



Investment Committee

California Public Employees' Retirement System

Agenda Item 9b

December 15, 2014

ITEM NAME: Responsible Contractor Program Policy Review Update

PROGRAM: Targeted Investment Programs

ITEM TYPE: Program Review – Information

EXECUTIVE SUMMARY

In the fall of 2013, staff initiated a review of the Responsible Contractor Program (RCP) and Neutrality Trial RCP Policies (Policies) to understand the effectiveness and possible impact of the Policies on CalPERS' investments. The review process has included round table discussions, interviews, and conversations with labor representatives, managers, and internal stakeholders, requests for written comment, and a survey of managers that are responsible for complying with the Policies. Staff has committed significant resources to the review and to working with managers and labor representatives to implement the Policies.

This item is intended to provide the Investment Committee with an update on the review process, and seek input on staff's preliminary recommendations. With input from the Investment Committee, staff will continue to engage with managers and labor representatives to bring draft revisions of the Policies to the Investment Committee in March 2015. If needed, staff will return to the Investment Committee in June 2015 for final approval.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability through actively managing business risks.

This agenda item supports CalPERS' Investment Belief 4 to create long-term value through effective management of financial, physical, and human capital. Effective management of human capital increases the likelihood that companies will perform over the long-term and manage risk effectively. This agenda item also supports Investment Belief 3 in which CalPERS' investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.

BACKGROUND

The CalPERS RCP Policy was established in 1994. Since inception it has been revised several times, most recently, in a policy review and revision process initiated in 2009 and ending in 2012. This process resulted in the establishment of the first

ever Neutrality Trial Program (NTP) in 2010, as well as comprehensive revisions to the RCP Policy that were approved by the Investment Committee in February 2012. The revised Policies established specific requirements related to neutrality, clarified and strengthened bidding notification, compliance and enforcement requirements, and significantly increased manager roles and responsibilities including making managers responsible for contractor compliance with the Policies.

In December 2013 staff presented the first annual reports to the Investment Committee under the revised RCP Policy. In response to issues raised by labor representatives, the Investment Committee requested staff initiate a policy review to determine if additional revisions to the Policies were necessary. This twelve-month process has required significant staff and consultant time and resources.

The policy review process began with a series of dialogues with labor representatives and external managers on the revised Policies. Staff held round table conversations with labor representatives and managers to discuss the issues raised by labor representatives and hear managers' views on the Policies. Staff also engaged with labor representatives and managers in individual conversations to discuss issues of concern. In general, labor representatives proposed a series of heightened policy requirements related to neutrality, bidding notification, compliance, and enforcement.

In order to receive consistent feedback from managers on the suggested policy revisions from the labor representatives, all Core and select non-core Real Estate and Infrastructure managers were surveyed anonymously on the current Policies and labor representatives suggestions. Through written comments, verbal conversations, and survey responses, managers have indicated which suggested revisions would have little or no impacts, and which would have more significant impact on cost or their ability to compete in the marketplace.

To understand current institutional investor practices, staff asked the Board's Real Estate Investment Consultant, Pension Consulting Alliance (PCA), to perform a survey (Attachments 1 and 2) on the RCP policies of CalPERS' peers. Peers were defined as the largest U.S. defined benefit public pension plans by assets under management (AUM). Eleven peer plans were identified ranging from \$77 billion to \$181 billion in AUM. The purpose of the survey was to compare CalPERS' Policies to peers' policies and analyze key similarities and differences. RCP policies are still not mainstream as the survey found only four of CalPERS' peers have an RCP Policy.

CalPERS has a deep interest in the condition of workers employed by CalPERS and its managers and contractors, subject to fiduciary duty. Investment Office staff in consultation with CalPERS' Legal Office staff, the Board's fiduciary counsel, and PCA have carefully weighed these goals and responsibilities in crafting all policy recommendations.

This agenda item outlines:

- Policy revisions requested by labor representatives,
- Managers input on suggested revisions, and
- Staff's preliminary recommendations

Staff's recommendations fall into three categories: 1) suggested policy revisions; 2) areas where additional time and work is needed to finalize any recommended policy changes; and 3) policy revisions that are not recommended by staff. The proposed revisions and resulting staff recommendations are outlined below starting with the Neutrality Trial RCP Policy, followed by the RCP Policy.

