

The Economic and Commercial Benefits of Long-term Sustainability **Les bénéfices économiques et commerciaux d'une croissance durable**

By Graham Ward and Fiona Crozier

1. Introduction

Companies exist to make a return to investors but now they are realising that in order to carry on providing a good return they must pay attention to issues which are going to determine performance over a very long period of time. These issues go beyond the standard operational challenges, and although they may vary according to the nature of individual businesses they are likely to include environmental issues, social issues and globalisation.

It is apparent that companies need to address these issues, not out of altruism or philanthropy but out of enlightened self-interest. If they do not, their ability to perform will in the end be limited by the attitudes of customers, employees and, indeed, society as a whole.

The Global Capital Markets and other stakeholders are scrutinising companies on their response and are seeking quality and verified information on social, ethical and environmental issues. There are now market indices such as the Dow Jones Sustainability Index which allow easy tracking of the performance of companies in upholding the values of sustainability which they measure.

2. Sustainability

The term "Sustainable Development" was defined for the first time in 1987 by the United Nations Brundtland Commission as:

*"meeting the needs of the present without compromising the ability of future generations to meet their own needs"*¹

Although there are limitations in this definition it is the oft-cited starting point for many studies on sustainability. It has been criticised because it is a broad-brush statement that few can disagree with but it does not focus in on specifics.

It has been said that sustainable development should encompass benefits to the majority rather than just a minority, it should involve operating to global standards everywhere in the world and it should not foreclose options to future generations. It should be something that is inclusive not exclusive, something that is progressive rather than regressive and enduring rather than temporary.

For a project to be truly sustainable, however, it must be economically viable.

Shell UK, for example, have said in their Report to Society:

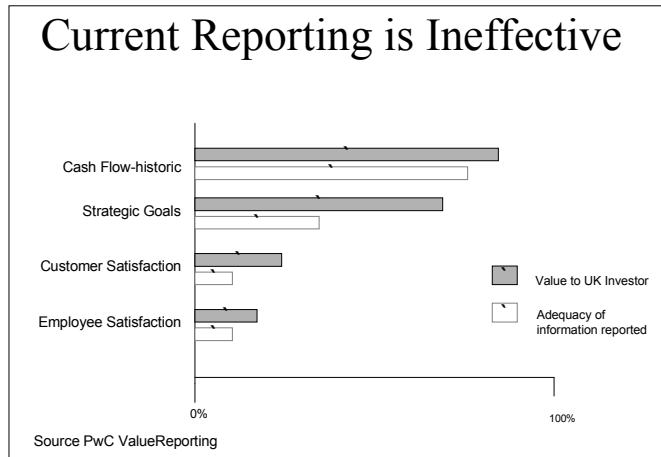
*".. a genuinely sustainable future and continued human progress must be built on the secure foundations of economic success."*²

3. Economic Success

3.1 Shareholder Value

It is widely accepted that the overall strategy of a company should be to increase the wealth of its shareholders: that is to increase the company's shareholder value. The value of quoted companies is readily determined from their stock market price. In theory, this price should represent the value attributed to the discounted value of the company's future cash flows.

Table I



The difficulty is that investors do not always have good information on which to judge either the future cash flows or the risks associated with them. A company’s approach to sustainable development affects both the value of the cash flows and the risks associated with them and can assist investors in deciding whether to buy, sell or hold a stock.

Research has shown that, under the current reporting regime, few companies provide enough information to meet the needs of investors and potential investors. These issues are examined in depth in the PricewaterhouseCoopers ValueReporting Forecast: 2001³

Although there are significant gaps across a wide spectrum of information (for example market dynamics), more detailed information was found to be needed about those activities which are seen to underpin value creation. These include innovation, brands, customers, employees, the supply chain and environmental and social activity. Table I illustrates graphically the results of some of this research. Highlighting how inadequate the current reporting regime is for UK investors. Further research carried out in several other countries indicates that there is a clear information gap between the information needs of the investment community and that provided by companies across the world.

The research also showed that only 33% of Chief Executive or Chief Financial Officers believed that they had control over the critical information flows to investors and only 10% had a consistent communication process or strategy which focussed on shareholder value.

