efficiency of markets.

What one single bribe actually cost*



Recent developments

2007 has seen a surge in corruption scandals, as practices that had long been tolerated have suddenly become the subject of strict enforcement action. German business was rocked by revelations that engineering giant **Siemens** had paid bribes of at least €426 million to secure telecommunications contracts going back several years. **Siemens'** chairman and chief executive both resigned over the news, and the sprawling business is being radically overhauled under the new CEO, with all senior managers having to reapply for their jobs. The company was recently fined €201 million by the German authorities, in the first of several rulings that could end up costing billions.

“ We have to make sure we align responsibility and accountability in the company from the top down. Leaders will lead the company, leaders will be responsible, leaders will have ethical standards. This is a multi-year programme. ”

Financial Times, “Löscher to transform Siemens' culture”, 9 December 2007, quoting Peter Löscher, Chief Executive, Siemens

The Woolf Committee

Most recently, F&C has made a submission to **BAE Systems'** Woolf Committee, reflecting its position as a long-term shareholder in the company and its concerns about the unprecedented level of attention the company has received over corruption-related issues.

F&C recognises that corruption has been widespread in the defence sector and that there is a danger of corruption-free companies being uncompetitive. Home-country governments, which often represent a defence company's largest customer as well as being the regulatory authority for exports, have allegedly been complicit in allowing corruption to happen in the past. This means there has been a systemic disincentive for companies in the defence sector to act to the highest standards of probity – in recognition of which F&C has engaged companies throughout the sector to achieve a general raising of standards, including **Boeing, Rolls Royce, Cobham** and **Thales**. F&C's recommendations to the Woolf Committee seek to take this into account, while believing that **BAE Systems** can operate to best practice standards without fundamentally compromising its competitive advantage. F&C's ten recommendations to the Woolf Committee⁸ for reducing corruption-related risks to shareholders at **BAE Systems** are:

1. Put in place anti-corruption assurance for the new Saudi deal.
2. Secure additional safeguards for the company in government-to-government deals.
3. Form a strategy to deal with legacy issues.
4. Demonstrate that controversial cases are thoroughly investigated internally.
5. Benchmark against non-defence companies.
6. Improve transparency.
7. Demonstrate board leadership.
8. Create a permanent external advisory panel.
9. Establish a process for engaging critical stakeholders.
10. Take a lead in defence industry anti-corruption initiatives.

Meanwhile, newly-merged **StatoilHydro** has referred itself to the US Department of Justice, having uncovered illegal payments to agents during the due diligence of the merger between **Statoil** and **Norsk Hydro**. Swiss-Swedish engineering giant **ABB** has also referred itself to the Department of Justice, following its own experience of being found guilty of paying bribes in Nigeria. In Korea, an unprecedented scandal is unfolding at **Samsung**, where a senior legal officer has claimed that the company, which has been investigated for corruption in the past, maintained a \$220 million slush fund to bribe judges and politicians. The company has vehemently denied the allegations, and the government looks embarrassed.

But the year's most controversial corruption-related story has been at UK defence giant **BAE Systems**. Amidst a series of allegations over corrupt deals around the world – strongly denied by the company – the company became the subject of an investigation by the UK's Serious Fraud Office into the company's contracts with Saudi Arabia, which date back to the 1980s. The UK government suddenly called off its case, citing threats to 'national security', prompting the US Department of Justice to launch its own investigation. The **BAE Systems** board has responded by commissioning a high-level committee, headed by Lord Woolf, the former Lord Chief Justice, to assess the company's ethical policies and processes, while the CEO has announced his retirement in August 2008.

F&C has engaged 281 companies on corruption-related issues over the past two years, including **ABB, Balfour Beatty, BP, CNOOC, ExxonMobil, Monsanto, ONGC, Petrobras, Petrochina, Royal Dutch Shell, RWE, Samsung, Siemens, Statoil** and **Total**. In particular, F&C has emphasised the need for: confidential internal reporting (a.k.a. whistleblowing) systems; internal policies and procedures for appointing and remunerating agents, intermediaries and other third parties; comprehensive policies on political influence, including donations and lobbying; extractive companies actively to support the Extractive Industries Transparency Initiative; and above all, a management, leadership and incentivisation culture that does not promote bribery or corruption, and the policies and procedures to back this up.

