California State Teachers' Retirement System
Dakota Access Pipeline
Engagement Report

April 1, 2018

Introduction

In accordance with Chapter 575, Statutes of 2017 (AB 20—Kalra), the California State Teachers' Retirement System (CalSTRS) is required to report, on or before April 1, 2018, to the Legislature and the Governor regarding the Teachers' Retirement Fund's investments in, and CalSTRS' engagement with, companies constructing, or funding the construction of, the Dakota Access Pipeline. This report is submitted in compliance with the bill. In addition to the reporting requirement, Chapter 575 stated the intent of the Legislature that the Teachers' Retirement Board review and consider factors related to tribal sovereignty and indigenous tribal rights as part of the board's investment policies related to environmental, social and governance issues.

Background

CalSTRS

With over 100 years of experience and over $223.2 billion of assets under management, CalSTRS is the oldest and largest educator-only pension system in the world. CalSTRS members include California public school employees, pre-kindergarten through community college, who teach, are involved in the selection and preparation of instructional materials, or are supervising persons engaged in those activities. CalSTRS members are employed by approximately 1,700 school districts, community college districts, county offices of education and regional occupational programs. CalSTRS is administered by the 12-member Teachers' Retirement Board. The board sets the policies and is responsible for ensuring benefits are paid by the system in accordance with the law.

One of the board's key core values is to ensure the strength of the retirement system by proactively addressing the risks of investing. Accordingly, the board has adopted its Investment Policy for Mitigating Environmental, Social and Governance Risks (ESG). The policy requires investment managers to consider 21 separate risk factors when investing for CalSTRS. A copy of the policy is included as Attachment A.

The Dakota Access Pipeline

The Dakota Access Pipeline (DAPL) is an underground oil pipeline project that covers a distance of nearly 1,200 miles, stretching from the Bakken shale oil fields in northwest North Dakota to an oil tank farm in southern Illinois. An early proposed route would have placed the pipeline approximately 10 miles northeast of Bismarck, North Dakota. However, this route was 11 miles longer and was rejected because of the potential threat to Bismarck's water supply. Instead, the pipeline's route ended up coming in close proximity to, but did not enter, the Standing Rock Sioux Reservation. Several Native American tribal nations and environmental groups expressed concern and protested against the pipeline, citing concerns about negative impacts to the environment, including potential contamination of water sources, and other adverse impacts to the reservation of the Standing Rock Sioux Tribe. The U.S. Army Corps of Engineers, after initially denying, approved an easement in early 2017, and construction of the pipeline was completed in April 2017. The pipeline became commercially operational on June 1, 2017.

The Equator Principles

The Equator Principles are a risk management framework, adopted by financial institutions, to determine, assess and manage environmental and social risk in projects (Attachment B). The Equator Principles are primarily intended to provide a minimum standard for due diligence and monitoring to support risk decision-making, which apply globally in all industrial sectors. There are currently 92 financial institutions in 37 countries that have officially adopted the Equator Principles. Those institutions commit to implementing the Equator Principles in their environmental and social policies, procedures and standards for financing projects and will not provide project financing or corporate loans for clients that will not, or are unable to, comply with the Equator Principles.

The Equator Principles recognize "that indigenous peoples may represent vulnerable segments of project-affected communities," although they differ in the standards that projects are required to meet depending on whether they are located in a developed or developing country. The Equator Principles specify that in developing countries, "projects with adverse impacts on indigenous people will require their Free, Prior and Informed Consent." However, in developed countries, the requirements of the Equator Principles can be met by "compliance with the relevant host country laws, regulations and permits that pertain to environmental and social issues."

Policy Review

Due to concerns about environmental protection and indigenous tribal rights, AB 20 requires CalSTRS to file a report with the Legislature and the Governor regarding its investments in, and engagement with, companies constructing, or funding the construction of, DAPL by April 1, 2018.

CalSTRS has a long history of engagement under the CalSTRS' existing ESG Policy. CalSTRS' ESG Policy was created to identify and evaluate risks as the fund increased investments in emerging markets. Since that time the policy has been expanded to cover the entire portfolio. While the 21 Risk Factors in the ESG Policy reference environmental risk, the current policy does not specifically include treatment of indigenous people.

