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QUANTIFYING IMPACT

White Paper

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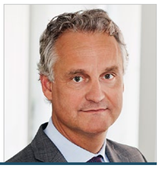
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Ethical Corporation – Quantifying Impact

By Mike Scott

The Taskforce on Climate-related Financial Disclosures (TCFD), set up by Michael Bloomberg and Mark Carney, governor of the Bank of England, calls on companies to examine and disclose the potential risks to their operations from climate change, both in terms of the physical impacts and the effect on doing business of government efforts to tackle the issue, consumer attitudes and investor sentiment – the so-called transition risks.

Efforts to tackle climate change won't work unless the issue is taken seriously, and that starts at the top, said Mark Lewis, managing director and global head of research at climate finance think tank Carbon Tracker. "The board has to understand that this is not an issue it can delegate down."

The European utilities sector provides a valuable lesson in how serious the implications can be, he said. "No sector or company likes being told to change the way it does business, it's natural human psychology. If you've been doing one thing very successfully for many years, it's natural to think that will carry on."

But E.ON, which was a €95 billion company is today worth about €20 billion, he pointed out. "Most of that reduction in value happened because the company misread the risk that climate change posed to the business. This

'Efforts to tackle climate change won't work unless the issue is taken seriously, and that starts at the top'

is a business risk and the people running the company have to understand it as such."

Thirty years ago, no-one in the utilities sector thought climate change presented any risk, but today, policy, regulation, technology and investor preference have all changed. Policy incentivised renewable energy and as the subsidies started to attract capital, economies of scale were brought to bear and the technology improved, enabling more capital to be deployed.

"Other industries such as oil and gas are facing the same challenges today as utilities did 10-12 years ago, but they are not recognising it," added Lewis, who has since moved to BNP Paribas, as head of climate change. "They just have to face up to it. This is not a 'nice-to-do'. But executives such as the CEO of BP say all this extra disclosure is a burden and that scenario analysis is just a gift to the lawyers. If that is your mentality, you're in trouble."

E.ON's compatriot RWE should have learnt its lesson by now, Lewis added, but in the run-up to the summit, its share price dropped 20% in four days after its efforts to clear a forest to enable the building of a coal mine (check) was stopped by a German court. "They are finding out the limits of lobbying power – you can't just say 'security of supply' and get what you want any more."

GE had to take a write-down of $23 billion on its acquisition of Alstom's power turbine business, he added. "It was a bet that gas-fired generation would grow strongly, but renewables have taken market share from gas. It's another sign that boards are misreading the signals."

If companies are resistant to change, a helpful message might be that they should be applying existing processes to climate change in response to developments such as the Paris Agreement, said Lois Guthrie, director – redefining value at the World Business Council for Sustainable Development (WBCSD), "but the risks are different to those that they normally deal with. There is a greater degree of uncertainty and that makes it harder to determine if the risk is material. That leads to boards making subjective judgements.

'..the risks are different to those that they normally deal with. There is a greater degree of uncertainty and that makes it harder to determine if the risk is material'

Lois Guthrie
Director

"If these issues are on your horizon, it's legitimate to conclude that there is nothing to report at the moment, but it's not legitimate to just ignore it. It has to be on your risk horizon," she said.

BHP has been concerned about climate change for a long time and started setting targets in the 1990s, said Fiona Wild, vice-president for climate change and sustainability at the mining giant BHP Billiton.

"Our approach has evolved to take a much more holistic view of risk," she said. "Rather than think about it as an environmental or sustainability issue, we now think about it as a business risk.

"I could design a climate change strategy by myself, but it's far better to bring in people from around the company and have a whole-company view of the risks climate change poses."

Scenario analysis is complicated and difficult, said Lewis, but it's something that we do all the time in our daily lives. "There is a tyranny of the status quo that, in a corporate context has companies assuming that things can only go one way. But you can get the board's attention by putting the numbers in front of them," Lewis added.

For a long time, we have had a carbon price that has not been very effective, but it is tightening now and companies need to look at that, he added. "The world is moving to a better understanding of these things, but some industries are moving faster than others. Automotive, for example, has embraced electric vehicles and are investing serious money in them."

'Scenario analysis is complicated and difficult, but it's something that we do all the time in our daily lives'

There is a difference between forecasts of what you think will happen and scenarios, which are different views of what is plausible, said Wild. "Our assumptions contain bias from looking at what happened in the past, but we need to plan for our investments across a range of different scenarios. So, we have a 2C scenario and an 'oh, shit' scenario, where people do nothing then suddenly realise how important it is and that we have to make a really rapid transition."

