

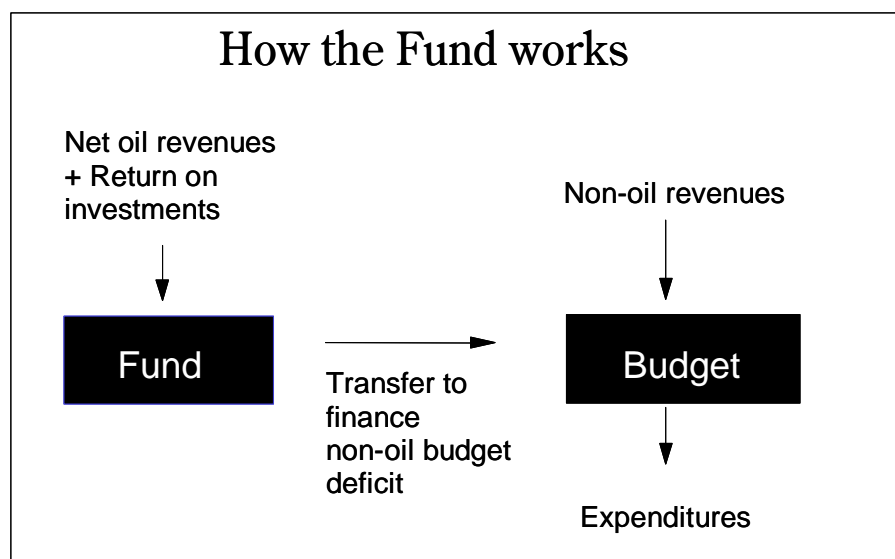
## 4 Government Petroleum Fund

### 4.1 Management of the fund

#### 4.1.1 Main aspects of management

The Government Petroleum Fund was established in 1990 when the Norwegian parliament (Storting) passed the Act relating to the Government Petroleum Fund (Act No. 36 of 22 June 1990). The Act defines the Fund's income as the government's net cash flow from petroleum activities and the return on the Fund's capital. The Fund's expenditure consists of an annual transfer to the Treasury in accordance with a Storting resolution. This transfer is equivalent to the non-oil government budget deficit. The first net allocation to the Fund of just under NOK 2 billion was made in 1996 when the central government accounts for 1995 showed a surplus.

The Petroleum Fund is a fiscal policy instrument which manifests the government's use of petroleum revenues. It was emphasised in the preliminary work on the Act relating to the Government Petroleum Fund that the allocation of capital must be part of a coherent budget process. Therefore, when the Fund was established, it was stressed that the Fund would not be built up unless there was an actual budget surplus. The relationship between the central government budget and the Petroleum Fund is illustrated in Chart 4.1.



*Chart 4.1 The relationship between the central government budget and the Petroleum Fund*

Source: Ministry of Finance

The Petroleum Fund is formally speaking a krone account in Norges Bank. This krone account is matched by an equivalent amount which Norges Bank has invested in foreign securities. The return on these foreign securities determines exactly the return on the Petroleum Fund.

The Act relating to the Government Petroleum Fund gives the Ministry of Finance

responsibility for management of the Fund. The Ministry of Finance has delegated operational management of the Fund's capital to Norges Bank. The guidelines for management are set out in regulations, guidelines and decisions which the Ministry of Finance has communicated to Norges Bank in letters. The Ministry of Finance and Norges Bank have also entered into a management agreement. These are available on the Ministry's website ([www.odin.dep.no/fin](http://www.odin.dep.no/fin)).

The regulations on the management of the Petroleum Fund specify where and in which type of securities the Petroleum Fund may be invested. The current regulations specify that 50-70 per cent of the Fund's portfolio is to be invested in fixed-income instruments and 30-50 per cent in equity instruments. The equity portfolio (excluding the Environmental Fund) is to be invested according to the following currency and market distribution: 40-60 per cent in Europe, and 40-60 per cent in the Americas, Asia/Oceania and South Africa. The distribution within these regions is determined on the basis of the size of each market. The fixed income portfolio is to be invested according to the following currency and market distribution: 45-65 per cent in Europe, 25-45 per cent in the Americas and 0-20 in Asia and Oceania. The distribution of the Fund's investments among individual countries within the regions is determined by the size of the markets in the individual countries.

As part of risk management, a benchmark portfolio has been established for the Petroleum Fund. This benchmark portfolio is a hypothetical portfolio composed of equity and fixed income indices from the countries in which the Fund is invested. The benchmark portfolio's equity portion and regional distribution correspond to the midpoint of the intervals specified in the regulations. The indices contain a representative selection of securities, so that developments in these indices reflect changes in value in the markets covered by the indices. The FTSE indices for each country are used for equities, while Lehman Global Aggregate is used for bonds. Chart 4.2 shows the composition of the benchmark portfolio.

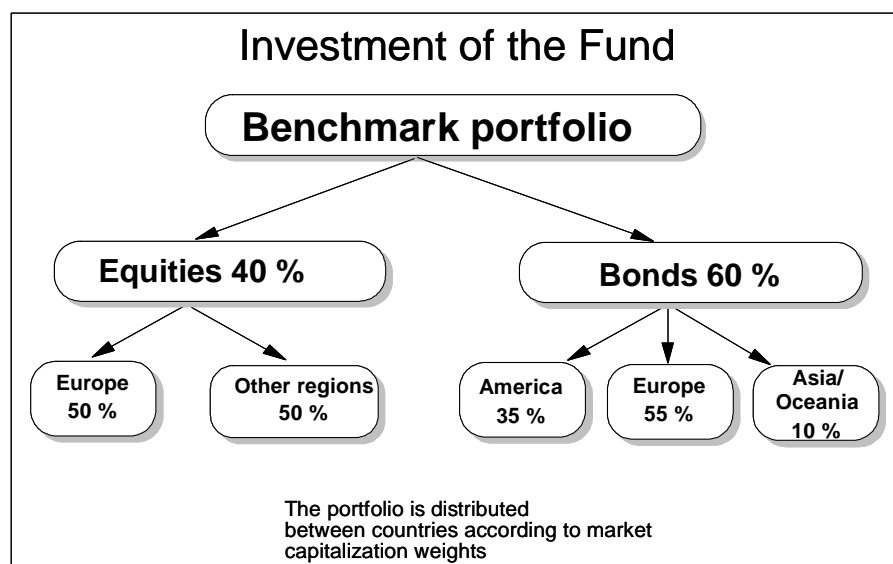


Chart 4.2 Petroleum Fund's benchmark portfolio.

Source: Ministry of Finance

The benchmark portfolio is used as a risk management tool. Limits are set for the acceptable deviation between actual investments and the benchmark portfolio. The

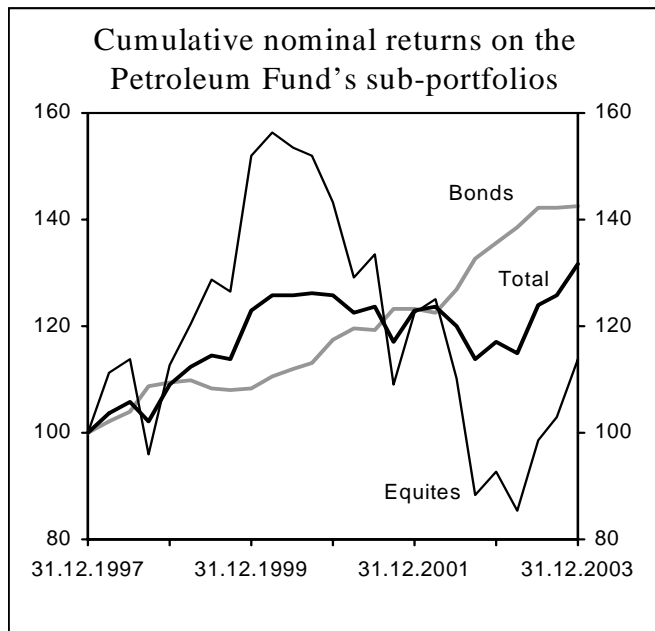
Ministry of Finance has set the limit for the deviation at 1.5 percentage point tracking error, which is a measure of the standard deviation of the difference between the return on the Fund and the return on the benchmark. Over time, this simply means that if Norges Bank utilises the risk limit to the full, the return on the Petroleum Fund will not deviate from the return on the benchmark portfolio by more than plus/minus 1.5 percentage points in two out of three years. Comparing the Petroleum Fund's returns with the returns on the benchmark over time will provide an indication of management performance.

There has been a broad consensus in the Norwegian Storting concerning the Fund's investment strategy. The Petroleum Fund should be managed with the objective of high return and moderate risk. Fluctuations in the Fund's international purchasing power provide the best measure of risk. The capital should contribute to safeguarding the basis for future welfare, including national pensions. This can best be achieved when the ownership share in individual companies is small and when the fund is a financial investor. The Fund is invested in such a way that the return is on a par with broadly diversified equity and bond indices in countries with well-developed corporate, stock market and securities legislation.

#### **4.1.2 Management of the Fund in 2003**

At the end of 2003, the Government Petroleum Fund amounted to NOK 847.1 billion, an increase of NOK 242.5 billion since the end of 2002. The increase in market value is due to several factors: positive return, transfer of new capital and a depreciation of the krone against the currencies in which the Fund is invested.

The return on the total Fund (including the Environmental Fund) in 2003 was 12.6 per cent, measured in terms of the currency basket corresponding to the composition of the Fund's benchmark portfolio. Measured in NOK, the return in 2003 was 20.0 per cent. The difference between these two return figures reflects the depreciation of the Norwegian krone in relation to the Fund's currency basket during the period. It is the return measured in the currency basket that is relevant for measuring the development in the fund's international purchasing power. The average, annual net real return, i.e. after deductions for management costs and inflation, has been calculated by Norges Bank to 3.7 per cent from the beginning of 1997 until the end of 2003. Chart 4.3 shows the development in nominal returns since 1998 when equities were included in the benchmark.



*Chart 4.3 Cumulative nominal returns on the Petroleum Fund's sub-portfolios. The portfolio's currency basket. Index 31 December 1997 = 100*

Source: Norges Bank

In this report, the Petroleum Fund's capital is estimated to grow to NOK 1016 billion at the end of 2004. This estimate is based on the Fund's capital at the end of 2003 and the benchmark's return up to mid-April. An annual real return of 4 per cent and a further depreciation of the Norwegian krone in accordance with forward exchange rates are assumed. The total net transfer from the Treasury to the Petroleum Fund during the year is estimated at NOK 91,9 billion.

In 2003 the return on the Environmental Fund was 22.9 per cent, measured in terms of the benchmark's currency basket. In this period, the annual return on the Environmental Fund's benchmark was 0.3 percentage points higher than the return on a comparable index in which no companies had been excluded.

The return on the Petroleum Fund depends mainly on the management guidelines stipulated by the Ministry of Finance. Norges Bank's contribution to the return is measured regularly by comparing the return on the Petroleum Fund with the return on a benchmark portfolio defined by the Ministry of Finance. To facilitate a comparison between Norges Bank's contribution and other managers' performance, the return on the benchmark should be adjusted for tax expenses and transaction costs related to changes in the benchmark for fixed income during the year. In 2003, the return on the Petroleum Fund's portfolio was 0.59 percentage points higher than the adjusted benchmark return. From the beginning of 1998 until the end of 2003, the average annual excess return, including the Environmental Fund, has been 0.43 percentage points.

The management agreement between the Ministry of Finance and Norges Bank concerning the Petroleum Fund lays down the principles for the remuneration payable to Norges Bank for managing the Petroleum Fund's portfolios. According to the guidelines, the Ministry of Finance's remuneration shall cover actual management costs up to a specified limit which in 2003 is set at 0.1 per cent of the Fund's average market value. The upper remuneration limit has been set on the basis of information

concerning the cost of this type of management in pension funds of similar size. The Ministry of Finance uses the Canadian company Cost Effectiveness Measurement Inc. (CEM) to prepare analyses which provide the basis for the cost comparisons. In addition to coverage of costs up to the specified limit, Norges Bank shall receive remuneration for performance-based fees to external managers.

In 2003, Norges Bank's management costs, excluding performance-based fees and calculated as an annual rate, was 0.09 per cent of the Petroleum Fund's average market value. Including remuneration for performance-based fees to external managers, Norges Bank received NOK 773 mill in remuneration for 2003.

The Ministry uses the consulting company Mercer Investment Consulting to check and verify Norges Bank's calculation of returns and to evaluate the performance-based results. They prepare monthly reports on the return of the Petroleum Fund. The annual report from Mercer is available on the Ministry's website ([www.odin.dep.no/fin](http://www.odin.dep.no/fin)).

#### **4.1.3 Management of the petro buffer portfolio and transfers from Petoro to Norges Bank**

The petro buffer portfolio forms part of the foreign exchange reserves, and Norges Bank carries both costs and profit responsibility. The petro buffer portfolio was established by Norges Bank in June 1998 to facilitate cost effective transfers to the Petroleum Fund. New allocations from the petro buffer portfolio to the Petroleum Fund are now transferred in the form of securities. The adequate foreign exchange is first accrued in the petro buffer portfolio and held in short-term interest receivables. Towards month-end this capital is placed in assets that are best adapted to rebalancing needs in the Petroleum Fund. In its letter of 27 August 2003 Norges Bank recommends that the Ministry of Finance assume ownership responsibility for the petro buffer portfolio, but that Norges Bank should remain in charge of managing the portfolio. The bank recommends that the Ministry of Finance establish guidelines for the management of the portfolio based on advice given by Norges Bank.

The rationale for the bank's proposal is that "costs, revenues and risk associated with the management of assets to be transferred to the Petroleum Fund should be borne by or accrue to the owner of the fund, i.e. the Ministry of Finance." The petro buffer portfolio has grown significantly larger than expected, and the risk facing Norges Bank is therefore greater than assumed. In the summer of 2003 the petro buffer portfolio reached a level equivalent to more than NOK 30 billion after transfers to the Petroleum Fund. Part of the reason was that Norges Bank bought excessive volumes of foreign exchange in the period from October 2002 to May 2003 after the Ministry of Finance revised down its forecasts for transfers to the fund in the autumn of 2002 and the spring of 2003. The petro buffer portfolio has also grown because the existing agreement with Petoro and Statoil determined that gross foreign exchange earnings from petroleum operations should be transferred to the petro buffer portfolio without regard to the Petroleum Fund's foreign exchange requirements. This contributed to further build-up of the size of the petro buffer portfolio in the second half of 2003.

In parallel with the treatment of this issue the Ministry of Finance, Norges Bank, Statoil and Petoro have signed a new agreement on foreign exchange transfers from the SDFI, the State's Direct Financial Interest in petroleum activities, to Norges Bank. The agreement was signed on 18 December 2003. The new agreement makes it very

unlikely that the petro buffer portfolio will expand beyond levels acceptable to the bank in the future.

However, the Ministry agrees with Norges Bank that costs and market risk associated with purchasing the Government Petroleum Fund's securities should be charged to the Petroleum Fund and not be met by Norges Bank. On the other hand, costs associated with obtaining foreign exchange should continue to be met by Norges Bank. This can be done without transferring ownership of the petro buffer portfolio from Norges Bank to the Ministry of Finance.

The new cost distribution regime requires no changes in the formal basis for management of the Government Petroleum Fund. However, reporting by the Petroleum Fund should preferably provide a separate statement of costs incurred in phasing-in securities.