ANALYSIS

Neutrality Trial Responsible Contractor Program Policy

The Neutrality Trial RCP Policy was established in 2010 to determine whether to modify the RCP Policy to require neutrality on certain service contracts.¹ The purpose of the NTP is to gather data on the investment impact, if any, of requiring neutrality with respect to employee union organizing efforts. Specifically, the NTP requires Core Real Estate program managers, contractors, and subcontractors to remain neutral during legal organizing efforts on building service (e.g., janitorial, security, window washing, or food service) contracts of \$100,000 or more.² The Neutrality Trial RCP Policy also encourages manager neutrality on non-service contracts.

Between 2010 and 2013, there was no unionizing activity, nor much contract activity, under the trial policy largely due to the economic downturn. To allow additional information to be collected the NTP was extended twice, resulting in a current expiration date of June 2015.

Managers and contractors subject to the Neutrality Trial RCP Policy file quarterly reports on the impact of the neutrality requirement. As of June 30, 2014, managers had reported the following during the NTP:

- An average of approximately 60 contracts per year totaling \$20 million met the program criteria
- One contract³ for \$122,000 has required an exception to the NTP
- One organizing event occurred in 2014 during the trial period. The manager and all contractors remained neutral during the organizing process

¹ The Neutrality Trial RCP Program Policy can be accessed at: <http://www.calpers.ca.gov/eip-docs/investments/policies/inv-asset-classes/real-estate/neut-trial-resp-cont-prog.pdf>

² The Responsible Contractor Program Policy continues to apply to non-core managers.

³ This contract for snow removal at a secure airport site was reported to the IC in August 2011.

- Managers have noted some initial cost to implement the program, but have consistently reported that the NTP has not resulted in any measureable compliance cost to them or CalPERS
- Two managers reported benefits to the NTP; one commenting on a larger pool of qualified responsible contractors, the other on better service by a new responsible contractor

The following are Neutrality Trial RCP Policy revisions suggested by labor representatives and staff's recommended response. In several instances, suggested revisions apply to both Policies and are addressed as such in staff's recommendations.

Recommended Revisions to the Neutrality Trial Program

➤ *Incorporate the NTP into the RCP*

There has not been robust organizing activity during the trial period. However, based on input received from managers indicating the NTP has not had significant impact on competition or cost, staff recommends that the NTP provisions, as currently written, be incorporated into the RCP Policy. Key elements of the current NTP include:

- CalPERS, Core managers, contractors and subcontractors are required to remain neutral in the event of an attempt to organize workers
- Neutrality provisions apply to service contracts over \$100,000
- Professional services and construction contracts are exempt
- Managers may grant themselves exemptions under certain circumstances outlined under the Policy
- All exemptions must be reported to CalPERS' staff within specified period of time

Recommend Additional Exploration

➤ *Extend the Neutrality Trial RCP Policy to non-core real estate managers*

In order to determine the impacts, if any, of requiring neutrality for nine non-core real estate managers and their assets, staff recommends exploring the development and implementation of a new NTP mandating neutrality of non-core managers, their contractors and subcontractors regarding service contracts. Key elements of a new non-core NTP would be likely to include:

- The non-core NTP would apply to all assets acquired after the program becomes effective July 1, 2015
- The non-core NTP would not apply to existing assets unless managers volunteer to make them subject to the program

Revisions Not Recommended by Staff

➤ *Expand the NTP to include construction contracts*

Managers state that construction contracts (usually, tenant improvements and alterations) are time critical in order to compete to purchase, lease, manage, and sell assets in the marketplace today. Managers do not believe contractors would be willing to agree to NTP provisions for construction contracts that by their nature are limited and short term. Managers unanimously state that mandating neutrality on construction contracts would increase costs and severely limit the number of responsible contractors that would be willing to bid on projects. Based upon our prior experience with these managers, we believe their concerns are credible.

Because the suggested revision would impact costs and managers ability to compete in the marketplace, staff does not recommend incorporating this revision into the policy.

➤ *Expand the NTP to include housing managers*

Housing managers are exempt from the Policies, and are asked to voluntarily report their efforts under the spirit of the language of the RCP Policy. Housing managers have volunteered to comply, and have provided information on their contracting efforts that have been included in annual reports to the Investment Committee.

In light of housing manager's exemption from the Policies, and their positive engagement and willingness to voluntarily comply, staff is concerned that requiring heightened neutrality provisions on housing managers would be difficult to administer and may result in managers ceasing their voluntary compliance with the RCP Policy. Therefore, staff does not recommend making the requested revision.

