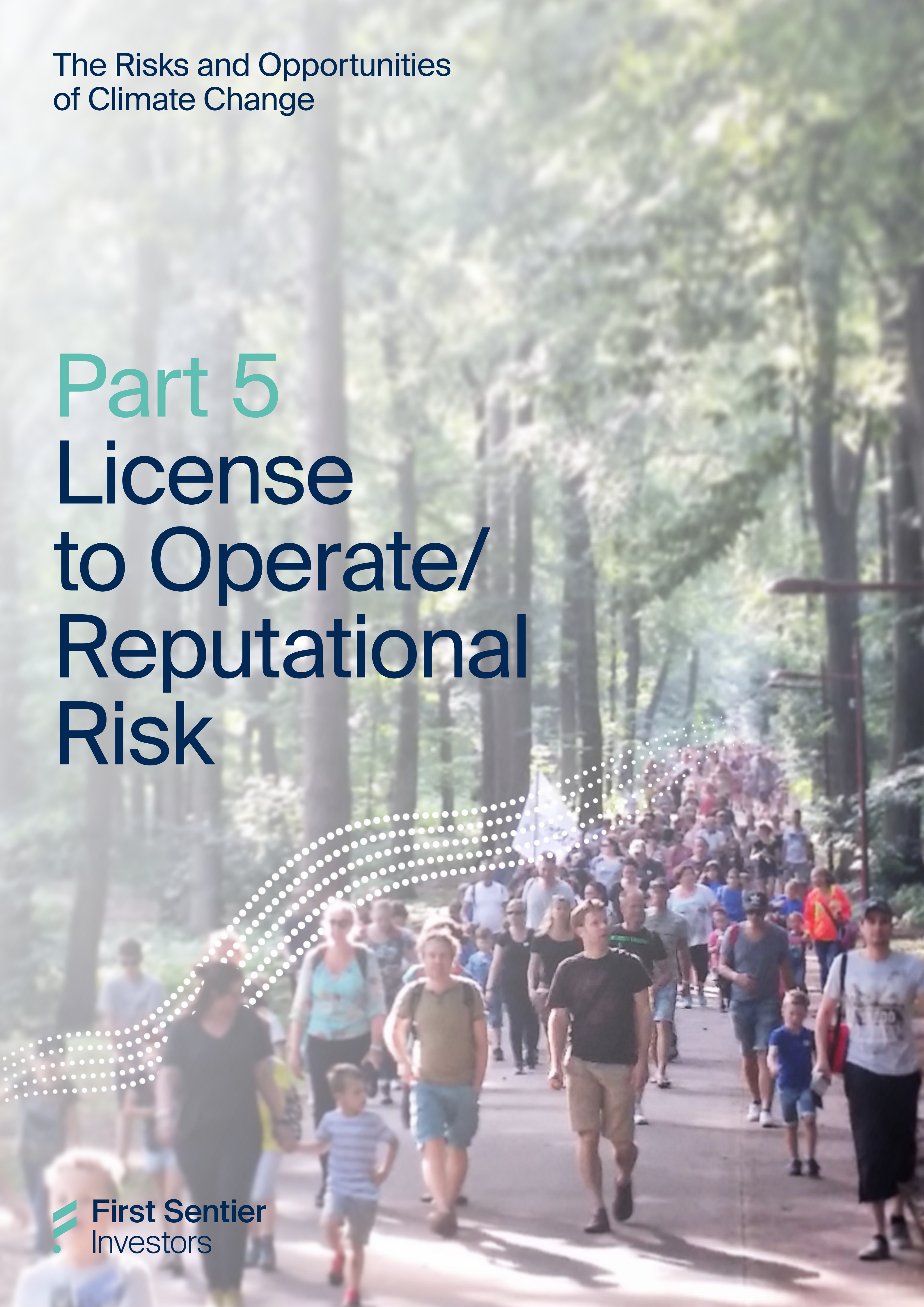
The Risks and Opportunities of Climate Change

Part 5
License to Operate/ Reputational Risk



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Introduction

A company's reputation and its 'social license to operate' (SLO) are two critical intangible assets. While sometimes conflated the two terms refer to related but different concepts.

Reputational risk has a number of commonly used definitions. Oliver Wyman, who have researched reputational risk for a number of years says that "Reputation risk is generally defined as the risk to the institution from changes of perceptions by key stakeholders, including customers, investors, and regulators." (Oliver Wyman, 2017) In it and other literature, this is often event driven and requires new information coming to light that changes stakeholder perceptions.

Social License to Operate meanwhile is commonly defined as broad social acceptance by the local community and other stakeholders, most frequently, as ongoing acceptance. This persistence and local community focus distinguishes it from reputational risks more event driven focus. On Common Ground identify three stages in gaining social license; legitimacy, credibility and trust (On Common Ground Consultants, 2003).

While different, there is a clear relationship between the two concepts. A strong social license to operate can indicate a reduced likelihood of negative events occurring because the company has already demonstrated a focus on social and environmental impacts. It can also reduce the reputational harm to the company when negative events do occur because they are likely to be more responsive and already be trusted. Conversely, the size or persistence of reputational events can undermine an organisation's, or an entire industry's, social license to operate if not well managed. The interaction can be thought of as increases and decreases in social capital.

Efforts to define, measure and develop management systems for both reputation and social license have been developed by groups including the CSIRO, Oliver Wyman and Business for Social Responsibility (BSR); however, clear and comparable measures, beyond surveying of local communities and case studies, remain elusive.

Accountability mechanisms for a company's and/or industry's actions (or lack of action) which can threaten its SLO largely manifest through NGO and community group opposition and the media including social media. Regulatory enforcement, legal or government action can also follow. The media's role is particularly important as it both uncovers and amplifies issues while the extensive on-the-ground networks of NGOs raise issues which might otherwise be difficult to detect.

