

Investing in sustainability

NEWSLETTER ON RESPONSIBLE OWNERSHIP

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Our main feature article in this second issue of Investing in Sustainability focuses on executive pay. Long a hot topic, this year it will be higher than ever on the agenda at annual general meetings. In 2010, as in previous years, APG will press for appropriate remuneration policies at the companies it invests in. Also in this issue is a report on our efforts against child labour in cocoa production. And, as promised in the first issue of our newsletter, we present the results of a global study on the sustainability of the real estate sector. Further features show what progress we have made in our engagement with Total about its operations in Burma, and the impact of oil extraction from tar sands.

Focus on bonuses

APG exercises the voting rights linked to the shareholdings it manages for pension funds.

In some countries the issues we are able to vote on include executive remuneration. Where we have a say, we assess whether the remuneration policy is appropriate. This is no easy matter - but then it never has been.

Executive remuneration controversial

For years, the sums paid to top managers of large companies have drawn wide criticism. 'It was greed, greed and more greed,' former minister Jaap Boersma once said in the Dutch weekly *Vrij Nederland* about what he saw in the late seventies, when he was still on the board of Ogem, a company that went bankrupt in 1983. Two decades on, in 1997, the then Prime Minister of the Netherlands, Wim Kok, expressed his distaste at executive pay rises on the Dutch TV news programme *Nova*. His qualification of such behaviour as 'exhibitionistic self-enrichment' became lodged in the country's collective memory, given that senior executives' pay consists of a lot more than just basic salary. Shell's chief executive, for instance, was paid a total of \$6 million in 2008, but only \$1.4 million of this was basic salary. The remainder consisted of bonuses and other components, including shares. In the heyday of the stock market, executive pay came under scrutiny following several high-profile takeover bids for listed companies (Numico, ABN AMRO), when the public became aware of how many shares the executives of these companies had been awarded over the years. The takeover of ABN AMRO by a three-bank consortium (with the Dutch government's blessing) meant a €26 million cash-in of shares and options by ABN AMRO's chief executive, condemned by Dutch Parliament as 'money-grabbing'. Dutch Liberal Party MP Frans Weekers subsequently submitted a parliamentary motion on pay which was passed on 17 October 2007.

The pay motion in the Dutch Parliament:

Parliament,

considering that the prospect of sizeable bonuses following a merger, an acquisition or severance and/or the possibility of early encashment of options and shares can lead company executives to put their private interests before the interests of the company;
considering that such perverse incentives can undermine corporate governance;
considering that such matters have been the subject of lawsuits outside the Netherlands;
requests that the government investigate the sufficiency of the legal remedy available to stakeholders in the Netherlands to test whether personal interests have prevailed over company interests, taking account of legal practice outside the Netherlands, and inform Parliament of its findings before the end of the year.





Limits to shareholder power

Dutch company law adopted on 1 October 2004 gives the shareholders' meeting the right to approve or reject pay policy and the granting of shares and options to executives. But how much power do shareholders really have? The government contracted law firm Nauta Dutilh to find out. In the report they produced in 2008 (over 300 pages), they concluded that shareholders both inside and outside the Netherlands theoretically have sufficient a priori influence on executive pay. Subsequent cases have proved them right. Shareholders at several large

Dutch companies have voted down the pay policy proposed by management. However, the lawyers also identified limits to shareholders' power. Royal Dutch Shell, for instance, is governed by UK law, which gives shareholders only an advisory role with regard to the remuneration committee's report on how employees are paid. Last year, Shell shareholders voted against the report, but this did not lead to any changes in remuneration practice. However, Shell did replace the chairman of its remuneration committee and tabled a new policy in 2010. KPN falls under the Dutch rules. These state that changes to remuneration policy must be submitted in advance for shareholder approval.

Last year KPN changed its policy, but the board was convinced that the change did not need to be put to the shareholders for approval, and did not include it on the agenda of the shareholders' meeting. Other companies, such as DSM and Heineken, did put remuneration policy on the AGM agenda, but with public feelings running high, they later decided to drop it.

Bonus debate widens

In 2009 public debate was fanned by government bailouts of financial institutions to protect savings and the payments system. The perception by the public at large was that banks had been saved with taxpayers' money. Scrutiny of financial sector pay became intense, and 'bonus' fast became the dirtiest word in the governance debate. In the Netherlands, the government appointed members to the supervisory boards of listed companies ING, Aegon and SNS Reaal. One of their responsibilities is to monitor pay. Even before the bailouts, the Dutch Banking Association (NVB) had set up an Advisory Committee on the Future of Banks, headed by Cees Maas. Its remit included producing a new remuneration framework for banks that offered less incentive for risk-taking.