➤ *Expand the NTP to require labor peace and project labor agreements*

Managers have entered into labor peace and project labor agreements in limited circumstances when bidding assets of a certain type and size located in markets where union representation is the norm. However, managers have voiced significant concerns over mandating labor agreements due to changing market conditions, increased costs, and the potential for significant impact on their ability to compete in the marketplace.

The Neutrality Trial RCP Policy is supportive of wages, benefits and training based on local market conditions. The Neutrality Trial RCP Policy references support for many of the ideals espoused by unions. However the Policies have historically been focused on hiring responsible contractors and have not required union labor agreements. To require labor peace and project labor agreements effectively changes the Policies to require union labor. This would be a significant change in the long-established intent of the Policies. In light of the impacts on cost and competition, as well as the change of overall intent of the Policies that would result, staff does not recommend the proposed change.

Responsible Contractor Program Policy

Similar to the Neutrality Trial RCP Policy, staff received several suggestions from labor representatives for revisions to the RCP Policy.⁴ In several instances, suggested revisions apply to both Policies. The following are staff's recommendations for revisions, additional exploration, and revisions that are not recommended.

Recommended Revisions to the RCP Policy

- *Amend the RCP to include a table of contents*

Staff agrees and will create a table of contents for ease of use in both Policies.

- *Amend the RCP to reference the Investment Beliefs*

Staff agrees and will reference the CalPERS Investment Beliefs in Section 1 in both Policies.

Recommend Additional Exploration

- *Revise the RCP to require managers to provide quarterly reports on RCP assets, contracts that have been let, and bidding and notification*

Staff recommends reviewing what managers are currently required to report and determine if any revisions are appropriate that would improve administration and compliance with the RCP Policy.

- *Revise the Certification of Responsible Contractor Status (Appendix 1 of the Policies) to match similar questionnaires used in public contracting for governmental assets*

While the incorporation of the lengthy (15 page) public contracting questionnaire is not anticipated, staff recommends additional exploration to determine if there are appropriate improvements to the Certification to assist in the determination of responsible contractor status.

- *Amend the RCP to require 30-day notice on bidding general contracts*

Staff does not recommend requiring 30-day notice on bidding general contracts. However, staff recommends additional review of Policy language to establish or clarify any requirements related to general contracting.

Suggestions that are Not Recommended by Staff

- *Expand the RCP Policy to include all private asset classes.*

Since its inception, the RCP Policy has addressed real assets. The Policy would require significant revision to be relevant to other asset classes. Also, the inclusion of

⁴ The Responsible Contractor Program Policy can be accessed at: <http://www.calpers.ca.gov/eip-docs/investments/policies/inv-asset-classes/real-estate/responsible-contractor.pdf>

private equity would be very problematic due to CalPERS' minority and limited partner status in almost all private equity investments.

Expansion into other asset classes would require the same level of due diligence and evaluation of impact on each of those asset classes as the Investment Committee and staff pursued with real estate assets, to determine if there were any adverse impacts and risks on investment costs, investment returns, competitiveness of our managers and investment opportunities available to CalPERS. Because of the practical difficulties related to creating a relevant RCP in private asset classes, and the existence of the Investment Beliefs that provide the basis for engagement on labor issues across the total fund, staff does not recommend the suggested Policy revision.

- *Amend the Policies to require a uniform or random audit of compliance with the Policies*

Managers unanimously expressed concern over the establishment of an audit process. Managers state that a process to verify the payment of fair wages and benefits would be burdensome, costly, and would significantly reduce the number of responsible contractors willing to bid on RCP contracts.

The RCP Policy revision process that was approved by the Investment Committee in 2012 significantly increased managers' responsibilities including assuring their compliance and their contractors' compliance with the Policy. The 2012 RCP Policy revisions heightened enforcement language such that any manager found to have a pattern on non-compliance with the Policy may be terminated.

In light of increased costs, reducing the number of responsible contractors willing to bid on CalPERS' assets, and the current strong policy language related to compliance and enforcement, staff does not recommend incorporating the suggested revision to the RCP Policy.

- *Amend the Policies to include strong penalties if managers or contractors do not give 30-day notice for bidding on any contracts*

A requirement for 30-day bidding notice was raised and considered during the 2012 policy revision process. At that time, managers expressed concern that 30-day bidding notice was well outside the competitive marketplace. Managers gave examples of instances where contracts must be let in short time frames to meet leasing and other agreements without triggering liquidated damages and other penalties that are typical in the marketplace today.

As a result, aspirational language was added to the RCP Policy that states: "If appropriate under the circumstances, Managers and Delegates shall use a 30-day pre-bid notification procedure to maximize Responsible Contractor bidding opportunities."

