California Public Employees' Retirement System

California Public Divest from Sudan Act
Annual Legislative Report

December 31, 2012

California Public Employees' Retirement System
Sudan Act - Annual Legislative Report
December 31, 2012

Table of Contents

Executive Summary

1. This Legislative Report sets out CalPERS implementation of the Sudan Act during 2012. The Sudan Act requires the identification, notification, determination, and divestment of investments in companies engaged in specified business operations in Sudan, subject to CalPERS overriding fiduciary duty, and finally the liquidation of any investments in such companies.

2. Since the 2011 Legislative Report was filed, CalPERS has continued to actively monitor companies as required by the Sudan Act and tracked progress towards portfolio companies withdrawing from Sudan.

3. Since the enactment of the Sudan Act, CalPERS divested from three companies operating in Sudan that failed to take substantial action as defined by the Sudan Act, and consistent with standards of materiality and fiduciary duty: Dongfeng Motor Group, El Sewedy Cables, Mangalore Refinery & Petrochemicals Ltd. New investments in these companies have been blocked as well.

   No divestment considered CalPERS in 2012.

4. CalPERS will continue to identify companies potentially subject to the Sudan Act, to notify them of the law's provisions, and call for their withdrawal from the country unless continued business activity is warranted on humanitarian grounds.

Introduction

This sixth report to the Legislature is provided by the California Public Employees' Retirement System (CalPERS) under the requirements of AB 2941 (Chapter 442), Government Code section 7513.6, commonly known as the Sudan Act.

CalPERS is the largest public pension plan in the United States, responsible for over $240 billion in global assets, which are invested to provide retirement and health benefits for over 1.6 million Californians. The CalPERS Board has sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits to its participants and their beneficiaries. The assets of the system are trust funds that must be held for the exclusive purposes of providing benefits to participants in the retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

Implementation of the Sudan Act

CalPERS has implemented the requirements of the Sudan Act throughout the reporting period and from the time the legislation became effective, January 1, 2007.

This report charts significant progress towards meeting the objectives of the Sudan Act, which are to ensure that companies curtail or cease business operations in the country, unless the companies are exempt on humanitarian grounds. The details are set out in the tables which follow.

The CalPERS Board issued a Position Statement in May 2006 which supports the Sudan Act which followed, stating that "companies that do business in Sudan may thereby be unwittingly furthering or condoning the egregious human rights violations that are occurring" and signaled its intention to engage with companies on the issue.

CalPERS continues to track events in Sudan. The 2005 Sudanese Comprehensive Peace Agreement (CPA) provided Southern Sudan a choice to continue within one country or to separate. In January 2011, the people of Sudan overwhelmingly voted for separation. On July 9, 2011, with the recognition of the Government of Sudan, the Republic of South Sudan was declared independent. The independence of South Sudan brings opportunities and challenges in the future as both countries pursue their relationship with each other and the international community.

Following the Republic of South Sudan's declaration of independence, the United Nations General Assembly admitted South Sudan as its 193rd member. On July 9, 2011, the United States announced its formal recognition of the Republic of South Sudan as a sovereign and independent state, and began to establish full diplomatic relations with the country.

In the year since South Sudan became an independent country, conflict between the two states has continued while negotiations take place on the unresolved issues. In April 2012, tensions between Sudan and South Sudan escalated when the South's army occupied the oil producing region of Heglig (an oil field that sits on the North-South border in Kordofan state), and Sudan responded with increased aerial bombardment in the South. The South eventually left Heglig and Sudan claims to have restarted production.

In late September 2012, with increasing pressure from the United States, the African Union, and the United Nations, the presidents of Sudan and South Sudan signed a cooperation agreement on security, oil, financial, nationality, and trade issues. United States Secretary Clinton, applauded the agreements between the two states stating, "this is a critical step towards the peaceful resolution of the outstanding issues and towards fostering a new peace, greater stability and development, and a new economic partnerships."

Requirements of the Sudan Act

The Sudan Act sets out a number of requirements, as follows:

The legislation requires that CalPERS identify companies with business operations in Sudan, as defined in the Sudan Act, or that provide revenue to the government of Sudan.

