

November 7, 2008

To

Dow Jones Sustainability Index - DJSI

SAM Research and DJSI World index Design Committee

Dear Sirs,

We hereby write this letter to you, acknowledging the importance of the Dow Jones Sustainability Index as the first global index to track financial performance of companies committed to sustainability, by feeding analysts with objective and reliable parameters regarding sustainability performance. DJSI has also inspired stock markets around the world leading to the creation, in Brazil, of the São Paulo Stock Exchange Sustainability Index (ISE-Bovespa).

Recently the Brazilian public opinion faced a controversy involving PETROBRAS – Petroleo Brasileiro S/A, on the supply of low sulphur diesel, mandated by law. Such fuel is *sine qua non* condition for the introduction of new heavy duty vehicle technologies, which in turn are absolutely necessary for urban air pollution control.

First of all, it is necessary to briefly provide context for this present inquiry. It is important to note that the inquiry described below is made by legitimate organisations of the Brazilian civil society, in the environmental, consumers and academic fields, as well as governmental bodies responsible for environmental affairs.

In Brazil, the production, import and marketing of almost all diesel consumed domestically are controlled by PETROBRAS. Its integral subsidiary PETROBRAS Distribuidora S/A – BR, has 7,000 service stations throughout the country and the leading market share of diesel. The Brazilian oil and oil by-products market is in practice a captive market and despite of claims by PETROBRAS that competition is welcome, the population cannot obtain a better quality fuel without the agreement and market involvement of PETROBRAS.

Currently, Brazilian diesel is divided, for quality control purpose, in “metropolitan” (25% of volumes sold) and “ordinary” (75% of the total volume). The first one has a

limit of 500 ppm S (parts per million of sulphur) and it is sold in the main metropolitan regions in Brazil. The latter can contain up to 2.000 ppm S and it is distributed to all other regions in Brazil.

It must be said that there has been significant improvements in air quality in Brazil, mainly due to the effective implementation of the Vehicles' Pollution Control Programme, established in 1986 (PROCONVE – Programa de Controle da Poluição do Ar por Veículos Automotores). Basically, under PROCONVE are established legal limits for new model vehicle emissions, progressively more stringent and embedding new technologies and better quality fuels. A research conducted by the Medical School at University of São Paulo¹ demonstrated that due to PROCONVE, 14,495 deaths were avoided, just in the metropolitan area of São Paulo, in the period of 1996-2005. If expanded to other metropolitan regions, such as Recife, Rio de Janeiro, Belo Horizonte, Curitiba and Porto Alegre, the number increases to 34,447 avoided deaths. Based on this research the Ministry of the Environment published in 2006 a document evaluating the 20 years of existence of PROCONVE.

However, the levels of sulphur in Brazilian diesel are still a major concern, not only from a health and environmental impact point of view but also due the fact that advanced emission control systems require low sulphur diesel. In order to further reduce the noxious emissions from diesel vehicles the Brazilian Environmental Council (Conselho Nacional do Meio Ambiente – Conama) established in 2002 that from January 1st 2009 (a new phase named "P-6"), a higher quality diesel fuel containing up to 50 ppm S (named S-50) would have to be available in the market, i.e. distributed countrywide for the new fleet. This legislation, CONAMA Resolution 315/2002 also determines that a standardised S-50 diesel test fuel should be available for engine development and tests at least 36 months prior to its release, which means January 1st, 2006.

CONAMA is the consultative and deliberative body of the Ministry of the Environment, created to settle conflicts, propose innovations, and resolve important environmental policy and resource management issues. CONAMA is headed by the Ministry of the Environment and includes broad representation of all sectors of civil society, federal, state, and municipal governments and businesses. Its decisions have legal authority

¹ Laboratório de Poluição Atmosférica Experimental da Faculdade de Medicina da Universidade de São Paulo

and are applied at the national level. Hence, the decisions from CONAMA must obtain the consent from all its participants.

Our concern relates to the non-compliance by PETROBRAS with the referred regulation and how it has been conducting the discussion process with its external stakeholders. Since S-50 was not made available for tests on the legally established deadline, several organisations from Brazilian Civil Society and other governmental bodies suspected that PETROBRAS would not be capable of complying at all with the Resolution. As a consequence, the matter was taken to court by the São Paulo State Public Attorney in response to a request by the Sao Paulo State Environmental Secretary and the Federal Public Attorney. It is important to explain that the Federal Public Attorney in Brazil is an independent body that participates in the trial of cases before all courts in Brazil, including the highest court, the Supremo Tribunal Federal (STF). Federal Public Attorneys are authorized by the Brazilian Constitution to bring action against private individuals, commercial enterprises, and the federal, state and municipal governments, in the defence of minorities, the environment, consumers, human rights and public interest in general.