## **4.2 Ethical guidelines for the Government Petroleum Fund**

In the autumn of 2002, the Government set up a committee to propose ethical guidelines for the Government Petroleum Fund. The Committee, which was chaired by Professor Hans Petter Graver, presented its findings on 25 June last year. The mandate and composition of the Committee, its report and the comments received from the consultative bodies can be found on the Ministry of Finance's website ([www.odin.dep.no/fin](http://www.odin.dep.no/fin)).

The Government is of the view that the proposals presented by the Graver Committee satisfactorily promote the ethical obligations that can reasonably be imposed on the Petroleum Fund. The Government intends to introduce ethical guidelines for the Petroleum Fund that reflect the report of the Graver Committee.

### **4.2.1 The Graver Committee's report**

#### *4.2.1.1 The ethical obligations of the Petroleum Fund*

The Graver Committee is of the view that the State's ownership of the Petroleum Fund should safeguard two ethical commitments:

- The obligation to ensure that future generations should also derive benefit from the nation's petroleum wealth. To this end, the Fund should be managed with a view to achieving a sound return in the long term.
- The obligation to respect the basic rights of those affected by the businesses of the companies in which the Fund invests. This entails that the Fund should not be invested where there is an unacceptably high risk that the Fund will be complicit in grossly unethical conditions.

The Committee stresses that long-term sustainability is a prerequisite for achieving a sound return on the Petroleum Fund over time. The creation of long-term financial results will therefore often go hand in hand with ethical considerations because in the long run companies acting in contravention of generally accepted ethical norms may weaken their reputation and profitability. The Graver Committee writes:

“The Petroleum Fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations. The financial wealth must be managed with a view to generating a sound return in the long term, which is

contingent on sustainable development in the economic, environmental and social sense. The Fund's financial interests should be consolidated by using the Fund's ownership interests to promote sustainable development."

The Committee is of the view that the breadth of the Petroleum Fund's investments is a further point in favour of emphasising ethical considerations because the Fund may suffer if one company engages in activities that might harm other companies in the portfolio.

The Committee argues that the Fund has an obligation to refrain from certain investments because financial investments in companies through the capital market may constitute complicity in the activities of the companies. The Committee writes:

"It is not entirely clear which actions might be regarded as constituting complicity in unethical behaviour. If an action is directly necessary for the unethical behaviour to occur, this obviously constitutes complicity. This situation will rarely arise in connection with investments in equities and bonds because this type of disposal has no direct effect on a company's capital flow. Thus, from the point of view of teleological ethics, it is not likely that a financial investor could be an accomplice in a breach of ethical norms. In terms of deontological ethics, an investment will also be unethical if the investor actively supports a company's production or behaviour even if the support is not necessary for the unethical behaviour to take place."

The Graver Committee is of the view that the ethical guidelines for the Petroleum Fund must take as their point of departure ethical norms that enjoy broad support in the population. The Graver Committee's proposals for ethical guidelines are rooted in international agreements and initiatives to which Norway has given her support and refer to the UN Global Compact and the OECD Guidelines for Multinational Enterprises. In the view of the Committee, taking these guidelines as a point of departure will ensure that the ethical requirements are based on solid foundations and supported by overlapping international consensus. The Committee writes:

"The themes that have been identified largely coincide with the issues on which there is broad consensus in Norway. By using these documents as a basis, Norway will also be supporting the work on these issues conducted by international organisations, which in itself is consistent with Norway's interests and Norwegian foreign policy. By supporting these initiatives, the Petroleum Fund will also strengthen the signals and expectations that are already exerting pressure on international companies, thus increasing the potential impact of these standards on the market. It is also an advantage for enterprises that the expectations and standards they are required to meet are co-ordinated."

The Graver Committee is of the view that foundations of this type will provide an ethical basis for management with a greater degree of stability and will ensure greater support for the ethical guidelines than would ethical foundations derived from a broader spectrum of political decisions.

The Committee notes that a greater obligation exists to use the Petroleum Fund as an instrument in cases where the Petroleum Fund represents an appropriate instrument for safeguarding ethical obligations. The Committee writes:

"The Petroleum Fund cannot meet *all* our ethical obligations. Many of our ethical obligations can be more appropriately addressed by means other than laying down principles for the Fund's investment strategy. This applies in particular to any obligations Norway might have to alleviate global poverty and distress. Many people

would say that because of the wealth reflected by the Petroleum Fund, Norway has a particular obligation to alleviate poverty and distress in the world. However, this is a question of how oil revenues should be used, and not how the capital to be set aside in the Petroleum Fund should be managed.”

#### 4.2.1.2 A three-track strategy

The Committee recommends that the ethical obligations of the State as the owner of the Government Petroleum Fund should be furthered with the aid of the following three mechanisms:

- *Exercise of ownership rights* to promote long-term financial returns based on the UN Global Compact and the OECD Guidelines for Multinational Enterprises.
- *Negative screening* to prevent inclusion in the investment universe of companies that produce, either themselves or through entities under their control, weapons whose normal use is in violation of fundamental humanitarian principles.
- *Withdrawal* from companies where there is an unacceptable risk as an owner of complicity in gross or systematic breaches of ethical norms within for instance the areas of human rights and the environment.

The Committee is of the view that responsibility for promoting the ethical exercise of ownership rights should rest with the manager of the Fund, Norges Bank, and should extend only so far that it remains consistent with the achievement of long-term financial return. In the view of the Committee, in many cases financial considerations are concurrent with ethical considerations. The Committee is of the view that the exercise of ownership rights is a suitable instrument for safeguarding ethical obligations only when ethical and financial considerations coincide, since it is unlikely that views that undermine the financial position of companies will be accepted.

The Committee recommends the screening from the Fund of particularly inhumane weapons and ammunition. According to the Committee these are: Chemical weapons, biological weapons, anti-personnel mines, non-detectable fragments, incendiary weapons, blinding laser weapons, nuclear weapons and cluster bombs. Most of these weapons are totally or partially prohibited under international law. The Committee is of the view that the Fund should screen out manufacturers of central components for such weapons, but not companies that produce parts with other uses.

Moreover, the Committee is of the view that the existing withdrawal mechanism should be extended so that the Petroleum Fund *withdraws from* companies in which there is an unacceptable risk of complicity in the future in:

- Gross or systematic violation of human rights, such as murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other child exploitation
- Gross violations of individual rights in war or conflict situations



- Severe environmental degradation
- Gross corruption
- Other particularly serious violations of fundamental ethical norms

Withdrawal should be based on a detailed assessment of the individual case.

The Committee is of the view that the Ministry of Finance should have responsibility for deciding on which investment opportunities the Fund should be precluded from pursuing. The responsibility for laying down ethical guidelines on what the Fund may invest in rests with the owner. The Committee proposes the establishment of a council on ethics and international law, which could advise the Ministry of Finance on companies in which the Petroleum Fund should refrain from investing in light of ethical considerations or international law.

In Chapter 6 of its report, the Committee outlined a proposition for ethical guidelines. Apart from certain minor adjustments, the Ministry's guidelines are identical to the Committee's proposal, see 4.2.3.

#### *4.2.1.3 The exercise of ownership rights*

The exercise of ownership rights describes all actions by the owners to ensure that their basic rights are respected and to contribute to corporate governance that serves the best interests of the shareholders. The owners' scope for exercising influence lies in dialogue with a company's management, the exercise of voting rights and representation on boards of directors. The Graver Committee assumes that as a financial investor the Petroleum Fund would generally not wish to be represented on company boards since the office of a director involves receiving inside information, which limits the Fund's scope for buying and selling shares. Instead, the Committee suggests that the Petroleum Fund should formulate principles for corporate governance and sustainable development as a central instrument in ensuring that board and management work to promote the long-term interests of the shareholders. By applying these principles the Fund can exercise influence by voting at general meetings and establishing a direct dialogue with the board and management of companies.

The Committee notes that most major pension funds have drawn up guidelines governing the exercise of the rights of ownership based on a widely-shared fundamental outlook. The Committee describes the areas normally covered in guidelines on investors' exercise of ownership rights:

- ” Shareholders' rights  
Investment managers' guidelines will include requirements that basic issues with regard to corporate structure, such as amendments to articles, issues and the sale of a company, shall be decided by the general meeting, not by the board of directors. In addition, the guidelines usually regulate requirements concerning how a general meeting should be prepared and conducted. Because of their interest in protecting shareholders' rights, financial investors will also normally focus on the principle of one share = one vote, and will be critical of “poison pills” or other structures that are intended to protect companies from takeover attempts.

- **Equitable treatment of shareholders**  
In the interests of equal treatment, financial investors will support the right of investors to vote, if they so wish, through representatives of their own choice, in addition to the principle of one share = one vote. The principle of equitable treatment often also includes the requirement that members of the board and management disclose any financial interest they might have in transactions that involve the company.
- **Responsibility and composition of the board of directors**  
Financial investors normally require that a company's articles of association include clear instructions on the responsibilities of the board of directors. Particularly important is the responsibility for drawing up a clear business strategy and monitoring the management to ensure that the strategy is followed up. The board's responsibility to provide information to the shareholders is also important to investors. Since the board of directors plays a decisive role in governance structures in relation to shareholders and management, financial investors will be keen to see that the board, in formal and in real terms, is independent of the managing director and other senior executive directors and that the board has been appointed on the basis of qualifications, and not on the basis of status, social ties or other factors that might undermine the real ability of the board to lead and monitor the management of the company. In addition, it will be important that the composition of the board as a whole protects shareholders' interests in a balanced manner.
- **Reporting**  
In order to send the best possible governance signals through voting at general meetings, financial investors' ownership policy will impose requirements with regard to the quality and content of the company's reporting. Requirements for comprehensive and complete accounting information and for regular reporting of performance, strategy, changes in ownership, remuneration for members of the board and management, key risk factors in the company's activities, etc. will often be included in guidelines for the exercise of ownership.
- **Reward structures**  
Reward structures for senior executives in companies are the shareholders' most important financial incentive for ensuring the best possible correspondence between their own financial interests and the financial interests of those entrusted to implement the company's strategy in the market. It is therefore not unusual for large investors to have very detailed rules for what they consider to be a reasonable reward structure. These rules will cover the size of and relationship between basic pay, bonuses and share-based option plans, among other things. The company's owners will also impose requirements on the system itself for stipulating managers' pay.

The relationship to employees, the authorities, the local community and the environment in general will also often be referred to in guidelines for the exercise of ownership rights. The connection between a company's activities in these fields and the shareholders' best financial interests is not as obvious as in the more classic areas that are normally regulated in investors' guidelines for corporate governance. The wording of guidelines in these areas tends therefore to be less detailed than for many

of the issues mentioned above. The Petroleum Fund faces a particular challenge here in relation to developing credible and sound guidelines."

Over the past decade there has been an increasing tendency for institutional investors to exercise their rights as owners. Moreover, the authorities in various countries have sharpened their focus on the role played by investors in the corporate governance of companies. The OECD has drawn up guidelines on the exercise of ownership rights, which are now undergoing revision. That being said, the way in which ownership rights are exercised varies from country to country. Nevertheless, most countries have advisory standards in place on the exercise of ownership rights and corporate governance. Until now, in exercising its ownership rights, Norges Bank has concentrated on 150 companies that in total make up approximately 50% of the market value of the share portfolio. Further details of Norges Bank's exercise of ownership rights can be found in the annual report on the management of the Government Petroleum Fund for 2003.

The purpose of exercising ownership rights is to promote the long-term financial interests of the Petroleum Fund. The Committee concludes that long-term returns will generally be safeguarded if the companies in the portfolio show respect for generally accepted standards of ethical behaviour.

The Committee writes:

"A linking of the Petroleum Fund's financial objectives with ethical considerations may be based on internationally accepted ethical norms as they are reflected in, for example, the UN Global Compact guidelines and the OECD Guidelines for Multinational Enterprises. In both these sets of guidelines, the target group is precisely companies all over the world. The same applies to the UN draft Code of Conduct for companies in the field of human rights. A clear advantage of basing ethical guidelines for the exercise of ownership rights on these documents is that they cover a wide range of issues within the fields of human rights, labour standards and the environment. Furthermore, they have been drawn up by international organisations whose members include the vast majority of the countries on the Petroleum Fund's list. The documents also express objectives that are generally accepted in the international community. In the long term, it would be difficult to raise substantial financial objections to the proposal that companies should conform to an ethical standard that enjoys wide international support."

Last year, the Global Compact network concluded a joint venture agreement with Global Reporting Initiative (GRI), which provides guidelines on the way in which companies should report on financial, environmental and social issues in order to safeguard the Global Compact principles. Since the publication of the Committee's report, an equivalent agreement has also been concluded in relation to the OECD Guidelines for Multinational Enterprises.

Reference is made to box 4.1 for further details of the Global Compact and the OECD Guidelines for Multinational Enterprises.

*Box 4.1 UN Global Compact and the OECD Guidelines for Multinational Enterprises as described in the Graver Committee's report*

“The Global Compact initiative was launched by UN Secretary-General Kofi Annan in Davos in January 1999. The Secretary-General challenged the international business sector to join with the UN in ensuring that international trade will be sustainable and in contributing to a globalisation that will have a positive impact on the majority of the world’s population. Five UN organisations, labour organisations, business organisations and non-profit organisations have been involved in developing the Global Compact principles. There are nine principles, derived from the Universal Declaration of Human Rights, the International Labour Organization’s Declaration on Fundamental Principles and Rights at Work and the Rio Declaration on Environment and Development.

The Global Compact principles urge companies to promote and respect international human rights as far as possible, and ensure that they are not complicit in human rights abuses. The principles refer to all human rights, i.e. including those in central UN conventions on political and civil rights, economic, social and cultural rights, torture, racial discrimination, discrimination of women and children’s rights, and a large number of other global and regional human rights conventions. The principles then point specifically to freedom of association, the elimination of forced or compulsory labour, the abolition of child labour and discrimination in respect of employment and occupation. Lastly, the Global Compact principles urge companies to support a precautionary approach to environmental challenges, undertake initiatives to promote greater environmental responsibility and encourage the development and diffusion of environmentally friendly technologies. (...)

The OECD has developed Guidelines for Multinational Companies. The Guidelines provide voluntary principles and standards for responsible business conduct in a variety of areas consistent with applicable laws. Although many business codes of conduct are now publicly available, the Guidelines are the only multilaterally endorsed and comprehensive code that governments are committed to promoting. The Guidelines contain voluntary principles and standards for responsible business conduct in relation to economic, social and environmental conditions and are based on input from the business community, employees’ organisations, the public authorities and non-governmental organisations. The Guidelines contain a general recommendation to respect human rights and to abolish child labour and forced or compulsory labour. They also refer to the internationally endorsed core labour standards. In relation to the environment, multinational companies are urged to increase their efforts by means of measures such as improving internal environmental management, increasing the volume of environmental information made publicly available, and improving emergency response planning to deal with environmental impact. The Guidelines also provide recommendations on how companies should avoid becoming involved in corruption, by promoting employee awareness, developing management control systems and being open about their ethical policies. When dealing with consumers, enterprises should act in accordance with fair business, marketing and advertising practices and should take all reasonable steps to ensure the safety and quality of the goods or services they provide, through product information and labelling, transparency and co-operation with the public authorities on product safety. The chapter on disclosure and transparency reflects the OECD Principles of Corporate Governance and endorses and encourages progress in the improvement of companies’ social and environmental responsibility.”

