Bellona's Recommendations for the Ethical Guidelines of the Norwegian Government Pension Fund – Global

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I. Introduction

With approximately $400 billion in assets, the Norwegian Government Pension Fund – Global (Statens Pensjonsfond – Utland, hereafter 'the Fund') is the world's second largest Sovereign Wealth Fund (SWF), after the Abu Dhabi Investment Authority, and the second biggest pension fund, after Japan's public pension fund. The Fund has been hailed as the gold standard amongst SWF's. The transparency of its policies and portfolio is laudable. The Fund's *Investor's Expectations on Children's Rights* has become a benchmark for other major pension funds in their engagement with companies.

The central premise of the Fund's Ethical Guidelines is to generate "a sound return in the long term" while avoiding investments that contribute to unethical acts or omissions. Severe environmental damage is specifically highlighted as such an act. As outlined in this document, Bellona believes that companies which materially contribute to global warming may represent increased long-term investment risk which could threaten the Fund's objective of achieving sound long-term returns. Bellona also believes the Fund has a moral obligation to avoid investments in companies that significantly damage the environment and fail to improve their performance.

The Fund investment strategy was originally designed in 1997. Since then, it has become increasingly clear that if the global community continues with 'business as usual', and bases its growth on inefficient use of fossil energy, the world as we know is at risk. The UN estimates that global investments in the range of $15 – $20 trillion will be required within the next 20-25 years to put the world on a development track that enables us to prevent run-away global warming.[1]

Two fundamental questions are how the transformation of the global economy will affect the Fund, and whether the Fund should be used to accelerate the change that is needed. We believe that if Norway is to continue to be credible as a promoter of sustainable development, the Government should adopt a proactive environmental strategy regarding current and prospective investments.

Bellona acknowledges that incorporating an environmental strategy in its portfolio selection process may require making adjustments to the traditional indexing approach for the benchmark portfolio, which uses primarily financial metrics to determine which companies and sectors are included. While the specifics of making such adjustments is beyond the scope of this document, it is becoming increasingly clear that the traditional measures for risk and return are insufficient given the potential damage related to spiraling global warming.

[1] UNs Chiefs Executives Board document CEB/2007/HLCP-XIV/CRP.4, September 11th, 2007

II. The Future of the Fund

If we are going to be successful in our fight against global warming, global emissions of greenhouse gases will have to be cut by up to 85% by 2050 (IPCC, 2007). This means that all businesses will have to factor resource management and greenhouse gas emissions into their decision-making processes. Many companies will resist change and prefer ‘business as usual’. Other companies will go even further and fight the change we need by lobbying against new restrictions and international climate agreements.

The Fund is invested in approximately 7,000 companies listed on the world’s most important stock exchanges. The Fund’s long-term returns are directly correlated to global performance, which will certainly diminish if resource-intensive growth is allowed to continue. Escalating global warming will change society as we know it and have a negative impact on financial markets. According to the Stern Review (Stern, 2007), the world economy could decline by 15-20 percent by 2050 as a result of unmitigated climate change.

Given the magnitude of the potential impacts of global warming, it can be argued it is financially prudent for the Fund to use its unique resources and market position to act on these issues. Along the same lines, the Ministry of Finance (Finansdepartementet, 2008b) seems to support the view of the Chesterham (2008) report, that negative externalities resulting from climate change and social impacts of child labor will harm the Fund’s portfolio in the long run.

Currently, the Fund helps to maintain ‘business as usual’ by investing in resource-intensive companies and businesses. Rather than acting as an agent for change, the Fund’s investments in companies that are materially contributing to global warming and natural resource depletion help preserve the status quo and escalate our challenges. By maintaining such investments, the Fund becomes a de facto supporter of global warming and the damage it causes.

The Fund has a stated long-term investment horizon, whereas the public companies it invests in generally manage quarter to quarter. Given the dramatic difference in time horizons, the Fund’s objectives regarding climate change are unlikely to be shared by many of the companies in its portfolio. Thus, the Fund must use its direct and indirect influence over current and prospective investments to ensure these companies adopt a progressive and effective strategy to remain successful in an emerging zero emissions society.

Bellona believes that the best way to realize long term returns with minimal risk is to be in the forefront of the change that will inevitably happen. For instance, if we are successful in our fight against global warming, *no carbon intensive companies will exist in 2050*. The Fund should incorporate an environmental strategy that includes active corporate engagement, negative screening and over time, positive selection.

Bellona’s vision for the Fond: By 2020 the Fund’s portfolio will be comprised solely of investments in companies that will have sustainable business models following the transformation to a carbon-neutral and resource-efficient society.

