Roundtable

Bridging the gap on water risk

How should large companies and their investors consider, and communicate, water risk? *Environmental Finance* and Irbaris brought the two sides together to find out. Mark Nicholls reports

Water is a material risk. Not everywhere, nor all the time. But, to a significant proportion of companies and their investors, scarcity of water, water of inadequate quality, or the pollution of water can lead to substantial losses. Conversely, better management of water risks presents commercial opportunity, whether through new products or services, or through corporate differentiation.

That much was agreed by the eight representatives of multinationals and investment firms that met at the London offices of strategic consultancy Irbaris, on 22 March – World Water Day – to discuss the issue.

But what was also agreed is that there are clear differences in how the corporate sector and the investment world look at water risk – and perhaps an even greater gulf between those investors and companies who 'get it,' and those who don't.

For those participating in the roundtable – and likely most readers of *Environmental Finance* – the question 'can water risk be material' may seem somewhat redundant. But, as David Hampton, managing director of Irbaris, noted: "You could replace everybody around this table with a company from the same industry who would not get why we are sitting here … who absolutely wouldn't see the argument.

> *"The value to a company is in business continuity, in licence to operate, in brand"*
>
> Marcus Norton, CDP

"We all believe we're right. What do we need to do to get the rest of the world to move?"

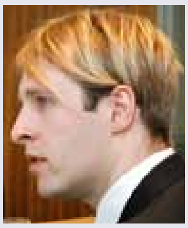
For many companies – even those operating in water-vulnerable sectors or water-stressed geographical regions – addressing water issues falls into the 'CSR' bucket, an optional 'nice to have' that struggles for resources in difficult economic times. Given that water use is often unpriced, or at least underpriced, it rarely attracts the attention of the chief financial officer. And risks of flooding or pollution incidents often seem remote – until they happen.

And, for many investors, concerns around water availability, for example, simply do not fall within their investment time horizon. Piet Klop, senior advisor for responsible investment at Dutch pensions manager PGGM, recounted his conversation with an investment bank analyst, discussing the risk that the Ganges in India could, in a decade or two, become a seasonal river.

"The implications of that are hard to imagine," said Klop. "And yet this guy says: 'So, you're projecting that will happen in 2025? Well you know what, come back to me in 2024.'"

But Marcus Norton, head of the Carbon Disclosure Project's (CDP's) water disclosure programme, noted that water risk can bite much more quickly – citing a series of water-related losses: clothing firm H&M's profits slashed in 2011 as drought pushed up cotton prices; flooding in Thailand last year preventing hard-drive manufacturers supplying their customers, who in turn delayed purchases of chips from Intel; the Hungarian aluminium producer MAL, fined $600 million and on the verge of bankruptcy following a pollution incident.

But, he added, on an ongoing basis, "many investors, and probably companies too, focus on the cost of water … What would happen to your earnings or profitability if the cost of water doubled or tripled or quadrupled? … For many industry sectors, however, water is a pretty small part of costs.



> *"Is there a risk for some businesses that … you get an infinite price for water?"*
>
> William Lynn, Irbaris

"The value to a company is in business continuity, in licence to operate, in brand. And those are really difficult things to quantify."

The complexity of addressing water issues and, by extension, communicating them to investors, was reflected by the differing significance of water to the four multinationals represented at the roundtable – all, in their way, leaders in addressing water risk – and their different approaches and priorities.

Switzerland-based food group Nestlé, for example, has designated water as one of three focus areas – alongside nutrition and rural development – with clear leadership from the very top. "Our chairman spends 25% of his working time on the water issue – that sends a very, very strong signal to the rest of the

Roundtable participants

Claus Conzelmann, vice-president, safety, health and environmental sustainability, Nestlé
Brigitte Dittrich-Krämer, sustainability manager, BASF
Brett Fulford, sustainability lead, operations, GlaxoSmithKline
David Hampton, managing director, Irbaris
Samantha Hoe-Richardson, head of sustainable development and energy, Anglo American
Hubert Jeaneau, sustainability analyst, UBS
Piet Klop, senior advisor for responsible investment, PGGM
Claudia Kruse, head of governance and sustainability, APG Asset Management
William Lynn, principal consultant, Irbaris
Marcus Norton, head of the Carbon Disclosure Project water disclosure programme

The roundtable was chaired by **Mark Nicholls**, editor of *Environmental Finance*

company," said Claus Conzelmann, Vevey, Switzerland-based vice-president of safety, health and environmental sustainability at Nestlé.