A significant part of staff's engagement in the last calendar year has been engaging with LiUNA and managers regarding bidding and notification issues. As LiUNA needs time to find signatory contractors to bid, and managers are not always able to provide 30-day notice, staff has asked all Core managers and several non-core managers to reach out to LiUNA to engage on bidding opportunities under the current Policy. Several managers are notifying LiUNA of intent to bid particularly when 30-days may not be feasible to provide LiUNA the needed time to recruit their signatories to bid.

To date, this engagement has resulted in managers reaching out to LiUNA, establishing on-going dialogue on current and future bidding opportunities, as well as attempting to secure competitive bids from LiUNA signatories. Based on the initial outcomes from this engagement, staff believes this process to be positive and productive. Staff will continue to seek other opportunities to improve the administration and outcomes under the current Policies.

Because this was raised, considered, and addressed in the past, and in light of managers' heightened engagement with LiUNA, staff does not recommend additional policy revision on this issue.

- *Amend the Policies to include compliance with the Policies when monitoring managers and considering additional commitments of capital.*

Manager compliance with all Investment Office policies, including notably the RCP and Neutrality Trial RCP Policies, are taken into account when monitoring managers and considering additional commitments of capital.

Section K of the RCP Policy states: "Unless a Manager promptly corrects a material Policy violation, the Staff shall place the non-complying Manager on a probation watch list. If the Manager does not modify this pattern of conduct, even after discussions with the Staff, CalPERS shall consider this pattern of conduct along with other information when it reviews the Manager for possible renewal."

- *Revise the RCP Policy to:*
 - *Mandate preference to managers that have a track record of ensuring labor peace in new manager selection and existing manager renewals in all private asset classes*
 - *Prohibit contractors that have policies either written or verbal, that exclude unions or defined benefit plans*
 - *Provide LiUNA the ability to review any policy that is questionable on the subject of unions or defined benefit plans*
 - *Mandate apprenticeships for each craft on every project*

- *Provide preference to contractors that provide benefits, healthcare, higher wages or training*
- *Mandate manager and contractor negotiation with unions to determine wages and benefits prior to contracts being let*
- *Incorporate labor peace agreements in new hotels*
- *Give preference to general contractors and contractors that are willing to sign pre-hire agreements and contribute to defined benefit programs and have relationships with union subcontractors*

Each of the suggested revisions above would shift the RCP Policy from hiring responsible contractors that are paid a fair wage and fair benefit based on local market conditions to a Policy that favors union labor under all circumstances. While the RCP Policy is supportive of the ideals espoused by labor unions, since its inception the RCP Policy has not mandated union labor. The RCP Policy was written to cover CalPERS' assets across all product and building types in all markets across the domestic United States, which cannot be accomplished if union labor is mandated. Inherent in the RCP Policy is the need to balance the goals of the Policy with CalPERS' fiduciary obligations.

Managers have expressed clear concerns that mandating or providing preference for union contracts will increase costs and limit their ability to compete to purchase, lease, manage and sell assets in the marketplace today.

Many of the revisions above were suggested, considered, and not recommended for inclusion during the 2012 policy revision process. Staff has considered suggested revisions, and sought input from managers. In light of the significant shift in the intent of the RCP Policy, increased costs, and impact on managers' ability to compete; staff recommends against inclusion of the above suggested revisions into the RCP Policy.

In conclusion, staff has committed significant resources to this review and to working with managers and labor representatives to continually improve the implementation the Policies. When labor concerns are brought to our attention staff proactively engages to resolve issues.

Staff seeks input from the Investment Committee on the recommendations noted above. In March 2015, staff will return to the Investment Committee with draft revisions to the Policies for discussion. Staff will return to the Investment Committee in June 2015 for final approval.

BUDGET AND FISCAL IMPACTS

During Fiscal Year 2013-2014, the approximate cost to support the RCP Policies and engage on labor issues was \$270,000 (which included staff costs of \$176,000 and consultant services of \$94,000). Costs have risen from the \$50,000 estimated in 2012 as more resources have been devoted to implementing and reviewing the RCP Policies and engaging on labor issues. Staff anticipates that costs for administrating the Policies will continue to rise should the current level of engagement and Policy revision continue.

BENEFITS/RISKS

Not applicable.

ATTACHMENTS

Attachment 1 – Pension Consulting Alliance RCP Peer Survey Report

Attachment 2 – Pension Consulting Alliance RCP Peer Survey Report PowerPoint

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