III. The Recommended Environmental Strategy

Institutional investors traditionally include measures like historical returns and volatility when they evaluate investment opportunities. Global warming has created a new paradigm that requires new techniques for measuring financial risks. As an example, companies that have been profitable for decades might not survive in a society where carbon emissions are correctly priced. Only companies that deliver resource-efficient products and services will be profitable in the long term. Similarly, companies that invest in environmentally friendly technologies may actually represent less financially risky investments.

Our primary recommendation is that the Fund incorporate a comprehensive environmental strategy in its investment review process. This strategy should include: (i) establishing and publishing environmental screening guidelines, (ii) conducting a portfolio review using these guidelines, (iii) strengthening corporate engagement and monitoring of portfolio investments, and (iv) adjusting the portfolio.

Establish and Publish Environmental Guidelines

Norges Bank Investment Management's (NBIM) own *Investor's Expectations on Children's Rights* has become a benchmark for other institutional investors. A similar *Investor's Expectations on Climate Change* should be created for climate change issues and serve not only as a basis for engagement but also for screening. Establishing the appropriate framework will require extensive analysis by NBIM, and could potentially be created in cooperation with other institutional investors. The *Investor's Expectations on Climate Change* should include the following:

- *requirements for emission disclosure,*
- *guidelines for assessing current and future climate change risks and opportunities for companies,*
- *guidelines for how CO_2 price scenarios should be applied to companies' investment decisions, and*
- *guidelines for the creation of emission reduction plans.*

By widely publishing these guidelines, the Fund will provide leadership in the investment community by establishing transparent guidelines for company management and other investors to follow.

A critical element for implementing the environmental strategy is building up the Environmental, Social, and Governance (ESG) expertise within NBIM. Additionally, ESG competence should be a core criterion for the selection of external managers.

Conduct a Portfolio Review Based Upon Established Guidelines

Upon establishing the framework, NBIM should initiate a full investment portfolio review to determine the potential impact of global warming on its portfolio investments. While most of the Fund's investments will not yet have conducted this level of analysis of their environmental exposure, the portfolio review will initiate a process whereby companies begin to incorporate these issues in their decision-making process.

Given the magnitude of this portfolio review, we recommend prioritizing the greenhouse gas intensive industries, specifically the following sectors:

- Oil, gas and coal
- Air and sea transport
- Land transport
- Iron and steel
- Aluminum
- Cement
- Pulp and paper

Corporate Engagement

The Fund has a strong record regarding corporate governance and supporting its positions through shareholder activism. This effort should be extended to the environmental strategy as well. As noted above, an Investor's Expectation on Climate Change should serve as a basis for Fund engagement. In addition to considering the criteria in shareholder votes, the Fund will need to proactively engage company and fund managers to explain the revised criteria and its importance to the Fund. This will have the combined effect of confirming the Fund's commitment to the cause and publicizing the importance of the issues it addresses. Lastly, it is imperative that the Fund continues to monitor its portfolio companies regarding the criteria, so that early success does not revert to "business as usual" once the scrutiny disappears.

Adjusting the Portfolio

Bellona is not advocating for the Fund to dramatically change its investment policies or compromise its long-term return objectives. Rather, we believe including explicit environmental screening criteria as part of its investment methodology will decrease long term portfolio risks, improve returns and adhere to its existing core principles.

Exclusion and Negative Screening

The Fund's management team should use greenhouse gas emissions benchmarks, combined with other environmental screening criteria to evaluate companies' ability to thrive in a low carbon, resource-efficient economy. The evaluation should be used to distinguish which companies in each sector are truly underperforming based upon the environmental criteria. Companies performing below a certain threshold should be excluded from the portfolio and the investment universe, assuming they are unable or unwilling to aggressively implement a strategy to mitigate the environmental damage they are causing. We support the establishment of a public watch list for companies that are at risk of being excluded from the Fund.

While the above strategy relates primarily to equity investments, the Fund should evaluate the issuers of corporate bonds with the same criteria and degree of scrutiny. As to sovereign bonds, given the game-changing nature of the climate change challenge, the Fund should consider excluding sovereign bonds of countries that do not ratify a post-2012 global climate agreement.

The second largest investor in the world carries influence well beyond its financial clout. By using (and publicizing) its screening process, the Fund provides leadership that attracts attention from the global institutional investment community. When the Fund publicly excluded Wal-Mart from its portfolio, Wal-Mart received significant negative attention in the global media. This negative publicity was arguably far more costly to Wal-Mart than the loss of one financial investor. Similarly, excluding sovereign bonds from non-ratifying countries of a post-2012 global climate agreement would send a strong signal that Norway will not let short term profit motives impact its long term financial objectives (or the world's health).

