Agenda Item 5b

April 13, 2015

ITEM NAME: Senate Bill 185 (de León) – Public Divestiture of Thermal Coal Companies Act

As Amended March 25, 2015

PROGRAM: Total Fund

ITEM TYPE: Legislation – Action

RECOMMENDATION
Take **No Position** on Senate Bill (SB) 185 (Attachment 1). The March 25, 2015 version of SB 185 reflects amendments developed jointly by the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). However, further amendment is recommended to remove the requirement that CalPERS consult with the Secretary of the California Environmental Protection Agency (CalEPA) when assessing the feasibility of divesting from fossil fuels. Staff believes implementation of SB 185 could be completed consistent with the CalPERS Board of Administration (Board) policy on divestment as outlined in the CalPERS Total Fund Investment Policy (Attachment 2) and only requires action when it is consistent with the Board's fiduciary responsibilities.

EXECUTIVE SUMMARY
SB 185 requires CalPERS and CalSTRS to constructively engage publicly traded coal companies (Company) that generate 50 percent or more of their revenue from mining thermal coal. If following engagement, a Company is not transitioning its business model to adapt to clean energy generation, it requires CalPERS to sell or transfer any investments in that Company, and report to the Legislature and the Governor regarding these investments within specific timeframes. SB 185 does not require divestment if CalPERS determines, in good faith, the action would not be consistent with its fiduciary responsibilities. The bill also requires a report on the feasibility of divesting from additional fossil fuel investments such as natural gas and petroleum.

Senator Kevin de León is to be commended for his leadership in tackling climate issues. CalPERS recognizes climate change as presenting risks and opportunities to investment decision making. We are tackling climate change issues through policy advocacy, engagement with portfolio companies, and investing in climate change solutions. Engagement is the first call of action and is the most effective form of communicating concerns with the companies in which CalPERS invests. This is why, when it comes to climate change and its risks, CalPERS' view is that the path to change lies in engaging energy companies, instead of divesting them. If we sell our shares then we lose our ability as shareowners to influence companies to act responsibly.

STRATEGIC PLAN
Divesting in response to external initiatives is outside the scope of the CalPERS 2012-17 Strategic Plan.

INVESTMENT BELIEFS
This agenda item supports Investment Belief 3 that investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries. The subject matter of SB 185 is also consistent with Investment Belief 9 in that risk is multi-faceted and not fully captured through measures such as volatility or tracking error. As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.

BACKGROUND
1. Constitutional Authority and Fiduciary Responsibility
   Article XVI, Section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement board of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the fiduciary of the public pension or retirement system to discharge his or her duties solely in the interest of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the systems so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.

   The Constitution, however, provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

2. California Divestment Legislation Trends
   Divestment, or pressuring institutional investors to divest of securities, is a method which attempts to apply economic stress on companies, groups, or countries whose practices are not condoned by investors or interest groups. In California, the practice of requiring pension funds to divest began in 1986 with the passing of legislation to divest from firms doing business with South Africa. From that point, the California Legislature has introduced dozens of bills that would encourage or require divesting from various companies and countries. The South Africa, Arab League's economic

boycott, Sudan and Iran legislation were the only successful divestment bills passed by the Legislature and signed by the Governor.

ANALYSIS

1. <u>SB 185 Requirements, if Enacted</u>
   Specifically, SB 185:
   - Makes findings that the combustion of coal resources is the single largest contributor to global climate change in the United States, that climate change affects all parts of the California economy and environment, and that the Legislature has adopted numerous laws to mitigate greenhouse gas emissions and to adapt to a changing climate.
   - Declares the Legislature's intent to require the governing boards of CalPERS and CalSTRS, consistent with, and not in violation of, their fiduciary responsibilities, to divest their holding of thermal coal companies, as defined, as one part of the state's broader efforts to decarbonize the California economy and to transition to clean, pollution free energy resources.
   - Defines "investment" as the purchase, ownership, or control of publicly issued stock, corporate bonds, or other debt instruments issued by a company.
   - Defines "thermal coal" as coal used to generate electricity, and distinguishes it from metallurgical or coking coal.
   - Defines "thermal coal company" as a publicly traded company that generates 50 percent or more of its revenue from the mining of thermal coal, as determined by the Board.
   - Prohibits the Board from making additional or new investments or renew existing investments of public employee retirement funds in a thermal coal company.
   - Requires the Board to liquidate investments in a thermal coal company on or before July 1, 2017. In making a determination to liquidate investments, it requires the Board to constructively engage with a thermal coal company to establish whether the company is transitioning its business model to adapt to clean energy generation, such as through a decrease in its reliance on thermal coal as a revenue source.
   - Specifies that its provisions do not require the Board to take any action if it determines and adopts findings, in good faith and based on publicly available information, that the action would violate the board's fiduciary responsibilities described in Section 17 of Article XVI of the California Constitution.
   - Indemnifies present, future, and former board members of CalPERS and CalSTRS, jointly and individually, along with state officers, employees, and investment managers for any decision to restrict, reduce, or eliminate investments in thermal coal companies.
   - Requires the Board to submit a report to the Legislature and the Governor on or before January 1, 2018, that:
     - Identifies the thermal coal companies from which it has liquidated its investments.

- Identifies companies that the Board engaged and determined are transitioning to clean energy generation, with supporting documentation to substantiate its findings;
- Identifies companies that the Board has not liquidated its investments as a result of a determination and adoption of findings that a sale or transfer of investments is inconsistent with specified constitutional and statutory fiduciary responsibilities.

- Requires the Board to assess the feasibility of divesting from additional fossil fuel investments, such as natural gas and petroleum, and its implications, in consultation with CalEPA, and summarize that assessment in its report to the Legislature and the Governor.