3.2 Information Needs

One of the major areas of debate is how to measure the success of projects and processes that businesses undertake. The shortcomings of the classical reporting model are being focussed on by many. Lynn E Turner, the Chief Accountant of the US Securities and Exchange Commission has said:

“ There is no doubt in my mind that we can improve annual reports by considering how and what creates value in businesses.”⁴

The focus on a single profit or earnings figure is no longer good enough to comprehend what is really happening to a corporation. The ValueReporting framework provides a platform against which a company can consider the areas of its business where value is created and consider how to improve reporting in these areas. This model is set out in Table II below:

3.3 What creates value?

Jack Walsh the CEO of General Electric has said:

“The three most important things you need to measure in business are; Customer satisfaction, Employee satisfaction and Cash flow. If you are growing customer satisfaction, your market share is sure to grow too. Employee satisfaction gets you productivity, quality, pride and creativity. Cash flow is the pulse – the vital sign of a company”⁵

Table II

ValueReporting™ Best Practice Model			
External		Internal	
Market Overview	Value Strategy	Managing for Value	Value Platform
<ul style="list-style-type: none"> •Competitive Strategy •Regulatory environment •Macro-economic environment 	<ul style="list-style-type: none"> •Goals •Objectives •Governance •Organisation 	<ul style="list-style-type: none"> •Financial Performance •Financial position •Risk management •Segmental 	<ul style="list-style-type: none"> •Innovation •Brands •Customers •Supply Chain •People •Reputation <i>Environmental Social, Ethical</i>

Those analysing business performance have long been aware of the importance of cash flow and although cash flow information is provided with most financial statements, the focus is often still on the headline profit figure. Factors affecting the future of the cash flow stream are now coming to the fore in the debate and the degree of certainty of, including the risks associated with, the cash flow need to be understood.

3.4 Cost of Capital

Nobel Prize winners Modigliani and Miller undertook the work leading to development of the capital asset pricing model. The model in essence states that the return required by an investor is related to the risk of the investment. Simply: that the more risky the investment the greater the return expected. It follows from this that in order to reduce the required return to be paid to investors (the cost of capital) the risks and the perception of them associated with the company should be reduced as far as possible.

In order to provide proper communication to investors the company must provide clear information about the risks it faces and how they are managed. In the UK, information on risks and the internal controls in place to mitigate them has recently been introduced as a requirement for companies listed on the London Stock Exchange⁶

Many companies, however, including leading energy companies such as Shell⁷ and BP⁸ have gone beyond this. They are seen to be at the forefront, providing information about how they operate and how their business culture has been changed to face the challenges associated with environmental, and social and ethical issues.

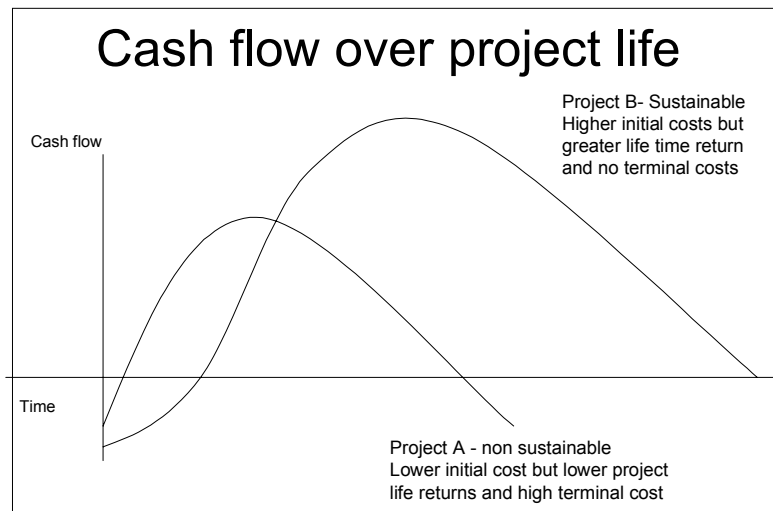
Shell is widely regarded as a leading example of the direction of corporate reporting in this sphere. They have seen their sustainable development integration in terms of a road map and have developed The Shell General Business Principles⁹ which cover items such as integrity, profitability, the environment, community and communications. Key features of the framework they adopted ensure that their values and business principles are based upon systems, standards, verification, continuous improvements and targets. So that management had knowledge of what was really happening in different areas of the business.

Systems were adopted that included best practice and where appropriate existing practices were used to minimise the need for new procedures. Standards were determined in dialogue with stakeholders and a series of key performance indicators (KPI) were developed. Although some of these may be specific to particular circumstances, the need for consistency and comparability is understood, as is the complexity of the creation of such standards. Verification is seen as important, just as with the audit of the financial statements and verification provides assurance to the stakeholders about the integrity of the social, ethical and environmental information reported. Just as the audit of financial information is of great value to shareholders and is seen to lower the cost of capital, it is consistent that independently verified non-financial information on environmental and social activities will provide greater assurance about the risks a company is facing. This should again result in a

lowering of the cost of capital. Indeed, evidence ¹⁰ is now available which empirically supports these theoretical arguments.

