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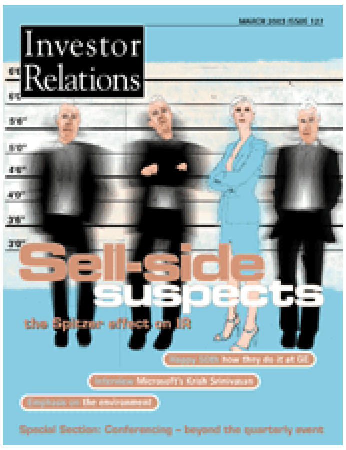
Emphasis on the environment, April Issue



Today's investors are taking note of how a company's environmental performance can affect its risk profile, writes Martin de Sa'Pinto

A November 2001 booklet entitled Environmental Information in the Mainstream Equity Sector informs us that 'if the capital markets were to exercise preference for companies with superior environmental performance, this would constitute a powerful mechanism for environmental self-regulation in the market.' This is, of course, a very big if, admits Mark Stoughton, project manager of the faculty reporting project at the Tellus Institute, a non-profit research and consulting organization focused on sustainability, and one of the authors of the booklet. Nonetheless, with the rapid growth of socially responsible investment (SRI) in recent years, many investors are indeed placing greater emphasis on environmental performance.

Judy Kuszewski, a senior adviser at SustainAbility, a UK and US-based strategic management consultancy, notes that companies have been slow off the madrk. 'Although investors looking for socially responsible investment opportunities have clear criteria which they use to filter their investments, many companies still aren't taking the issues seriously,' she says. Kuszewski stresses that environmental factors can present serious financial risks. For example, 'If companies are exposed to climate change risk, there is evidence that insurance and reinsurance companies are starting to take that into account.'

According to Michael Meacher, UK minister for the environment, SRI funds in the US have grown from $65 bn in 1985 to some $2.3 tn today. These funds have become a force to be reckoned with, and companies can no longer afford to ignore them. Many investors apply a lower risk profile to companies demonstrating a greater environmental awareness than their peers, so these companies may well enjoy a lower cost of capital. But how can companies prepare their environmental reports in a way that provides investors with all the information they need?

A new field

Since environmental reporting is a relatively new field, most companies are only now beginning to develop their reporting methodology. Many are still unsure what SRI investors are looking for. The development of the Global Reporting Initiative (GRI) is an important step towards standardizing reporting. The GRI's stated goal is to promote 'international harmonization in the reporting of relevant and credible corporate environmental, social and economic performance information to enhance responsible decision-making.' However, many key issues regarding the methodology of evaluating environmental impacts are still to be resolved.

Kyle Johnson is director of index services at KLD Research & Analytics. His company advises US fund manager Domini Social Investments, which has more than $1.9 bn under management, on the environmental and social performance of companies. Johnson wants to see companies discussing how they are dealing with their most difficult issues. For example, oil companies should discuss the measures in place to deal with oil spill pollution, climate change, human rights issues, the impact the company is currently having in these areas, and the improvements it is aiming at.

Rob Lake, head of SRI engagement and corporate governance at Henderson Global Investors, concurs. 'We're not interested in pictures of people planting trees,' he explains. 'We want to see that a company has thought about how to address the issues that affect it. For example, if it uses a lot of energy, what are its policies for dealing with carbon dioxide emissions? Has it set itself a target for reducing emissions and potential clean-up costs?'

SRI investors say environmental reports have no value without detail: 'We want to see emissions data, responses to specific incidents, management systems descriptions, and so on,' says Johnson. 'Explanations for trends are helpful, so that we know whether a company reduced its emissions through plant shutdowns or better practices,' he adds.

Iain Watt, corporate accountability specialist at Ceres (Coalition for Environmentally Responsible Economies), notes that transparency has become an important issue: 'If companies only report on their externalities after they have been discovered, this causes suspicion and creates a bad impression among investors that often lasts a long time. It is in companies' best interests to be proactive in this field.' Indeed, investors are ever more anxious to know about the potential environmental liabilities of their investments.

There are other sound reasons why companies should take environmental issues seriously. Watt points out that, for example, 'In terms of recruitment, people want to work for a responsible firm. A good environmental report is a good recruitment tool, since it is often perceived as a solid indicator that a company is well managed.'

Watt also claims that a company's openness about its environmental performance will have an impact on its bottom line. 'Many of these issues have a strong impact on brand value, for example,' he affirms, pointing to Baxter International as an environmental reporting pioneer. 'The company produces a report that includes scenarios showing what the costs would have been if they had not introduced certain procedures such as recycling or an energy reduction program; they try to give a financial basis to their environmental reporting,' claims Watt.

The early days

William Blackburn, vice president of corporate environmental affairs at Baxter, describes how environmental reporting evolved at his company: 'Our report was initially an internal document examining strategies to reduce our environmental impact,' he says. 'We soon recognized a need to demonstrate to our board of directors that such strategies made good business sense.' Nowadays the company uses its report as a measure of its performance. 'It helps us know where the gaps are, and making it public has had an important effect on the workforce,' says Deborah Spak, director of external communications at Baxter International.