“ ...Taking a cold-eyed view, BAE could now benefit from change at the top. Much will depend on the quality of the next chief executive. But a different style - good cop, rather than bad cop - would be appreciated by clients, particularly defence agencies on both sides of the Atlantic, who bore the brunt of the chief executive's legendary pugnaciousness. A new boss could also signal a generational shift and put behind BAE the corruption probes into arms deals with Saudi Arabia, which have - to Mr Turner's chagrin - sometimes overshadowed the group's commercial success.... ”

Financial Times, “BAE must now seek a 'good cop' for its top job”, 16 October 2007



Focus on Supply chain factory labour standards

Our objectives

F&C aims to encourage companies:

- To adopt a code of conduct on labour standards (based on ILO Core Conventions), and to develop a management system to implement the code, audit compliance and work with suppliers to address weaknesses.

Engagement by F&C

The Issue: factory labour standards in crisis

Investors were first alerted to factory labour standards in the 1990s, when sportswear brands were attacked for sourcing from sweatshops. Following unrelenting public pressure, including by F&C, global brands had, by 2000, committed to auditing factories against the ILO Core Conventions⁹. Still, despite some examples of good practice, including **GAP**, **Nike**, **Marks & Spencer** and **Nokia**, companies have not been able to head off further exposés – to their frustration, despite good-faith efforts to improve practices. In 2007, with the Beijing Olympic Games looming, campaign groups have turned up the heat, pointing the finger at brands for persistent breaches, while Western consumers increasingly question whether where they shop is “green” and “ethical.” F&C’s concerns are:

- **Security of supply:** Business models that rely on low-cost supply bases require secure supplies of a high-volume of goods. Poor factory working conditions may lower productivity and employees may protest through work stoppages, or simply move to the competition, as has happened in China. Companies sourcing from such factories may therefore encounter unexpected problems and be forced to find new suppliers at short notice.
- **The impact on consumers:** In Western markets, allegations of sweatshops erode consumer confidence in brands marketed as “green” and “ethical.” As investors increasingly chase returns in emerging markets, one key value driver is the rise of the domestic consumer, a trend that is fuelled by growing wages. As emerging economies mature and wages rise, investors will seek out value by funding businesses that capitalise on this trend.

F&C acts

F&C has engaged with vulnerable companies on supply chain labour standards by asking them the following:

Do you have a labour standards policy?

F&C has written to all of the highest-risk companies in which it invests that have not adopted a labour standards

policy, calling on them to do so and to base this on the ILO Core Conventions. This comprises 50 companies worldwide, including **Hermes International**, **Seven & I Holdings**, **Olam International**, **Financière Richemont**, **Ted Baker** and **Woolworths** (Australia).

Are your factory audits picking up on problems?

Several companies with well-established auditing programmes have later found problems, raising concern about whether audits are done properly. After visiting Central American factories supplying **Wal-Mart**, F&C recommended that auditors leave factory workers with pocket-sized cards bearing the auditor’s contact details. **Wal-Mart** adopted our recommendation, meaning factory workers can more easily contact auditors to alert them to employment concerns.

We expressed concern to **GAP** about Indian children embroidering GapKids products, recommending it review how child labour is detected. **GAP** has reinforced its no-child labour policy to Indian suppliers, suspended the offending supplier, committed to long-term assistance and education for the children removed from work, reported publicly on its investigation and will review its auditing methods.

F&C has recommended fashion retailers improve labour standards in Bangladesh, where clothing exports are important to the economy, but associated with unsafe factories providing low wages. **Primark** will audit all high-risk factories in 2008 to better identify problems, **Hennes & Mauritz** will focus on robust auditing and train workers and factory managers on workers’ rights, while **Marks & Spencer** and **Tesco** are reviewing how the industry can work together to raise standards.

Do your factory audits indicate labour standards are improving?

Weak public reporting by companies means it is difficult for investors to assess whether supply chains are well managed. After repeatedly requesting changes at **Tesco** with limited success, F&C abstained on a labour standards resolution filed at its 2007 Annual General Meeting, and recommended the company report transparently on factory performance against its code. **Tesco** has since committed

to doing this and consulted with F&C on its reporting practices. Following F&C's requests, **Carrefour**, **Apple** and **Wal-Mart** have published better information on factory audit results, although we remain concerned that **Wal-Mart** still does not provide a "warts and all" report.