As illustrated in Table III, there may be additional extra initial cost associated with sustainable projects, such as higher insulation costs or emission treatment costs. These may, however,

Table III



be recouped over the longer sustainable project life as indicated for project B. The full lifetime cost of a non-sustainable project A, including items such as clean-up costs, may not always be apparent at the start of a particular project. There may, therefore, be an element of education required to ensure that long term gains are not given up for apparent lesser short term benefits.

3.5 Globalisation

We believe that globalisation means that companies can no longer act in isolation. The standards set by the best companies will be those that are required by all companies in the future. Emission and other environmental standards, set in the “green” countries, will be those by which other countries and companies are scrutinised.

We have recently seen an example of this in the UK. Safety standards applied to workers in the UK handling hazardous waste in the 1950’s and 1960’s are now being used by the UK courts as the standard by which the overseas operations of UK companies were expected to operate during the same period¹¹. So it appears that it is no longer acceptable to have one set of safety standards for workers in the first world and a different (lower) set of safety standards for workers in the third world.

Globalisation, though offering unprecedented opportunities to do business in new countries, also represents a threat, as companies find themselves caught up in situations of conflict and allegations of human rights violations. The need for a strong company culture to deal with activities that are acceptable at a local level but unacceptable at a global level is clear. For example, some companies have clearly stated that they will not allow employees to give or receive bribes. Other companies have refused to do business in countries where bribery is endemic in the local culture.

3.6 Summary of Economic Benefits

We have outlined how the greater understanding of the risks associated with a particular operation and how these are managed can lead to the economic benefit of a reduction in the cost of capital for a company at a micro economic level.

This understanding is only achieved by companies clearly communicating to stakeholders the activities they are undertaking which are enhancing the sustainable development of the company and hence will lead to increases in the long term economic value of the organisation.

There is beginning to be limited evidence that some environmental and ethical investment funds have performed better than some funds which merely attempted to reproduce the standard indices. Clearly, this is an area where further work will be performed.

Macro-economic benefits are readily identifiable as: reduction in pollution, lower clean up costs and more effective utilisation of resources. In general, the responsibility for pollution and other costs has been borne by society as a whole. The cost of cleaning up after the benefits provided to today's generation are often borne by future generations. The principle of sustainability would place this responsibility on those who have greatest ability to control these costs: those who are receiving the benefits.

4. Commercial Benefits

This section considers the commercial benefits which flow to an organisation which embraces the principles of sustainability.

We consider these benefits under the following headings:

- Customers
- Suppliers
- Employees
- Society
- Innovation
- Strategy
- Reputation
- Access to Capital

4.1 Customers

There are many benefits to a company of satisfying the needs of the customer. The demands of the customer vary according to industrial sector. Historically, much of the energy industry has been driven by price concerns. The ideas of sustainability have, however, increased the opportunities for energy to change from being a simple commodity into a branded product. Many customers are focussing on a desire for a "green" product and many more customers do not wish to be associated with companies that have a "dirty" image.

It is widely accepted that it is cheaper to keep your existing customers content than to attract new customers. By focussing on their desires, greater long-term customer satisfaction can be achieved. It has been suggested, for example, that providing a hotel chain with power from a sustainable energy source could help to improve the reputation of that hotel chain and hence increase its desirability to its customers. For example, TXU have agreed to provide Bass Hotels with over \$100m of energy over 3 years and the project includes energy efficiency planning¹².

Other heavy power using customers, perhaps in historically "dirty" industries, could see their reputation enhanced by using greener sources of energy supply or energy from ethically reputable suppliers. By focussing on sustainable development it has been said that the

decision about the purchase of energy has been lifted from the “purchasing department” into the Boardroom.

4.2 Suppliers

The commercial benefits to suppliers are not dissimilar to those of customers: a desire to gain reputation by association with reputable companies.

A company is also in a position to influence its suppliers to act in environmentally friendly and ethical ways. This has the advantage of establishing long term business partnerships with suppliers by the sharing of expertise.