Under the Sudan Act, a company has business operations in Sudan if the company meets the following criteria:

1. The company is engaged in active business operations in Sudan. If that company is not engaged in oil-related activities, that company also lacks significant business operations in eastern, southern, and western regions of Sudan.

2. The company (A) is engaged in oil-related activities or energy or power-related operations, or contracts with another company with business operations in the oil, energy, and power sectors of Sudan, and the company failed to take substantial action related to the government of Sudan because of the Darfur genocide, or (B) the company had demonstrated complicity in the Darfur genocide, or (C) the company supplies military equipment within the borders of Sudan.

"Business operations" is defined in the Sudan Act to mean "maintaining, selling, or leasing equipment, facilities, personnel, or any other apparatus of business or commerce in Sudan, including the ownership or possession of real or personal property located in Sudan."

- **Identification**

The process for researching and identifying the companies that have business operations in Sudan has been developed with care and attention to detail. For this report, CalPERS utilized external third party resources including the Principles for Responsible Investment (PRI) Sudan Engagement Group for the initial identification of companies subject to the Sudan Act.

In addition, CalPERS continues to participate in the UN Leaders Summit, which has developed a resource for companies and investors entitled “Guidance on Responsible Business in Conflict-Affected and High-Risk Areas” which will further inform engagement with companies operating in Sudan and South Sudan.

- **Notification**

Once identified, CalPERS has provided timely and full notification to each company, setting out the provisions of the Sudan Act, and seeking a substantial response which can be properly assessed.

To ensure the highest level of engagement, letters have been couriered to the most senior board member of each company, for example, the Chairman, CEO or President. The critical provisions are those in the Sudan Act that relate to exemption through boycotting the government, curtailing business, and selling company assets, equipment and property. CalPERS has also carefully considered petitions for exclusion on grounds of humanitarian activity and ensured that the intention of the Act has been firmly applied.

Staff actively pursue a substantive response to these corporate engagements, for example by identifying parent companies where decisions will be made, and if need be, making use of translating services to ensure clear communication.

- **Determination**

Following the communication with identified companies, staff makes a determination of their status under the Sudan Act. The companies’ responses are analyzed by CalPERS staff to determine the applicability of the Sudan Act’s provisions. Where company activity is deemed to be subject to the Sudan Act, the determination includes an assessment of whether the company is taking substantial action to withdraw, or making substantial progress towards this. An additional consideration is whether a company is exempt on humanitarian grounds.

In its commitment to fulfill the provisions of the Sudan Act, CalPERS has worked diligently as an individual investor and collaboratively with CalSTRS.

- **Divestment Policy**

The CalPERS Investment Committee has adopted a policy on the topic of divestment. This policy builds on the concepts of fiduciary duty and some of the possible implications of divestment on these responsibilities. The policy defines instances when CalPERS will undertake divestment as follows:

1. CalPERS will sell targeted company investments or refrain from making them to the extent investment in the targeted company is imprudent and inconsistent with fiduciary duty.

2. CalPERS will comply with federal laws requiring divesting, if any.

3. To the extent required by law and consistent with fiduciary duty, CalPERS will comply with constitutional California state laws that require divesting.

- **Fiduciary analysis**

The Sudan Act requires that CalPERS divest its shares in those companies that have not provided evidence of exemption from the Sudan Act's provision, within 90 days of being notified. However, the Sudan Act specifies that this does not "require the board to take action as described…unless the board determines, in good faith, that the action…is consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution." (Gov Code §7513.7(k).)

Hence, the Sudan Act requires that divestment be consistent with the California Constitution which determines that the board of CalPERS take action with a singular focus on the purpose of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system.

- **Liquidation**

The Sudan Act requires the sale of any investments in companies subject to divestment within an 18 month time period from the point of such determination. CalPERS has completed liquidation of three companies subject to the Sudan Act in 2011.

The Sudan Act has specific reporting requirements, which are addressed as follows.