The company has carried out a water footprinting study, finding that its direct annual use comes to 140 million cubic metres, while its indirect footprint – the use of water by its suppliers – comes to about 30 billion cubic metres. The company applies shadow water pricing to its investments affecting direct consumption – valuing water around the world at the same price as it pays in Switzerland, at around Sfr1 ($1.10) for a cubic metre.

Likewise, Germany's BASF has, since 2005, made water one of its sustainability priorities alongside other topics such as energy and climate protection, said Brigitte Dittrich-Krämer, sustainability manager, based in Ludwigshafen, Germany. Unlike Nestlé, the vast majority of the company's water footprint is for internal use – in this case, for cooling purposes.

In some regards, that makes water risk for BASF much more about local stewardship. Some 60% of its water use is accounted for by its main Ludwigshafen plant, which is located in relatively water-rich southern Germany. In 2010, the company conducted a global analysis of its production sites which showed that about a fifth are located in water-stressed areas – however, those sites use just 6.5% of the total and account for less than 1% of total fresh water use.

She said that the company has "a lot of specialists, real water

"We're not seeing these questions coming from mainstream investors"

Samantha Hoe-Richardson, Anglo American

experts", that have embraced water stewardship. "But for us the opportunities are also important … chemicals drive solutions for water problems."

GlaxoSmithKline, the UK's largest pharmaceuticals firm, has similarly found that its direct water exposures are likely to be an order of magnitude smaller than its carbon exposures, but there are "pockets of risk within our business, and those pockets have been managed relatively well," said Brett Fulford, the company's Brentford, UK-based sustainability lead, operations.

Its focus is on its extended supply chain – especially for parts of the business that are dependent on agricultural inputs – "and I think all companies struggle with how you influence externally to the business", he added.

For global mining giant Anglo American, meanwhile, "water is a critical input to our business," said Samantha Hoe-Richardson, head of sustainable development and energy. "Without it, we can't operate a mine. And over 80% of our operations and new projects are in water-stressed areas … If we don't have water, we don't have a project."

So, for Anglo American, water "is high up on our strategic risk register. It is a core business risk – and that is essentially how I am able to influence people in the business to take action … It's absolutely fundamental. It's the future of our business."

Does framing water risk as central to Anglo American's business ensure that investors pay attention to the issue? Up to a point. "We're not seeing these questions coming from mainstream investors. [But] we do absolutely from the socially responsible investment analysts … They see it."

"We live in the absence of a sustained price signal [for water use]," said Klop at PGGM. "This is a big handicap … And around risk right now, we are at the stage of collecting anecdotes."

That is not to deny the real interest in the issue from many investors. Hubert Jeaneau, a London-based sustainability analyst within the equity research team at Swiss bank UBS, said that a major research report on water risk published by the bank last year was, for several weeks, its most-read report out of the thousands produced over the period.

And some of his colleagues carrying out sector analysis are explicitly addressing water risk, he said, citing analysts looking at the basic materials and commodities sector, given the water-intensity of copper mining in Latin America, and issues around

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Brigitte Dittrich-Krämer, BASF

iron ore in China. "You have stories that will likely impact the cost of production and therefore the cost of commodities. So in some areas it's already factored into the analysis."

However, as with many environmental, social and governance questions, "it's very difficult for those issues that might be very important, but [where] you don't have a number – linking it to a typical analyst's model is a problem."

Water pricing, would, in principle, provide a number for analysts to plug into their models. While there was broad consensus that water pricing will become increasingly widespread, it is extremely problematic. For example, the value added per litre used varies widely, meaning some sectors – such as mining – would be able to outbid other sectors such as agriculture if price was the only determinant of allocation.

Moreover, observed William Lynn, a principal consultant at Irbaris, issues around allocation can potentially act as a constraint to growth. "You could see a situation where regulators and public bodies are going to have to decide: what's a good use of the water they have? … Is there a risk for some businesses, some industries, that regulators simply decide: that's not a good use of our water and we're just not going to allocate you any. You get an infinite price."

Even less draconian water pricing can have unintended consequences: "Putting a price on water is not an easy process," said Dittrich-Krämer at BASF. "To take the right decisions, we must look at the whole environmental picture." For example, for BASF, reducing cooling water would mean substantial increases in energy use.

So, ahead of clear and consistent price signals for water, more data on usage is needed. "Ultimately what we need is

"It's not only risk exposure but mitigating strategies that matter"

Claudia Kruse, APG Asset Management

much more granular data around not just water efficiency, but also security of supply and indeed the behaviour of everyone else in the watershed," said Klop at PGGM.