How can your industry improve labour standards?

F&C has encouraged companies to form global industry bodies to push standards higher. F&C has welcomed the following new bodies and recommended they base their codes on the ILO Core Conventions, introduce robust supply chain monitoring, involve key stakeholders and act transparently: the Global Social Compliance Programme for retailers, the Council for Responsible Jewellery Practices and the Electronic Industry Code of Conduct.

F&C's assessment

Criticism of companies over sweatshops will continue until their responses are better adapted to the challenges of sourcing from factories in emerging markets. Poor working conditions in factories are not entirely the fault of purchasing companies, but rightly or wrongly, they will get much of the blame, and risk compromising their brands and supply chains unless labour standards improve.

F&C's recommendations for purchasing companies are:

- **Deliver on commitments:** Companies must work with factories and incentivise them to drive up labour standards faster. Companies cannot cherry-pick which labour standards they implement; challenging issues, such as wages and trade union rights, must be tackled and multi-stakeholder industry approaches are the best forum for creative solutions.
- **Align your sourcing model with the ILO Core Conventions:** Companies should take steps for buying practices, such as production planning, and incentives, to support labour standards. Companies need to develop better internal management tools to identify and reduce the negative impacts of buying practices on factory working conditions.
- **Transparency is the best insurance policy:** Even with the best systems, problems will not disappear. The best way to maintain discipline and disarm critics is to report annually about progress, challenges, successes and failures. Reporting must indicate the percentage of high-risk suppliers engaged with to improve practices, factory compliance with the labour standards policy, improvements delivered, and comment on performance trends.

“The reality is that most major retail firms are in the same game, cutting costs and not considering the consequences. They should know by now what outsourcing to India means. It is an impossible task to track down all of these terrible sweatshops, particularly in the garment industry when you need little more than a basement or an attic crammed with small children to make a healthy profit.”

Bhuwan Ribhu, Global March Against Child Labour
The Observer, 28 October 2007

We said...

“F&C's research finds that your company's current level of public disclosure, particularly the absence of a published labour standards policy that commits to the ILO Core Conventions, does not meet emerging standards in good practice supply chain management.”

Extract of F&C letter to high-risk holdings with no labour standards policy, November 2007

“Tesco will have an important role to play in developing higher standards of reporting across the industry.”

Extract of F&C letter to Tesco's Chairman, 31 July 2007

They said...

“At a time when its India plans – or lack of them – are in the spotlight, back home Tesco faced what is an unprecedented shareholder revolt in its AGM over the weekend, over the compensation of its [Chief Executive], Sir Terry Leahy and its low wages paid to workers in developing countries. In a David Goliath kind of situation, shareholders showed up the contrast between the Tesco board's refusal to pass a resolution promising 'living wages' to its outsourced employees in developing countries, while at the same time voting 'excessive' pay packages for its CEO.”

The Economic Times,
“Tesco shareholders highlight pay disparity”,
2 July 2007



Focus on Biofuels

Our objectives

- Encourage adoption of clear, long-term government policies to shift to low-carbon economy
- Encourage companies to measure and reduce greenhouse gas emissions from the biofuels production process, and to manage sustainability risks.

Introduction: the biofuels bubble bursts

In 2006, the global capital markets witnessed a series of frothy initial public offerings (IPOs) of biofuel companies. Promising high returns, energy independence and a way to reduce greenhouse gas emissions caused by transport, a fledgling biofuels industry shot to prominence. One year later, with the market chastened by a series of profit warnings, the biofuels industry has been stunned by an aggressive political backlash, at first led by environmental campaigners, that has steadily snowballed into a chorus of concerns voiced by United Nations' food and agriculture officials and the Organisation for Economic Cooperation and Development (OECD).

What is a biofuel?

Biofuels are transport fuels made from agricultural produce or waste. They are seen as having two key advantages over fossil fuels: first, they have the potential to cut greenhouse gas emissions; and second, they can often be produced domestically, with benefits for security of supply. The main "first-generation" biofuels in commercial use are ethanol, a grain-based alcohol, and biodiesel, which are produced from oil crops or animal fat. The US and Brazil favour ethanol, whilst in Europe and Malaysia, biodiesel based on vegetable oil is more popular. "Second-generation" biofuels use more advanced production techniques. Cellulosic ethanol, for instance, uses specialist enzymes in the production process, and is widely recognised as a more sustainable biofuel, but is only in early-stage development.