The Committee describes what might be the practical consequences of exercising ownership rights where ethical considerations are emphasized. The Committee's comments include the following:

- The Fund can require companies in which it owns shares to carry out more comprehensive reporting on how the company's activities affect key stakeholders, such as employees and local communities. Comprehensive reporting should comprise more information than is already required from the company under national legislation, for example in line with the proposals in the Global Reporting Initiative (GRI).
- Together with other investors, the Fund can require companies to establish systems to prevent the company from contributing through its operations to violations of fundamental human rights, environmental degradation or the acceptance of bribes. This may be particularly appropriate in companies operating in countries or sectors where these problems seem to be especially widespread. Working to ensure that firms that risk being involved in these problems have systems in place to prevent this is highly likely to be consistent with the objective of protecting long-term shareholder values.
- In a system that involves corruption, the company's values, and thereby also the shareholders' values, are wasted. Corruption is considered one of the most important obstacles to the improvement of living standards in poor countries. In this sense, financial considerations and ethical considerations go hand in hand. The Petroleum Fund, alone or in co-operation with others, can chart whether companies have adapted to, or will adapt to, the business principles developed by, for example, the anti-corruption organisation Transparency International."

The Committee also refers to specific instances in which financial investors have jointly challenged companies to address ethical issues that could have negative financial consequences for the companies if not taken seriously. One of these, "The Carbon Disclosure Project", is an international survey, conducted on behalf of 35 institutional investors, of the ways in which the world's 500 largest companies are reacting to the threat of climate changes and what future financial risk they forecast that this will have for the companies. A similar initiative is the recommendation by a number of investors, including the UK pension fund Universities Superannuation Scheme, the Dutch pension fund PGGM, ISIS Asset Management and Henderson Global Investors, to the pharmaceutical industry on the ways in which it should cooperate with the international community in fighting the spread of HIV/AIDS in many of the world's poorest countries.

The Graver Committee is concerned that ownership rights should be exercised in such a way that genuine influence is achieved and believes that the level of ambition of the Petroleum Fund in this area should be high. Nevertheless, the Committee sounds a note of warning against exaggerated expectations about what can be achieved through the exercise of ownership rights and points out that it is unlikely that those subjects that command greatest attention amongst the public from an ethical perspective will

necessarily coincide with what major capital managers will give priority to with a view to protecting the long-term values of shareholders. The Committee writes:

"In a number of issues where there is strong ethical involvement by various pressure groups, the link between ethics and financial return will be more tenuous than in the more classic ownership issues, such as requirements for accounting information and independence between boards and management. Because of the need to balance resource use against expected long-term gains, it is likely that issues where the aim of protecting the long-term interests of shareholders seems to be clearest will be given priority. In cases where the connection between ethics and long-term return is either unclear or negative, the exercise of ownership rights will not be an appropriate instrument for promoting ethical considerations. In other words, the exercise of ownership rights to achieve long-term return will not be the answer to all the ethical challenges Norway faces through its ownership shares in international business and industry, nor will it cause politically or ethically based criticism of the activities of the Petroleum Fund to cease."

In the view of the Committee, the manager should be responsible for exercising ownership rights on behalf of the Petroleum Fund. The overarching guidelines should be laid down by the Ministry of Finance and be anchored in the Storting in the usual way. The Committee writes:

"The exercise of ownership rights is part of operational fund management. As is the case for other aspects of fund management, ownership rights should for technical and supervisory reasons be exercised under the financial responsibility of the manager, within the general limits drawn up in the Ministry of Finance guidelines. The guidelines for the exercise of ownership rights are intended to contribute to a balance between long-term and short-term return objectives in the management of the Fund."

The Committee is of the view that it is important for the manager to have an incentive to give priority to exercising ownership rights and that this can be achieved by introducing a reporting requirement. The Committee is of the view that a report of this type should contain information on the guidelines drawn up by the manager, the way in which these guidelines have been followed up, including the way in which votes have been cast on behalf of the Petroleum Fund at corporate general meetings. Moreover, the report should contain information on Norges Bank's dialogue with companies, but without thereby undermining the scope for achieving results in dialogues with individual companies.

#### *4.2.1.4 Negative screening and withdrawal*

Negative screening involves the creation of a system for capturing companies involved in a particular activity and ruling them out as investment prospects for the Fund. The Graver Committee proposes the screening of companies with products that it is viewed as ethically unacceptable to be involved in the production of. Exclusion means withdrawal from a company after an individual assessment of the situation if an investment in the company represents an unacceptable risk of complicity to actions or omissions that are viewed as grossly unethical. The Committee is of the view that the difference between these instruments is not necessarily particularly great. Nevertheless, the distinction reflects the difference between the scope for identifying a company's products and a company's behaviour. The Committee notes, inter alia, that

"companies may have a direct responsibility for some activities that may at the same time be screened out, for example the production of certain types of weapons. On the other hand, other matters, such as human rights abuses resulting from a company's conduct, may be very difficult to capture using screening procedures. In its proposal, the Committee has assumed that this information will emerge on an ad hoc basis through the media and other channels, and will subsequently be assessed against the criteria for withdrawal."

### *Screening*

Negative screening is justified on the grounds of a wish to avoid contributing to the production of unethical products. The Committee refers to international conventions of which Norway is a signatory and processes in which Norwegian authorities have involved themselves as suitable points of departure for determining which products or processes should be excluded from the Petroleum Fund. These conventions are not directed at companies, however; rather they apply to national authorities that have undertaken to follow up the conventions in their national legislation. Moreover, the wording of convention provisions is often general and may leave considerable scope for discretion. Accordingly, the Committee does not regard conventions as directly applicable instruments for the negative screening of products or production processes. Nevertheless, in its specific proposals on screening the Committee refers to convention provisions when assessing which products should be excluded from the Fund.

The Committee is of the view that negative screening represents a powerful means of expressing what the Norwegian authorities regard as so unethical that the Petroleum Fund should not under any circumstances invest in such activities. The Committee is therefore of the view that the criteria should be rooted in products from which the Norwegian authorities have clearly distanced themselves and which active steps are being taken to limit or prohibit internationally.

Based on this point of departure the Committee recommends screening out companies involved in the production and sale of nuclear weapons and cluster bombs, as well as weapons that international law prohibits the production or use of. This applies for example to chemical and biological weapons, anti-personnel mines, incendiary weapons (for example napalm), weapons with non-detectible fragments (plastic projectiles not detected by X-rays) and blinding laser weapons.

It is unlikely that companies in which the Petroleum Fund might invest would be involved in the production of weapons that are explicitly prohibited under or encompassed by rules of humanitarian law. Until now, only a single company has been excluded from the Petroleum Fund on the basis of the current withdrawal mechanism based on international law.

Nuclear weapons and cluster bombs are not banned under international law. Nevertheless, the Committee is of the view that it would be in keeping with long-standing and consistent Norwegian policy in this area to avoid investing in companies involved in the production of such weapons.

Norway has practised a clear and unambiguous policy on nuclear weapons since the end of the Second World War. A fundamental element of what is known as the base policy prohibits nuclear weapons on Norwegian territory in peacetime. By ratifying

the Non-Proliferation Treaty and other related treaties, Norway has supported the cause of nuclear disarmaments and non-proliferation for the last five decades.

On the subject of cluster bombs, the Committee points out that the Storting has expressed a clear and negative stance on the use of cluster bombs, and that these weapons are no longer used by the Norwegian Defence Forces. The fact that cluster bombs represent a major humanitarian problem, at the same time as which it can be argued that they come within the ambit of the ban in humanitarian law on weapons that fail to distinguish between military and civilian targets, means that this weapon should, in the view of the Committee, be excluded from the investment universe of the Petroleum Fund.

The Committee is of the view that the pace of technological development in the weapons industry is such that it is not inconceivable that new weapons or types of ammunition will prove to be contrary to the fundamental principles of humanitarian law. The Committee therefore recommends that scope for including new weapons or types of ammunition on an exclusion list should be maintained.

The Committee is also of the view that a line must be drawn to distinguish subsidiaries, associate companies and companies that in other ways might be related to companies involved in the production of such weapons. This distinction must be drawn in the individual case on the basis of a substantive evaluation of the involvement in the undesired production. The Committee writes:

“The basis for the assessment must be the justification for the negative screening. The justification for excluding certain types of weapons is that Norway is not to contribute to the production of such weapons through the Petroleum Fund. If the concept of complicity is extended too far and too indirectly, it will become fragmented and diluted in that “almost everyone” is deemed to be contributing. This will undermine the force of the ethical argument against contributing to such production. Thus, only key components and typical parts should be excluded. For example, there is no point in excluding a screw producer. It is our view that, for example, F-16 aircraft should not be excluded even though these aircraft are designed to carry nuclear weapons. Norway has bought such aircraft for entirely different reasons.”

The Committee considered screening the Fund for companies involved in the production of ammunition containing depleted uranium, but did not recommend doing so. The Committee points to the uncertainty attaching to the effects of depleted uranium on health and the environment, but argues that the ethical issues relating to depleted uranium are equivalent to those encountered in a number of fields where uncertainty exists about the harmful effects of products.

The Committee also considered excluding the production of arms in general, but believes that it is unlikely that such a proposal could be justified on the basis of an overlapping consensus in the Norwegian population.

The Committee considered screening the Fund for companies that use ozone-depleting substances and persistent organic pollutants, given the existence of three conventions in this area, the contents of which are so specific that they could provide the basis for negative screening. The Committee has not recommended this, because negative screening on the basis of substances that are already prohibited in international conventions will always lag behind developments. A plan already exists to phase out substances of this nature, whereas the greatest problems generally relate to substances to which no restrictions as yet apply.



The Committee failed to reach agreement on the question of whether the Fund should screen out companies involved in the production and distribution of tobacco. The harmful effects on health and the costs that these effects cause society, together with the international efforts aimed at limiting and preventing the damage caused by tobacco, point in the direction of screening the Fund for such companies. However, the fact that tobacco is a lawful product is a counter-indication. Nevertheless, the Committee did agree that tobacco companies displaying grossly unethical behaviour could be excluded following an assessment in the individual case.

The Committee also considered whether the Fund should screen out companies involved in genetically modified food, nuclear power, coal power and petroleum, as well as companies engaged in illegal logging or in other ways posing a threat to biodiversity. The Committee does not regard negative screening of activities of this nature as an appropriate instrument. The Committee is of the view that specific examples of, for example, unlawful logging should instead be handled through the withdrawal mechanism. The Committee also points out that certain investors now focus on forestry certification as part of the exercise of ownership rights and is of the view that this would also represent a more efficient strategy for addressing climate issues relating to fossil fuels than does screening, if the intention is to bring about change in the companies in question.

### *Withdrawal*

The existing withdrawal mechanism entails that companies may be excluded only if investing in them might be at variance with Norway's commitments under international law. The Graver Committee suggests extending the existing withdrawal mechanism to allow the exclusion of companies from the Petroleum Fund on the grounds of gross or systematic breaches of ethical norms. The Committee writes:

“Exclusion from the investment universe should also apply to companies if, for example, ethical considerations are increasingly incompatible with an optimal return on the Fund’s investments, or if there is no significant hope of changing the unethical practices through ethical ownership. In that case, the only way of avoiding complicity is by disposing of ownership interests. Examples of such unethical practices are grave violations of human rights and labour standards, gross corruption and deliberate or qualified severe environmental degradation.”

The Committee continues:

“If a company that has committed a violation has implemented measures to prevent similar events from occurring in the future, ownership interests in that company do not contribute to unethical practices. If these measures are implemented after the Petroleum Fund has discussed the matter as part of its exercise of ownership interests, it can in fact be said that the Petroleum Fund has satisfied an ethical obligation to deal actively with unethical practices in its investment universe. This may suggest that exclusion should be limited to the most serious cases where the company in which the Petroleum Fund has invested is directly responsible for unacceptable breaches of standards, and there are no expectations that the practices will be discontinued.”

The withdrawal mechanism is not intended to have a retrospectively punitive characteristic; rather it is intended to ensure that the Petroleum Fund does not continue to participate in clearly unethical behaviour. The Committee writes:

” The assessment must also take into account that given the way international markets function today, any investment will involve ethical considerations. In other words, the Petroleum Fund cannot be required to invest only in companies with ethically unimpeachable conduct. On the other hand, the acceptance of this risk cannot serve as an excuse for inaction with regard to investment in companies engaged in clearly unethical practices. The challenge lies in striking a balance between the two extremes.”

The purpose of excluding companies is not primarily to influence them to change their behaviour. The Committee writes:

” The Committee does not recommend the use of exclusion as a means of exerting influence. The Committee believes that the exercise of ownership rights might be more effective in influencing a company’s conduct. Disposing of holdings in a company in order to influence its conduct presupposes that the publicity around the Fund’s withdrawal would result in the company changing its practices. It is not realistic to believe that by excluding a company the Fund could contribute to reducing the company’s access to capital or causing demand for the company’s stock to decline in such a way that the company would be compelled to change its conduct.”

The Committee is of the view that certain reference points must be established for what constitutes an unacceptable ethical risk. Only the most serious breaches of ethical norms should provide grounds for withdrawal and the Committee provides examples of this in the form of a list of behaviour indicating that withdrawal from a company should be considered, see the guidelines on withdrawal and screening in 4.2.3.6.

In many cases, breaches of ethical norms occur in companies in which the Petroleum Fund does not have direct investments, but with which companies in the portfolio have ties. The Committee argues that it is unlikely to be sensible to lay down clear limits on what links should result in withdrawal, but that a substantive assessment should be conducted in the individual case. The Committee writes:

“If the links are so close between a company in the Petroleum Fund’s portfolio and a company where there is an ethical risk that the two can be identified with each other, the company’s legal structure cannot be decisive in the ethical assessment of complicity. Factors that could be decisive for such identification are the size of the ownership interests, whether the companies act as one externally, and whether shareholdings in one of the companies have implications for the other. Even if there is no identification, it may still be reasonable to argue that complicity exists. However, it would not be sufficient to argue that a company has small ownership interest in a company that is guilty of gross breach of ethical standards. Where ownership is concerned, it is reasonable to require that the company have actual control over the entity involved in unethical action before complicity on the part of the Petroleum Fund can be invoked.

When the link is not ownership, but a customer-supplier relationship, the assessment may be different. From the point of view of efficiency, it is often the case that an important customer has greater influence on a sub-contractor than many others. In the case of companies that make extensive use of sub-contractors with a high ethical risk, it can be argued that the investments should not be withdrawn if it is possible to influence the practices of their sub-contractors. Even if a company has unethical sub-

contractors, it may be sensible to refrain from excluding investment unless there is a pattern where the company uses the sub-contractors with dubious practices without seeking to influence the situation. The situation will approach complicity if the customer relationship is long-term or repeated after the unethical practices have been identified. If the customer relationship is of lesser importance or transitory, for example a hotel that is used for child prostitution, emphasis should be placed on whether the company is facilitating this type of violation or contributing as a result of improper passivity.

Particular problems arise in connection with companies that have activities in states where severe human rights violations occur. Such violations can also occur in connection with the companies' activities, for example through the use of security forces that commit abuses to protect the company's property and installations, deportation of people and environmental damage to facilitate the company's projects, or arrest and persecution of workers who are seeking to promote trade union rights. Complicity on the part of the company can be invoked only if direct action is taken to protect the company's property or investment and if the company has not taken reasonable measures to prevent the abuse."