4.3 Employees

The new economy is being driven by knowledge. Knowledge and how to use it will be critical factors for future success despite recent advances in information technology. A company's key knowledge is usually contained within the people it employs. It therefore becomes of fundamental importance to attract, train, and stimulate good people and to capture and share the knowledge they create. This is what human capital management is all about.

It has been said that:

“Companies that ignore Human Capital will go the way of the Dinosaurs”¹³

Evidence from the Industrial Society in the UK indicates that 82% of UK professionals would not work for organisations whose values they did not believe in¹⁴ and that nearly 60% chose the company they work for because they believe in what it does or what it stands for.

It is clear that reputation is vital to attracting and retaining high value human capital.

The value of human capital is one of the major explanations of the growing gap between company values reported in accounts and stock market values. Reporting of employee satisfaction, employee retention, training received and days lost due to accidents or illness can provide indications of the value of the human capital within an organisation. Detailed reporting to investors and other stakeholders on how human capital builds long term capital value are being developed by the Institute of Chartered Accountants in England & Wales¹⁵ among others.

It now seems clear that major commentators in this area are following the view that it is not sufficient to include within a corporate report only some general phrases on the company's policies on human capital. There is a clear need for appropriate measures, targets and independent verification to ensure that human capital is suitably valued. Opinion is now moving away from incorporating more information in a redesigned balance sheet and profit and loss account, towards further descriptions in operating and financial reviews published within the annual report.

Investors may also be keen to understand the company's view of issues such as their policy towards child labour. The use of child labour in developing economies to manufacture products sold as premium products in the developed world has led to well publicised boycotts of company products and falls in a company's value.

Ethical investment funds are beginning to look closely at the way employees are treated within organisations before making their investment decisions.

In the UK and the US this may involve the company's view of the flexibility given to employees to integrate their work and non-work life. For example, some UK employers recognise that older staff provide better customer service but that they like to have longer vacation time. Companies able to adapt to these needs may gain an edge through the service they offer.

Increasingly companies are recognising the benefits of career breaks or secondments. Often during these periods employees will work for a charitable organisation, whilst being paid by their employer, undertaking a project of benefit to the community. These employees return to the original organisation with renewed insight, which can be of enormous benefit to the business, even though the project undertaken often had no apparent direct relevance to the employee's usual company role.

4.4 Society

Members of society, acting in concert as NGOs, or as individuals may take direct action, or engage in some other form of protest if they believe that a company is acting in an inappropriate manner. This can be very difficult to approach as there is a plethora of different pressure groups wishing companies to act in different and sometimes contradictory ways. This is why it is important for companies to identify a clear strategy of what they are seeking to achieve and to engage in constructive dialogue so that the views of NGOs and others can be considered.

4.5 Innovation

There is beginning to be anecdotal evidence that companies adopting sustainable policies are becoming more innovative. It would seem that articulating a company's environmental stance allows its workforce to think of innovative solutions that are sustainable. Research into this is continuing¹⁶.

Energy companies are providing new and different ways of supplying power to their customers. Sometimes this may involve long term partnering to find sustainable solutions, possibly leveraging off the stricter environmental regulations that are being introduced around the world. For example, this could be linking the provision of heating to a local community close to a major heat generative industrial plant. Traditionally it may be expected that either the local government or the industrial company should provide this service but today this provides excellent opportunities for energy companies to lever their knowledge of energy supply.

A senior oil company executive has said that it is no longer possible to dictate what products a customer wishes to buy. Companies must innovate to produce the products customers desire. For example, lead free petrol was in part an innovation created by customer desire to reduce the toxic lead content of the fuel they consumed.

4.6 Strategy

Articulating a firm's strategy and getting all stakeholders to believe in and follow it is a critical challenge for corporate leaders. Clear articulation of an ethically and environmentally sound business strategy amongst management is an essential prerequisite to achieving the performance required.

Some companies, and Texaco are often cited here, are linking executive pay to social performance – helping tangibly to reinforce the company strategy.

It has been said ¹⁷ that yesterday's leader was one who drove people and did things right but that tomorrow's leader is one that inspires people and does the right thing.

4.7 Reputation

Corporate reputation is difficult to build and to nurture but is very easy to destroy. The commercial value of a good reputation is very high, especially in the energy business where, as Sir John Browne, CEO of BP, has expressed, global companies have often been perceived to have a secretive and untrustworthy image.