What are the concerns about biofuels?

Biofuels crops have started to compete for land with food crops, with significant implications for food prices, food security and rural livelihoods. First-generation biofuel crops typically require new plantations, which have prompted allegations of corruption, illegal expropriation and mistreatment of small farmers and indigenous peoples. Meanwhile, concerns have multiplied that the actual emissions saved by biofuels are lower than often claimed. Producing ethanol releases emissions – for example, when fertilisers are produced and crops are harvested – while growing crops such as palm oil for biodiesel may involve clearing forests and peat bogs, which destroys valuable carbon sinks.

The Issue: is a sustainable biofuels industry feasible?

The biofuels industry initially promised a solution to climate change, incentivised by stretching government targets – so how did it go so wrong? What is the future for the industry?

F&C's view, based on analysis of 30 companies¹⁰ is that the industry's future is highly uncertain because of political risks. Negative investor sentiment has arisen from a range of factors. When coming to the markets for finance, many biofuels producers bet on continued low commodity prices; misjudged government sensitivity to food price inflation and environmental concerns; and failed to work together to find industry solutions to sustainability challenges, such as deforestation associated with sourcing palm oil. The oil and gas industry, with its history of high levels of public scrutiny, has a better grasp of the importance of sustainability issues, and may play a pivotal role in building standards for good practice.

The biofuels industry faces clear challenges as a result of the changed political climate, including tighter regulation of sustainability standards. However, the biofuels industry may still be viable and stands to benefit from new opportunities, if it takes a more pro-active and forward-looking approach to tackling some of the challenges and criticisms it faces.

How big could the biofuels industry become?

The International Energy Agency estimates that biofuels could contribute up to 30% of the global road transportation fuels by 2050. The European Union's current regulatory objective is for biofuels to comprise 10% by energy content of EU fuel by 2020. The US Renewable Fuels Standard aims for 7.5 billion gallons of renewable fuel in the US market by 2012, compared with current US motor fuel consumption of over 180 billion gallons, and at the time of going to press there were proposals underway for the new US Energy Bill to mandate a further increase to 36 billion gallons by 2022.

They said...

“...the Government has announced its intention that the RTFO [Renewable Transport Fuels Obligation] will reward fuels according to their carbon savings.”

Department for Transport statement, October 2007

10 European companies: Argent Energy, D1 Oils, Verbio AG, Petrotec, Ensus, Dupont, Neste Oil, Tesco, Marks & Spencer, Total, BP, Shell, Eni and Statoil. Emerging Markets companies: Petrobras, Brasil Ecodiesel, Clean Energy Brazil, CNOOC and China Sun Bio-Chem Technology. US companies: Global Ethanol, Pacific Ethanol, Archers Daniels Midland, Verasun Energy, Potash Corporation, Bunge Ltd, Aventine Renewable Energy, Metabolix, Marathon Oil, Tesoro and Chevron.

Engagement by F&C

F&C acts: how is the biofuels industry addressing sustainability challenges?

F&C has engaged in depth with key actors in developing a more sustainable biofuels industry that will be attractive to long-term investors.

Talking to the new biofuels producers...

F&C has conducted in-depth research of initial public offerings of eleven specialist, first-generation biofuels producers to assess to what extent they provide climate change solutions (see Fig 1). We have found:

- **Limited public disclosure of carbon savings:** few companies have published the results of life-cycle assessments of greenhouse gas emissions, raising questions about the carbon savings biofuels offer. F&C welcomes the UK government's recent decision, following F&C's recommendations, to develop mandatory public reporting standards for biofuels, overseen by a new government body, the Renewable Fuels Agency.
- **Poor supply chain oversight:** Biofuels producers have low awareness about supply chain biodiversity and labour standards issues; this is surprising given their supply chains are agricultural and, as such, high-risk, particularly for biodiesel producers.
- **Reluctance to develop global industry standards for sustainability:** at the time of research, no companies were involved in formulating these.
- **Low investment in second-generation biofuels:** this raises concerns about where how investment in innovative technologies will be funded.

We said...

“For some biofuels, the emissions from the production process may wipe out the greenhouse gas savings.”