The Committee suggests that corporate bonds and shares should be on an equal footing in terms of withdrawal and screening. Ownership rights cannot be exercised in respect of bonds since bonds do not confer ownership rights on the bondholder. The Committee does not recommend the exclusion of government bonds or bonds issued by international organisations on the grounds of an ethical assessment. Where the UN adopts sanctions against a country in the form of binding trade restrictions or the like, the sanctions will when incorporated in Norwegian law normally impose a ban on investment in the country in question. This will include investment on the part of the Petroleum Fund.

#### *4.2.1.5 The Petroleum Fund's Council on Ethics*

The Committee is of the view that the Ministry of Finance should determine which companies should be excluded from the Petroleum Fund by means of withdrawal or screening. The principles governing withdrawal and screening should come from the Storting. The Committee recommends the continuation of the existing scheme under which an external council assesses whether specific investments should be excluded. The council's responsibility for determining which companies should be excluded will be greater than at present, and the council will cover a wider area than in the past.

The Committee writes:

"The Committee is of the view that the Council should determine which companies should be subject to negative screening and which companies should be subject to the exclusion mechanism. The Council should be free to decide whether a closer assessment of a company should be conducted. The Council's assessments can, even when the Council does not choose to recommend exclusion, be made available to Norges Bank, and be useful in the exercise of ownership rights.

The Council can be responsible for undertaking negative screening or use consultants to provide it with assistance. Under the exclusion mechanism, the Council should also be responsible for procuring available information. It is the Committee's view that the possibilities for applying screening criteria to identify all companies engaged in

unethical practices are very limited. Information that may justify exclusion will probably to a large extent come to light on an ad hoc basis in the form of input from such sources as non-governmental organisations or the media.

The Council should have sufficient expertise in the areas to be assessed. This may require that the Council be expanded to include five members. The Council must be provided with sufficient time and resources so that the relevant procedures can be performed thoroughly. The Council's tasks will be expanded in relation to the current situation. Experience shows that it is not possible to rely fully on external services. It is also important for the legitimacy of the mechanism that the Council is provided with the necessary independence and possibility to develop its expertise. The Committee is therefore of the view that the Council should have its own secretariat and sufficient resources to conduct its analyses."

The Committee is of the view that companies that are affected should as a matter of procedure be given the opportunity to comment on a proposal for a recommendation by the Council and the background to the recommendation. In the opinion of the Committee, a dialogue of this nature could serve to improve the quality of the information upon which an exclusion decision is based and would also provide useful information for the required risk assessment. The Committee recommends that Norges Bank should be responsible for contact with the companies.

The Committee is of the view that the recommendations of the Council to the Ministry of Finance should be made public. The Committee writes:

"The Council's recommendations to the Ministry of Finance should be available to the public. The publication of the Council's final report is in line both with current practice and with the principle of public access to documents in the public administration. The Ministry of Finance should have the right to postpone public disclosure if this is necessary for the disposal of equities or bonds in a financially sound manner."

#### **4.2.2 The main points of the comments of the consultative bodies**

The Graver Committee's report was circulated for comment on 24 September 2003, with responses requested by 1 January 2004. The Ministry of Finance has received 53 consultative statements. 38 consultative bodies have submitted comments to the Committee's recommendation. These are published on the Ministry of Finance's website ([www.odin.dep.no/fin/](http://www.odin.dep.no/fin/)).

The consultative responses note that the report provides an extensive and thorough review of issues relating to the appropriate management of the Government Petroleum Fund. There is broad support for the basis for ethical guidelines for the Government Petroleum Fund presented by the Graver Committee: A key ethical consideration is that the Petroleum Fund should secure a reasonable proportion of the nation's oil wealth for future generations. At the same time, there is an obligation to avoid investments that represent an unacceptable risk that the Fund will contribute to circumstances that are grossly unethical.

Many of the *voluntary organisations* are of the view that in the event of conflict, human rights or environmental considerations should take priority over financial considerations. Several of the organisations also argue that the guidelines should make an active contribution to the promotion of basic human rights and to stimulating a more efficient use of resources and less environmental damage. The possibility of

using investments from the Fund as a means of aiding development in nations in the southern hemisphere is also pointed out.

*Norges Bank and The Confederation of Norwegian Business and Industry* are of the view that the Committee's proposal strikes the right balance between ethical considerations and the responsibility the Fund has to future generations to secure a satisfactory return. They agree with the Committee that the State has other – often more direct – means than the Petroleum Fund for promoting specific objectives. *The Confederation of Norwegian Business and Industry* points out that specifically political objectives such as support under aid policy must be funded within the confines of the National Budget.

*Norges Bank* agrees with the Committee that it might be unethical in relation to future generations of Norwegians to inflict costs on the Fund simply to implement symbolic ethical measures in support of a policy that might better be promoted by other means. The Bank also agrees with the Committee that when the consequences of ethical standpoints become more extensive, allowing a direct cost to be pinpointed on more definite grounds, it will be necessary to determine whether better means are available for achieving the ethical goals than by inflicting costs on the Petroleum Fund. *Norges Bank* points out that the extensive use of negative screening and withdrawal could involve considerable costs in the form of a reduction in expected return or higher market risk and in the form of greater complexity when it comes to assessing the management of the Fund.

#### *4.2.2.1 The exercise of ownership rights*

Most of the consultative bodies agree with the Committee that as a general rule companies improve their expected long-term earnings by acting in accordance with sound ethical norms. *The Confederation of Norwegian Business and Industry* points out that on the whole, maintaining a dialogue with companies represents a more useful strategy for bringing about change than does selling off assets to other investors that do not observe the same ethical considerations.

*Norges Banks and The Confederation of Norwegian Business and Industry* are in favour of using the UN Global Compact and the OECD Guidelines for Multinational Enterprises as a basis for the exercise of ownership rights. The Bellona Foundation points out that the UN's Global Compact and the OECD Guidelines for Multinational Enterprises are general but also extensive guidelines, which if applied as intended to the entire portfolio of the Petroleum Fund would represent a considerable step forward in the management of the Fund.

*The Norwegian Foundation for Environment and Development, Save the Children Norway, The Future in Our Hands, The Norwegian Mountain Touring Association, The Norwegian Humanist Association and Friends of the Earth Norway* point out that the UN Global Compact and the OECD Guidelines for Multinational Enterprises being voluntary frameworks are often not sufficiently precise in the requirements they make of companies. These organisations are accordingly of the view that the guidelines should instead be rooted in key relevant international conventions. Moreover, that the ambition of the Petroleum Fund should be to encourage companies to raise the standards of their businesses to a higher level than the current minimum requirements in relevant international treaties. The organisations also point out that the influence of the Petroleum Fund is limited by the fact that it may hold stakes of no more than 3% in companies and that in practice its ownership holdings are far lower.

Several of *the voluntary organisations* argue that Norges Bank should delegate the exercise of ownership rights to others. They note that if Norges Bank is to exercise the rights of owner itself, it will be necessary to enhance Norges Bank's expertise in the fields of human and workers' rights, environmental issues and the relevant conventions. They also point out the possibility of establishing an international forum of owners to facilitate coordinated action by managers and owners across national borders.

*Norges Bank and The Confederation of Norwegian Business and Industry* agree with the Committee that the managers of the Fund should exercise ownership rights as part of their general assessments and that Norges Bank will need to develop its own set of operational regulations governing the exercise of ownership rights and suited to the Bank's role as a financial investor.

*Det Norske Veritas* argues that in its exercise of ownership rights the Petroleum Fund should contribute to the development of standards and standardised company information, and moreover that the Fund should perform analyses of the consequences of exercising commercial social responsibility on the profitability of industries and individual enterprises.

*The Norwegian Foundation for Environment and Development, Save the Children Norway, The Future in Our Hands, The Norwegian Mountain Touring Association, The Norwegian Humanist Association and Friends of the Earth Norway* are of the view that Norges Bank should develop and publish a 2-3 year strategic plan for ethical management and report progress relative to the plan.

#### 4.2.2.2 Negative screening

*Many of the consultative bodies* argue that tobacco too should be excluded from the investments sphere of the Petroleum Fund. Amongst other points, they refer to Norway's attitude towards tobacco in the form of restrictions on sales, tax policy, support for measures aimed at tobacco producers in international bodies such as the WHO and the extensive campaign of influencing the population.

Several of *the voluntary organisations* are in favour of extending screening to take in other products, including the production and distribution of alcohol, pornography, arms, nuclear power, petroleum and some forms of biotechnology. Some of the organisations also argue that screening should be applied to negative behaviour, such as environmental damage or working against international environmental treaties.

*The Norwegian State Church Endowment Fund* supports the Committee's delimitation of negative screening, but argues that tobacco should be screened from the Fund. *Norges Bank* stresses that in the interest of achieving a satisfactory spread of risk across the portfolio of the Fund it is necessary to define strict limits on the use of negative screening. *The Confederation of Norwegian Business and Industry* supports the restrictive use of negative screening.

#### 4.2.2.3 Withdrawal

*Many of the voluntary organisations* argue that the guidelines governing the withdrawal of companies should go further than proposed by the Committee.

*The Norwegian Confederation of Trade Unions and The Fafo Institute for Applied Social Science* are of the view that the Committee's proposals do not sufficiently reflect the right to organise and bargain collectively. They argue that gross breaches

of the ILO's core conventions should be defined as a basis for withdrawal. *Norwegian Church Aid* is of the view that the Committee should be clearer about the conditions for considering the phasing out of companies that fail to fulfil the Fund's ethical guidelines on workers' rights.

Several of *the voluntary organisations* are of the view that an advance assessment should be conducted of risk in relation to the criteria for withdrawal. This should include the systematic compilation of information on the stances taken by other funds and indices with ethical guidelines towards the companies in question.

*The Norwegian State Church Endowment Fund* is of the view that the destruction of ancient monuments should be included in the ethical guidelines of the Petroleum Fund.

*Norges Bank* agrees with the Committee on the proposed use of withdrawal as an instrument and that the use of withdrawal must be confined to cases in which gross breaches of norms can be expected to reoccur in the future. *Norges Bank* stresses that for large funds, selling off holdings in major companies is not a realistic option since the funds' size makes it necessary for them to maintain a presence in a large part of the investment universe in order to spread risk. If withdrawal is used extensively, the spread of risk across the Fund's portfolio will be less satisfactory. Moreover, it will be difficult to evaluate the quality of management of the Fund in comparison with other funds that are not subject to similar restrictions. *Norges Bank* points out that a failure to spread risk and an absence of transparency may give rise to considerable costs in relation to the primary objective of the Fund.

*The Confederation of Norwegian Business and Industry* and *The Norwegian Financial Services Association* support the restrictive use of the withdrawal mechanism. *The Confederation of Norwegian Business and Industry* argues that it should be applied only when active ownership and dialogue fail to bear fruit.

*KLP Insurance* points out the problem of how companies that have been excluded can be re-included at a later stage. *KLP Insurance* is of the view that the potentially extensive influence of the Petroleum Fund represents a challenge in terms of communication, and that in this context it will be necessary to assess how the question of insiders should be treated.

#### 4.2.2.4 *The proposed Council on Ethics and International Law*

Several consultative bodies stress that a council on ethics and international law should comprise members drawn from a wide variety of disciplines.

*The Norwegian Foundation for Environment and Development*, *The Future in Our Hands*, *Save the Children*, *The Norwegian Mountain Touring Association*, *The Norwegian Humanist Association* and *Friends of the Earth Norway* propose the development of a convention-based foundation for the Council to base its assessments on and that the Council should have a duty actively to seek out information and establish procedures and methods for doing so. In their view, when the Fund sells off holdings in companies on the advice of the Council on Ethics and International Law, the reasons should be made public at the earliest possible time.

*The Norwegian Foundation for Sustainable Consumption and Production* supports the proposal that the Council should have the authority to initiate investigations into companies but believes that it would not be appropriate for the Council to have to use *Norges Bank* as an intermediary when compiling information and clarifying facts.

*The Norwegian Confederation of Trade Unions* is of the view that every effort must be made to ensure that the recommendations of the Council are made public. *Norges Bank* stresses that from the perspective of managing the Fund efficiently, *Norges Bank* should have scope for selling off the securities in question before the recommendations of the Council are published.

*The National Insurance Scheme Fund, The Norwegian Centre for Human Rights and The Norwegian Foundation for Sustainable Consumption and Production* are of the view that there are grounds for considering whether there should be closer cooperation between the Council on Ethics and *Norges Bank* to ensure that the exercise of ownership rights also takes into consideration the ethical aspects of the operations of the companies. *The National Insurance Scheme Fund* points out that cooperation of this nature could also probably contribute to a more efficient coordination of the work involved in screening/withdrawal and the active exercise of ownership rights.

#### 4.2.2.5 Other issues

Several consultative bodies argue that, as a supplement to the ethical guidelines, part of the portfolio should be invested on the basis of *positive criteria*, i.e. selecting companies that are assumed to be the best rather than excluding the worst. Some of the bodies argue that part of the Fund, for example the Environmental Fund, should be set aside for investments aimed at climate measures or the development of alternative sources of energy.

Those consultative bodies that have considered the question of *consistency with the other activities of the State* agree with the Committee that it is appropriate to expect consistency between the regulations adopted for the Petroleum Fund and the ways in which the State operates as a financial investor in other contexts. Some note that equivalent ethical requirements should also be applied when the State acts in other roles than as an investor. However, several point out that the State can take ethical considerations into account only when the positive effects are expected to be reasonable in relation to the cost.

#### 4.2.3 The ministry's assessment

In the ministry's assessment the Graver Committee's recommendation successfully incorporates ethical obligations that are appropriate to the Government Petroleum Fund. The ministry intends to introduce ethical guidelines for the Government Petroleum Fund along the lines proposed by the Graver Committee's study.

The ministry agrees that the Government Petroleum Fund should promote fundamental ethical obligations. It is important that future generations benefit from the wealth represented by the oil and gas resources. This will be assured by accumulating capital in the Government Petroleum Fund and by managing the fund's assets with a view to achieving sound long-term returns. A further well-founded ethical consideration is that financial assets should not be accumulated in the Government Petroleum Fund at the expense of those who are affected by the activity of companies in the fund's investment universe. Hence the fund should not be invested in companies if doing so constitutes complicity in grossly unethical conditions.



Conditions that are generally regarded as unethical are likely to reduce the return achieved in individual companies or in the economy as a whole, as in the case of corruption. The ministry agrees with the Graver Committee that considerations of long-term financial return will often coincide with other ethical considerations. Hence exercise of ownership rights may be an instrument well-suited to promoting ethical and financial considerations in the management of the Government Petroleum Fund.

The ministry agrees that companies should only be excluded if there is an unacceptable risk of complicity in gross or systematic breaches of ethical norms. The criteria for screening out or excluding companies should, in the ministry's view, be strict. Negative screening and exclusion must be balanced against the ethical obligation of assuring future generations good long-term returns, against the likelihood of changing companies' behaviour through the exercise of ownership rights and, in more general terms, against other instruments available to central government.

#### *4.2.3.1 Exercise of ownership rights*

In the Revised National Budget for 2003 the Storting was informed by the Government of changes in Norges Bank's internal guidelines and practice as regards the bank's exercise of ownership rights. According to section 11 of the regulations relating to management of the Government Petroleum Fund, Norges Bank shall not "exercise ownership rights pertaining to shares unless this is necessary in order to secure the fund's financial interests." In 2003 Norges Bank established, within the framework of these regulations, internal guidelines for the exercise of ownership rights with a view to assuring the fund's financial interests. The guidelines are reproduced in Norges Bank's letter of 12 February 2003 which formed an annex to the Revised National Budget for 2003. The bank justified the increased focus on exercise of ownership rights with reference to the scandals resulting from poor management practices at some major companies, increased collaboration between large institutional investors and to the increased size, and thereby influence, of the Government Petroleum Fund.