In the 2007 Social and Environmental Report the company literally affirms: "During the year, some segments of Brazilian society, for example government sectors and NGO's, demanded PETROBRAS to give a position on the diesel sulfur level of the product sold in Brazil. Another question was why a product with less sulfur was not available on the market earlier. In November the Company informed that from 2009 on it will supply fuel with 50 ppm of sulfur for heavy diesel vehicles. Nine billion reais will be invested by 2012 in diesel hydrotreatment plants in nine refineries to achieve these targets." Nevertheless, this statement it is not in accordance with the facts mentioned earlier, nor is the ongoing negotiation between PETROBRAS and the Federal Public Attorney addressing the necessary actions to establish desirable compensation measures for not complying with the Resolution.

Additionally, as an initiative led by the organisations that subscribe to this letter, PETROBRAS' publicity, where it claims to be environmentally responsible, was also questioned and taken to the National Council that self-regulates publicity in Brazil (CONAR – Conselho Nacional de Auto-Regulamentação Publicitária). Although PETROBRAS is one of the biggest advertisers in the country, CONAR decided to

prohibit PETROBRAS to affirm in any publicity its responsibility towards the environment, since its behaviour was demonstrating the opposite.

Moreover, another episode to be pointed out refers to the fact that PETROBRAS, during CONAR process, refused to provide access to the information that was part of its defence under the excuse of Government Classified Information, confronting DJSI foundation pillar of transparency as a fundamental component for effective stakeholder engagement and sustainability promotion. It is also important to remember that PETROBRAS is a company whose capital mainly belongs to the Federal Government, what makes this attempt of imposing restrictions to access to information on environmental and health impacts remind us of the dictatorial period in Brazil. Just to give an idea of what it represents, the organisations that subscribe to this letter could not even copy the documents used by PETROBRAS, since they would be protected by a decree that refers to "the protection of classified data, documents and material that are important to the maintenance of national safety, in the sphere of federal public administration". (Decree n. 4553 of 27/12/2002).

Taking into consideration that the matter refers to the quality of Brazilian diesel and its impacts on human health and the environment, the usage of "Government Classified Information" indicates that the company does not respect the rules of transparency and refuses to establish dialogue with its external stakeholders. Even so, in its defence in CONAR process, Petrobras claims that transparency is inherent to all its actions and refers explicitly to the Global Reporting Initiative (GRI) as one of its conquerors in that field, demonstrating that Petrobras has been using GRI's reputation in all of its explanations regarding the Diesel 50 ppm S controversy.

For those reasons, an advertisement published on the Brazilian press² called our attention. It said: "Petrobras has been awarded by the most important prize given to Social and Environmental Balances in the world. (...) Petrobras' Social and Environmental Balance was considered the best in the world by the Global Reporting Initiative (GRI), the main international reference in Sustainability Reports." However, Petrobras does not clarify the referred title was attributed by report readers through direct election and NOT by the organisation GRI, creating ambiguity in the advertisement's interpretation, improperly utilising GRI's reputation and credibility. It

² Folha de São Paulo, 11/05/2008, page A11

continues: "The GRI Readers' Choice Award is the most important prize that a company can receive in this field, adding to the recognition by the organisation Transparency International (TI), who places Petrobras among the oil and gas companies with the highest Corporate Transparency. It is the confirmation that Petrobras acts with transparency and ethics". The same way that utilizes GRI's credibility in an ambiguous manner, Petrobras does not clarify that TI's recognition only refers to Revenue Transparency³ and NOT to Corporate Transparency as a whole, which includes several other aspects beyond financial disclosure. This is just one of many other examples where Petrobras promotes propaganda.

In order to prevent such behaviour to reoccur, the same organisations that subscribe to this letter requested GRI and TI to examine the case. The organisations recognized the misuse of their reputation and advised Petrobras to be more precise in future communications, as shown in Annex I.

Considering the DJSI Corporate Sustainability Monitoring criteria, we believe that the reported facts can be considered as a critical environmental and social crisis, with considerable economic impacts due to potential reputation loss. The "Diesel Case" may be considered as just a part of PETROBRAS' business in Brazil and in the world, but it certainly represents a lot more from the Brazilian population's health point of view and definitely tells a lot about its sustainability strategy and performance.