Clear principles

In 2009, the ground was therefore laid for discussion between Dutch company boards and shareholders on executive pay. This year, the main platform for this discussion is the shareholders' meeting, typically held between March and May. As a shareholder, APG will again have to evaluate the pay policies of Dutch companies that it invests in on behalf of its clients. We study each proposal individually, basing our assessment on the 'Principles for a sound remuneration policy for members of the management boards of Dutch listed companies' published in October 2009 by the Dutch corporate governance forum Eumedion (www.eumedion.nl). The latest trend is for Dutch companies to discuss their

remuneration policy with their shareholders before the AGM. We believe this is a positive development.

Remuneration and sustainability

Besides a fixed salary, the remuneration of management board members at large companies also contains a variable component. While the fixed salary is largely based on the size and complexity of the company, the variable component has become customary in the past few decades as a way of encouraging the board to keep the long-term interests of shareholders in mind – something they tended to forget. To align the interests of management and shareholders, the variable pay component is linked to the Total Shareholder Return (share price performance plus dividend), and payment is often made in options or shares. The institutional investors represented in Eumedion believe the emphasis on Total Shareholder Return as the sole criterion for awarding a long-term bonus has had several unforeseen side effects. Eumedion therefore suggests taking sustainability-related criteria into account as well.

Choosing the right criteria

APG is cautious about such non-financial targets. We invest for a good pension, and that means certain financial targets simply have to be met. But as responsible investors, we are of course aware that good management of social and environmental risks and opportunities can improve the long-term results of companies. Therefore, we are positive in principle about integrating sustainability criteria into pay policies. But these criteria must be aligned with the company's strategy. We look just as closely at non-financial targets as at financial ones, to determine whether they are relevant, measurable and specific enough. For mining companies, for instance, outstanding health and safety performance is very important as it saves lives and minimises production downtime. For producers of brand products, customer satisfaction is crucial to financial success. Criteria such as 'operational excellence' used by Shell or

'employee and customer satisfaction' introduced by ING make sense to us, as they are true indicators of the company's success. But we do not support companies using their ranking in the Dow Jones Sustainability Index to determine executives' long-term bonuses. If the credit crisis has taught us anything, it is not to rely on ratings, and certainly not on general scores that say little about a company's success. It is up to the company's supervisory board to find the right criteria. As investors, we in our turn monitor them.

Bonuses for bankers

Proposals abound as to how best to reward bankers. In February 2009, the US president announced a cap on pay. Top executives at banks receiving bailout money from the government are not allowed to earn more than \$ 500,000. Deutsche Bank CEO Joseph Ackerman predicted that this measure would result in a drain of top banking talent out of the United States.

In the Netherlands, the financial markets authority AFM and the Dutch Central Bank jointly published their first 'Principles for a controlled remuneration policy' in May 2009, and later published good practices as an elaboration on those principles. The Dutch Bankers Association NVB published its own self-regulatory Banking Code on 9 September 2009.

The European Commission directive on capital requirements for banks published in July 2009 also introduces a form of supervision of pay practices at banks. In August 2009, the UK Financial Services Authority published a remuneration code for the country's 26 largest banks. In the same month, the French government reached an agreement on pay with the country's banks. At a global level, the Financial Stability Board's recommendations on financial sector remuneration were adopted by G20 leaders at their September 2009 summit.

In spite of this considerable movement on the issue, the UK government decided late in 2009 to impose a one-off 50 per cent super-tax on bankers' bonuses. The French government liked the idea, but other European countries did not follow the British example. Deutsche Bank announced it was making a provision in connection with the super-tax on bonuses in the UK, to be charged to 2009 fourth-quarter results. CEO Joseph Ackerman explained that this provision was a way of sharing the burden between shareholders and staff.

APG a winner in Asia

APG has its own office in Hong Kong so that we can stay in close touch with the fast-growing economies of the Asia-Pacific region. In Hong Kong, too, we integrate sustainability into our investment processes, and this is now gaining recognition. APG Asset Management Asia was recently judged 'Best Fund House for Sustainable Investing in Asia Pacific' in the investment magazine Asia Asset Management's seventh annual 'Best of the Best' awards. President of the judging panel Tan Lee Hock said, 'This award recognises that APG invests wherever possible in companies or projects that produce clean energy, and as such contributes to energy efficiency in Asia.'