The ministry views the Graver Committee's proposal regarding exercise of ownership rights as a natural extension of the present regime. Recent years have seen several examples of companies where weak owner control and deficient internal management and control systems have resulted in substantial financial problems. Investors have lost their capital, and company staff have lost their jobs. For a major long-term owner it would be desirable both from a financial and an ethical vantage point to prevent such situations from arising. The Graver Committee points out that companies value their reputation, and that breaches of generally accepted ethical principles can cause a company financial harm. In cases where long-term financial objectives and ethical objectives coincide, exercise of ownership rights may be an instrument well-suited to influencing companies' behaviour in the right direction.

At the same time there is a need to be aware of the limitations inherent in the exercise of ownership rights. In many cases the connection between ethical and financial objectives will be ambiguous or unclear. The need to weigh up resource use against expected long-term gain suggests giving priority to issues where the need to protect long-term shareholder values is most clearly evident. The ordinary division of responsibilities between a company's owners, management board and administration should also be observed. The owners' natural tasks are to appoint the board of directors and decide overarching strategic issues. It is neither feasible nor desirable

for the Government Petroleum Fund to go into the minutiae of company administration.

Several consultative bodies call for the exercise of ownership rights to give priority to ethics in the event of conflict between ethical and financial considerations. The Graver Committee believes that in many cases ethical considerations and financial considerations will coincide. In the event of conflict between the two, however, it is unlikely that viewpoints that militate against a company's long-term financial return will win through. Moreover, conduct for which other actors see little justification may well impair one's chances of gaining acceptance in more general terms.

The ministry's intention is that Norges Bank, as manager, should retain responsibility for exercising ownership rights over the Government Petroleum Fund. The overarching objective will be to promote the fund's long-term financial interests. This accords with the Graver Committee's study. In Annex 8 the committee writes:

"The committee considers that the overarching objective for the exercise of ownership rights in companies in which the Government Petroleum Fund has ownership interests must be to assure the entire portfolio's long-term return. In many cases this objective will induce the Government Petroleum Fund to sharpen its focus on ethical issues in companies in which the fund's assets are invested. A system in which a balance has to be struck between financial and ethical considerations is infeasible given the Government Petroleum Fund's current governance structure."

The committee has looked into the possibility of turning ethical considerations into an independent objective for the exercise of ownership rights, and has come out against doing so. The committee writes:

"If ethical considerations were to be an independent rather than a derived objective for ownership policy, financial goals would constantly have to be weighed up against ethical goals in the implementation of ownership policy. It has previously been argued that owner control is an inappropriate instrument if the overarching or independent goal is to be anything other than long-term financial return. Weighing the pros and cons of financial versus ethical goals is a political task which cannot be left to Norges Bank. Since it would be highly inexpedient to seek to separate financial from ethical issues in the performance of owner control, it follows that another entity, at the political level, should be charged with implementing the entire ownership policy. The committee is not aware of instances where major institutional investors have established guidelines for the exercise of ownership rights with anything other than long-term financial return as their overarching goal."

The ministry shares this view. If Norges Bank were to be responsible for promoting ethical considerations to a point beyond what is in the fund's long-term financial interest, the result would be an unclear division of responsibilities between the Ministry of Finance and Norges Bank. It would require the ministry to draw up detailed guidelines for Norges Bank's exercise of ownership rights and to decide directly or indirectly the volume of resources to be devoted by the bank to this end. The bank's responsibility for financial performance might become blurred, and there would no longer be a satisfactory benchmark for assessing the bank's performance as a financial manager.

Other managers who have guidelines for their exercise of ownership rights also have financial performance as their main criterion. There appears to be a broad consensus on certain basic principles of corporate governance as regards the composition and

appointment of corporate boards, fixing of management remuneration and so forth. There also seems to be a consensus that having a clear idea of the risks faced, for example on the environmental front, is a good thing for companies' operations.

The Ministry of Finance intends to establish guidelines for Norges Bank's exercise of ownership rights along the lines of the Graver Committee's proposal. In its consultative statement on the Graver study Norges Bank writes the following as regards the exercise of ownership rights:

"Point 3.2 of the proposed guidelines states that "exercise of ownership rights shall broadly speaking be based on the UN Global Compact and the OECD Guidelines for Multinational Enterprises. Both these documents address enterprises and their conduct and set out rules for their business, and are not specifically targeted at financial investors' exercise of ownership rights. Norges Bank nevertheless views the guides to enterprises' conduct that are given in the UN and OECD documents, as they presently stand, as valuable. For its part, Norges Bank will have to develop an operational set of rules for its exercise of ownership rights that is geared to the role of financial investor.

The committee's proposed guidelines give priority to the fund's primary purpose, which is to achieve high long-term returns. The committee also presumes that no significant conflict will exist between this priority and the principles of the documents on which the exercise of ownership rights is to be based.

However, the committee also states that "in cases where the link between ethics and long-term return is either unclear or negative, the exercise of ownership rights is not a suitable instrument for promoting ethical considerations" (chapter 5.2.1).

Norges Bank agrees with this. In the interest of even greater clarity, Norges Bank believes it should be made clear that the principles in the UN and OECD documents should be applied within the framework of the overarching objective of ensuring the fund's financial interests. This calls for some adjustment of the committee's proposal for the ministry's guidelines for the exercise of ownership rights."

The ministry agrees with Norges Bank's perception of the Graver Committee's recommendation. Only where financial considerations coincide with ethical considerations should Norges Bank promote ethical considerations through the exercise of ownership rights. In the ministry's view this is clear from the guidelines for the exercise of ownership rights.

The Graver Committee's intention is that Norges Bank should establish detailed guidelines for its exercise of ownership rights within the framework of the overarching guidelines set by the ministry. This is a continuation of current practice. The ministry expects Norges Bank to continue to develop its operational guidelines within this framework. It would also appear prudent to opt for a gradual build-up of the activity and to apply the experience gained in the process. In its consultative statement Norges Bank writes:

"Norges Bank also emphasises that exercise of ownership rights should be based on a detailed set of rules which precisely define the criteria on which the operational exercise of ownership rights is to be based. Norges Bank's executive board will therefore devote much effort to formulating such a set of rules and to developing the operational rules based on the experience gained.

The committee highlights the exercise of voting rights and dialogue with enterprise managements as a relevant aspect of the exercise of ownership rights. The committee

further states that Norges Bank will "be responsible for apprising enterprises of the general expectations inherent in the guidelines, and seek to ensure that enterprises establish internal routines and procedures to demonstrate that these expectations are being acted on. Nonetheless Norges Bank cannot be a guarantor that all enterprises at all times meet the ethical requirements or expectations specified in possible guidelines from the Ministry of Finance" (chapter 5.2.1). Norges Bank supports these views."

The ministry expects Norges Bank to use the instruments available to it in its exercise of ownership rights, such as voting at general meetings and dialoguing with companies in cases where the bank deems this to serve a purpose. An important part of this work is to publicise the bank's priorities. Norges Bank must itself assess the volume of resources that need to be devoted to exercise of ownership rights in order to generate good financial results in the long term.

It is increasingly commonplace for investors to dialogue with other investors who embrace an active strategy for the exercise of ownership rights, and a number of informal contact forums have been established to this end. Such forums are likely to spawn suggestions that investors should adopt a common stance vis-à-vis companies or industries. The Graver Committee considers that the guidelines formulated for the exercise of ownership rights should in large measure coincide with guidelines adopted by other broadly invested, long-term asset managers. The committee writes in Annex 8:

"Joining forces with other funds in the exercise of ownership rights will reinforce the ability to exert influence. Owners can concentrate their efforts through the medium of alliances. Their signals will come across more clearly and will be simpler for enterprises to respond to. The upshot is that the principles upon which the Government Petroleum Fund bases its exercise of ownership rights will have greatest impact if they coincide with the principles embraced by other major asset managers."

The ministry expects Norges Bank to dialogue with other investors and to take a position on whether or not the bank should join various common initiatives.

The ministry's intends the guidelines for exercise of ownership rights to contain a reference to the OECD's guidelines for exercise of ownership rights. This comes in addition to the UN's Global Compact and the OECD's guidelines for multinational enterprises.

The Graver Committee points out that measuring the results achieved through the exercise of ownership rights presents a challenge. The committee states, first, that it will be difficult to demonstrate how far an enterprise's actions are due to its own influence or the influence of others. Second, it will be impossible to state precisely how the enterprise's earnings and share price would have turned out if the enterprise had acted differently. The ministry agrees with the Graver Committee that probably the best approach is to request a thorough account of the corporate governance activity and to make a qualitative assessment of whether this activity is efficiently organised and geared to the goal of protecting long-term shareholder values.

The Graver Committee expects a report on corporate governance activities to "contain information on the guidelines drawn up by the manager, how these guidelines have been followed up, including how votes have been cast on behalf of the Government Petroleum Fund at enterprises' general meeting. Further, a reporting system must be devised to ensure that satisfactory information is given about Norges Bank's dialogue

with enterprises, but without this impairing the ability to get the message across when dialoguing with individual companies".

The degree to which managers publish their exercise of their ownership rights varies widely. Some, very open, managers report their activity on a continual basis, while others believe that more can be achieved by reporting some time after the activity has taken place.

In keeping with the Graver Committee's recommendation, the Ministry of Finance expects Norges Bank to publish a report on its exercise of ownership rights on an annual basis. The Graver Committee's proposed guidelines refer to this document as "a separate report". Whether the report should be published separately or as part of the ordinary annual report is a matter which Norges Bank should be free to decide. For the time being the Ministry of Finance will not impose detailed requirements as to the form or content of the report, but presumes that the bank will have an eye to common practice among other managers when making its decision.

The Ministry of Finance will monitor Norges Bank's exercise of ownership rights in the same way as it monitors the bank's overall management regime. The ministry utilises an external adviser who assesses the bank's performance as an asset. The ministry will consider whether the reporting of the bank's exercise of ownership rights should also be subject to external evaluation, although it might be natural to give Norges Bank some time in which to develop its reporting arrangements before such an evaluation takes place.

#### *4.2.3.2 Negative screening*

In keeping with the Graver Committee's study, the ministry proposes negative screening from the fund of companies that either themselves or through entities they control produce weapons whose normal use violates fundamental humanitarian principles. Alongside weapon types whose use is already prohibited under international law, this includes cluster bombs and nuclear weapons. There is a consensus in Norway to the effect that the use and manufacture of such weapons is unethical. In keeping with the committee's recommendation, the ministry does not intend to exclude manufacturers of weapon components that can also serve other, legitimate purposes. According to the committee, very few companies are likely to be excluded under the proposed criteria since the manufacture of such weapons by listed companies is extremely limited.

The committee failed to reach agreement on the issue of negative screening of the tobacco industry. When prime minister Bondevik's first coalition government proposed screening from the Government Petroleum Fund companies whose main business is tobacco production, a majority of the Storting came out against the proposal. The present report does not propose screening tobacco manufacturers from the fund. However, tobacco companies may be withdrawn under the exclusion mechanism based on an individual assessment in cases where there is an unacceptable risk of complicity in gross breaches of ethical norms, see 4.4 of the guidelines for negative screening and exclusion. Such an assessment may for example be applied in regard to unethical practices in the production or marketing of tobacco.

The Graver Committee has also considered negative screening from the fund of companies that manufacture weapons, ammunition containing depleted uranium, genetically modified food, nuclear power, coal power, petroleum and companies that use ozone depleting substances or persistent organic compounds or which engage in

illegal logging or otherwise jeopardise biological diversity. The committee has not recommended screening out such activities. Several consultative bodies have called for a number of these products, as well as gambling and alcohol, to be screened from the fund. The ministry shares the Graver Committee's view and will not extend the list of products to be excluded from the Government Petroleum Fund.

The committee writes that negative screening will in principle be applied to the fund's entire investment universe, comprising some 26,000 companies. In the ministry's view it is hardly realistic, within the bounds of reasonable resource use, to expect to be able to form a detailed perception of what all these companies produce. Systematic information will probably only be available in the case of companies figuring in the major share indices, numbering just over 2,000. Where other companies are concerned, exclusion will probably be based to a greater degree on individual assessment.

#### *4.2.3.3 Exclusion*

The Graver Committee is of the view that exclusion should only be considered in the case of gross or systematic breaches of fundamental humanitarian or labour standards, severe environmental degradation, gross corruption or other serious violations of fundamental ethical norms. The ministry supports this view.

Several consultative bodies have called for a more comprehensive exclusion mechanism. One proposal is to remove from the guidelines for exclusion the requirement that violations of ethical norms must be gross, serious, systematic etc. The Ministry of Finance has asked the Government Petroleum Fund's Council on International Law to assess possible consequences of such a move. In its reply the council writes:

"The Council on International Law would point out that removing the reference to gross, serious, systematic etc., violations would result in a far broader scope for the mechanism than that envisaged by the Graver Committee. It would mean that all breaches of human rights and worker rights, all environmental degradation and all cases of corruption etc., could fall within the scope of the exclusion mechanism, regardless of the gravity of the event(s) in question. The recommendation would also require an evaluation of the risk of complicity in such events. Adopting the proposed changes would result in a very wide-ranging assessment for the exclusion mechanism. Implementing the arrangement would probably be a daunting task. For example, a company's failure to implement article 7 (d) of the International Covenant on Economic, Social and Cultural Rights, which recognises all workers' right to holidays with pay and remuneration on public holidays, could lead to demands for exclusion of the company in question."

The council continues:

"The Council on International Law is of the view that a exclusion mechanism which includes exclusion on the basis of serious breaches of international-law and ethical norms will help to draw attention to companies' ethical profile and companies' conduct worldwide. Although the Graver Committee's primary justification for exclusion is to avoid continued complicity in plainly unethical behaviour, it is also likely that exclusion from companies by the Norwegian Government Petroleum Fund will also focus attention on censurable conditions in individual companies, including their relationship to human rights, worker rights, the environment and corruption etc. In the council's opinion an excessively broad-based arrangement could weaken the

signal effect of exclusion. If the Government Petroleum Fund can be withdrawn from all companies that have contributed to or that entail a substantial risk of violation of any international legal or ethical norm whatsoever, the exclusion mechanism might quickly lose its impact."

The Graver Committee believes that the exercise of ownership rights would in many cases be a more effective instrument for influencing a company's conduct than exclusion, and that this argues for tighter criteria for exclusion.

The ministry does not advocate a wider-ranging exclusion mechanism than that proposed by the Graver Committee. In the interest of sound fund management, of the feasibility of implementing the mechanism in accordance with the guidelines, the ability to exert influence by continued investment in companies and the stronger signal effect of excluding just a minority of companies, only gross breaches of ethical norms should give grounds for exclusion.

Several consultative bodies consider that both exclusion and exercise of ownership rights should be based on international conventions rather than on the guidelines set out in the Global Compact and the OECD's guidelines for multinational enterprises. The ministry cites the Graver Committee's view that conventions address states and not the conduct of companies. Conventions are, with some exceptions, insufficiently concrete to be used as a basis for formulating rules of action for companies.