John Hughes, general manager of corporate communications at mining giant Rio Tinto, says the company's environmental, health and safety (EHS) report started life as an internal document some ten years ago and has been available to the public for the past six. 'It is very time and space consuming to cope with all the various issues,' comments Hughes. 'Rio Tinto's web site dedicates some 1,700 pages to CSR issues, so we have developed a road map aimed at helping investors locate those issues that concern them. We also provide a summary in hard copy.'

Co-op Investment Services is a relative newcomer to the field, only producing environmental reports over the last two years, but the company has already received acclaim for its environmental efforts. 'We felt it was important that environmental issues should be given sufficient coverage to explain to our stakeholders what we are doing in this area,' explains Paul Burke, head of social accountability at CIS. A solid performance has brought CIS onto the radar screen of many potential investors. As KLD's Johnson suggests, 'Even if companies are just starting out, a focus on their most challenging issues will earn the respect of audiences.'

Apples & apples

In spite of the varying impacts of companies from sector to sector, many recognize the need for comparability, and hence for some degree of standardization in their reports. To this end, Baxter, Rio Tinto and many other companies are providing continuous input to the Global Reporting Initiative.

Burke admits that the first CIS report focused more on the wider context – for example the challenges posed to the company by climate change – whereas the second provided a fuller treatment of its environmental impacts and how they were being monitored, managed and reduced.

In its next report CIS aims to integrate environmental reporting more fully into its annual report and, with supporting economic data, move towards a sustainability report. 'We will make much greater use of GRI economic indicators, which will allow stakeholders to compare and contrast our performance with that of competitors,' explains Burke.

Mark Goyder, director of a UK think-tank, Centre for Tomorrow's Company, affirms that there is an enterprise focus and a society focus in any evaluation of a company's environmental impact. For example, in the case of a paper producer, the enterprise may look at how much fiber has gone into the river and hence been lost, while society will look at the cost of clearing the fiber from the river.

Says Goyder: 'Often the operational efficiency measure has a negative correlation with the environmental impact.' Statistically, for example, the more miles a salesman does in his car, the more money he will make for the company. However, via his carbon emissions, he will also do a greater amount of damage to the environment.

According to some observers, this is where governments need to decide which costs can be evaluated by the companies themselves, and which need to be identified by society as a whole. As Goyder says, 'In some cases the company can reduce its own costs, but they're offloaded onto society. Society therefore needs to specify the costs it wants to identify, since sometimes the company will be reluctant.'

Evaluation can be complex, especially when the company works in numerous fields and various geographies. Hughes of Rio Tinto tells of his company's experience: 'As we went along we found we were trying to aggregate things that couldn't really be aggregated because of external pressure. For example, there is a great difference between the effect of water consumption in a dry, arid area compared to a wet and temperate area.'

Mark Stoughton points out that 'most companies and bodies engaged in efforts to render voluntary reporting more comparable aren't focused on producing this kind of contextualized information.'

'One of the biggest challenges to us and others is the area of metrics,' adds Baxter's Blackburn. 'We need to identify the most important issues such as our impact on climate change and water conservation. We want to get even more strategic about our approach to this, setting goals and being more aggressive.' He admits Baxter has been searching for a common metric for a long time, but has not yet found a suitable model.

New measures are evolving, but it is difficult to measure the impact of, say, carbon dioxide emissions because perceptions vary around the world. However, once there is a trading platform for emissions (and one seems to be developing in the wake of the Kyoto agreements) the value of these externalities will quickly be established by market forces.

Moves such as the September 2002 bill, signed into law by California governor Gray Davis, which created a forest carbon registry allowing companies to receive pollution credits for reducing their greenhouse gas emissions, will give added impetus.

Verification is a problem that some companies are trying to overcome by using external consultants. 'As well as using KPMG to audit our reports, we use the respected academic Professor Paul Ekins [of the Policy Studies Institute] to provide an independent third party review of our report and identify any gaps in coverage,' Burke of CIS says. His company wants a robust methodology to assess its own impact and that of its peers, including independent third-party audit processes to ensure the quality of the data.

Shape up or lose out

Blackburn, too, admits that his company struggled with verification for many years, since 'large accounting firms didn't understand our environmental performance, and didn't have the processes in place to assess it.' The external firm involved in the company's ISO 14001 certification has now been employed for verification purposes.

Skeptics say CSR is too costly because pandering to the politically correct lobby furthers the idea that there's a problem, which leads to more criticism and finally to heavy regulation. But companies such as Baxter and Rio Tinto have discovered for themselves the good business sense of improving their image as good corporate citizens.

Furthermore, much of the pressure for improvement has come not just from green firebrands but from a wide section of the investment community that wants both a solid investment performance and the reduced risk profile now associated with better environmental practices. As Hughes explains, 'If you don't get the environmental and social aspects right, the economics won't be right.'

And change is afoot, according to KLD's Johnson: 'Currently, there is little price for not reporting. That is changing, however. Transparency is increasing in importance as a gauge of corporate citizenship.' Henderson's Lake best sums up the opinions of a large and growing body of investors: 'We are unlikely to invest in a company that doesn't recognize its own environmental impact, since failing to acknowledge this can cause damage to a company's reputation and leave it wide open to other risks.'