Environmental Oversight: In the Eye of the Storm

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Are the companies you serve truly "green"? Here is a litmus test.

Board members of multinational companies are often ill equipped to address an area of perhaps the greatest risk and strategic importance to the long-term viability of the corporations they oversee. What is that? The environment. No, not the "environment" defined by the era of compliance and remediation we have lived through the past 20 years. This "environment" is entirely different—and several orders of magnitude more significant. It cuts to the very core of strategic plans the board approves each year.

Yet despite the importance of the environment, board members, by their own admission in a recent NACD survey,* are not well equipped to provide effective oversight in this area. In fact, the three areas board members rank themselves weakest are the same three areas most important as the business world's new "global agenda" rapidly takes shape. These are: strategic planning, risk management, and engagement with stakeholders (other than shareholders).

New World "Agenda"

To come to grips with the new role for the environment in business, board members are well advised to take a signal from the annual meetings of the World Economic Forum (WEF). At the 2000 meeting in Davos, Switzerland, world leaders ranked global climate change as the number one issue facing business and society in the coming years. (This should not be surprising, considering the 178 countries that signed the Kyoto Climate Change Treaty.) The insight from this year's WEF meeting in New York is that the world faces a global environmental governance crisis that global institutions (such as the United Nations and World Bank) cannot solve alone. Multinational corporations need to provide leadership.

CEOs of 3M, Ashland, BP, DuPont, Shell, and a host of other companies have recognized this (see Case Examples box on p. 7). They are investing, even in these difficult economic times, in broad-based environmental programs that involve strategic planning, risk oversight, and/or shareholder relations.

The Environmental Mindset

Adding environment to a business's strategic priorities goes far beyond public relations. It requires a whole new mindset.

◗ ***"Forget" compliance.*** Compliance with environmental regulations has been a board issue for 20 years, and of course it is still important. But to even begin to grasp the magnitude of the issues and opportunities posed by the pending environmental governance crisis, directors, CEOs, and the senior team need to move beyond the box of compliance. There is considerable "unlearning" to do.

◗ ***Strategy: think broadly.*** Using the combined power of local communities, stock markets, the news media, and the Internet to police air and water discharges from private companies, nongovernmental organizations (NGOs) often have the power to severely disrupt business operations. The rapidly increasing expectations from a broad group of stakeholders are expanding the set of "environmental" issues to include climate change, human rights, stakeholder engagement, biodiversity, product life cycle, social responsibility, and business integrity, among others.

◗ ***Risk: analyze the business impact of impending environmental crises***. Most of us do not see it here in the U.S., especially in the vast center of the country. But daily reminders from *The Financial Times, The Economist*, and dozens of international business journals remind us of the impending pressure that a growing population is placing on rapidly declining ecosystems, clean water, and clean air on which our businesses and society depend. Examples of broad environmental challenges are legion. Here are just two that have surfaced in recent days.

—On August 12, 2002, Reuters, Associated Press, and CNN reported the discovery of an "Asian Brown Cloud" that is causing deaths from respiratory illnesses and could pose a global threat. The two-mile-thick cloud, which so far has travelled from Sri Lanka to Pakistan, could travel farther.

DIRECTOR SUMMARY

Environmental oversight involves more than compliance. It requires a knowledge of current environmental problems, and a plan for addressing them with respect to strategy, risk oversight, and constituency relations. ◗

* *The 2001-2002 Public Company Governance Survey* (Washington, D.C.: NACD, 2002).

—On August 13, a United Nations report (by the U.N. Department for Economic and Social Affairs) predicted that by 2025, up to half the world's population could experience water shortages, and Middle East countries will face very serious shortages in the next 10 years.

These are both problems that threaten worldwide health, and that could be curbed with the help of better environmental practices on the part of corporations. As noted in a recent landmark report, "board members should pay special attention to the company's climate risk that is now embedded, to some degree, in every business and investment portfolio in the United States."*

◗ ***Shareholder relations: calibrate the rising tide of emotion.*** The anti-globalization sentiment on show in Seattle, Davos, Washington D.C., Prague, and Genoa does not disappear when the picket signs are put away. Loosely connected environmental groups are using the Internet to advance their cause.

Investor Response

Slowly, financial markets are beginning to see the new set of risks and to respond. The Dow Jones Sustainability Index (DJSI) is gaining recognition. Multinational companies with a single, stringent environmental standard have much higher market values than companies that default to less stringent or poorly enforced standards in host countries. Investors are rewarding companies that provide positive environmental and social contributions to society.

The shift underway is from "ethical investing" (negative screening of no firearms and cigarettes) to "sustainability investing" (positive screening for companies that meet the triple bottom line criteria of delivering shareholder value, environmental stewardship, and social responsibility).

◗ The number of financial institutions licensing the DJSI to manage their portfolios increased 71 percent between January 2000 and October 2001. The DJSI continues to outperform the Dow Jones Global Index and outperformed the Morgan Stanley Capital International World Index.

◗ "Socially responsible investment" (SRI) funds now represent almost 13 percent of all investment in the U.S. (over $1.5 trillion). SRI funds outperformed all mutual funds (four- or five-star ratings from Morningstar rating group).