The Graver Committee points out that ethical norms will in many cases be breached by companies in which the Government Petroleum Fund is not directly invested but with which companies in the portfolio have a connection. The ministry agrees with the Graver Committee that while it is difficult to set clear-cut rules in such cases, it would seem reasonable to withdraw from companies that exert considerable influence over the unethical circumstances in question.

The ministry intends, in keeping with the committee's recommendation, to place corporate bonds and equities on an equal footing in terms of negative screening and exclusion. Moreover, government bonds or bonds issued by international organisations will not be excluded on ethical grounds unless they fall within the scope of international sanctions.

#### *4.2.3.4 The Government Petroleum Fund's Council on Ethics*

In keeping with the Graver Committee's proposals, the ministry plans for the establishment, by Royal Decree, of an ethics council of five members. The council will advise the Ministry of Finance on whether specific companies should be excluded from the Government Petroleum Fund under the ethical guidelines. Many consultative bodies have emphasised that the council should be broadly based. The ministry agrees.

The intention is that the council, either on its own initiative or at the request of the Ministry of Finance, should consider whether specific investments should be excluded under the guidelines for negative screening and exclusion, see 4.4 of the guidelines. The council will also, at the request of the Ministry of Finance, advise on whether an investment conflicts with Norway's obligations under international law. This is a continuation of the current exclusion mechanism. The council will routinely consider whether a basis for exclusion continues to apply. The ministry states that the council should be charged with devising a system for ascertaining whether companies' activities conflict with the ethical guidelines. While it would be natural for the council to enlist the services of consultants in this area, it is important that the council itself

has the expertise needed to assess the information which emerges. The Council will submit an annual report on its activities to the Ministry of Finance.

The Graver Committee expects the Ministry of Finance to decide which companies should be excluded from the Government Petroleum Fund. The ministry will base its decision on the council's assessment, but will also take into account Norges Bank's assessment of whether exercise of ownership rights might serve to reduce the likelihood of grossly unethical circumstances.

Affected companies will be invited to express their view on the rationale for a decision in favour of negative screening or exclusion. In keeping with the Graver Committee's recommendation, the ministry's intention is that Norges Bank, as the owner of the securities, should be responsible for contact with companies. Norges Bank will, as at present, assist the council in obtaining information on corporate structures in order to enable the council to consider which holdings entail complicity in grossly unethical circumstances.

The Graver Committee is of the view that the council's recommendations and the ministry's decisions should be published, but that the ministry should be entitled to defer the date of publication if this is deemed necessary to assure due and proper disinvestment from a financial point of view. The ministry agrees.

#### *4.2.3.5 Financial and administrative consequences*

The Ministry of Finance is the formal owner of the Government Petroleum Fund and is responsible for the overarching guidelines for management of the fund. These guidelines are anchored in the Storting. Norges Bank manages the fund in accordance with the guidelines established by the ministry. There is a clear distinction between the decisions taken by the ministry as owner and the decisions taken by Norges Bank as manager of the fund. Norges Bank is assessed on the basis of the results achieved within the guidelines drawn up by the ministry. Hence there is a clear-cut and expedient distribution of responsibilities between the ministry and the bank. A strong point of the Graver Committee's proposal is its implementability within this division of responsibilities. The introduction of ethical guidelines for the Government Petroleum Fund along the lines of the committee's recommendation has no significant administrative consequences.

Where financial consequences are concerned, the ministry assumes that the expenses incurred on limited exclusion of companies from the Government Petroleum Fund will be modest. The ministry bases its assumption *inter alia* on the study by economics professors Thore Johnsen and Ole Gjølberg which forms Annex 11 to the committee's report. The issue is also assessed by Norges Bank in its consultative statement. Norges Bank writes:

"The financial and administrative consequences of the three mechanisms proposed by the committee will depend above all on the scale on which negative screening and exclusion are applied. Norges Bank agrees with the committee that "once the consequences of ethical viewpoints reach the point where a definite direct cost is identified, consideration should be given to better ways of achieving ethical objectives than by exposing the Petroleum Fund to a financial burden" (from section 5.5.1). Extensive use of negative screening and exclusion may in Norges Bank's perception entail substantial costs in the form of lower expected return or higher market risk, and in the form of a poorer basis on which to assess the fund's performance. The committee has not looked into these costs. Norges Bank emphasises that these costs



may prove far higher than the direct costs of running the Council on Ethics and International Law, of maintaining a benchmark portfolio and of verifying that managers do not invest in companies outside the investment universe."

The ministry believes that exclusion and negative screening of companies could in principle expose the Petroleum Fund to a greater risk of loss. The fund's investments are dispersed across a large number of companies to ensure that events in individual companies do not have a major impact on the Petroleum Fund's returns. The greater the number of companies invested in, the smaller the significance of individual companies for the returns achieved by the fund. Exclusion and negative screening could also reduce the opportunities for active position taking. A portion of the Government Petroleum Fund is currently invested with a view to selecting shares and bonds that will produce better-than-average returns when managed on an active basis. An advantage of active management is the ability it affords to choose from a wide range of investment mediums. However, the exclusion of a relatively small number of companies cannot be expected to have a significant effect on overall risk and return. With a rising number of exclusions, particularly if entire industries are excluded from the fund's investment universe, the financial consequences may be greater.

The Graver Committee estimates that the Council on Ethics requires an annual expenditure budget of NOK 4-6 million, to be provided over the fiscal budget. This includes costs of any external services required in connection with negative screening and costs of secretariat functions which the Council on Ethics is responsible for organising in conjunction with the ministry. Norges Bank will incur direct costs on adjusting index data since companies excluded from the fund will also be excluded from the benchmark portfolio. Norges Bank's costs will be debited directly to the Government Petroleum Fund.

The costs borne by Norges Bank on the exercise of ownership rights are part of the costs of managing the Government Petroleum Fund. Since the bank exercises these rights with a view to promoting the fund's financial interests, they will not represent a net cost for the fund in the long run.

#### *4.2.3.6 Guidelines*

This report from the Ministry of Finance lays the basis for establishing ethical guidelines which will in all essentials be identical to those proposed by the Graver Committee. The ministry aims to issue new regulations for the management of the Government Petroleum Fund once the Storting has completed its deliberations. The ethical guidelines will be established pursuant to the above regulations. The Council on Ethics will thereafter be established, and Norges Bank will draw up internal guidelines for the exercise of ownership rights. The ethical guidelines will in due course be reviewed in light of the experience gained.

### ***Ethical guidelines for the Government Petroleum Fund***

#### *1 Basis*

The ethical guidelines for the Government Petroleum Fund are based on two premises:

- The Government Petroleum Fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations. The financial wealth must be managed with a view to generating a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense. The Fund's financial interests should be consolidated by using the Fund's ownership interests to promote sustainable development.
  
- The Government Petroleum Fund should not make investments that entail an unacceptable risk that the Fund is contributing to unethical actions or omissions, such as violations of fundamental humanitarian principles, gross violations of human rights, gross corruption or severe environmental degradation.

## *2 Mechanisms*

The ethical basis for the Government Petroleum Fund shall be promoted using the following three mechanisms:

- *Exercise of ownership rights* to promote long-term financial returns based on the UN's Global Compact and the OECD Guidelines for Corporate Governance and for Multinational Enterprises.
- *Negative screening* from the investment universe of companies that either themselves or through entities they control produce weapons whose normal use violates fundamental humanitarian principles.
- *Exclusion* of companies from the investment universe where there is deemed to exist a considerable risk of contributing to:
  - Gross or systematic violation of human rights, such as murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other child exploitation
  - Gross violations of individual rights in war or conflict situations
  - Severe environmental degradation
  - Gross corruption
  - Other particularly serious violations of fundamental ethical norms

## *3 The exercise of ownership rights*

### 3.1

The primary objective of Norges Bank's exercise of ownership rights for the Government Petroleum Fund is to safeguard the Fund's financial interests. The exercise of ownership rights shall be based on a long-term horizon for the Fund's investments, and broad investment diversification in the markets that are included in the investment universe. The exercise of ownership rights shall primarily be based on the UN's Global Compact and the OECD Guidelines for Corporate Governance and for Multinational Enterprises. Norges Bank's internal guidelines for the exercise of

ownership rights shall stipulate how these principles are to be integrated into the exercise of ownership rights.

### 3.2

Norges Bank shall report on its exercise of ownership rights in connection with its ordinary annual reporting. An account shall be provided of how the Bank has acted as owner representative – including a description of the work to promote special interests relating to the long-term horizon and diversification of investments in accordance with Sections 3.1 and 3.2.

### 3.3

Norges Bank may delegate the exercise of ownership rights to external managers in accordance with these guidelines.

## *4 Negative screening and exclusion*

### 4.1

The Ministry of Finance shall make decisions on negative screening and exclusion of companies from the investment universe based on the recommendations of the Government Petroleum Fund's Council on Ethics.

The recommendations and decisions are to be made public. The Ministry can in certain cases postpone the time of public disclosure if this is deemed necessary in order to ensure a financially sound implementation of the exclusion of the company concerned.

### 4.2

The Government Petroleum Fund's Council on Ethics shall be composed of five members. The Council shall have its own secretariat. The Council shall submit an annual report on its activities to the Ministry of Finance.

### 4.3

The Council is to issue recommendations at the request of the Ministry of Finance on whether an investment may be in violation of Norway's obligations under international law.

### 4.4

The Council is to issue recommendations on negative screening of one or several companies on the basis of the production of weapons whose normal use is in violation of fundamental humanitarian principles. The Council is to issue recommendations on the exclusion of one or more companies from the investment universe where there is

deemed to exist a considerable risk of contributing to actions or omissions that involve:

- Gross or systematic violation of human rights, such as murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other forms of child exploitation
- Gross violations of individual rights in war or conflict situations
- Severe environmental degradation
- Gross corruption
- Other particularly serious violations of fundamental ethical norms

The Council is to raise matters under this section on its own initiative or at the request of the Ministry of Finance.

#### 4.5

The Council is to gather the necessary information on an independent basis and ensure that the matter is elucidated as fully as possible before a recommendation concerning screening or exclusion from the investment universe is issued. The Council can request Norges Bank to provide information as to how specific companies are dealt with in the exercise of ownership rights. All enquiries to such companies shall be channelled through Norges Bank. If the Council is considering an exclusion recommendation, the draft recommendation, and the grounds for it, shall be submitted to the company for comment.

#### 4.6

The Council shall review on a regular basis whether the grounds for exclusion still apply and can on receipt of new information recommend that the Ministry of Finance reverse the exclusion decision.

#### 4.7

Norges Bank shall receive immediate notification of the decisions made by the Ministry of Finance in connection with the Council's recommendations. The Ministry of Finance can request that Norges Bank inform the companies concerned of the decisions taken by the Ministry of Finance and the reasons for the decision.”

### **4.3 Evaluation of the Environmental Fund**

#### **4.3.1 Introduction**

The Environmental Fund was established on 1 January 2001. The fund is part of the Government Petroleum Fund and is managed by Norges Bank. The first allocation to the fund, NOK 1 billion, was made on 31 January 2001. The Environmental Fund received a further allocation of NOK 1 billion after prime minister Bondevik's second coalition government took office in the autumn of 2001. At the end of 2003 the Environmental Fund was worth NOK 1.5 billion.

It was decided at the outset to evaluate the fund after three years. In its recommendation, the Storting's standing committee on financial affairs wrote:

"A trial arrangement can provide greater insight into whether financial management based on such guidelines provides a different return and into what environmental benefits may be achieved by this form of investment."

In the National Budget for 2003 the Government announced that the evaluation of the Environmental Fund would start that year in order to allow the fund to be viewed in conjunction with the follow-up to the Graver Committee.

The Storting has on several occasions debated the introduction of special ethical guidelines for the Government Petroleum Fund's investments. Prime minister Bondevik's first coalition government made the following recommendations in the Revised National Budget for 1999:

- to hive off a small part of the fund into a separate entity that would be managed in accordance with special environmental criteria
- to use the voting rights attached to the fund's shares to promote human rights and environmental considerations
- to prohibit the fund from investing in companies whose main business is the manufacture of tobacco products.

Of these recommendations, the establishment of the Environmental Fund was the only one endorsed by the Storting.

The Government now proposes ethical guidelines for the entire Government Petroleum Fund, see 4.2 of this report. The proposal comes after renewed assessment of ethical issues related to the Government Petroleum Fund, including the use of voting rights and the question of what investments should be excluded from the fund. The Environmental Fund needs to be evaluated in this overall context. An assessment has also been made of the extent to which the Environmental Fund has fulfilled the intentions underlying its establishment. The Revised National Budget for 1999 stated the following in this regard:

"The Government emphasises that imposing requirements on investors can act as a spur to improving public information on environmental aspects of individual companies' business, for example by giving assignments to specialist entities in this field. Moreover, such measures will be signal to the world at large that the issue is being taken seriously. This gives hope that other investors will in due course apply similar requirements to their investments, thereby reinforcing the effect of the guidelines selected for the Government Petroleum Fund."

Norges Bank has evaluated the financial performance on commission from the Ministry of Finance. Norges Bank's letter of 5 February 2004 which assesses the impact of the environmental criteria on returns, risk and costs is discussed in 4.3.3. An evaluation of the environmental performance follows in 4.3.4. The latter evaluation

was a joint effort by the Ministry of the Environment and the Ministry of Finance. It is based on available literature on the effect of this type of fund, as well as on reports from the Environmental Fund's information suppliers and meetings with organisations, companies and individuals presumed to hold informed views on the Environmental Fund or similar investments. An overall assessment follows in 4.3.5.

#### **4.3.2 Description of the Environmental Fund**

The Environmental Fund's investment guidelines differ from the Government Petroleum Fund's guidelines in two important respects:

- The Environmental Fund can only invest in equity capital instruments, essentially shares.
- The Environmental Fund can only invest in companies which meet specific environmental criteria.

There are also some minor differences between the two funds' respective list of countries. The Environmental Fund can only invest in equity capital instruments quoted on stock exchanges in the following countries/areas:

- *Europe*: Belgium, Denmark, Finland, France, Greece, Ireland, Italy, Netherlands, Portugal, Spain, United Kingdom, Switzerland, Sweden, Germany and Austria
- *Americas*: Canada and the United States
- *Asia and Oceania*: Australia, Hong Kong, Japan, New Zealand and Singapore

The regional breakdown of the Environmental Fund's benchmark portfolio was originally 50 per cent Europe, 30 per cent North America and 20 per cent Asia/Oceania. Country weightings within each region are determined by the market value of the companies that meet the criteria. The regional weightings in the Environmental Fund are not rebalanced, but float with the trend in relative market value between the regions.

The Environmental Fund can be invested in companies figuring in the FTSE indices for the above countries that meet *defined environmental requirements*. The British consultancy firm Ethical Investment Research Service (EIRIS) identifies these companies on commission from the Ministry of Finance. Companies in industries which in EIRIS' view have little negative impact on the environment are automatically included in the fund. Companies in industries which in EIRIS' view have a larger negative impact on the environment have to present an environmental report or an environmental management system that qualifies for a minimum EIRIS grade of "good".

EIRIS assesses environmental reports with the aid of ten criteria. To qualify for the grade "good", an environmental report must give an account of basic environmental policy, how the company impacts on the environment, quantitative data such as energy use, material use, water use, discharges etc., and the degree to which the company achieves its environmental objectives. The environmental report must also be independently verified. The reports are also assessed using criteria for description of the environmental management system, violations (environmental fines, accidents etc.), financial consequences of the environmental policy such as clean-up costs, dialogue with interest groups and espousal of sustainable development.