Reporting Requirement of Section 7513.6(i)(3) – Whether the Board has Reduced its Investments in any Companies Described in Section 7513.6(b) or (c) ("Covered Companies")

CalPERS has fully divested from three companies which continue to have business activities in Sudan and were unresponsive to CalPERS engagement: Dongfeng Motor Group, El Sewedy Cables, Mangalore Refinery & Petrochemicals Ltd. New investments in these companies have been blocked as well.

The decision to divest and block these investments was presented to the CalPERS Investment Committee for approval May 16, 2011, following a detailed process by staff to identify, engage, and analyze companies in compliance with the Sudan Act.

Progress on Company Withdrawal from Sudan

The table that follows sets forth CalPERS current holdings in the non-US companies that have been identified as potentially having business operations in Sudan, as defined by the legislation.

The progress on company withdrawal from Sudan or exemption from the Sudan Act is as follows:

1. (Table 1) 9 Companies Being Monitored by CalPERS.

2. (Table 2) 3 Companies Divested by CalPERS Pursuant to the Act.

Conclusion

CalPERS continues to diligently implement the requirements of the Sudan Act. Through this process CalPERS has tracked significant progress in company withdrawal and reduction of activity in Sudan. In part, this reflects the growing geo-political risk in the country, but it also demonstrates a positive response to active shareowner engagement and economic sanctions. CalPERS will continue to identify, notify, and make a determination to divest and liquidate investments in companies engaged in specified business operations in Sudan, subject to materiality and CalPERS overriding fiduciary duty.

It is clear that the situation is changing rapidly; however, CalPERS will ensure its commitment to diligent compliance with this legislation, that the Board is kept fully apprised of developments, and that staff are positioned to review our response as required.

TABLE 1: 9 Companies Being Monitored by CalPERS				
Company Name (Domicile)	***Summary of Ties to Sudan***	***Summary of Changes From 2011***	***Shares Held by CalPERS 10/31/2012***	***Market Value ($) of Shares Held by CalPERS 10/31/2012***
Bharat Heavy Electrical Limited (India)	Bharat Heavy Electricals Limited (BHEL) is an India-based power and energy company, 67.7 percent owned by the Indian government. The company's first businesses in Sudan were in the transport industry, providing Sudan Railways with eight mainland locomotives in 2005 and exporting locomotive parts in 2006. The company's subsequent and current operations in Sudan have been power-related. BHEL confirmed for MSCI Group in December 2007 that it was developing a 500-megawatt power plant in Kotsi, Sudan, which is scheduled to supply power to the whole of Sudan. It declined to provide further details on its activities in Sudan. However, Africa Energy Intelligence reported on April 2, 2008, that the cost of the project will be USD $457 million.	CalPERS has no current investment position in Bharat Heavy Electrical Ltd.	0	0
JX Holdings (India)	JX Holdings is the result of a merger between Nippon Oil Corporation and Nippon Mining Holdings. Nippon Oil Corp had previous involvement in Sudan which has been attributed to the new entity. Nippon Oil purchases Sudanese crude oil primarily because of the quality and environmental requirements of the company's clientele. In the 2008 annual report the Company explained, "Nippon Oil's purchases of Sudanese crude oil are made through international traders and other entities: the Company has never entered into direct contracts with the Sudanese government or Sudan's State-owned oil company. Similarly, we have no exploration or production rights or facilities in Sudan, and have no intention of acquiring any such rights in the foreseeable future."	CalPERS initiated engagement with JX Holdings in November, 2011. In correspondence with JX Holdings, dated February 15, 2012, the Company confirmed it does not have any offices or mineral exploration or production rights or facilities, or other assets or concessions that could generate revenue in the Republic of Sudan and has no intentions of doing so in the future. CalPERS has concluded that the Company is not subject to the divestment provisions of the Sudan Act.	7,835,700	$41,663,611
KunLun Energy Company (Formerly CNPC Hong Kong) (Hong Kong)	According to its website and public filings, Kunlun Energy (formerly CNPC (Hong Kong) Ltd.) is a publicly traded subsidiary of the state-owned China National Petroleum Corp. (CNPC), which holds a 52.7 percent interest in Kunlun Energy. The Associated Press reported on July 2, 2007 that CNPC signed a 20-year contract in June 2007 for Block 13 in northern Sudan under which it entered into a six-year phase for offshore oil drilling exploration and a 20-year concession for shared oil production.	CalPERS has no current investment position in KunLun Energy Company	0	0