According to the list of issues that are identified and reviewed in the DJSI monitoring process, the reported facts demonstrate that in terms of:

- Codes of Conduct, PETROBRAS has clearly stated that will not be able to comply with the Brazilian regulation. It is important to say that this is the first time in 20 years that a PROCONVE regulation will not be attained. Besides, by maintaining the levels of sulphur in the range of 500-2000 ppm, leaving no options to the population in general, this behaviour could be considered an abuse of power by the company and the Brazilian Government. As opposed to the tobacco case, where individuals can choose if they want to smoke or where non-smokers can choose if they want to breathe the smoke or not, in the Diesel

³ Promoting Revenue Transparency – 2008 Report on Revenue Transparency of Oil and Gas Companies. Transparency International, 2008

Case the population has no choice. The polluted air and its effects are imposed to everyone: children, pregnant women, elders and adults in general.

- Corporate Governance, PETROBRAS demonstrates a lack of transparency by prohibiting access to information considered as public related interest (impacts of their product on human health);
- Customer Relationship Management, PETROBRAS has been providing a low quality product (evidences show that an engine using a diesel with high levels of sulphur can deteriorate faster than an engine using a low sulphur diesel⁴), and which represents a threat to human health, again leaving no option to the consumer. As mentioned before, Brazilian oil market is a captive market and cannot obtain a better quality fuel except from PETROBRAS;
- Risk and Crisis Management, PETROBRAS was unable to identify that an eventual refusal to comply with regulation could represent a major risk for the company, mainly regarding its reputation. Furthermore, it has not been able to manage the resulting crisis, putting PETROBRAS reputation at stake. It is very important to note that the matter has been receiving full coverage by the main newspapers and television in Brazil, as showed in Annex II.
- Environmental Management, by not complying with CONAMA Resolution 315/2002, PETROBRAS can certainly be responsible for grossly mismanaging long-term air pollution. What is most critical is the fact that although Brazil is a major economy in the developing world, and has the necessary technology to provide a better fuel, the current levels of sulphur are behind Mexico and Thailand (that are adopting the 50 ppm S in 2009) and far behind the USA and Europe (that are using 15 ppm S and 10 ppm S respectively). Brazilian levels of sulphur are compared to countries such as Algeria, Libya, Botswana and Namibia⁵, which currently lack of the mentioned resources and face many other bigger challenges in ensuring the health and quality of life of their population.

4 Opening the Door to Cleaner Vehicles in Developing and Transition Countries: The Role of Lower Sulphur Fuels, United Nations Environment Program – UNEP, 2007

5 Global Environment Outlook: environment for development (GEO-4), UNEP, 2007, page 58.

As closing remarks, we believe it is crucial to remember that sustainability is about going beyond compliance and integrating social and environmental aspects into business strategies. If we take as an example Bob Willard's Five Stage Sustainability Journey⁶ (Willard 2005) where the first two stages, non-compliance and compliance, are reactive stages, and the three others, beyond compliance, integrated strategy and purpose/mission, are essentially proactive, we see that as companies move from stage 1 to stage 4 and 5 they definitely improve their sustainability performance.

Although PETROBRAS can be considered as the major cultural sponsor in Brazil, has been investing large amounts of resources in philanthropy and publicly announced that will invest 500 million reais (R\$500,000,000) in its Environmental Program from 2008-2012, when it refers to integrating sustainability into its core business there is still a long journey to take. As reported here, PETROBRAS is struggling between stages 1 and 2 and clearly adopting a reactive approach regarding the transition to a cleaner diesel, even though it has recently been considered the 7th biggest oil company in the world⁷, proving that lack of resources and capacity cannot be considered as an excuse. Therefore we believe it is highly questionable if PETROBRAS can be seen and rewarded as an organization committed to sustainability.

Based on these facts, the organisations that subscribe to this letter kindly request SAM Research and DJSI World Index Design Committee to examine the reported information and, if considered pertinent, take the appropriate measures.

Thank you for considering the issues we have raised thus far. We are available to answer any questions you may have regarding the content of this letter and we would like to emphasise the importance we attribute to your initiative.

Sincerely,

**Secretaria de Meio Ambiente e Desenvolvimento Sustentável do
Estado de Minas Gerais
JOSÉ CARLOS CARVALHO**

⁶ The Next Sustainability Wave, New Society Publishers, April, 1 2005

⁷ http://www2.petrobras.com.br/ri/port/InformacoesAcionistas/swf/2007_02/pdf/2007_02.pdf

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