Positive Selection

Those companies that are performing well according to the environmental criteria should be considered for further investment if they meet the Fund's other investment objectives. For instance, the Fund should invest more in companies that would thrive under strict climate regulation and a high price on greenhouse gas emissions. Over time, positive selection should be increasingly used when making new investments. This does not entail excluding entire industries or sectors, but only excluding "worst in class" companies in each sector from further or new investments.

Bellona acknowledges that incorporating an environmental strategy in its portfolio selection process may require making adjustments to the traditional indexing approach for the benchmark portfolio, which uses primarily financial metrics to determine which companies and sectors are included. While the specifics of making such adjustments is beyond the scope of this document, it is becoming increasingly clear that the traditional measures for risk and return are insufficient given the potential damage related to spiraling global warming.

IV. New Asset Classes

To date, the Fund's investments have been limited to public equities and bonds, with a recent decision to include an allocation of up to 5 percent to commercial real estate. Bellona believes the Fund should add selective venture capital, private equity and infrastructure investments targeting renewable energy solutions. Additionally, we believe part of the Fund's real estate allocation should be directed toward green real estate projects.

While some will argue that adding these asset classes will increase the Fund's risk profile, they have historically produced competitive returns and diversification benefits, but most importantly have been the source for much of the world's innovation. Bellona believes accelerating technological innovation and expediting the commercialization process of proven technologies may actually decrease the risk to a large institutional investor like the Fund. As previously mentioned, Bellona believes the greater financial risk is to invest assuming that global warming will not have a material impact on existing companies.

Venture Capital / Private Equity / Infrastructure

To prevent global warming and natural resource depletion, new technologies and companies need to be developed and promising existing technologies need to be scaled and made commercially viable. To facilitate this development, Bellona recommends that the Fund expand into three new investment categories: early stage venture capital fund, private equity investment in mid-sized growth companies and infrastructure project investments. In each case, the investments must meet a rigorous set of investment criteria.

Early stage venture capital funds focused on clean tech are likely to be the source of many of the innovations that create alternatives to fossil fuel. History has proven that relatively small venture investments can have significant impact on society. Private equity investments (growth capital) in mid-sized companies with proven technologies allow these companies to expand manufacturing, marketing and distribution capabilities, which in turn lead to market acceptance and widespread deployment of these new products and services.

Lastly, investments in large scale infrastructure projects (e.g. wind farms, solar plants or high-speed railways) allow accepted technologies to become mainstream, cost-competitive alternatives to fossil fuels.

Green Real Estate

We believe the Fund should focus a material share of its new real estate allocation toward real estate funds with a mandate to maximize energy efficiency in their portfolio assets, as well as to invest in targeted green real estate funds.

As the Finance Ministry itself notes, real estate investments offer an opportunity to address energy and resource issues. There is an opportunity to influence the environmental impact of traditional real estate (through fund ownership). While it is currently difficult to differentiate most real estate funds based on environmental performance, large funds will always contain assets with a vast potential for improvements. Even if current performance criteria (e.g.

energy consumption per m^2) is not the most relevant factor in the investment decision, real estate funds' *targets* for environmental monitoring and improvements should be taken into consideration when evaluating investment decisions. We believe a share of the Fund's real estate allocation should target real estate funds with a specific mandate to develop green projects that utilize the latest energy saving technologies.

V. Russia

Given Bellona's deep familiarity with Russia and the fact that Russia was recently added to the Fund's investment universe, we feel obligated to comment on investments in Russia. Since the collapse of the Soviet Union, Russia has been through a period of democratization, market reform, ecological awareness and rule of law. However, the overall development since 2001 has been a return towards more state control, less democracy, an increase in human rights violations, less attention to the environment and a society more characterized as rule by law instead of rule of law.

Corruption is rapidly increasing (Russia is ranked 143 of 184 on the world corruption barometer of Transparency International). In such an environment, we strongly recommend the Fund exercise very active engagement in all investments and conduct extremely thorough due diligence prior to making investments. Our experience indicates all environmental and legal disclosures from Russian companies need to be verified and constantly monitored. While Russian equities and bonds may represent an attractive long term investment opportunity, our view is that in the current environment Russian investments are highly risky and require significant scrutiny, specifically in natural resource-intensive industries like oil, gas, fishing and forestry.

VII. The Norwegian Clean Energy Development Company

Global warming will hit developing countries particularly hard, resulting in extreme food and water shortage and seriously degraded livelihoods. Correspondingly, developing countries will particularly affect global warming as they legitimately increase their energy use to fuel economic growth and improve their livelihoods.