TABLE 1: 9 Companies Being Monitored by CalPERS				
Company Name (Domicile)	***Summary of Ties to Sudan***	***Summary of Changes From 2011***	***Shares Held by CalPERS 10/31/2012***	***Market Value ($) of Shares Held by CalPERS 10/31/2012***
	China Energy Weekly reported on July 14, 2006, that CNPC had completed an upgrade of the largest oil refinery in Khartoum. The article also reported that CNPC holds a 40 percent stake in the Greater Nile Consortium, which produces 330,000 barrels of oil per day from three oil blocks in Sudan. CNPC also owns a 42 percent stake in two blocks in Malut. In addition, CNPC is investing in an oil terminal on Sudan's Red Sea coast and runs a pipeline connecting the Khartoum refinery with the Fula Oilfield, according to the article.			
MISC Berhad (Malaysia)	MISC Berhad is the leading international shipping line of Malaysia. MISC Berhad operates a fleet of over 100 vessels, specializing in the shipping of energy products such as liquefied natural gas and petroleum (Company Website). MISC has a joint venture which provides shipping services to Sudan.	CalPERS has no current investment position in MISC Berhad.	0	0
Oil & Natural Gas Company (India)	As of January 2011, it is reported that ONGC has assets in both North and South Sudan.	CalPERS has no current investment position in ONGC.	0	0
PECD Bhd. (Malaysia)	As of August 2011, PECD Berhad, an investment holding company, provides engineering, procurement, construction, and commissioning (EPCC) services. The company has operations in Malaysia, the United Arab Emirates, the Islamic Republic of Iran, the Republic of Indonesia, the Sultanate of Oman, and the Republic of Sudan.	CalPERS has no current investment position in PECD Berhad.	0	0
PetroChina (China)	PetroChina is reported to have no operations in Sudan. However, the relationship between PetroChina and CNPC has resulted in significant scrutiny being placed on the role PetroChina could play in CNPC's operations in Sudan.. Management at CNPC and PetroChina almost completely overlap and frequent asset transfers between the two entities, which often take place at subsidized rates, have made CNPC completely reliant on PetroChina for its financial health.	CalPERS has no current investment position in PetroChina.	0	0
Petronas (Malaysia)	According to the company's 2010 annual report, Petronas operates in Sudan through its wholly owned subsidiary, Petronas	CalPERS has no current investment position in Petronas.	0	0

TABLE 1: 9 Companies Being Monitored by CalPERS				
Company Name (Domicile)	***Summary of Ties to Sudan***	***Summary of Changes From 2011***	***Shares Held by CalPERS 10/31/2012***	***Market Value ($) of Shares Held by CalPERS 10/31/2012***
	Marketing Sudan Limited (PMSL). The company is involved in marketing and retailing petroleum products and lubricants in Sudan. Petronas through its subsidiary PMSL operates retail stores in Sudan. According to the 2010 annual report, the company expanded its retail network to 78 service stations. Furthermore, the company is engaged in marketing and retailing lubricants. PSML also provides into-plane fueling service at the Khartoum International Airport and the El-Obeid International Airport. In 2010, the company disclosed that it has started production in Sudan's block 3 & 7 of Nahal Base oil field. Reuters also reported in September 2010 that Petronas is working with Sudan's stated owned company National Petroleum Company to boost oil recovery in 2020 by one billion barrels. Reuters also added that Petronas holds a 77 percent stake in block 8 of Northern Sudan, which has a potential gas reserves of a trillion cubic feet.			
Sudan Telecom (Sudan)	Sudatel is a telecommunications and Internet service provider in the Sudan. The company is responsible for the construction and maintenance of Sudan's telecom infrastructure. Sudatel is more than 60% owned by the Sudanese government; the remainder being owned by private interests.	CalPERS has no current investment position in Sudan Telecom.	0	0
		Category Total:	**7,835,700**	**$41,663,611**