However, both investors and companies sounded a note of warning. First, collecting and analysing such data can be incredibly time consuming – and, if not assessed in context, can be actively misleading.

The UBS water report involved ranking companies primarily on the number of sites they had in water-stressed regions – a process he noted was "labour intensive", and was designed only to be a starting point for the analysis, rather than the basis for investment decisions.

"It's not only risk exposure but mitigating strategies that, in the end, matter," agreed Claudia Kruse, head of governance and sustainability at Netherlands-based investment giant APG Asset Management.

"Quite often, local data wouldn't be so significant at the overall level. There has to be some way of bringing it up to an aggregate level that takes account of both exposure and mitigation. But it can be a trigger for the start of a conversation with management."

"We have 10% of our factories in areas of extreme water stress," said Conzelmann at Nestlé. "But what I'm very wary of is those data being taken for some ranking." What is equally important is how those risks are being managed, he said.

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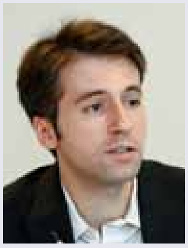
> Claus Conzelmann, Nestlé

An alternative approach is the Aqua Gauge, which Irbaris developed with US investor and environmental coalition Ceres. Rather than looking at granular, bottom-up data, the Aqua Gauge instead attempts a top-down examination of corporate governance around water. "The problems today are not going to be the same as the problems tomorrow," said Hampton. "Understanding the role of governance – that is a question investors seem to want to ask."

The CDP is being pressured by some to score companies on their responses to the water information request, Norton noted, but it is resisting that pressure until better metrics can be agreed. "When we score companies initially, it will likely only be on the quality of disclosure," he said.

But both investors and companies recognise the value of ranking in driving improvements. "In terms of getting visibility on the issue, CEOs are very competitive," noted Fulford at GSK. "They don't want to be in the bottom quartile."



> *Water "will at some point impact the cost of production and therefore the cost of commodities"*
>
> Hubert Jeaneau, UBS

"The urge that many in this space feel to be comprehensive is going to be the kiss of death," said Klop at PGGM, warning about companies being faced with "687 questions they have to fill out". He praised a "back of the envelope" exercise carried out by the World Resources Institute with Bloomberg analysts in ranking utilities in the US southeast, in terms of their water exposure. It looked at how much water they needed, and where they were located.

"Combining those two strands of data allowed you to rank companies by their exposure as a percentage of overall generating capacity to water risk … I believe that the moment we collectively succeed in getting this ready for the Bloomberg terminal, you'll see that all of a sudden the issue will get more attention."

And, when it comes to investment decisions, it is critical that both companies and investors are talking about the issues that matter, said Kruse at APG: "If you want to reach the portfolio managers who make the investment decisions, you need to make sure that water issues, if presented on, are embedded with and relevant in the context of a particular strategic discussion."

But there is an opportunity – perhaps a necessity – for companies working hard to address water risk to frame the debate they have with investors on the issue.

"I think the obligation on companies is to be able to communicate where the risks are and then explain how those risks are being managed and mitigated," said Fulford at GSK. "That's the challenge that businesses have."

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> Brett Fulford, GlaxoSmithKline

"In the corporate sector, that's probably our greatest area of opportunity," said Hoe-Richardson, "in the better communication of these risks and articulating them in a way that's consistent with the way you articulate your business risks."

But it's not only about risks. By actively managing issues around water availability and usage, Anglo American is able to demonstrate clearly the value added, Hoe-Richardson said. "Particularly in developing countries where water supply is a critical issue, the fact that us coming in with a track record of having helped communities get access to water is, we believe, a potential source of competitive advantage and will get us into those resources. That's where it can be translated through to value."

So too with Nestlé. "We position water as part of the wider sustainability discussion as a clear strategic driver now, both for R&D and for new product development as well as for brand and positioning, to show that our products have a lower environmental impact compared to alternative offers."

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Without doubt, water risk is a complex business, and enormous amounts of work need to be done by both companies and their investors in assessing and communicating on the issue. We are a long way from finding the right metrics to quickly assess headline corporate water risk, and companies are rightly cautious about overly simplistic metrics.

But, as leading companies such as those around the table better understand their own water-related risks and opportunities, they are also getting better at framing and communicating them to investors. The gulf in understanding seems not to be between investors and companies, but between those investors and companies who are getting a handle on water risk, and those who are not. **EF**