◗ CalPERS, the largest public pension fund in the U.S. with $150 billion in assets, has added human rights criteria (country factors) to its traditional economic criteria for stock selection.

◗ The Folksam Group, one of Sweden's biggest investment managers controlling investments totalling $9.5 billion, said that beginning January 2002, it would use CO_2 emissions as a major indicator when deciding whether or not to hold shares in a company.

◗ The U.K. has recently introduced new rules for pension funds, requiring them to declare what social, environmental, or other ethical factors they take into account when investing.**

If boards are to provide effective leadership in guiding companies through the transition from environmental compliance to environmental governance, they must first understand what is required for sustainable growth, and how their priorities must match those requirements.

Cost Issues

Environment has historically cost manufacturing and petrochemical companies 2 to 4 percent of sales. Research has shown that over the past 10 years, the

* Source: "Value at Risk: Climate Change and the Future of Governance," press release by Robert K. Massie, the executive director of CERES, April 2002.

**The U.K. Greenhouse Gas (GHG) Emissions Trading Scheme was launched on April 1, 2002.

CASE EXAMPLES

Strategic Planning

◗ **Dow** estimates that its yearly savings through reduction of wastes and emissions pays twice the investment. **Proctor and Gamble** saved $560 million in waste reduction programs over the last several years.

◗ **DuPont** has turned its metrics for success 180 degrees. For the past 200 years, the metric has been pounds of product shipped. Today, the new metric is creating shareholder and societal value while reducing the company footprint from the wellhead to the landfill.

◗ **Sony** has achieved zero waste emissions at 17 sites.

Risk Management

◗ **BP** and **Shell** see the carbon challenge for the 21st century: how will society substitute the 7 billion metric tons of fossil carbon burned each year (which are converted into 26 billion metric tons of CO_2). The move by both companies into solar and other renewable energy sources has won plaudits from CEOs and NGOs alike in the December 2001 *Financial Times* piece on the world's most respected companies.

◗ To preserve its reputation, **3M** dropped its Scotchgard line in 2000 after learning that it persisted in both the environment and in the human body for years. At the time, this line of products delivered 2 percent of 3M's $16 billion in annual sales.

Stakeholder Relations

◗ **Ashland**'s world class assurance letter process starts with the CEO, taps into the best insight of the local managers around the world, and bubbles back up to the CEO and the board of directors. Relations with stakeholders locally and at the corporate level are an important input to this process.

◗ **Dow** thought it had picked all the "low hanging fruit" from waste reductions at its massive Midland, Michigan, plant. Then, challenged by NRDC (an environmental group), Dow agreed to a full re-examination, resulting in a 35 percent reduction in 26 toxic chemicals, saving $5 million per year. ◗ ***G.H.***

stated percentage is understated by a factor of 3 to 4 making known environmental costs as high as 12 to 15 percent of sales. And that does not account for very important externalities like greenhouse gas emissions and relatively free water.

Sooner or later, these externalities will carry a market cost. It is happening today with greenhouse gas emissions in companies (BP, Shell) as well as countries (U.K.). Faced with rapidly depleting groundwater sources and swelling population, China has initiated a five-year, phased-in increase in the price of water.

Questions to Ask

Boards need to prepare themselves for a new onslaught of business risks. To do so, they should be asking the right questions now about environmental issues (see "Questions" box below).

QUESTIONS BOARD MEMBERS SHOULD BE ASKING TODAY

◗ How does our governance system stack up with respect to the environment?

◗ What would a "sustainability audit" of our business portfolio reveal?

◗ Which of our products, services, assets, and investments are in the environmental "red zone"?

◗ What are the key issues in the countries where we operate?

◗ What is the true cost of environmental programs to our business?

◗ What is our carbon risk exposure and our CO_2 strategy?

◗ What is the full environmental footprint of our company?

◗ Have we signed on to codes of conduct, such as the principles of the Coalition for Environmentally Responsible Economies (CERES)?

◗ Which environmental groups and national governments could become allies and help us gain competitive advantage?

◗ How can we build a world-class reporting and communications system? ◗

Gib Hedstrom

Avoid These Traps

Based on over 30 direct interactions with boards (or board committees) that oversee corporate responsibility and the environment over the past 10 years, I have observed first-hand three traps:

◗ ***The layer of clay.*** Somewhere in the middle of virtually all organizations is the layer of clay: that place where the messages brought up from the bottom get filtered and distorted and the place in the organization where the CEOs messages about the importance of quality, or corporate social responsibility, or environment tend to get translated into "just make your numbers."

◗ ***The crowded agenda.*** These are big, long-term issues that cry out for board leadership. Yet, the reality is that today's typical board meeting format confines directors to consider very important issues in the 10-minute open session at the end of semi-annual, two-hour meetings with packed agendas. In contrast, Shell spent a full 50 percent of the time of its annual top management meeting on this set of issues, with lots of time for open discussion and debate.

◗ ***The short-term/long-term clash.*** The widely discussed misalignment between short-term senior executive incentives and longer-term interest of shareholders falls squarely in the lap of directors.

If directors watch out for these traps, ask the right questions, and close the gaps in their strategic thinking, the road to sustainable corporate growth will most likely be paved in more than one kind of "green." ◗

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