“Some people think the caricature of the oil industry is reality – that we're men in black-secretive, arrogant, working in the dark, indifferent to any destruction or pollution we cause”¹⁸

Although the intrinsic appeal of a good reputation is easily recognised, putting an economic value on it is much harder. Evidence that superior ethical behaviour leads to a better reputation is an area for further research but evidence that unethical behaviour is linked to a higher risk profile for a company is more readily available. The deterioration of the public image of companies whose ships were involved in what were perceived to be avoidable oil spills is a case in point.

In the US there is now some evidence that reputable behaviour can have clear financial benefits, as the law courts can take into account a company's environmental related internal control policies when considering fines or compensation for environmental damage.

4.8 Human Rights

A company's attitude towards human rights, as part of its general ethical stance, affects its reputation. Human rights issues feature more prominently for many energy companies than for most companies.

Published policies should cover attitudes toward indigenous people, fair remuneration, child labour and equal opportunities. In many countries these issues have been dealt with by government and often there are laws to prevent exploitation. In countries where they have not been addressed or the implementation is weak, however, it is prudent to consider the global view of the effect of local business practice.

4.9 Access to capital

We have highlighted that the cost of capital to a company is reduced if an internal control system addressing environmental and social issues is in place. There is some further evidence¹⁹ that in the United States, where environmental regulations are in place and litigation risk is significant, companies which do not have adequate systems in place are denied access to capital.

Ethical funds are becoming more popular with the investing public. They provide an additional source of funds which are not available to companies which fail to meet the ethical standards required.

5. Triple Bottom Line Reporting

We have discussed above some of the limitations of the current company reporting framework and the focus on investors alone rather than wider stakeholders has been considered²⁰. Also we have argued for greater focus on areas outside the current structure, to include social, ethical and environmental information within the regular reporting regime.

Triple Bottom Line Reporting is reporting which brings together the financial, environmental and social reporting needs of a company (or other organisation) and attempts to bring them together into an easily understood whole.

This process is not easy. The much criticised current standard of financial reporting has been in existence in its current form for more than 50 years. It has existed in earlier forms since double entry bookkeeping was invented in the 14th Century and in simple tallies since time immemorial.

Environmental and to a greater extent social reporting are in their infancies and it is likely that several different reporting measures and targets will be tried before readily understandable measures are in common usage. But just because the framework is not yet perfect should not stop us from reasoned experiment. A process of iteration will create better measures.

Frameworks have been and are being developed by a number of groups, for example by the Global Reporting Initiative²¹ which was established in 1987. Energy Companies, such as

TXU Europe, have been among the first to pilot reports under this Initiative. The process is evolutionary and it has been said that the journey that will continue for many years.

Difficulties arise in part because financial measures are generally well understood and the framework for financial reporting and verification (audit) is also readily comprehended. In other areas, deciding what to measure is not simple and may well vary greatly according to different activities undertaken by the business preparing the report. The verification process is similarly not necessarily well understood, with the need for independent experts only now really being appreciated.

Table IV

Triple Bottom Line



6. Web based Reporting

The internet has transformed information access. Companies can use their website to provide detailed information about their operations and philosophy which is not realistically possible using a paper-based medium. It is a cheaper, faster and more efficient way to reach a global audience.

Most of the major energy company websites provide information on the company's approach to sustainability and often provide fascinating examples at a very detailed level. For instance, one website highlights the problem of malaria carrying mosquitoes living in the water collecting on the top of oil drums in tropical locations. A cheap and simple plastic lid was developed to stop the water collecting and hence reduced the need for anti-malaria medicines.²²

Research²³ indicates, however, that although company web sites allow easy access to investor relations' sections fewer had an adequate site map or search facility. What was surprising but very welcome was that many innovative companies are now offering some if not all their web information in a range of languages – Intel (a computer chip company) offers its press releases in 20 different languages. Shell was highlighted in the research as one of the best examples of a site which clearly states its corporate values and principles.

Most websites also encouraged stakeholders and NGOs to contact them. In summary, use of a website permits greater scrutiny of companies by interested stakeholders and also allows easier comparison amongst companies.

6.1 XBRL

As yet the internet does not provide a simple way for users to extract and analyse corporate information. To prepare comparative data it is necessary to delve into the various reports reproduced on the websites and then extract the detail. While considerably easier than obtaining the reports by post, this is still a cumbersome process.

A new “language”, called XBRL, (eXtensible Business Reporting Language) is being developed by a consortium representing the corporate reporting sector. It is intended that this will provide a method by which information or data can be tagged on the internet. Hence it should be possible to extract quickly and simply say, the revenues from a variety of different companies which are buried within their own separate financial statements on the web. It will also be able to look for specified items that are within notes to the accounts. Analysts will then find it easy to compare and contrast different company results. It seems likely that pressure for both more frequent and more timely financial and non-financial information will follow. We expect that company reporting information will more closely align with the information actually used to arrive at analysts’ valuations and will include information on value creating activities.