2. Author's Intent
According to the author,
"Coal combustion for energy generation is the single leading cause of the pollution that causes global climate change. According to the United States Energy Information Service and the Union of Concerned Scientists, 'coal plants are the nation's top source of carbon dioxide (CO2) emissions, the primary cause of global warming. In 2011, utility coal plants in the United States emitted a total of 1.7 billion tons of CO2. A typical coal plant generates 3.5 million tons of CO2 per year.'"

"Burning coal is also a leading cause of smog, acid rain, and toxic air pollution. Some emissions can be significantly reduced with readily available pollution controls, but most U.S. coal plants have not installed these technologies. Coal clearly is the highest polluting source of energy per unit consumed so it's a logical place to begin the effort of investing with our values."

3. CalPERS Engagement on Climate Change
CalPERS has a fiduciary duty to be a principled and effective investor to meet our financial commitments to our members and employer partners. We believe engagement, using our shareowner voice, is the first call of action, and results show that it is an effective form of communicating concerns. Examples of CalPERS using its voice include:

- CalPERS is a member of the Ceres-led Investor Network on Climate Risk – a network of over 100 U.S. institutional investors, representing more than $10 trillion, advocating a policy agenda that calls on governments and regulators to introduce carbon pricing and disclosure, so that risks can be addressed effectively.
- CalPERS is a signatory of the United Nations (UN) supported Principles for Responsible Investment and helped craft its six tenets that serve as a guide for investors to better understand the implications of sustainability and how to incorporate these issues into their investment decision making and ownership practices.
- CalPERS joined forces with Ceres in urging the U.S. Securities and Exchange Commission (SEC) to issue guidance requiring disclosure of climate change risks

in corporate filings. The work led to a major milestone in 2010 when the SEC approved the first economy-wide guidance for climate change disclosure.

- In a Global Investor Statement on Climate Change, CalPERS joined 365 investors representing $24 trillion in assets at the 2014 UN Climate Summit to call on governments to develop an ambitious global agreement on climate change by the end of 2015. This Statement supports policy making that encourages capital deployment at scale to finance the transition to a low carbon economy and encourage investment in climate change adaptation; provide stable, reliable and economically meaningful carbon pricing that helps redirect investment commensurate with the scale of the climate change challenge; and phase out subsidies for fossil fuels.
- CalPERS is an active thought leader of the Ceres Carbon Asset Risk Initiative that draws together 70 global investors managing more than $3 trillion of collective assets. The initiative asks more than 45 large oil and gas, coal, and electric power companies to assess the financial risks that climate change poses to corporate business plans – companies on the list include ExxonMobil, BHP Billiton, Rio Tinto, and Vale. Recent achievement of this initiative includes British Petroleum and Shell having agreed to back shareowner proposals on climate risk reporting.
- CalPERS is targeting 33 companies in the energy sector this proxy season calling for shareowners to have the right to nominate directors to corporate boards – proxy access. Changing corporate directors is one of the best ways to change corporate practices. Recent proxy access proposals at companies engaged by CalPERS have won a majority of support, including Nabors Industries, Chesapeake Energy, and Verizon Communications.

4. <u>Evaluating and Implementing Thermal Coal Divestment</u>
   Existing Board policy (Attachment 2) for responding to external or internal divestment initiatives, addresses initiatives that seek to achieve certain goals that do not appear to be primarily investment-related. However, CalPERS has historically viewed climate change as an investment issue, adopted investment beliefs and principles in that regard, and consistently engaged companies, other institutional investors, governments, and non-governmental organizations to formulate strategies to address the risks and opportunities posed by climate change and transition to low- and no-carbon energy sources. While the Board’s divestment policy generally prohibits divesting in response to divestment initiatives, it does permit CalPERS to use constructive engagement, where consistent with fiduciary duties, to help divestment initiatives achieve their goals.

5. <u>Evaluating Fossil Fuel Divestment</u>
   If enacted, SB 185 requires CalPERS, in consultation with CalEPA, to make a comprehensive assessment of the feasibility of divesting of additional fossil fuel investments, such as natural gas and petroleum, and its implications for the fund. Staff recommends removal of the requirement that CalPERS consult with CalEPA when assessing the feasibility of divestment. Any assessment of a divestment

decision must be consistent with the Board's fiduciary duty, and the Board should consult with CalPERS fiduciary counsel or experts as it deems appropriate.

BUDGET AND FISCAL IMPACTS

If the Board takes action to divest, program costs would include investment transaction and administrative costs to divest of thermal coal companies and then subsequently complete the reporting requirements mandated by January 1, 2018. Total cost will depend on the number of CalPERS holdings in companies that meet the criteria for divestment pursuant to SB 185. Currently, it is expected that CalPERS portfolio includes publicly traded common stock and fixed income investments in thermal coal companies as defined by SB 185.

BENEFITS/RISKS

1. Benefits
    - May improve CalPERS standing when engaging with electric power generators that burn thermal coal to encourage them to transition to low or no-carbon fuel sources.
    - May reduce stakeholder perception that CalPERS investments contribute to climate change.

2. Risks
    - Eliminating alternatives from the investment opportunity set reduces diversification and return potential.
    - Eliminating a specific industry or market segment is atypical to CalPERS normal investment activity and removes CalPERS ability to affect change through engagement.
    - There is some risk of a "slippery slope" of external parties directing portfolio activities. This is mitigated somewhat by the fiduciary language in the bill.

ATTACHMENTS

Attachment 1 – Senate Bill 185, as amended March 25, 2015
Attachment 2 – Excerpt from the CalPERS Total Fund Investment Policy
Attachment 3 – Legislative History

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