Karina Litvack, Head of F&C's Governance & Sustainable Investment Team, Bloomberg, 17 May 2007

...and the seasoned oil and gas majors...

F&C has identified the oil and gas sector as a key player in shaping the biofuels industry. Oil and gas companies may produce biofuels as part of their own climate change strategy, and even where they do not, government targets may compel them to distribute biofuels in petrol pumps. F&C has had detailed discussions with a number of oil and gas companies, including **Total, ExxonMobil, Chevron, Petrobras, Statoil, BP, Eni** and **Shell**.

Company responses showed a wide variation in approaches¹⁶. **Total**, for instance, is already involved in biofuels production, while **ExxonMobil** has expressed deep scepticism about the achievability of US biofuels goals, and is funding scientific research into second generation biofuels production. Some companies do have involvement in biofuels, but are responding to concern about destruction of Indonesian rainforests and peat bogs – important carbon sinks – by explicitly removing palm oil from their supply chain altogether.

Other companies' policies do not go into this level of detail. Whilst the involvement of the oil majors in first-generation fuels is, in general, relatively limited, most have research programmes into second-generation alternatives, some of which represent very substantial investments. **Shell**, for instance, recently announced plans to build a commercial plant producing biodiesel from algae within the next two years.

Fig 1. How is the biofuels industry addressing sustainability challenges?

Company name	Managing greenhouse gas emissions? ¹¹	Management systems for sustainable practices in sourcing of feedstock? ¹²	Managing labour standards? ¹³	Public disclosure ¹⁴	Working with industry peers on sustainability challenges? ¹⁵	Researching 2 nd generation biofuels?
Argent Energy	✓		✓	✓		
Aventine Renewable Energy						
Brasil Ecodiesel		✓	✓	✓		
China Sun Bio-Chem Technology	✓					
Clean Energy Brazil		✓	✓			
D1 Oils	✓	✓	✓	✓		
Ensus	✓					
Global Ethanol	✓					
Pacific Ethanol	✓					
Petrotec	✓			✓		
Verbio AG	✓	✓		✓		

¹¹ F&C assessed a company as "managing greenhouse gas emissions" if it had either conducted or planned to conduct a life-cycle assessment, or was actively reducing emissions through clear management systems.

¹² This question was only relevant to companies involved in biodiesel

¹³ F&C asked whether labour standards are managed in both the direct workforce and supply chain workers

¹⁴ F&C considered public disclosure to be evident in a website section covering sustainability practices, such as greenhouse gas emissions and sourcing practices

¹⁵ For example, evident in membership of the Roundtable on Sustainable Palm Oil

¹⁶ Some of the variation is explained by the different levels of involvement in biofuels amongst the different companies; for example, **Total** is currently involved in the production of biofuels, whereas **Shell** is only acting as a distributor right now, but is involved in R&D into future technologies.



Focus on Biofuels (continued)

Certain companies, such as **BP** and **Shell**, are taking a holistic approach and seeking to support biofuels that will genuinely reduce emissions and have minimal negative impacts on biodiversity in their supply chain. But overall, the oil and gas industry is taking a “wait-and-see” approach, with limited public disclosure about sourcing practices and how food security concerns will be addressed. F&C considers that the oil and gas industry needs to take a strategic approach towards biofuels, actively engaging in public debate about them and developing industry-wide sustainability principles for biofuels.

Case study: tackling the ‘Food vs. Fuel’ challenge

There is concern about biofuel crops competing with food crops for use of agricultural land. In the biodiesel market, **BP** is focusing on biofuels where feedstock costs are delinked from food. It is investing \$160 million in a joint venture to cultivate jatropha, a non-edible oil-bearing crop that can grow on marginal land, thereby not displacing precious food crops or natural forests. Jatropha also needs less irrigation than standard crops. **BP** is also working with an independent Indian think tank, TERI, to assess this crop’s net carbon savings, its biodiversity impacts, the labour standards on plantations and the economic opportunities for smallholder farmers.

They said...

“The rush to energy crops threatens to cause food shortages and damage to biodiversity with limited benefits.”

OECD Roundtable on Sustainable Development, “Biofuels: is the cure worse than the disease,” September 2007

...calling for industry action...

