Shropshire County Council

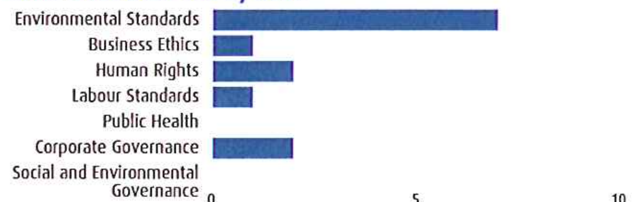
Q3 2015

The purpose of the ***reo***® (responsible engagement overlay)* service is to engage with companies held in portfolios with a view to promoting the adoption of better environmental, social and governance (ESG) practices. The ***reo***® approach focuses on enhancing long-term investment performance by making companies more commercially successful through safer, cleaner, and more accountable operations that are better positioned to deal with ESG risks and opportunities. Through a combination of constructive dialogue and active share voting, ***reo***® works to drive behavioural change with companies, and records successful outcomes as 'milestones' – changes in corporate policies or behaviour following intervention.

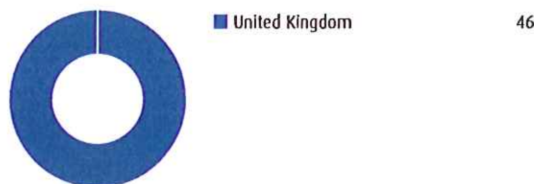
Companies engaged this quarter

Companies engaged	46
Milestones achieved	13
Countries covered	1

Milestones achieved by issue



Companies engaged by country



Companies engaged by issue **

BMO Global Asset Management

* ***reo***® is currently applied to £66bn ($103.7billion / €93billion) of assets as at 30th June 2015. ** Companies may have been engaged on more than one issue. *** This report has been compiled using data supplied by a third-party electronic voting platfo

Company Engagement and Your Fund

Name	Country	Priority Company	Engagement	Milestone	In this report	Environmental Standards	Business Ethics	Human Rights	Labour Standards	Public Health	Corporate Governance	Social and Environmental Governance
Acal PLC	United Kingdom		✓		✓						●	
Anglo American	United Kingdom	✓	✓	✓	✓	●	●		●			●
Antofagasta	United Kingdom		✓			●	●					
Associated British Foods	United Kingdom	✓	✓						●			
Barclays	United Kingdom	✓	✓	✓	✓	●		●			●	
BG Group	United Kingdom	✓	✓			●	●					
BP	United Kingdom	✓	✓		✓	●	●					
British American Tobacco	United Kingdom	✓	✓		✓			●	●			
Burberry Group plc	United Kingdom		✓						●			
Centrica Plc	United Kingdom		✓			●	●					
Clipper Logistics Plc	United Kingdom		✓		✓						●	
Compass Group	United Kingdom			✓	✓	●						
Dixons Carphone PLC	United Kingdom			✓	✓						●	
Drax Group	United Kingdom		✓			●	●					
Eurasian Natural Resources Corp (ENRC)	United Kingdom		✓			●	●					
European Bank for Reconstruction and Development (EBRD)	United Kingdom		✓		✓	●						
Experian Plc	United Kingdom		✓		✓						●	
Fiat Chrysler Automobiles NV	United Kingdom		✓			●	●					
Gas Natural	United Kingdom		✓			●	●					
Greggs	United Kingdom		✓						●			
Halma	United Kingdom		✓		✓						●	
J Sainsbury	United Kingdom		✓		✓				●			
Jupiter US Smaller Companies PLC	United Kingdom		✓	✓	✓						●	
Lloyds Banking Group	United Kingdom			✓	✓	●		●				
Majestic Wine	United Kingdom		✓						●			
Marks & Spencer	United Kingdom		✓						●			
Marks & Spencer Plc	United Kingdom		✓						●			
National Grid	United Kingdom		✓			●	●					
Next plc	United Kingdom		✓						●			
Photo-Me International	United Kingdom		✓						●			
Premier Oil Plc	United Kingdom		✓		✓	●					●	
Randgold Resources Ltd	United Kingdom		✓			●	●					
Reckitt Benckiser Group PLC	United Kingdom	✓	✓		✓						●	
Rotork	United Kingdom		✓		✓						●	
Royal Bank of Scotland Group	United Kingdom			✓	✓	●						
Royal Dutch Shell	United Kingdom	✓	✓	✓	✓	●	●					
Shire Plc	United Kingdom	✓	✓		✓		●			●		
Sports Direct International	United Kingdom		✓						●			
SSE Plc	United Kingdom		✓			●	●					