TABLE 2: 3 Companies Divested by CalPERS Pursuant to the Act				
Company Name (Domicile)	***Summary of Ties to Sudan***	***Summary of Changes From 2011***	***Shares Held by CalPERS 10/31/2012***	***Market Value ($) of Shares Held by CalPERS 10/31/2012***
Dongfeng Motor Group Company Ltd. (Hong Kong)	Dongfeng Motor Group includes DongFeng Automobile Co., an automobile manufacturer, whose military division is under investigation for violating the United Nations arms embargo against Sudan. In 2006, the United Nations Panel of Experts monitoring the Darfur arms embargo reported that it saw a shipment of green military trucks at Port Sudan in August 2005. It said that similar trucks were later seen on the grounds of the Sudanese Air Force in Darfur in October 2006. The panel commenced an investigation, which found that the Ministry of Finance and National Economy of Sudan had purchased 222 vehicles-212 military trucks of model EQ2100E6D and 10 chassis of model EQ1093F6D-from Dongfeng on behalf of the Ministry of Defense. Following the release of the report, Dongfeng failed to answer directly any inquiries regarding its sale of military vehicles to Sudan. In December 2007, Dongfeng Motor Group confirmed for MSCI that it sells products to customers in Sudan, but it said that it does not have any equity interest in companies there. It added that it supplied trucks to the Khartoum government under a contract approved by the Chinese government. On July 14, 2008, a BBC investigative program found Dongfeng Automobile Co's (a DongFeng Motor's subsidiary) military vehicles, whose plates and markings showed a post-embargo manufacture date, in the possession of a Darfur rebel group that had reportedly captured them from the Sudanese Armed Forces. Its markings, captured on film, show the truck was exported by China to Sudan in 2005, after the United Nations banned the transfer of military goods to Darfur. Aside from documenting the presence of these vehicles, witnesses confirmed that they had seen them used during a December 2007 attack on Sirba town in West Darfur. In a press release issued on November 18, 2008, the UN panel of experts denounced that the Sudanese government and rebel groups in Darfur have continuously and flagrantly violated the arms embargo from September 2007 to September 2008. The panel's report included photos of equipment	In May 2011, the CalPERS Investment Committee approved divestment of shares in companies which continued to have activities in Sudan and was unresponsive to our engagement.	0	0

TABLE 2: 3 Companies Divested by CalPERS Pursuant to the Act				
Company Name (Domicile)	***Summary of Ties to Sudan***	***Summary of Changes From 2011***	***Shares Held by CalPERS 10/31/2012***	***Market Value ($) of Shares Held by CalPERS 10/31/2012***
	reportedly from the Sudanese government that was manufactured after the 2005 embargo, including a Dongfeng Automobile military truck and 120 mm mortars and post-embargo ammunition found in the hands of the rebel Justice and Equality Movement.			
El-Sewedy Electric Co. (Egypt)	El-Sewedy Cables provides significant support to Sudan's electricity generating infrastructure. The company owns and operates a plant in Sudan that produces power transmission cables.	In May 2011, the CalPERS Investment Committee approved divestment of shares in companies which continued to have activities in Sudan and was unresponsive to our engagement.	0	0
Mangalore Refinery & Petrochemical Ltd. (India)	Mangalore Refinery is a majority-owned publicly traded subsidiary of the Indian Oil & Natural Gas Corporation Ltd (ONGC). According to international news sources, Mangalore Refinery itself is involved in oil-related projects in Sudan. According to Reuters in 2007, and the United News of India reported on Oct. 28, 2008, the company refined crude oil from Sudan that is exported to India. In total, the oil processed by Mangalore Refining makes up 15 percent of the total oil produced by ONGC in Sudan.	In May 2011, the CalPERS Investment Committee approved divestment of shares in companies which continued to have activities in Sudan and was unresponsive to our engagement.	0	0
		Category Total:	**0**	**$0**

Appendix A:

Definitions

"**Active business operations**" – A company engaged in business operations that provide revenue to the government of Sudan or a company engaged in oil-related activities.