BHP has coal, oil, gas, copper and uranium assets. About three years ago, it decided to disclose the information to the market. “It was quite tortuous – it is forward-looking information and we’re trying to quantify the impacts. People got quite twitchy about it. But we disclosed in 2015 and it was really well-received. It helps us have much more involved conversations with our investors. We’re demonstrating that when we make investment decisions, we’re not just assuming that tomorrow looks like yesterday,” Wild said. “We try to understand which scenario is becoming more dominant and shape our strategy accordingly.”

If you’re not ready for scenario analysis, you can start with sensitivity analysis, which just considers a change in one factor, Guthrie pointed out, but there are good examples of scenario analysis on the TCFD hub. “We need to think about why we’re doing this,” she added. “TCFD says that it is to demonstrate your resilience against the risks that could occur because of climate change.

“We base it on the most recent third-party information, for example how climate scenarios are applied by the International Energy Agency. You need to make sure it’s a credible source. And you have to ensure you make it specific to your company, your business model, your strategy, your assets and your future.”

However, Wild warned that while the IEA scenarios are useful for the energy industry, they may need to be adapted for other sectors. “The IEA scenarios are good for the energy parts of our business, but not for things like copper or steel. They’re difficult to use for companies not in the energy sector. You need to tweak and adapt them so you have the right levers in your business.

‘We need to think about why we’re doing this... it is to demonstrate your resilience against the risks that could occur because of climate change’

Another issue, Lewis pointed out, is that any scenario developed for a multilateral agency will be very incremental and linear in its approach. “In the real world, it never happens like that. It goes in fits and starts, which are very difficult to capitalise in a linear model. You don’t want to treat this as just another box-ticking exercise.”

The same attractive subsidies for solar power that hit the European utilities sector also had unforeseen effects on European solar equipment manufacturers, he said. “They attracted a lot of capital into Chinese manufacturers and the cost of panels fell orders of magnitude more quickly than anyone predicted. It bankrupted the German PV industry but it also meant that the solar sector grew much more quickly than anyone predicted. It was completely outside the parameters of the way people were thinking.

“You can’t know in advance that certain things will happen, but you can be alive to the possibility that, for example, China will move rapidly to electric vehicles, not just to fight climate change but also for public health and air pollution reasons. Air pollution is a very large local issue and it’s an area where the government has a very obvious incentive to act. You need to think about where public policy is most likely to be effective.”

What people would like is some kind of reference manual and template of what to consider and how to act, but that is totally contrary to the whole nature of scenario analysis, said Guthrie. “It has to be a company view of how it can succeed or otherwise. Investors are interested in a range of scenarios, but although most companies do some kind of scenario planning, some firms are resistant to considering extremes,” she added.
When developing scenarios, it is important to use the most up to date and accurate scientific information, said Wild. BHP’s previous analysis was based

China will move rapidly to electric vehicles, not just to fight climate change but also for public health and air pollution reasons

on the latest reports from the IEA and the Intergovernmental Panel on Climate Change. The company will look at the IPCC's recently-published 1.5C report and its key findings, think about the potential impacts that it outlines and hardwire them into its thinking about climate risk, she added.

One issue with the TCFD, Wild said, is that the long term is not defined and it means different things to different actors – for miners, the long term can be anything between 15 and 100 years, while for investors it can be defined as anything from six months to a year. But disclosing under TCFD guidelines has made it "very clear that the scale of the challenge is much greater than we hoped".

Whether we are aiming to limit temperature rises to 2C or 1.5C, we are badly behind, said Lewis. "We're currently on track for 3C and eventually, we will come to the realisation that we can't go on like this. If you look at the report of the PRI (the Principles for Responsible Investment), The Inevitable Policy Response to Climate Change, it is clear that there will be big changes between now and 2030. You have to think there will be a more rigorous policy environment at some point in the future.

the transition is happening anyway, given the changes that are occurring in technology and social attitudes

"And the transition is happening anyway, given the changes that are occurring in technology and social attitudes. After a while, you get tipping points that change attitudes. These things happen whether companies like it or not. Then, they have to change, or they will have to start writing down the value of assets in future. If it can happen to utilities, it can happen in any sector – after government bonds, utilities were the safest investment there was. But that's no longer true. The sector has lost 60% of its value in the last 10 years."

In response, Guthrie asked: "When is a scenario not a scenario? When it's a fact. It is going to be dangerous in future and you are almost impelled to act.

You almost have to treat it as a scientific approach to which business needs to respond."

Lewis went even further. "This is actually happening now. This is not a practice. It's a never-ending source of amazement to me that that it is happening all around the world and people are just ignoring it. GE is one of the biggest blue-chip companies on the planet and it had to write down $23 billion of gas generating assets that are meant to be a safe investment in fossil fuels.