However, in the past, CalSTRS has analyzed the treatment of indigenous people through a combination of the 21 Risk Factors, including:

Respect for Human Rights
The investment's long-term profitability from its business operations and activities in countries that lack or have a weak judicial system. Assess the risk to an investment's long-term profitability from its business operations and activities in a country that engages in or facilitates the following: arbitrary or unlawful deprivation of life, disappearance, torture and other cruel, inhuman, or degrading treatment or punishment, arbitrary arrest, detention, or exile, arbitrary interference with privacy, family, home, or correspondence, use of excessive force and violations of humanitarian law in internal conflicts. Consideration should be given to governmental attitude regarding international and non-governmental investigation of alleged violations of human rights.

Respect for Civil Liberties
The investment's long-term profitability from operations, activities, and business practices in countries or regions that do not allow freedom of speech and press, freedom of peaceful assembly and association, freedom of religion, freedom of movement within the country, allowance for foreign travel, emigration, and repatriation.

Discrimination Based on Race, Sex, Disability, Language, or Social Status
The investment's long-term profitability from business practices and activities on discrimination, such as discrimination against women, children, and persons with disabilities, national/racial/ethnic minorities, or indigenous people.

Actions Taken

CalSTRS Engagement

Initially, CalSTRS staff designated the DAPL project as "watch" during the time the claims by the Standing Rock Sioux Tribe were being considered by the courts and by the federal regulatory authorities. Then CalSTRS staff, along with other public pension systems, met with tribal representatives, including Dave Archambault II, Chairman of the Standing Rock Sioux Tribe on February 28, 2017. CalSTRS staff heard the tribe's concerns about the lack of enough opportunity for participation in the consultation process to help determine the pipeline's route and the safety of the pipeline.

Construction Companies

CalSTRS identified within its portfolio holdings of debt or equities in the following 10 companies associated with the construction of DAPL:

Enbridge, Inc.
Enbridge Energy Partners, L.P.

Energy Transfer Equity, L.P.
Energy Transfer Partners, L.P.
Marathon Petroleum Corporation
MasTec, Inc.
MPLX, L.P.
Phillips 66
Phillips 66 Partners, L.P.
Sunoco Logistics Partners, L.P.

Several of these companies are interrelated, as follows:

- Energy Transfer Partners, L.P., the majority owner of DAPL, merged with Sunoco Logistics Partners, L.P. and is controlled by Energy Transfer Equity, L.P.
- Enbridge Energy Partners, L.P. and MPLX, L.P. formed a joint venture, MarEn Bakken LLC, which in turn owns a minority share of DAPL.
  - Enbridge Energy Partners, L.P. is owned by Enbridge Inc.
  - MPLX, L.P. is owned by Marathon Petroleum Corporation.
- Phillips 66 Partners, L.P., the other minority owner of DAPL, bought its stake from its parent company, Philips 66, following the construction of the pipeline.
- MasTec, Inc. was a construction contractor of the pipeline.

Financial Institutions

The following 17 banks were identified as financing the construction of DAPL, and CalSTRS, as of June 30, 2017, had holdings in all of these banks, except BayernLB:

Banco Bilbao Vizcaya Argentaria (BBVA)
Bank of Tokyo Mitsubishi UFJ
BayernLB
BNP Paribas
Citigroup
Credit Agricole
DNB ASA
Industrial and Commercial Bank of China
ING Groep
Intesa Sanpaolo
Mizuho Bank
Natixis
Société Générale
Sumitomo Mitsui Banking Corporation
SunTrust
Toronto-Dominion (TD) Bank
Wells Fargo

CalSTRS staff engaged with all of the affected companies. CalSTRS generally initiated its engagement by sending a letter requesting a meeting to discuss the company's involvement in the DAPL project. A more detailed description of the engagements and the results and efficacy of the engagements, are included in Appendix 1.

In addition to engagement with companies that have direct ties to constructing, or financings the construction of DAPL, CalSTRS has proactively engaged with 18 other banks that provide, or have provided, general purpose financing to the companies involved with the construction of DAPL. CalSTRS staff engaged with these banks in an abundance of caution to confirm that they were not involved in the financing of DAPL. Engagement was also intended to confirm that they have policies, procedures and standards in place to mitigate risks for projects similar to DAPL. CalSTRS was able to meet with the management of 10 of these banks.

Other Actions

In relation to tribal sovereignty and indigenous tribal rights, at the February 7, 2018, board meeting CalSTRS staff proposed changes to the CalSTRS ESG Policy, including the creation of a risk factor specifically addressing indigenous people's rights. The board reviewed the item and recommended changes, which will be incorporated and re-presented to the board at the May 2018 board meeting. The proposed risk factor states:

> **Respect for Indigenous People's Rights**
> The investment's long-term profitability from operations, activities and business practices that do not adequately respect the cultural value and ethnic identities or that dispossess or materially degrades lands, territories or resources.