Company Engagement and Your Fund

Name	Country	Priority Company	Engagement	Milestone	In this report	Environmental Standards	Business Ethics	Human Rights	Labour Standards	Public Health	Corporate Governance	Social and Environmental Governance
Standard Chartered Plc	United Kingdom		✓	✓	✓	✓		✓				✓
SThree Plc	United Kingdom		✓		✓				✓		✓	
Supergroup Plc	United Kingdom		✓						✓			
Tesco Plc	United Kingdom		✓		✓				✓			
Transport for London (TfL)	United Kingdom		✓		✓	✓						
Tullow Oil	United Kingdom		✓			✓	✓					
Vedanta Resources	United Kingdom		✓	✓	✓	✓	✓	✓	✓		✓	✓
Wesfarmers	United Kingdom		✓		✓				✓			
WH Smith	United Kingdom		✓						✓			
WM Morrison Supermarkets	United Kingdom		✓						✓			
WPP Group Plc	United Kingdom		✓		✓						✓	

reo® Viewpoint - Public

August 2015

Matthias Beer, Associate Director; Juan Salazar, Associate Director; Kajetan Czyz, Analyst, Governance and Sustainable Investment (GSI)

This research provides overview and analysis of our engagement activities on the theme of "stranded assets". A series of detailed confidential reports on the oil and gas, coal and the utility sectors have been published to our responsible engagement overlay service - ***reo*** - clients in 2015.

Stranded Assets - Mitigating investment risk posed by climate change

- Political movement on climate change, and advances in alternative energy technologies, are turning the transition to a lower-carbon future from theory into reality. This is presenting a key challenge to fossil fuel businesses, and investors in these companies.
- A core part of the response is investor engagement which aims at pressing investee companies in carbon intensive sectors to address the risks to their business strategy and to be transparent to stakeholders.
- Our GSI team has engaged almost 100 companies in 24 countries, across the oil and gas, mining and utility sectors.

There is a major energy transition taking place, the effects of which will impact investors and companies globally for the foreseeable future. Drivers include:

- Leaders of the G7 leading industrial nations agreeing in June to cut greenhouse gases with the objective of ending the use of fossil fuels by the end of this century;
- Renewable sources accounting for more than 40% of new global electricity generating capacity[1];
- China, the world's biggest carbon emitter, committing to peaking its climate warming gas emissions by 2030 and;
- United Nations leading negotiations on a global agreement on mitigating climate change which could be adopted in Paris in December.

The result of all this is that the dominance of fossil fuels - the engine of global growth since the Industrial Revolution - is under threat. This transformation will not happen overnight but we consider the evolving dynamics of the energy system to be a structural, macroeconomic trend. This will have implications for the future growth and profitability of companies dependent on fossil fuel extraction and use. There will be winners and losers from this change, with companies that are able to make their business models more robust to a wide range of future energy scenarios more likely to finish in the winning camp.

The 'stranded assets' challenge

In recent years, the dialogue between investors and companies concerning climate change has focused increasingly around the so-called concept of "*stranded assets*". This is based on studies which have argued that under certain scenarios where carbon emissions will be restricted, such as for example the establishment of a robust and legally-binding global climate change deal, there will be a limited amount of carbon that could be emitted in to the atmosphere (also known as the "*carbon budget*").

Analysis[2] has shown that 60-80% of the known reserves of publicly listed companies which extract coal, oil and gas are unburnable and would have to remain in the ground if global warming is to be limited to two degrees centigrade. Even if

[1] Frankfurt School and United Nation Environment Programme analysis "Global Trends in Renewable Energy Investment 2014"
[2] Carbon Tracker Initiative's 2013 analysis "Unburnable carbon 2013: Wasted capital and stranded assets".

Continued

policy falls short of the two degrees goal, rapid technological changes could lead to the demand for fossil fuels (oil and coal in particular) declining sooner than expected. These forces put companies' long-term projects at risk of not realising their projected value – i.e. fossil fuel assets may become "stranded".