In addition to the ISO 14001 and EMAS certification systems, EIRIS assesses companies' own self-defined environmental management systems. As a rule the individual production site is assessed rather than entire company groups. If a company has ISO 14001 or EMAS certification, at least 33 per cent of the business must be covered in order for a company to be included in the Environmental Fund. For companies with self-defined environmental management systems, EIRIS has nine criteria which should ideally be met. If only five are met, 66 per cent of the business must be covered for the company to be included. If six criteria are met, at least 33 per cent of the business must be covered to qualify for inclusion. Establishing targets in all key areas is mandatory.

Companies in industries which in EIRIS' assessment have little negative impact on the environment, and which are therefore automatically included in the Environmental Fund's investment universe, account for about 60 per cent of the FTSE index's market value. They include, among others, companies in the financial services and IT sectors. The remaining 40 per cent are assessed individually against the environmental criteria. About one-half of these are included in the fund's benchmark index. The Environmental Fund's benchmark index accordingly contains about 80 per cent of the market value of the FTSE indices for the countries in which the fund is invested.

The Environmental Fund exemplifies positive selection based on separate criteria and a "tailor-made" benchmark index. The criteria for the Environmental Fund's benchmark index are established by the Ministry of Finance.

In principle, positive selection is also possible by investing on the basis of so-called ethical share indices. The best known standardised indices of this type are the Dow Jones Sustainability Group Index (DJSI) and the FTSE4Good. They include a significantly lower share of market value than the Environmental Fund's benchmark index. The DJSI contains about 10 per cent of the best companies in each industry group in the Dow Jones index based both on ethical and traditional business criteria. Industry groups in which all companies are regarded as very sub-standard are excluded. A parallel aim is to include about 20 per cent of the global index's market value. At the end of 2003 the DJSI included about 30 per cent of market value in the Dow Jones index. The FTSE4Good index includes about 50 per cent of the market value in the FTSE index. This index is constructed using both positive and negative selection of companies.

At the end of 2003 about EUR 2.5 billion was invested on a global basis in accordance with DJSI and about EUR 1.2 billion in accordance with FTSE4Good. This is very little compared with investments based on other indices.

### **4.3.3 Evaluation of financial and environmental performance**

#### *4.3.3.1 Financial performance*

Norges Bank has evaluated the Environmental Fund's financial performance. In its letter of 5 February 2004 on the results of the evaluation, Norges Bank reports that accumulated *return on the Environmental Fund* from February 2001 to December 2003 inclusive was a negative 25.28 per cent in terms of the reference portfolio's currency basket. In terms of Norwegian kroner the accumulated return was a negative 33.96 per cent. There are only small divergences between the return on the actual portfolio and the reference portfolio since the Environmental Fund is managed as an index portfolio.

Norges Bank writes:

“A key element in the evaluation will be to examine the consequences of environmental criteria for the return achieved on the Environmental Fund. However, this cannot be done by comparing the return on the Government Petroleum Fund with that of the Environmental Fund. There are several reasons for this. First, the Environmental Fund is invested exclusively in shares while the Government Petroleum Fund is invested in both bonds and shares. Second, the Environmental Fund is not invested in all the countries in which the Government Petroleum Fund has share investments. Third, there are differences both in the choice of regional classification and rebalancing principle (the Environmental Fund is not rebalanced). Fourth, the return on the two funds is affected by the divergences the managers make from the respective reference portfolios. The Environmental Fund is managed as an index portfolio with only small divergences from the benchmark index, whereas the divergences, and the opportunity to make divergences, are larger in the case of the Government Petroleum Fund.

A meaningful evaluation of the environmental criteria should accordingly be based on a comparison of the return on the Environmental Fund's reference portfolio with the return on the Government Petroleum Fund's reference portfolio within the same country.”

According to Norges Bank's calculations, accumulated return on the Environmental Fund's reference portfolio since 2001 has been about 2.2 percentage points lower than the return on the reference portfolio for the Government Petroleum Fund's ordinary share portfolio, in terms of Norwegian kroner. If the return on the ordinary share portfolio is calculated on the basis of country weights as in the case of the Environmental Fund, the difference is reduced to 2.0 percentage points.



Part of the differences in return between the Environmental Fund and the Government Petroleum Fund's ordinary share portfolio is due to differences in sector composition. According to Norges Bank's calculations, environmental criteria give rise to relatively wide disparities in sector weights for the USA and Canada, whereas they only produce small effects on the sector weights for the United Kingdom and Japan. Norges Bank reports that environmental analyses and environmental reporting in general are most widespread in the USA, Canada and the United Kingdom (and other European countries), but occur less frequently in Asian countries. Norges Bank writes:

“As expected, the Environmental Fund shows an overweighting in financial services and information technology, sectors in which all companies automatically meet the environmental criteria. The sectors commodities (especially in Canada), non-cyclically sensitive merchandise and general manufacturing (in the USA) are the most underweighted. This is because most use is made of environmental criteria in sectors where environmental problems are presumed to be greatest.”

Sectoral disparities can in principle result in both higher and lower return in the environmental index. Technology shares have been overweighted in the environmental index, and have performed far below the average for all sectors in the period the Environmental Fund has existed. This has weakened the Environmental Fund's return compared with that of the benchmark index for the Government Petroleum Fund's share portfolio. Norges Bank writes:

“This is clearly the case for the USA, where the fact that non-cyclically sensitive merchandise which has shown above-average return for all sectors is underweighted also pulls in a negative direction. However, the overweighting in financial services pulls in the opposite direction since this sector has shown better return than the average.”

Norges Bank has also assessed the *risk inherent in the Environmental Fund* in relation to the risk in a corresponding part of the Government Petroleum Fund's share portfolio. The difference in risk between the portfolios depends inter alia on how many companies are excluded from the Environmental Fund, and on their size. Changes seen in industry composition when environmental criteria are used to exclude companies are also risk-significant.

According to Norges Bank's calculations the return on the Environmental Fund's reference portfolio from January 2002 to end-December 2003 in terms of Norwegian kroner showed an annualised standard deviation of 21.1 per cent. In the same period the

return on the Government Petroleum Fund's ordinary benchmark share index showed an annualised standard deviation of 20.9 per cent. The return on the Government Petroleum Fund's ordinary benchmark share index using the Environmental Fund's country weights showed an annualised standard deviation of 20.6 per cent. Hence the

Environmental Fund has carried somewhat higher risk than a comparable portfolio devoid of environmental criteria.

Where *management and transaction costs* are concerned, Norges Bank writes:

“The Environmental Fund makes the management of the Government Petroleum Fund more complex. The Environmental Fund has to be managed as a separate portfolio in parallel with the other assets managed by Norges Bank. It was necessary to establish a separate custody account for settlement, bookkeeping and return measurement. Since the benchmark index is tailor-made down to single-company level, it is not possible to make direct use of the same deliveries from the index manager as in the case of the other portfolios managed by Norges Bank. Between the establishment of the Environmental Fund and the end of October 2003, overall costs on external service providers for custody, settlement, accounts, return measurement and maintenance of the benchmark index have amounted to NOK 5.3 million. A large part of the costs of support and settlement functions benefit from economies of scale, but given the relatively complex structure these cost benefits will not be available to the same degree. Although the Environmental Fund constitutes a very small part of the overall assets that are managed in the Government Petroleum Fund, the costs account for a larger share than their size would suggest.”

Norges Bank gives the following *overall assessment of the financial results* of the management of the Environmental Fund:

“The accumulated return on the Environmental Fund’s reference portfolio from the time of the establishment of the fund up to and including December 2003 is lower than the accumulated return on the Government Petroleum Fund’s ordinary reference portfolio for shares in the same period. Although this difference is partly due to diverging country weights, most of it is ascribable to a combination of differing sector distribution within the individual country and differing company composition within the individual sector. The risk in the environmental reference has been marginally higher than the risk in the ordinary share reference. (...) The establishment of a separate portfolio in the Government Petroleum Fund that is managed by environmental criteria has entailed extra management and transaction costs for the Government Petroleum Fund.”

Norges Bank warns against assigning excessive significance to the results of the evaluation:

“Data from the Environmental Fund’s initial year are too incomplete to permit detailed evaluation of return and risk across the entire fund’s lifetime. Even if three years of complete data had been available the differences brought to light could not be expected to be reliable (...). There is no knowing how representative the period behind us will be for future periods. So far the results do not provide a basis for asserting that environmental criteria as such have a significant impact on expected

return and risk, although they give rise to differences in sector and country distribution which may in turn have consequences for return and risk.”

This accords with the assessments made ahead of the establishment of the Environmental Fund.

Knowledge of economic analyses of funds that are directly comparable with the Environmental Fund is lacking. Ole Gjølberg and Thore Johnsen have evaluated *literature which analyses Socially Responsible Investments (SRI)* in their report “Evaluation of ethical management: method, performance and costs”, Annex 11 to the Graver Committee’s study. Gjølberg and Johnsen point out that the conclusion regarding SRI performance often depends on the choice of period and the funds or indices covered by the survey. The literature from the 1990s suggests that over “normal” economic cycles and in periods of economic recovery, SRI need not entail significantly divergent results compared with investments without restrictions on choice. However, Gjølberg and Johnsen find a lack of symmetry in the relationship between SRI losses in cyclical downturns and SRI gains in cyclical upturns or normal periods. Losses in downturns and periods of adjustment tend to be significantly larger than excess returns in upturns or normal periods. In upturns a fairly uniform positive trend is often seen across relatively dissimilar portfolios. A downturn, on the other hand, may produce larger differences in return between industries, countries and companies than has been usual in a normal period.

Against this background, Gjølberg and Johnsen consider that imposing specific restrictions on portfolio composition is likely to result in lower return since there will often be a greater likelihood of including companies, countries or industries that experience heavy losses. They also write that this type of asymmetry between portfolios with and without restrictions can be expected to exist in the longer term. Hence, selected funds may contain risk that is not apparent in a normal situation and is therefore not priced. Such funds will in this case achieve an approximately normal return in normal situations but will not pay the investor for risk that materialises in an abnormal situation.

Gjølberg and Johnsen summarise their findings as follows:

"If a fund manager is subject to SRI restrictions by the fund's owners, all parties should be aware that a significant downside risk may attend such restrictions. The size of such risk will depend on the extent of the restrictions on the manager's freedom to choose."

#### *4.3.3.2 Environmental performance*

The evaluation of the Environmental Fund's environmental performance started out from the objectives defined for the Environmental Fund at the outset. The aim of the fund was to improve public information on environmental aspects of individual

companies' business and to induce other investors to apply corresponding requirements to their investments. The evaluation also seeks to ascertain whether companies are influenced by investors' requests for environmental information, whether environmental reporting and certification are good indicators of environmental performance and whether the fact that the Environmental Fund is invested with a basis in a separate set of criteria, and not on the basis of an external index (for example DJSI or FTSEGood), carries weight with the companies.

Substantial methodological problems attend the measurement of environmental performance. Moreover, since the Environmental Fund has only been in operation for three years, it is not yet possible to trace long-term effects. The assessment is based on meetings with, and two reports from, the Environmental Fund's information supplier, EIRIS<sup>1</sup>. In addition, meetings have been held with other enterprises, organisations and individuals with informed perceptions of the Environmental Fund or the effects of equivalent investments. Meetings have been held with:

- the supplier of screening data to the Dow Jones Sustainability Index.
- Storebrand Asset Management, which is a major actor in the field of ethical asset management in Norway.
- Research staff at the Norwegian School of Management BI and Statistics Norway who have analysed factors affecting enterprises' ethical assessments, and a consultant who has been involved with ethical asset management for a number of years.
- GRIP, a foundation for sustainable production and consumption, founded by the Norwegian Ministry of the Environment.
- Representatives of Norsk Hydro and Statoil, both of which are included in FTSE4Good and DJSI. These two companies are included in the analyses of the majority of investment analysis firms.
- Representatives of Framtiden i våre hender ("The Future in Our Hands"), Bellona and the Norwegian Society for the Conservation of Nature.

The Environmental Fund's information supplier, EIRIS, believes that the Environmental Fund has indirectly induced other investors to apply the same requirements to their investments. EIRIS cites the fact that the Ministry of Finance's global-data requirement meant that EIRIS was subsequently able to deliver global environmental data to the FTSE indices. EIRIS's environmental criteria are the basis for the ethical index FTSE4Good. EIRIS also believes that the Environmental Fund has contributed to the increased focus on corporate social responsibility.

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<sup>1</sup> EIRIS: "The effects of SRI on companies' behaviour" and "Assessment of the Environmental Government Petroleum Fund", 2003. The reports are available on the Ministry of Finance's website.

Other observers believe that the Environmental Fund has had no effect in terms of inducing other investors to apply similar requirements to their own investments.

EIRIS also believes that the Environmental Fund has helped to improve publicly available information on environmental aspects of individual companies' business. They point out that by imposing a global-coverage requirement, the Ministry of Finance induced EIRIS to extend its analysis to a wider range of countries. EIRIS also points to the significance of the fact that they can use the Government Petroleum Fund's name to add weight to its requests for environmental information from companies.

Other observers believe that the Environmental Fund as such has not had an effect on the environmental information made available by companies. Several point out that a fund such as the Environmental Fund influences companies in situations where inclusion in the fund is an attractive proposition. However, if companies are to be able to relate to and allow themselves to be influenced by an ethical fund, the fund must be fairly large and widely known, and it must be clear what the companies need to do in order to qualify for inclusion. Companies have made a greater effort to be included in the ethical share indices<sup>2</sup> than to meet portfolio requirements designed by individual investors.

EIRIS states that companies they have been in touch with believe they are influenced by investors' requests for environmental information. In this context "investors' requests" also refer to inquiries from the designers of "ethical" stock exchange indices.

Framtiden i våre hender and Bellona both consider it to be self-evident that companies are influenced by investors' requests for environmental information. Several other respondents point out that ethical investors' requests for information have led to greater openness and improved communication on the issue of social responsibility. However, some believe that it is the communication process, and not concrete actions, that benefits. They point out that companies have become better at communicating the steps they actually take. They state that while the resources devoted to the environmental effort has remained largely unchanged for some years, more resources are spent on reporting.

On the other hand, importance has also been attached to the fact that SRI investments bring change by initiating a structured – and to some extent new – analysis of companies' situation and views on ethical issues. It is pointed out that a need for change is brought to light in a new way and that follow-up tools are being developed, and that the SRI questionnaires can promote the emergence of an arena for shared understanding and communication between corporate bodies (management, health,

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<sup>2</sup> FTSE4Good and DJSI the two most important ones. See the end of 4.3.2 for a closer account of these two indices.

environment and safety staff, financial staff, reporting units etc). Several observers believe that the motivation to qualify for SRI investments is not a question of capital supply, but of a desire to be among the best in terms of environment and ethics. They also point out that this is a marketing and sales argument used by companies. It is important to measure up to competitors. Moreover, it may have an educative effect within the company, and financial market analysts use this type of information in their analyses because it says something about the company and its management. Some point out that uncovering defective routines/internal procedures is important because it prompts improvements.