"**Authorized business operations**" – A United States company that is authorized by the federal government to have business operations in Sudan.

"**Board**" – The Board of Administration of the Public Employees' Retirement System or the Teachers' Retirement Board of the State Teachers' Retirement System, as applicable.

"**Business operations**" – Maintaining, selling, or leasing equipment, facilities, personnel, or any other apparatus of business or commerce in Sudan, including the ownership or possession of real or personal property located in Sudan.

"**Oil-related activities**" – The export of oil, extracting or producing oil, exploration for oil, or the construction or maintenance of a pipeline, refinery, or other oil field infrastructure.

"**Research firm**" – A reputable, neutral third-party research firm.

"**Substantial action**" – A boycott of the government of Sudan, curtailing business in Sudan or selling company assets, equipment or real and personal property located in Sudan, or undertaking significant humanitarian efforts in the eastern, southern, or western regions of Sudan.

Appendix B:

Requirements of the Sudan Act

The implementation steps and requirements specified within the Sudan Act are:

1. Contracting with a research firm to identify companies that have business operations in Sudan.

2. Identification by the research firm by March 30, 2007 of companies with activities in the specified areas of oil-related, energy, power-related business that have not taken substantial action, or, companies that supply military equipment within the Sudan.

3. The board shall contact other institutional investors that invest in companies with business operations in Sudan.

4. By March 30, 2007 the board shall determine if the companies identified meet the criteria of the Sudan Act and should such companies be contained in external, actively managed commingled funds, request the managers of those funds remove the companies or create a fund or account devoid of those companies by June 30, 2007.

5. Notification to such companies that their activities may make them subject to divestment unless they take “substantial action” within 90 days.

6. Determine which companies have not taken substantial action or made significant progress toward substantial action within the time period.

7. Monitor and review companies in 90 day increments regarding their making sufficient progress toward “substantial action”.

8. Determining that a company that is not taking or making significant progress toward substantial action in any 90 day period is subject to “divestment” and making no further investments into such company.

9. Fiduciary analysis to determine that actions to be taken are consistent with the boards’ fiduciary responsibilities as established in the “California Constitution, article 16, section 17”.

10. Liquidation within 18 months of investments determined to be subject to “divestment”.

11. Report annually to the California Legislature regarding the status of CalPERS compliance with the Sudan Act.

Appendix C:

CalPERS Divestment Determination Process

Staff implements the following process to determine the costs and values of divestment under Government Code Section 7513.6:

A. Firms Involved: Obtain list of companies considered for divestment.

B. Approximate Value: Determine the market value of CalPERS holdings in each individual company as well as the approximate total value of the list of companies considered for divestment.

C. Divestment Determination Steps:

   1. Determine the company has failed to complete, or has failed to make sufficient progress towards substantial action within the time specified by statute.

   2. Estimate the trading costs and price impact using an applicable trading cost model, and estimate how long it would take to sell the securities after the decision to divest.

   3. Use a portfolio construction process and simulate reinvestment of the proceeds of the sales of divested securities, aiming at a minimal expected performance impact on the appropriate asset class portfolio.

   4. Estimate the execution costs of the reinvestment trade list, using the appropriate trading cost model.

   5. Use the new expected performance impact estimate (from No. 3 above) to calculate the performance at risk (PAR) resulting from divestment.

   6. Include any expected loss-of-opportunity performance impact with the costs of divestment.

   7. Calculate the costs and values as determined above.

   8. Gather and analyze all additional facts that could be relevant to a divestment decision.

   9. Review with Fiduciary Counsel and General Pension Consultant, and prepare a recommendation to the Board: either in favor of divestment, or in favor of a Section 7513.6(k) determination.

   10. Submit the recommendation to the Investment Committee.

   11. If the decision is to divest, isolate the affected securities and immediately notify all appropriate managers to cease purchasing the identified entity’s securities.