Competitive drivers can deter companies from acting sustainably. To create change, companies need both to act individually and to engage with fellow industry players to set sector-wide standards. Following its disappointing research findings, F&C has encouraged the industry to form a new Roundtable on Sustainable Biofuels, building on the experience of the Roundtable on Sustainable Palm Oil (see case study below). This would have the aim of promoting biofuels certified as sustainably-sourced. F&C has contributed to the standards required of members of this new roundtable, and recommended these specifically address:

- Ecosystems based on the Convention on Biological Diversity
- Labour standards based on the ILO Core Conventions
- Public reporting by companies on sustainability practices.

Case study: industry initiatives

The Roundtable on Sustainable Palm Oil is an existing industry-led initiative aimed at promoting sustainable cultivation of oil palm in South East Asia. Although actions taken by the Roundtable mean certified palm oil will be available in 2008, Greenpeace has severely criticised the initiative, questioning its effectiveness and warning that any further expansion of the palm oil industry will result in loss of carbon sinks, such as forests and peat bogs, thereby undermining climate change goals.

...and engaging the public policy makers

For companies to invest in climate change solutions, they need a regulatory environment that rewards them for adopting the right behaviour, and penalises them for not doing so. F&C therefore engages with public policy makers as well as companies directly to ensure targets, incentives and subsidies are carefully devised.

F&C has called on UK, EU and US climate change policy to:

- Link greenhouse gas savings the biofuel generates with the level of subsidy provided, so that targets do not solely focus on volumes of biofuels produced Set minimum standards for emissions reduction, biodiversity in feedstock sourcing and labour standards in agricultural supply chains;
- Require companies publicly to report on their sustainability practices;
- Remove protectionist barriers to international trade in biofuels.

F&C has also encouraged companies within the industry to engage with policymakers to shape future regulation on sustainability standards.

We said...

“We would also encourage a link between the greenhouse gas saving offered by different types of biofuels.”

Extract of F&C letter to the UK Minister for State for Transport, 16 May 2007

They said...

“**The development of new bioenergy industries could provide clean energy services to millions of people who currently lack them, while generating income and creating jobs in poorer areas of the world. But the rapid growth... could have negative economic and social effects, particularly on the poor who spend a large share of their income on food.**”

United Nations, *Sustainable Bioenergy, A Framework for Decision-makers*, 2007

2. **The biofuels industry needs to work more closely with governments** to promote political objectives on carbon savings, technology, food prices, food security and international development. The industry also needs to encourage governments to support easier distribution of biofuels.
3. **Global industry-wide standards must be implemented** to ensure biofuels have a net positive impact on ecosystems. This needs to happen fast, as biofuels producers face a profit margin squeeze due to rising commodity prices, and many are sourcing low-cost feedstocks, regardless of the long term environmental damage they cause.
4. **The industry must engage more actively in public debate** about biofuels and demonstrate transparency about carbon savings and sourcing impacts. The biofuels industry stands at a crossroads and must collectively address public concerns. If companies do not convince the public that they will move towards sustainable business models, they may find that governments turn back on the targets and subsidies that are driving their industry's growth.

F&C assessment: what is the biofuels industry's future?

After extensive discussions with key players in the industry and with outside experts, F&C's assessment is that although government targets will drive demand for cleaner transport fuels, the global biofuels industry faces high political risks and its future shape is uncertain. Few US, European or Emerging Markets companies indicate they understand the scale of the challenge involved in creating a sustainable biofuels industry, much less demonstrate commitment to rising to this challenge.

F&C believes that in spite of these setbacks, it is possible to create a sustainable biofuels industry. However, four things need to happen in the next 12 months for the biofuels industry to rebuild public confidence and to deliver sustainable investment returns:

1. **Governments need to set a clearer political and regulatory framework for a sustainable and competitive biofuels industry**, and remove European and US trade barriers such as tariffs on Brazilian ethanol imports. Governments need to promote investment in new technology, as this will be key to the industry's success, and ensure policies are driven by climate change and link subsidies to achieved carbon savings.

We said...

“**The biofuels industry presents long-term opportunities, but currently the economics are unfavourable, with excess capacity and rising input prices. Until this changes, and until there is also greater clarity on regulatory policies, we will be very wary about any investments in the sector.**”

Terry Coles, Co-Manager,
F&C Global Climate Opportunities Fund


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Important information. All data is as at 31 December 2007, unless otherwise stated.

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