"If you are looking at the financials, barely a week goes by without seeing a material impact on companies to do with climate change and the broad range of issues that are linked to it. What happened to VW over the Dieselgate issue is a prime example," he added. "The public health impacts of climate change are an issue that is rising up the agenda much more quickly than people realise."

'The public health impacts of climate change are an issue that is rising up the agenda much more quickly than people realise.'

The TCFD may still be in its early stages, but it has gained traction quickly, and it will have a growing impact on companies' approach to climate change in years to come. ■

Natural capital case study: AkzoNobel puts a price on its impact across four capitals

Angeli Mehta reports on how measuring financial, environmental, human and social dimensions led the chemicals firm to increase its use of renewable energy and make better use of raw materials

AkzoNobel has been trying to measure impacts in its value chain for some years. In the early 2000s it worked on lifecycle assessments, but this approach has limitations as it only includes the environmental aspect of sustainability, explains Emma Ringström, sustainability manager at its pulp and performance chemicals business,

In 2014, the company embarked on a pilot at its bleaching chemicals business in Brazil to investigate the entire impact of its business across financial, environmental, human and social dimensions. In collaboration with True Price and sustainability consultants GIST Advisory, it did full profit and loss accounting across these four capitals – what it calls 4D accounting. The exercise confirmed that its sustainability strategy did indeed cover the most important elements, says Ringström.

It led AkzoNobel to increase its use of renewable energy, and put greater focus on better resource use of both energy and raw materials. Looking at impacts on human capital brought more emphasis on training and

'We got the possibility to identify the biggest impacts, and to scale up the positive and reduce the negative'

developing capabilities; while social capital led to work improvements in health and safety, and rights at work.

Later, it piloted the Natural Capital Protocol for the production of chlorate, used for bleaching paper. "Using the monetisation element of the protocol, we got the possibility to identify the biggest impacts, and to scale up the positive and reduce the negative impacts ... We can see the hot spots here and there, which are most important to work on."

Emma Ringström, sustainability manager at AkzoNobel's pulp and performance chemicals business.

After the pilots, AkzoNobel applied the 4D approach across its entire pulp and performance chemicals business, followed in 2016 by environmental, social and economic profit and loss accounting across the entire business. It reported a monetary value for these three capitals, across its value chain.

Social impact assessment is in its infancy, but includes value related to the knowledge and skill development of employees and their future salary development.

The environmental assessment includes value through its products that help customers cut emissions. To put a monetary value on key impacts such as CO2 emissions and use of fossil resources, it uses a science-based approach that takes a long-term view. Prices are, says its report, based on what would happen in 50 to 100 years if we keep on using resources as we do today.

AkzoNobel has a wealth of data from its businesses, and more is becoming available in its supply chain, so the actual measuring is getting easier, says Ringström. Valuation, however, is more difficult.

"We'd welcome more scientifically based methods that are transparent and publicly available," Ringström adds. "It's important that the methods are transparent, so we can judge if the values are representative for our case, as well as interpret the results in a correct way."

As part of the Forest Solutions group at the World Business Council for Sustainable Development, AkzoNobel is piloting a forest sector guide, which will give the industry more specific guidance on measuring and valuing natural capital impacts. AkzoNobel is looking at the potential impact of changes in natural capital: for example, regional changes in water supply. The guide is expected later this year. ■

'It's important that the methods are transparent'

Major funds launch toolkit to help investors measure SDG impact

By Terry Slavin

A dashboard developed by CISL's Investment Leaders Group, including PIMCO, Union Bancaire Privée and Zurich Insurance provides metrics to assess corporate social and environmental impact. Terry Slavin reports

Cambridge University's Investment Leaders Group has developed a framework that allows investors to measure the impact of their investments against the Sustainable Development Goals.

The Investment Leaders Group (ILG), a global network of pension funds, insurers and asset managers convened by the Cambridge Institute for Sustainability Leadership (CISL), has created a dashboard, called the Cambridge Impact Framework, that uses existing data to help the industry assess funds against six themes derived from the 17 SDGs: resource security, healthy ecosystems, climate stability, basic needs, wellbeing and decent work.

The dashboard uses a traffic light system to categorise impact from very negative (red) to very positive (deep green).

'We struggle to answer one of the most basic questions that can be asked about a fund: Is it doing harm or good?'

But Dr Jake Reynolds, executive director at the Cambridge Institute for Sustainability Leadership, and lead author of the report, warned at the launch event at the Institute of Directors in London last week that the framework is only a crude approximation, compared to the ideal metrics that will need to be developed in future to measure impact.

“The reality of environmental and social disclosure is that we struggle to answer one of the most basic questions that can be asked about a fund: Is it doing harm or good?” Reynolds said.


The framework measures impacts against SDGs including climate stability.

“It’s very hard to properly generate, with today’s data, the tests that you’d want to make on a fund. These would be extremely complicated, deep evaluations of a firm’s operations and its value chains.”