Given the enormous wealth Norway has accumulated by exporting fossil fuels, we would argue that Norway has a special obligation to help mitigate global warming. Bellona therefore suggests that the Government creates the Norwegian Clean Energy Development Company (the ‘Development Company’) to undertake the particular kind of investments needed to meet the dual challenge of global warming and providing clean energy to improve livelihoods in low-income countries. Funding for the Development Company should come from the petroleum revenues, starting small and increasing as experience builds. The Development Company should be a separate entity and not part of the Fund.

Billions of people live without access to electricity and in extreme poverty. Providing these people with clean energy to allow for sustainable growth will be paramount in building a sustainable low-carbon society. Among other things, this means developing renewable energy systems, both in the form of village-size stand-alone energy systems as well as large-scale grid-connected power plants. The aim of the Development Company would be to develop and provide funding for such projects. This means investing in companies (Norwegian or foreign) that provide clean energy solutions and infrastructure for developing countries.

It might, however, be difficult to find companies that undertake such projects, as they are often capital intensive and considered too risky. Bellona suggests that the Development Company builds in-house expertise to develop creative projects for large-scale deployment of clean energy in developing countries. Bellona’s earlier proposal to undertake, build and operate large-scale solar power plants in developing countries (StatSol) could be such a project.

In addition to meeting the dual challenge of global warming and the need for sustainable growth, Bellona believes such a Development Company could be profitable in the long term. To the extent the Development Company would help mitigate global warming, it would also help ensure the long-term profitability of the Government Pension Fund – Global.

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Appendix 1: Representative Examples of Funds with Innovative ESG Strategies

England and Wales Environment Agency Pension Fund (EAPF)
(Assets as of 31/12/07: $2.7 billion)
All investments of the EAPF are managed externally. When the Environment Agency decided to fundamentally change its investment strategy, it first created an Environmental Finance and Pension Fund management team in order to integrate the agency's thinking on these two topics. Thereafter, consultants were selected to assist in the selection of external fund managers. New mandate descriptions and tendering procedures were established and conducted with the help of external consultants. Fund managers were asked to document their competence on environmental, social and governance issues and how they would integrate them in the fund management.

California Public Employees' Retirement System (CalPERS)
(Assets as of 31/12/07: $225.0 billion)
In 2005, CalPERS allocated $200 million to its private equity Environmental Technology Programme. This was scaled up in 2007 to $600 million by diversifying the investment universe geographically and by including new sectors. It is a portfolio of clean technology-focused investments spread across stages, strategies, geographies, and structures. Areas of particular interest include, but are not limited to, alternative and renewable energy (clean energy), water technologies (clean water), advanced materials or nanotechnology (clean material), air purification technologies (clean air), and transitional infrastructure opportunities. It is expected that investment returns in this sector will be commensurate with the risk-adjusted returns of the general private equity market. The $600 million are being managed externally by seven different investment partners.

The CalPERS Board has set an energy reduction goal of 20 percent in its core real estate portfolio over the next five years. Investments in real estate that comply with Leadership in Energy & Environmental Design (LEED)/Energy Star are given priority. CalPERS has asked real estate partners to report on waste recycling as part of its quantitative data gathering process.

PGGM
(The Netherlands' pension fund for health and social workers - assets as of 31/12/07: $97 billion)
A dialogue was started in 2006 with all external managers to establish their *Environmental, Social and Governance* (ESG) scores. The aim is to continuously increase this score. In parallel, ESG factors are included in the selection of new external managers

Henderson Global Investors

(Assets as of 12/31/07: £59.2 billion)

Henderson Global Investors' Industries of the Future Fund was established in 2005 and it invests exclusively in ten industries identified for their long-term growth potential:

Cleaner Energy	Sources of energy that combat the effects of global warming, increase the use of renewable energy and help pave the way to a hydrogen economy.
Efficiency	Products and processes that reduce energy consumption, make more efficient use of resources and increase efficiency in business.
Environmental Services	Goods and services that improve the quality of the environment and reduce pollution and waste.
Health	Goods and services that help people live longer, healthier lives.
Knowledge	Supplying educational goods and services that enhance quality of life and improve opportunities for full-time students and those in employment.
Quality of Life	Goods and services that promote sustainable lifestyles among all age groups, including children and the elderly.
Safety	Minimizing the risk of safety incidents at work, at home and in the community.
Social Property & Finance	Providing property for social benefit, access to housing, regeneration, and better and wider access to financial services.
Sustainable Transport	Shifting to less polluting forms of transport, and cleaner transport technologies.
Water Management	Managing and conserving water, and minimizing pollution.

The investment universe of the fund is composed by looking at each and every listed company of a certain size in these industries – all in all about 5,000 companies across the world. This was the first such exercise of its kind in the world – defining from scratch an investment universe instead of tinkering with the major stock indexes like MSCI or the FTSE. Through its lifetime, the fund has outperformed the MSCI World