Banks that provided financing for the construction of DAPL retained Foley Hoag LLP, a law firm that specializes in corporate social responsibility services, to provide an independent report, using DAPL as a case study, that considered international industry good practice for community engagement in the development of oil pipelines, especially in relation to engagement with indigenous peoples (Attachment C). Foley Hoag noted the complexity of the U.S. legal system that consists of multiple levels of law (federal, state and municipal), in which non-tribal community engagement varies by state. In order to perform more consistently and to reduce risk, Foley Hoag advised companies to develop corporate policies and processes that go beyond compliance with the applicable laws and are based on international industry good practice. Under federal laws, regulations and presidential executive orders, federal agencies are required to consult with indigenous tribes even if a project is not on federally recognized tribal lands when federal actions, such as permitting, may impact the tribes in certain ways. Foley Hoag notes, however, that each federal agency has developed its own consultation guidelines, which differ significantly from one another.

Foley Hoag stated that international law, and related international industry good practice, has developed rapidly in recent years, especially as it relates to indigenous rights. Therefore, U.S. law is less stringent than international law, particularly because international industry good practice:

- Provides more detailed guidance than U.S. federal law on what constitutes company-tribal consultation, defined as a two-way exchange that begins early, with tribes playing an active role in risk identification, mitigation and monitoring.

- Calls for the company-tribal consultation, and even free, prior and informed consent, in a significantly wider range of circumstances than U.S. federal law, regardless of whether impacts are on private or public land or a federal permit is required.

A group of 10 banks, including six held in the CalSTRS portfolio, authored a letter to the Equator Principles Association to express concern regarding shortcomings of the Equator Principles they found in relation to DAPL (Attachment D). The letter noted that the banks were publicly and harshly criticized for supporting a project in which consultation with an indigenous community did not involve free, prior and informed consent. The banks stated that the criticism was largely based on the fact that local laws in relation to engagement with indigenous communities are lacking compared to best practices for free, prior and informed consent. They also had no leverage with the project sponsors because there was no breach with applicable environmental and social standards being used. The banks noted the reputational damage to the banks themselves and that they believe the lack of engagement in this case would likely damage the reputation of the Equator Principles as well.

To avoid similar situations in the future, the banks proposed two changes to the Equator Principles that would significantly improve them:

- Applying the more rigorous environmental and social standards for projects in developing countries to projects in developed countries.
- Amending the Equator Principles framework to facilitate the resolution of issues resulting from a potential breach of the applicable environmental and social standards that may lead to significant damage to the environment and/or communities.

Planned Actions

CalSTRS will continue to engage the companies identified on risks related to the environment and indigenous people’s rights. Furthermore, the board has directed staff to propose revisions to the ESG Policy to more explicitly recognize risks related to indigenous people. Lastly, CalSTRS will work with other investors and Equator Principles signatories to remove implementation differences between emerging and developed markets, effectivity requiring consultation with indigenous people with the goal of free, prior and informed consent on projects.

CalSTRS intends to continue to meet with banks that have been identified as providing general purpose financing to the companies involved in the construction of DAPL, and the results will be discussed at the 21 Risk Factor Review Committee. The 21 Risk Factor Review Committee consists of 13 senior staff members: the Chief Investment Officer, the Deputy Chief Investment Officer, the Chief Operating Investment Officer, two senior staff members from Global Equities, two senior staff members from Fixed Income, two senior staff members from Corporate Governance, one senior staff member from Private Equity, one senior staff member from Real Estate, one senior staff member from Operations, and one senior staff member from the Innovation and Risk Group. In 2014, the committee adopted a charter governing its operation and scope of duties (Attachment E).

Conclusion

As noted in this report, CalSTRS will continue to invest its funds in a responsible and prudent manner and adhere to the board's ESG Policy. CalSTRS will continue to address the concerns and risks around the environment and indigenous rights raised by the DAPL situation through complete engagement with all companies identified in which CalSTRS has holdings, including those that provided general purpose financing to the companies involved with the construction of DAPL. CalSTRS will also revise the ESG Policy to specifically include treatment of indigenous people and work with banks and other investors to improve the environmental and indigenous people's rights requirements in the Equator Principles.