The Environmental Fund's criteria for screening companies in its investment universe are environmental reporting and environmental certification. Most observers consider these to be good indicators of companies' environmental effort. At the same time a warning is given against weaknesses: certification only indicates what companies say they intend to do, and poor companies can draw up good reports. It is pointed out that minimum requirements should be imposed on all companies: none should be included because they are assumed to have little impact on the environment. A recent study<sup>3</sup> shows that certified Norwegian companies carry out more environmental work than other companies. Although a growing number of companies are gaining certification, they still constitute a relatively small portion of the market. According to EIRIS, companies which do not meet the requirements as to environmental reporting and environmental management systems normally also fail to meet the requirements as to environmental efficiency.

Most respondents state that companies seek qualification for the FTSE4Good and DJSI indices, and that less prestige is attached to qualifying for investment in a small fund with its own criteria. According to EIRIS, among others, investing in such indices rather than in a self-designed fund could enable the indices to attain "critical mass". The result could be that the firms which prepare the indices are more likely to get their requirements across. At the same time it is pointed out that concentration of investments in the above indices will result in standardised requirements on companies. This could give companies an incentive to seek to bring about changes in the criteria or to adjust their reporting. Greater breadth in the requirements facing companies will make it less easy for them to make do with superficial changes.

As a step in the evaluation of the environmental impact of the Environmental Fund, an attempt has been made to find corresponding studies of similar funds, although there is no confirmation that such studies exist. However, a report from the Swedish Environmental Protection Agency<sup>4</sup> discusses, against the background of interviews

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<sup>3</sup> Bjarne Ytterhus of the Norwegian School of Management BI (2003): "Environmental Policy Tools and Firm-level Management Practices. National report: Norway" p. 26 "The presence of a certified EMS is associated with improved environmental performance. (...) The results based on a chi-square test confirm that the results are statistically significant."

<sup>4</sup> Angel and Rivoli: "Does Ethical Investing Impose a Cost Upon the Firm? A Theoretical Perspective", 1977.

with companies, whether investments in environmental funds have a positive environmental impact. According to the report, the utility, if any, of the environmental funds consists in their investing in companies which are presumed to have a positive environmental effect. This gives companies confirmation that their environmental effort is on the right track, and provides a positive signal within the company and to competitors and the industry as a whole. The report supports the existence of a positive impact.

The report from the Swedish Environmental Protection Agency also asserts that environmental funds' acquisition of shares in a company can spur demand for the company's shares. Even if this were true, it does not imply a reduction in the companies' cost of capital. A study<sup>5</sup> indicates that the effect on a company's cost of capital of being excluded from investors' portfolios is likely to be fairly small unless the company is excluded from a large portion, perhaps 20-30 per cent of the capital market. Thore Johnsen and Ole Gjølberg also reject the notion that capital costs are affected, cf Annex 11 to the report of the Graver Committee.

A study carried out for the OECD in 2003 by researcher Bjarne Ytterhus<sup>6</sup> at the Norwegian School of Management BI shows that managements in Norwegian companies do not perceive shareholders as an important factor of influence in the company's environmental effort. This finding tallies with previous surveys of Norwegian conditions by Ytterhus. It also tallies with similar surveys carried out under OECD auspices in France, Germany and Japan. PricewaterhouseCoopers' study from 2002 of companies based in the USA confirms this picture<sup>7</sup>. However, OECD surveys from the USA, Hungary and Canada show that business leaders view shareholders as a somewhat more important factor of influence. According to Ytterhus' study, governmental regulatory measures have the greatest impact on Norwegian companies' environmental effort. Moreover, the management of the company is stated to be an important driving force, along with orders issued by companies' head office, other employees, corporate customers (pressure along the value chain), the local environment, trade unions etc.

The Graver Committee reviewed the literature on SRI investments in Annex 5. They write that the literature seems

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<sup>5</sup> Swedish Environmental Protection Agency: Nordic Environmental Funds, 1999 ([www.naturvardsverket.se](http://www.naturvardsverket.se)).

<sup>6</sup> Bjarne Ytterhus (BI): "Environmental Policy Tools and Firm-level Management Practices, National report: Norway", 2003. Collaboration with the OECD Environment Directorate.

<sup>7</sup> PricewaterhouseCoopers LLP 2002 Sustainability Survey Report (can be downloaded from PWC Environmental Advisory Services' website at [www.pwcglobal.com/eas](http://www.pwcglobal.com/eas)).

"... to have been little concerned with whether various ethical guidelines for investments have in fact had any effect beyond the purely economic one. This could be due to many factors, not least the fact that there are methodological difficulties in distinguishing between SRI-related effects and other effects, and that it is difficult to quantify and measure such effects."

An article by Lloyd Kurtz from 2000<sup>8</sup> states that only a few studies exist of the effects of ethical investments. Extant studies appear to be predominantly concerned with economic consequences. EIRIS' studies also point out that even though there are some success stories, it is difficult to measure concrete effects of ethical investments. They also state that changes in companies' behaviour are generally a result of a variety of longer-term external influences and not of demands from individual investors.

#### *4.3.3.3 Summary*

The general impression is that the Environmental Fund had a favourable start-up effect in that EIRIS widened its analysis to take in global data and that FTSE4Good used EIRIS' environmental criteria in its index, but that the fund has otherwise had little or no environmental impact. Several observers nonetheless recommend that the Environmental Fund should continue, but with a sharper focus and greater publicity. Others consider that the Environmental Fund should be closed down if the Graver Committee's proposal for ethical guidelines is introduced for the entire Government Petroleum Fund since continuation of fund would not bring any added environmental gains.

Few studies exist of the environmental effects of this type of fund. It does seem reasonably clear, however, that companies' cost of capital is not affected by the existence of environmental funds. It may also be doubted whether companies perceive shareholders as an important factor of influence in their environmental effort.

#### **4.3.4 The ministry's assessment**

The Environmental Fund was an initial step in promoting ethical considerations in the management of the Government Petroleum Fund. The Storting's standing committee on financial affairs pointed out in 2001 that the fund was being established on a trial basis. If the Environmental Fund is to continue to operate, it should be on the basis of an assessment that this type of ethical investments has potentially favourable effects on the environment beyond the effects of the guidelines being drawn up against the background of the Graver Committee's study, see 4.2 in the present report. Any such positive effects must be weighed up against their costs.

The evaluation of the Environmental Fund points to three alternative solutions:

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<sup>8</sup> [www.srisstudies.org/essayh.html](http://www.srisstudies.org/essayh.html)



- wind-up of the Environmental Fund once ethical guidelines have been introduced for the entire Government Petroleum Fund,
- continuation of the fund along present lines or
- revision of the Environmental Fund's selection criteria such that significantly fewer are included in the fund, either by changing current criteria or by opting for another benchmark index for the fund.

The evaluation of the Environment Fund's financial performance shows marginally lower return and somewhat higher risk than a comparable portfolio devoid of environmental criteria. The Environmental Fund also carries higher administrative and transaction costs than the Government Petroleum Fund as a whole.

The ministry's assessment is that the Environmental Fund's environmental performance does not provide a basis for believing that continuation of the fund will provide an added environmental gain, now that ethical guidelines that include environmental considerations are to be introduced for the entire Government Petroleum Fund in keeping with the Graver Committee's recommendation. Few positive environmental effects can be adduced from the trial arrangement involving the Environmental Fund.

The ministry has noted the feedback on the fund's selection criteria. Most observers consider environmental reporting and environmental certification to be good indicators of companies' environmental effort. At the same time a warning is given against weaknesses: certification only indicates what companies say they intend to do, and poor companies can draw up good reports. It is pointed out that minimum requirements should be imposed on all companies: no company should be included merely because it is assumed to have little impact on the environment. The environmental organisations desire more radical changes in the investment strategy and a clear sharpening of the fund's profile.

Changes in the criteria for selecting companies can be considered as an alternative to the current Environmental Fund. A possible alternative would be to invest the current Environmental Fund on the basis of an index which selects companies based inter alia on social and/or environmental criteria. Several observers have pointed out that many companies devote considerable resources to qualifying for inclusion in ethical indices such as FTSE4Good and DJSI. On the other hand, it appears that both FTSE4Good and DJSI have already achieved the critical mass in terms of investments and attention that is needed for companies to put a premium on inclusion.

Norges Bank is the ministry's adviser on investment strategy issues. As part of the process of identifying the consequences of alternative solutions for the Environmental Fund, the Ministry of Finance asked Norges Bank by letter of 6 February 2004 for an assessment of the consequences of the three alternative solutions for the Environmental Fund. In its reply of 26 February 2004, which is enclosed with this report, Norges Bank states that recent research provides no clear-cut conclusion as to

what consequences enterprise screening on an environmental or ethical basis has for investors' financial return. Norges Bank writes inter alia:

"Norges Bank's evaluation of the Environmental Fund does not provide a basis for asserting that this fund will provide a consistent excess or deficit return compared with the Government Petroleum Fund's ordinary reference share portfolio. An alternative to a limited negative screening, as in the case of the Environmental Fund, is a clear-cut selection strategy in which only the supposedly best companies are included in the index based on defined criteria. The Ministry of Finance's letter mentions this as one of three alternatives. The Dow Jones Sustainability Index (DJSI) is an example of such a selection strategy. Several surveys exist of whether this index, or similar indices, have given investors a higher return which is directly due to the environmental focus, and not to distortions in portfolio composition which negative screening would entail. The conclusions of such surveys are somewhat contradictory. For example, in a report published in the autumn of 2003 the investment bank WestLB analysed the return on the European portion of the DJSI index in the period January 1999-August 2003, concluding that "sustainability pays off". The above-mentioned report from Gjølborg/Johnsen<sup>9</sup> presents a similar analysis of the data, but reaches a different conclusion.

Both the current Environmental fund and a screened index such as the DJSI contain sector weights and regional weights which diverge significantly both from FTSE World and from the Government Petroleum Fund's benchmark index. Such divergences are a normal result of negative screening, and will be of significance both for return and risk in screened funds. Other characteristics – such as the balance between large and midsized/small companies and between "growth" and "value" shares – would also be affected. A number of analyses of longer time series in equity markets conclude that such differences give rise to expected differences in return. Such differences, which cannot be related directly to the companies' ethical profile, must also be expected to dominate the differences in return between screened and unscreened indices in the future.

The fact that considerable uncertainty surrounds the extent to which positive screening on an ethical and/or environmental basis actually produces greater – or lesser – return in the short and long term is supported by the fact that Norges Bank has so far received very few suggestions regarding such management in response to announcements of external active equity-management mandates. Norges Bank has not imposed specific guidelines either for or against particular management techniques or strategies when announcing these mandates."

Norges Bank also states that the excess return in relation to the benchmark index that Norges Bank has so far achieved on its management of the Government Petroleum Fund cannot be generated by a separate portfolio such as the Environmental Fund.

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<sup>9</sup> Annex 11 to the Graver Committee's study

Since the Government Petroleum Fund was established, gross excess return on the equity portfolio has stood at 0.69 per cent per annum. Norges Bank writes:

"Ordinary management of the Government Petroleum Fund's share portfolio includes both active management and so-called extended indexing. The Environmental Fund is managed as a pure index product. In light of the purpose of such a portfolio, it is thought desirable to define the investment universe as equal to the companies included in the benchmark index, based either on the current reference or an external index. Narrowing down the investment universe impairs the opportunities for active management since it reduces the number of potential management positions. This pulls in the direction of low return."

Both the evaluation of the financial performance of the Environmental Fund in 4.3.3 and Norges Bank's assessments of the consequences of more extensive screening show that it is difficult to establish any clear-cut relationship between ethical criteria and financial return. Even so, the ministry's assessment is that some conclusions can be drawn as regards the financial consequences:

- Narrowing down the investment universe is likely to reduce the return achieved over and above index return. Since the Government Petroleum Fund was established, this excess return has stood at 0.69 per cent per annum.
- The Environmental Fund makes management of the Government Petroleum Fund more complex, which increase management costs. Total expenditure on external service providers for custody, settlement, accounts, return measurement and maintenance of the benchmark index between the establishment of the Environmental Fund and the end of October 2003 totalled NOK 5.3 million.
- The financial risk inherent in a portfolio rises when restrictions are imposed on companies that can be invested in, and the effect strengthens the tighter the screening requirements that are applied. This effect is not appreciable in the context of today's Environmental Fund, but it will become more significant given tighter restrictions.
- Assessing the risk inherent in a portfolio with a markedly narrower investment universe is likely to be more difficult. Losses in downturns and adjustment periods may exceed the potential excess returns in upturns or normal periods, cf the discussion at the end of section 4.3.3. One reason for this is that it is often the case that substantially larger disparities are observed in return between industries, countries and companies than in upturns or normal periods.

Based on purely financial considerations, the ministry believes against this background that extensive negative screening of companies based on environmental or other ethical considerations is not desirable.

Using an external index as the benchmark for a possible environmental portfolio may in the ministry's view create confusion as to the ethical guidelines for the Government Petroleum Fund. The Graver Committee emphasised that the fund's ethical guidelines should be grounded in an "overlapping consensus" in the Norwegian community. Reliance on external index providers and the assessments employed by the latter for selection of companies in accordance with ethical criteria would readily lead to reliance on ethical assessments other than those that the Norwegian authorities consider to be appropriate for the Government Petroleum Fund. There is also the risk of having to devote substantial resources to verifying and checking the consultancy firms' information base.

Norges Bank compares the FTSE4Good and the DJSI in its letter of 26 February:

"There are also wide differences in the composition of ethical indices. The two market-leading global indices that screen investment universes on the basis of the companies' level of social responsibility are the Dow Jones Sustainability Index (DJSI) and the FTSE4Good (F4g). The DJSI shows a stronger degree of positive selection ("best in class") than F4g. Sixty-four companies which the Dow Jones regards as leaders in the sector in terms of social, environmental and financial responsibility are not included in F4g, even though the latter index contains far more companies than the DJSI."

The ministry agrees that these factors argue against using an external index as the reference for an environmental portfolio. On the other hand it is also difficult for the ministry to establish separate, sound selection criteria for an environmental portfolio.

The ministry believes that having two sets of selection criteria – one for the Environmental Fund and one that will apply to the entire Government Petroleum Fund – will be problematic. Confusion and doubt will be cast on the ethical guidelines applying to the entire Government Petroleum Fund and weaken the chances of achieving results through the exercise of ownership rights. Norges Bank writes:

"Norges Bank believes that little purpose is served by formulating a separate ethical rationale for the management of a small portion of the Government Petroleum Fund now that a general ethical set of rules is to be established for the management of the entire fund. Such an arrangement would in Norges Bank's view be likely to sow doubt about the ethical guidelines that are to apply to the entire fund."

Norges Bank goes on to say:

"In the view of Norges Bank, active exercise of ownership over the entire fund is a more targeted instrument than a limited environmental portfolio when it comes to encouraging companies to be concerned with the relationship between social responsibility and maximisation of long-term shareholder values."

The ministry agrees with this view. Active exercise of ownership rights in the Government Petroleum Fund appears to be better instrument for inducing the companies in the fund's portfolio to take account of the relationship between social responsibility and maximising long-term shareholder values than can be achieved through a separate, limited environmental portfolio.

Based on an overall assessment, the Ministry of Finance has decided not to continue the trial arrangement involving a separate environmental fund as a sub-portfolio of the Government Petroleum Fund now that ethical guidelines that include environmental considerations are recommended for the entire fund. The ministry believes that general rules for the entire Government Petroleum Fund are the best solution both in terms of financial return and in terms of ethical management of the fund. Financial considerations argue against a separate environmental portfolio. Moreover, it is difficult to substantiate the view that continuation of the Environmental Fund will have a significant environmental impact.