The systemic risk this poses to economies and markets has been seen as sufficiently serious by the Bank of England to incorporate it into their core economic research programme and, more recently, for the G20 nations to request the international Financial Stability Board to convene an enquiry on the subject. The question increasingly being raised to investors is: as the risks become more apparent, could failing to take any account of climate risk be seen as a breach of fiduciary duty?

Responding to the challenge through company engagement

There are many ways in which investors can be more proactive in their consideration of climate risk, but one of the most widely-used has been engagement, with the aim of challenging investee companies on their climate risk preparedness.

Over the past two years, we have been at the forefront of raising concerns around potential asset stranding with a wide range of executives and boards within the oil and gas, mining and electric utility sectors. We are now seeing that the concepts of stranded assets and a limited carbon budget have begun to resonate within these industries - and increasingly at board level – in ways that previous discussions on climate change did not.

Much of our activity occurred in the context of collaborative investor initiatives, where we took a lead role in the dialogue with many companies. We engaged a total of 95 companies – 58 in oil and gas, 15 in mining and 22 utilities, including 46 meetings. In addition to targeting large-cap companies such as **Exxon**, **Royal Dutch Shell**, **BP**, **Anglo American** and **Glencore**, we also reached out to emerging market and mid-cap oil and gas companies like **Pemex** and **Husky**.

Our main engagement objectives are:

- **Risk management**: To encourage companies to stress-test and disclose the range of possible future energy scenarios used for their strategy planning.
- **Transparency and Commitment**: To provide greater disclosure on carbon risks embedded in their assets and to set clearer targets for mitigating these risks by reducing exposure to high-cost, high-carbon projects.
- **Board oversight**: To strengthen board expertise on climate change economics and improve oversight to ensure that business models are resilient to rapid energy transition pathways.
- **Political advocacy**: To ensure that lobbying activities are consistent with the company's stated climate change policies and to support publicly policy mechanisms, such as carbon pricing, that are designed to drive an orderly transition toward a lower carbon economy.

Industry response

Oil and Gas: The sector has until recently been highly inward-looking, struggling to face up to the potential speed of change in the energy system. The concept of stranded assets is now slowly starting to resonate, with boards and CEOs beginning to take notice. Investor pressure has injected momentum into the debate. Highly publicised shareholder resolutions on climate change, namely those at Shell and BP's recent annual shareholder meetings which received 98% support, have been particularly instrumental. Some companies are now beginning to take more seriously the need for enhanced risk management frameworks to examine the economic impact of climate change on their business.

Compared to a few years ago, there are also indications that more corporate resources are being dedicated to look into the climate change challenge. By developing a better capability to anticipate these impacts, leading companies should be able to divert investments away from assets that face a higher risk of economic stranding. There are some encouraging steps in terms of public repositioning and instances of reviews to risk management assumptions, but it is too early to assess the impact these will have on companies' long-term strategies and investment decisions. Despite a sharp fall in crude prices in the past year, we still often encounter "business-as-usual", sceptical industry attitudes that revolve around bullish commodity price and demand forecasts. These underpin the management rationale for continued investments in high-cost assets which require a high oil price to break even.

In how companies present themselves to stakeholders and policymakers, a more visible rift has opened up lately between some of the European and US majors. While the Europeans are becoming increasingly eager to be seen as part of the solution to climate change, the largest US oil companies continue to resist any strengthening of climate policy.

Coal mining: In the past couple of years, weakening demand and a glut in the supply of thermal coal, used to make electricity, have had a dramatic downward impact on prices and mine asset valuations. At the same time, they are significantly exposed to risks from policy moves to curb global emissions as thermal coal is highly carbon intensive.

Companies in the industry have responded differently to these risks. The largest diversified miners do not see the risks materialising in a way that would make their coal assets become stranded. Their assessment hinges on the diversification of their portfolios, the positioning of most of their assets at the low end of the cost curve, and that pay-back periods for most present and future investments in coal are relatively short. We consider these views valid, yet continue to press companies to improve disclosures on their assumptions.

Pure coal players, on the other hand, remain particularly vulnerable, especially those based in the U.S. as shale oil and gas production increases. Companies based in, or exporting to, emerging markets are less vulnerable. Similar to the export-oriented diversified miners, they are betting on coal remaining

Continued

the fuel of choice to continue spurring economic growth in these markets in the next two to three decades. However the change in the energy strategy in China – the world's largest consumer - shows the risks to this assumption.