6.2 Advantages of web based communications

The web in part reduces the difficulty that Chief Executives have in controlling the flow of key information to investors, as it permits the company to tell its message direct to the investor. Most companies now have an investor relations area on their website. The importance of keeping this information current cannot, however, be over emphasised.

The web also permits companies to provide very detailed information on specific areas to individual groups of stakeholders, without the need to bombard all stakeholders with information they may not find relevant.

By contrast, a real management challenge arises as a result of the web; it is easy for disgruntled employees (or ex-employees), dissatisfied customers or NGOs to advertise their grievances widely on the web. Meeting this challenge requires companies to be aware, on a timely basis, of what is being said about them and ensure that the true facts about their position are brought promptly to the markets and the public. A company with a high general reputation will find it easier to refute misleading allegations. Underlying all of this is the need for frequent and continuous dialogue with all relevant parties interested in a company’s activities.

7. Conclusion

The financial advantages of adopting sustainable company strategies, policies and principles are becoming clear. The demands of the global capital markets and other stakeholders for corporations to embrace sustainable development will determine the performance of companies and those that do not change will not succeed. Globalisation and advances in web based reporting will not allow any place to hide.

We suggest that companies should:

- Consider how sustainable development affects what their business is trying to do
- Consider how this affects corporate strategy
- Open a dialogue with stakeholders – employees, customers, suppliers, NGOs etc. This should be a two way interaction
- Having listened to stakeholders, develop the corporate policies to:
 - Develop or adopt measures that will provide information on key aspects of the strategy be it emissions, human capital or human rights
 - Set targets

- Measure performance regularly against these targets
- Independently verify the results
- Communicate the results to stakeholders.

The Global Capital Markets will receive the information on sustainability and combine their assessment of this with other available financial and non-financial information when forming a view on investment prospects. Strong performers will reap the benefits in better access to capital at lower cost. Also their commercial relationships will be stronger and their employees will be more motivated and innovative.

Sustainability considerations are essential to managing companies in the 21st Century. They are not something to be delegated to a small backroom team but must be a core part of corporate strategy in the forefront of the minds of boards.

As the chief executive of one of the world's very largest global corporations has expressed, "look no further, I am our sustainability manager".

¹ The Brundtland World Commission on Environment and Development – "Our Common Future" 1987

² Shell UK Report to Society– May 1998

³ PricewaterhouseCoopers ValueReporting: Forecast :2001 October 2000

⁴ Lynn E Turner Chief Accountant US Securities & Exchange Commission – Speech 9th December 1999 – SEC web site www.sec.org

⁵ Fortune Magazine 25 January 1993.

⁶ Internal Control – Guidance for Directors of Listed Companies Incorporated in The United Kingdom – 1999 Institute of Chartered Accountants in England and Wales.

⁷ www.shell.co.uk – Issues and dilemmas

⁸ www.bp.com - The environmental impact of BP Amoco's operations

⁹ www.shell.co.uk – Issues and dilemmas

¹⁰ {FT Marketing Globalisation Series}

¹¹ "Companies with nowhere to hide" Richard Meerson The Times London 1st August 2000

¹² TXU Press Release 15 February 2001 www.txu.com

¹³ Press Release – Human Capital and Corporate Reputation : Setting the Boardroom Agenda The Institute of Chartered Accountants in England and Wales June 2000

¹⁴ Corporate Nirvana: The Industrial Society December 2000

¹⁵ Corporate Nirvana: The Industrial Society December 2000

¹⁶ Buried Treasure: Uncovering the business case for sustainability; SustainAbility in partnership with United Nations Environmental Programme and others; 2000

¹⁷ The Death of the Traditional CEO: Nick Oblensky, The Centre for Tomorrow's Company Spring 1999

¹⁸ Sir John Browne – Speech, Morehouse College, Atlanta, Georgia, USA 29th September 2000

¹⁹ www.sustainability.co.uk – Business case for sustainability web based matrix

²⁰ The Department of Trade & Industry "Company Law Review"

²¹ Global Reporting Initiative – www.globalreporting.org

²² www.shell.co.uk – Environmental reporting area

²³ PricewaterhouseCoopers ValueReporting Forecast :2001 Getting the most from your web reporting October 2000