Proud of recognition

According to the judges, APG's initiatives and track record are impressive, as is APG's commitment to responsible investment and high corporate governance standards. APG is one of the few European investors with its own sustainability and corporate governance specialist based in Asia. Needless to say, we are very proud of the recognition we have received for our efforts. Going forward, Asia in particular still faces numerous challenges with regard to the environment and working conditions. There is also plenty of room for improvement in corporate governance at listed companies. APG will keep up its good work in these areas.





Sustainability in real estate

Real estate (offices and retail property) is an important asset class for APG. Because sustainability plays a key role in all our investments, we also screen real estate companies for their sustainability performance. Our initial findings are not encouraging. The majority of real estate companies and funds do not have a robust sustainability policy. Many say that sustainability is important to them, but fail to 'walk the talk'. This was revealed in a major global study of the real estate sector commissioned by pension investors APG and PGGM in the Netherlands and USS in the UK. In the long term, a weak sustainability policy can have negative consequences for real estate companies and funds.

More sustainable real estate

APG is focusing increasingly on sustainable real estate. This is not merely for corporate social responsibility reasons, but also because research has shown that energy-efficient and eco-friendly buildings produce better investment returns at less risk than conventional buildings. Maastricht University researchers tested two hundred real estate companies and funds, including numerous large European funds, against the pension investors' criteria, and compared their sustainability policy to their actual sustainability performance. On average, these companies and funds scored only 33 out of 100. 'Even though a near-100 per cent score is feasible, as proved by the best funds in Europe and Australia,' says Sander Paul van Tongeren, responsible for sustainable real estate investment at APG. 'For example, we found that over 80 per cent of the real estate funds do not know the electricity and water consumption figures for the buildings in their portfolio.'

Big differences

The differences worldwide are considerable. Companies and funds in Asia and Southern Europe, for instance, are relatively poor performers, while those from Australia, Sweden and the UK are true pioneers when it comes to sustainability policy and action. The research also showed that listed companies consistently performed far better than unlisted funds. In general, real estate funds turn out to be far better at developing sustainability policy than at implementing it. Of the Dutch companies investigated, Unibail-Rodamco was an outperformer, ranking sixth in a list of 72 listed companies. Wereldhave and Corio also performed above average. Others performed considerably worse. Of the unlisted funds, a number of ING Real Estate Investment Management's funds got high marks.

The study is intended to serve as a reference-point for investors. 'We wanted a consistent methodology and approach, so we could really compare regions and listed companies versus unlisted funds,' Van Tongeren explains. APG intends to discuss the findings with the real estate funds that it invests in. What we ask them to do will vary from fund to fund. 'APG is not about to impose a single target on the entire sector. The differences are too big for that,' says Van Tongeren. 'The management of our large investments will receive suggestions specifically geared to their individual portfolio. The idea is to repeat this survey at regular intervals, every other year for instance, to measure sustainability change in the real estate sector and the effects of investor engagement.'



New energy

APG invests in sustainable projects if the return prospects are sufficiently attractive. We do not always manage these investments in-house. Sometimes we invest in specialist external sustainable investment funds. APG is one of the initiators of Triodos Bank's Ampere Fund and a cornerstone investor in NIBC's infrastructure fund. Recently these two funds together invested in a portfolio of nine solar parks in Andalusia with a total capacity of 46 MW. Their sunny location in southern Spain should guarantee that solar panels that have been installed will

work at full capacity. Ampere invests exclusively in sustainable energy generation in Western Europe. One of its investments in the past year was the Spremberg wind farm in Germany. Situated in a major brown coal mining region, the wind farm is a perfect illustration of the contrast between old and new energy. At 191 meters the wind turbines dwarf the 160 meter high cooling tower of the nearby brown coal fired power plant: so at least the new is higher than the old!

Nestlé publishes sustainable cocoa action plan

Over half of the world's cocoa is produced in West Africa. Despite many initiatives by companies and non-governmental organisations, children are still widely involved in cocoa farming. They do not just do light work outside school hours, or help out on the family farm. In Ghana and Ivory Coast, the situation is unacceptable: children there work with dangerous pesticides and do not attend school. Over a year ago we started engagement with the world's largest chocolate manufacturers about conditions for the farmers they buy their cocoa from, either directly or indirectly. We want these companies to take a far more active stance against child labour in their supply chain and to be transparent about their performance in this area. As shareholders, we expect them to monitor their suppliers, not only to guarantee the quality of the cocoa they buy, but also to ensure that the cocoa is produced responsibly.