Electric utilities: European electricity generating companies face their own challenges. These are in the form of overcapacity of power supply, increasing penetration of renewables (now 20% of total power capacity) and an energy policy reform which is aiming to accommodate intermittent renewables within the existing power market.

"Utilities must adapt to this new paradigm or risk being squeezed out."

Moody's

Utilities have responded to these challenges in a number of ways. Firstly, there has been a consolidation of assets with unprofitable plants being mothballed, closed or sold – **GDF Suez**, **Centrica** and **EDP** are good examples. A second approach involves moving towards more regulated markets e.g. transmission and distribution or in developing countries. The third response is developing energy services and trying to get closer to the end client. This is specifically a response to a growing number of competitors from outside the sector (e.g. **Tesla**, **Google**, **Apple**) offering storage, smart grid and smart home solutions which in the medium term can cause a structural reduction in demand for electricity.

Conclusion and next steps

Amongst leading companies, more time and resources are being dedicated to analyse the implications of the climate change challenge. This is, in part, a direct result of investor engagement.

However, with a small number of exceptions, analysis is not yet feeding through into action. Companies in the carbon-intensive industries are still falling short of pro-actively developing a systematic approach to address structural risks which an accelerated shift toward lower carbon energy would entail. Many of the measures being introduced remain relatively short-term fixes – such as dealing with a fall in commodity prices - and genuine long-term robust planning to tackle climate change risk is still rarely forthcoming.

Climate change is no longer a risk to investments that can be considered purely long-term and arising far away in the future. Already, coal miners and electric utilities are increasingly facing the urgent need to develop alternative business models to stay relevant and profitable. As momentum builds towards a global deal in Paris later this year, we will continue to press management and board directors to closely examine the economic impact of climate change on their business.

Engagement vs. Divestment?

The "stranded assets" concept has fuelled a broad debate among investors and spurned a variety of responses ranging from outright sector exclusion[3] to selective divestments of the most carbon intensive companies[4]. Alongside these moves, the debate has also led to a significant increase in engagement activity by investors pressing companies to develop strategies for transition to a low-carbon economy[5].

Much of the debate on stranded assets risks in the fossil fuel sector has centered on the question to what extent investors should engage companies on this issue more actively or take a divestment approach. Selective divestment approaches appear to be getting more traction with mainstream investors, as reflected in the recent announcements by the Norwegian sovereign wealth fund and the French insurer **Axa**, committing to reduce their exposure to coal industry investments. We would argue that engagement and divestment approaches are not exclusive to each other when considering a responsible investment approach on climate change.

In pushing companies for greater justification of riskier investments within their portfolios – be that in high-cost oil projects, thermal coal, or carbon-intensive utility assets – our engagement aims to achieve disclosure enhancements that ultimately should enable investors to distinguish better between companies' exposure to, and ability to manage, energy transition risks. Our dialogue thus not only tries to improve company approaches to deal with stranded assets risks, but it also aims at facilitating more informed decisions around how organisations wish to remain invested in the fossil fuel sector in the coming years.

Engagement and divestment therefore, rather than representing two disconnected and opposing strategies, can be considered as complementary approaches. Both aim at addressing the same issue – pushing companies and helping investors to anticipate and prepare for the pace of change ahead and to allocate capital in ways that enable a rapid and orderly transition toward a lower carbon economy.

[3] See e.g. http://350.org/

[4] See e.g. the recent decision of the Norwegian Government Pension Fund to not divest outright but opt instead for active ownership and selective exclusion on a case-by-case basis. https://www.regjeringen.no/en/aktuelt/Report-from-the-Expert-Group-on-investments-in-coal-and-petroleum-companies1/id2342780/

[5] For an overview, see reo Viewpoint "Global warming mitigation gaining momentum", October 2014

BMO Global Asset Management

This note reflects voting and engagement undertaken on behalf of clients of our *reo*® (responsible engagement overlay) engagement service, and on holdings in funds managed by BMO Global Asset Management within the Europe, Middle East and Africa (EMEA) region. There are certain exceptions: separate governance policies currently apply to assets managed by LGM Investments, Pyrford International, Thames River (Thames River Capital LLP and Thames River Multi-Capital LLP), F&C Portugal, Gestão de Patrimónios, S.A. and BMO Real Estate Partners. In some cases clients may not mandate us to vote or engage within a segregated account. F&C, the F&C logo, REO and the 'reo' logo are registered trademarks of F&C Asset Management plc.

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