For example, on decent work, ideally one would want to know the total number of jobs that pay a living wage and offer safe and healthy working conditions. However the closest approximation today is data from Bloomberg on the number of workers in full-time employment.

When it came to measuring resource security, the best information available to the industry at scale was total net waste. But the ideal metric would explore losses of products into the environment as well as toxicity and scarcity of materials within a circular economy.

And on the healthy ecosystems theme, the closest approximation was data on fresh water use. “That’s a pale shadow of what we want to be measuring,” Reynolds said.

The report proposes both ideal and base metrics for each of the six SDG themes, so that fund managers can make the first stabs at measuring impact, while the industry tries to come up with better metric over the longer term. Both sets are intended to provide objective, comparable, consistent and reproducible results.

Reynolds pointed out that getting an accurate measurement of social and

‘All investment has impact, and arguably it’s more important to discover what the impact is of a fund when it is very conventional’

The framework measures impacts against SDGs including climate stability.

environmental impact was not just a question for impact funds, which have a desired social or environmental impact. "All investment has impact, and arguably it's more important to discover what the impact is of a fund when it is very conventional. This goes right across the capital mix."

Union Bancaire Privée (UBP), one of the members of the Investment Leaders Group, stress-tested the framework on its newly launched Positive Impact Equity fund, a portfolio of 25-35 stocks of companies that "address the world's most pressing environmental and societal challenges".

Victoria Legett, head of impact investing at UBP, said: "There is building momentum from our client base for a product like this."

Legett said she had feared that the dashboard would flash red in most categories, but on well-being and basic needs, the fund was in very positive territory, in decent work it was positive, while it was neutral for healthy ecosystems, and negative for both resource security and climate stability.

She pointed to the huge gap between the ideal metrics and those that can be practically used today to measure impact in the dashboard.

'By using the framework we can move into the carbon foot-printing space with much more clarity'

"It's not a silver bullet. It's not a complete solution. We are just not there as an industry yet. But it is a really exciting shift and in making a start we are creating hopefully a platform, and from this platform we can both advocate for improved disclosure and at the same time give clients something that is practical and comparable right now."

Johanna Koeb, head of responsible investment at Zurich Insurance, said the framework would help with its target, set in 2017, of doubling its impact investment to $5bn of its $200bn under management. Zurich has a goal of improving the lives of 5 million people a year, and saving 5 million tons a year of CO2 equivalent emissions.

Impact per US$ 1m invested

She said the framework would help Zurich footprint its investments for positive and negative impact "looking at what the underlying assets are doing and the traces companies leave in the world, including their climate impact". Until now, she said, it has not been easy. "But by using the framework we can move into that space with much more clarity."

By allowing funds to get an outcomes perspective, "it really completes the picture of who we own".

Niamh Whooley is senior vice-president for ESG at California-based investment manager PIMCO, which oversees $1.69trn in global assets on behalf of retirement savers, public and private pension plans, educational institutions, central banks and government agencies, sovereign wealth funds, and foundations and endowments.

She said the company applies ESG integration across all its holdings, and while it only measures impact in the smaller universe of its impact funds, Pimco has the longer-term ambition to apply impact metrics to its entire portfolio.

'Many of the issuers are framing their activities within the positive lens, but not disclosing the trade-offs in terms of their negative impact'

"We have already begun this journey in a number of areas," she said. For example, with SDG and green bonds it has a proprietary screen for pre- and post-issuance seeking evidence to significant positive outcomes compared to business as usual.

On the climate theme, she said PIMCO was close to using ideal metrics, as the ESG desk has worked with the energy desk to develop tools to evaluate the impact of climate change on its portfolios.

Pimco's Niamh Whooley says the need for common impact indicators has never been greater

On other themes, available data is more limited. She pointed out that PIMCO in November evaluated the level of ESG data provided by 240 of its largest corporate and financial issuers.

While 63% mention the SDGs in their annual reports, and 39% had mapped their business activities against them, only 19% of those that referenced the SDGs have set qualitative targets to meet the goals.

"Many of the issuers are framing their activities within the positive lens, but not disclosing the trade-offs in terms of their negative impact of their operations and value chain."

Nor were they looking at the inter-relationships between impacts like climate, water and air pollution.

She said the need for companies to converge on a common set of impact indicators has never been greater.

"We are delighted to have been part of the ILG initiative, which has provided us a toolkit to start the measurement journey."

She said PIMCO planned to do more collaborative work using the new toolkit, including as part of the Climate Action 100+ group of investors, which is pushing the top 100 polluting companies to align their business strategies with the Paris Agreement. ■

'We are delighted to have been part of the ILG initiative, which has provided us a toolkit to start the measurement journey'