Progress

We are already seeing the first evidence of the success of our approach, for example, with the Swiss food giant Nestlé. Although Nestlé was already taking various steps to tackle child labour in cocoa production, we felt their approach lacked structure. Over the last year we have spoken to Nestlé on several occasions about how it organises its supply chain monitoring. Following the example of some of its competitors, Nestlé has now changed the way the supply chain is organised by grouping small farmers into cooperatives and buying from these cooperatives. This new approach will not only improve farmers' circumstances and eradicate child labour, but also guarantee supplies of good-quality cocoa. The latter is particularly important, as supply of good quality cocoa has become tighter in recent years. Aging tree stocks, climate change and less than efficient business models involving smallholder producers make





supply vulnerable to shortages. This is a business risk for companies that depend on this crop.

Action plan

Nestlé has recently published an action plan on its website, promising more training for cocoa farmers and an expansion of its certification programme. For one of its products, the KitKat bar, Nestlé has switched to using only Fairtrade cocoa. In 2010, we will continue engagement with Nestlé and other companies in the sector to ensure that they do not relax their efforts to tackle problems in the cocoa supply chain.



Total pushes for reform in Burma

Burma is a country where human rights are grossly abused, and forced labour is common. APG wants companies operating in Burma to contribute towards improving the human rights situation. This is an uphill battle, but some modest progress has been made. The French oil major Total is regularly criticised for operating in Burma. The country has for decades been ruled by a military junta with an appalling human rights record. Since 2008, we have been discussing with Total how it can do business in Burma without becoming involved in human rights abuse. This included visiting their Burmese operations. We saw company's gas project and spoke to employees at the local headquarters, and we visited the gas drilling platform and the gas pipeline corridor. We also visited the villages in the area and spoke to people who live there about their experiences

and expectations. Total showed us what steps it had taken to avoid becoming involved with what the Burmese army does to its own people. For example, Total's security guards work alongside the army, but not with it.

Positive contribution

In addition, Total works to raise awareness in its Burmese workforce. In 2009, it provided human rights training for its employees, given by experienced trainers from a Danish NGO. The course was well received, and Total intends to repeat it annually. Another way Total contributes is by investing in infrastructure. The company has set up an extensive local community programme, building schools and roads and improving healthcare facilities. To gear these projects to the actual needs of the local community, Total has set up a consultation process in which village representatives have regular meetings with the company. These contacts ensure that Total is in touch with what is going on in the area and can respond swiftly to developments, for





example human rights abuse by local army units in the pipeline corridor. Total has demonstrated to APG that it raises issues with the government where necessary, and that this is effective.

We believe that a company that is as important to Burma as Total is can also contribute positively to improving the country's human rights situation. With this in mind, we urged Total to call on the military regime to introduce democratic reforms. Needless to say, this is a sensitive issue. But in the summer of 2009, Total publicly voiced its concern about the prosecution of opposition leader Aung San Suu Kyi.

Total goes further

In other ways, too, Total has responded to our request to engage with the regime on human rights issues. An example is the training sessions on international law and

human rights Total has run for civil servants from various Burmese ministries. Over two weeks, a United Nations representative taught some 30 participants about how the United Nations work and about international treaties, including those on human rights. Total has announced that it intends to run this course on an annual basis. Total has also demonstrated that it is urging other foreign companies in Burma to comply with human rights standards. It is taking the initiative by exchanging information with these other companies about issues like compulsory land purchase procedures and community projects. In 2009, Total teamed up with the International Labour Organisation to further improve its development projects and align them more closely with local community interests. The ILO representative visited Total's operations and provided information in the villages about the ILO and how to report instances of forced labour.

Oil from Canadian tar sands

In the decades ahead, as the global population grows and the standard of living rises in China and other emerging countries, demand for oil is likely to continue to rise. Meanwhile, production from existing oil fields is declining, while new finds are getting scarcer and are often in politically sensitive or remote areas. This is making Canadian oil look increasingly attractive. At 175 billion barrels, Canada's oil reserves are second only to Saudi Arabia's. But most of this oil is trapped in so-called tar sands. Producing oil from the Canadian tar sands is expensive and very energy-intensive, however, and it has a massive impact on the environment, the landscape and the local population.

Assessing risks

APG and 32 other institutional investors have asked 17 oil companies to indicate how they deal with the various risks. Last autumn, we and 11 other investors spoke in Canada to the management of five of these companies, as well as the Prime Minister of Alberta and representatives of the Pembina Institute, an independent think tank. In 2010, we intend to continue our engagement with oil companies about the risks of producing oil from tar sand, as the issue is becoming increasingly topical. High oil prices between 2002 and 2008 have led to a doubling of production to 1.3 million barrels a day. This rapid expansion has sharpened opposition to tar sand operations on the part of environmental activists and local minority communities. Whether the Canadian tar sands will remain a profitable energy source depends on oil price trends and production costs. APG has therefore pressed the oil companies involved for transparency

Tar sand





about their approach to environmental and social issues, disclosure on additional costs, and development of new technologies to reduce energy and water consumption and the overall environmental impact of their operations. A group of 140 shareholders has submitted shareholder resolutions at the forthcoming Shell and BP AGMs calling on the companies to set up independent board committees to review oil sands risks. The group presents a solid case, and we share many of their concerns. If the companies fail to provide us with adequate information, we will vote in favour of these resolutions.

Large carbon footprint

The environmental impact of producing oil from tar sands is significant. Producing petrol from tar sands generates 1.5 to 2 times as much greenhouse gas as producing it from conventional oil. Meanwhile, climate policy in various countries will lead to tougher regulation of CO₂ emissions. In California, for instance, a bill has been passed capping 'well-to-wheel' emissions. Petrol from tar sands is currently still 10-15% above that ceiling. In Canada itself, companies are also obliged to pay carbon tax. While these costs are still modest, to meet long-term targets oil companies will have to store carbon dioxide underground. Capture and storage of all carbon emissions would raise the cost price of a barrel of oil (currently around \$70) by \$10. This would put heavy pressure on the profitability of tar sand oil recovery. Oil companies are confident that carbon capture and storage costs can be reduced. Shell is the first company planning a large-scale test with CCS and has received over \$800 million in grants from the governments of Canada and Alberta. From 2015, when this project should be up and running, Shell expects to be able to store 1 million tonnes of carbon dioxide a year and reduce emissions by 40%.

Land reclamation and waste management

In places where tar sands are less than 60 metres under the surface, the so-called overburden is first removed by gigantic power shovels and trucks. Then the tar sands are excavated layer by layer. Oil companies are responsible for repairing the damage to the landscape, and that

damage is considerable. The total area of disturbed land is estimated at 500 square kilometres. Only 0.2% of this land has been given a reclamation certificate by the government. The standards for reclamation of forests and wetlands are not always clear. An additional problem is that oil companies disclose very little information on their reclamation efforts. Consequently, future costs of land reclamation are not sufficiently transparent to us. Fine tailings are another problem with surface mining. This yoghurt-like mixture of clay and water is what remains after the oil has been separated from the sand. In the past 40 years, this waste has been contained in huge settling ponds, where the clay can sink to the bottom. Fine tailings hardly settle at all, however, and the ponds now cover an area of 140 square kilometres. In 2009, a new law came into force in Canada including stricter rules for cleaning up tailings ponds. An analysis of the reclamation plans that oil companies are obliged

to submit shows that only two of the nine mines meet the new requirements. The new legislation is likely to jumpstart research into new methods of recovering further oil from the fine tailings. On top of these risks, the companies face stricter limits on the amount of water they are allowed to use, and local First Nations groups are filing legal claims for damages.

The only future is a sustainable future

The oil industry in Alberta seems surprised by the regulatory clampdown and public protest. While the industry still has a long way to go to solve the problems with fine tailings, we observed on site that a lot of attention is being paid to energy efficiency and water consumption. But the challenges are still huge. We believe that oil from tar sands only has a future if the industry comes up with sustainable solutions.

A 400-ton truck-load of tar sand produces 200 barrels of oil.



Investing in Sustainability

Investing in Sustainability is a newsletter on the integration of sustainability and shareholder rights into APG's investments. This newsletter explains how we give our clients better service by improving our risk/return profile, demonstrating social responsibility and safeguarding the integrity of financial markets. This policy allows our clients to demonstrate their own social responsibility. The international sustainability and corporate governance standards we apply are based on the United Nations Global Compact, the International Corporate Governance Network Statement on Global Corporate Governance Principles and the OECD's Guidelines for Multinational Enterprises and Principles of Corporate Governance.

For more information on APG's sustainability and corporate governance policy, feel free to mail us at communicatie@apg.nl or call +31 45 5798100.

The six pillars of responsible investment:

-  Responsible investment is an integral element of our investment process.
-  We engage companies with activities that contravene the UN Global Compact, and reconsider our position if they do not improve their performance.
-  We seek to influence the companies we invest in by actively using our shareholder rights.
-  We actively look for opportunities to make pioneering sustainable investments.
-  We do not invest in companies that are directly involved in the manufacture of landmines, cluster ammunition and biological or chemical weapons, or of launch systems for such weapons.
-  We communicate our responsible investment policy and actively urge others to follow our example.



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