NGO influence and changes in global campaigning

Environmental NGOs have long played a role in campaigning against projects or companies they find harmful to the environment or communities. Over the last several years, and in particular as it relates to climate change, there has been a marked increase in sophistication and coordination globally.

This is best demonstrated by the Climate Action Network (CAN), which includes over 1,100 member organisations from 120 countries around the world. CAN includes small community based groups to large global NGOs like 350.org (Climate Action International, 2018). Other global environmental NGO's such as the Rainforest Action Network, WWF and Greenpeace have also campaigned, financed and supported climate related initiatives around the world. Social media and global connectivity have further strengthened the reach and responsiveness of these groups.

In recent years the influence and credibility of climate focused NGOs has grown as the impacts from a changing climate has become clearer, particularly following the Paris Climate Change Agreement. Business focused NGOs including Carbon Tracker and the 2 degree investing initiative have also emerged. Unlike traditional environmental NGOs and think tanks, these groups were specifically set up to provide information to the financial and corporate sector on the risks of climate change not traditionally covered by financial analysts. They have had significant impact both in promoting concepts like the "Carbon Bubble" and in the regulatory sphere as described in previous papers in this series.

The diversity and reach of the growing civil society movement as it relates to climate change has sharpened SLO and reputational risks faced by companies and industries as well as for investors and other financiers who are not seen to be acting in accordance with international goals to reduce emissions.

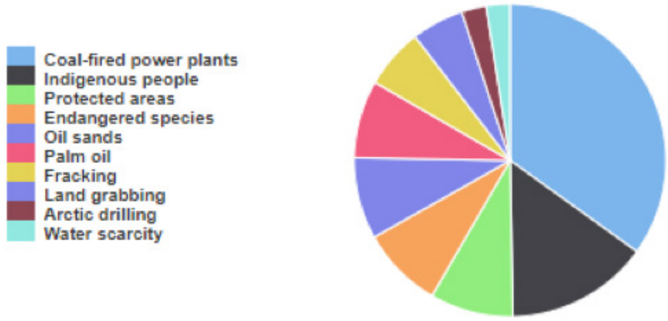
Reprisk controversy monitoring. A window into reputation and SLO risks.

The manifestation of reputational issues related to climate change and how they influence an organisation's license to operate differ by industry and country. However, climate change does not fit neatly into the types of high profile, high direct cost events to which reputational risks are often attributed (e.g. large oil spills, tailings damn collapses).

Reprisk tracks controversial news and NGO activity for over 100,000 companies across a range of topics. Climate change is categorised by Reprisk as part of 'global pollution including climate change'. While this category is not amongst the most controversial ESG issues, the data shows that it is an issue that has been consistently scored since at least 2007. This indicates that while some issues, like the currently highest rated issue of tax avoidance, have grown significantly since 2014 with large swings in their controversy ratings, concern around climate change has been more constant.

Reprisk data seeks to highlight controversial issues for companies and projects and so would not necessarily capture regulatory changes or changes in consumer preferences that may be linked to an industry's or a company's performance on climate change. However, when looking at controversial issues, climate change related issues dominate, including coal use, deforestation, water scarcity and tar sands.

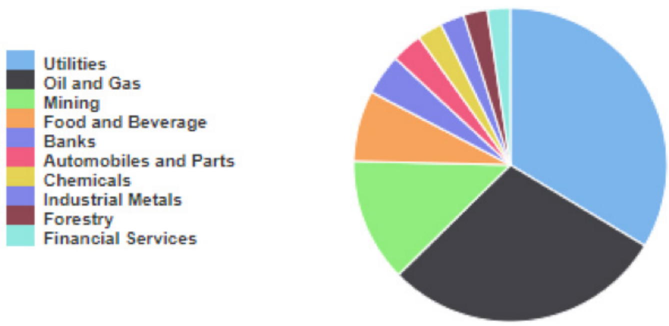
Most common issues flagged



Source: Reprisk 3 July 2019.

As highlighted in other papers in this series these issues vary by industry and country. Utilities, oil and gas, and mining dominate the industries represented in flagged controversies, with two-thirds of the total; however food and beverage, and banks also feature in the top five.

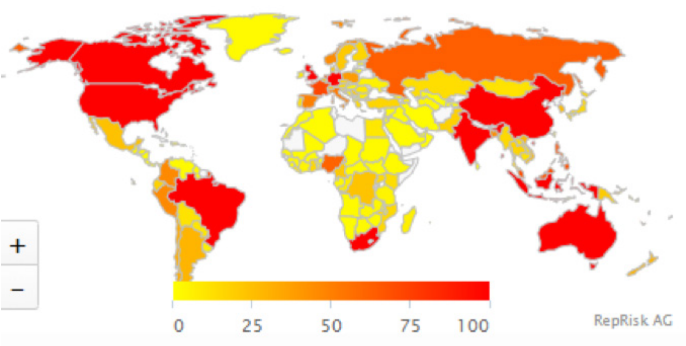
Sectors with largest climate change related controversies



Source: Reprisk 3 July 2019.

Country distribution of controversies related to climate change is wide spread with issues as diverse as the proposed Adani Coal mine in Australia, financing of coal fired-power stations across Asia, and deforestation in Indonesia and Brazil.

Countries with largest climate change related controversies



Source: Reprisk 3 July 2019

Analysis of the Reprisk data reveals some consistent trends globally including that:

- There is an increasing expectation that electric utilities transition from high carbon, particularly coal-fired generation, to renewables;
- The banking and finance sector is under increasing scrutiny in relation to its lending or investment in fossil fuels with significant focus on new coal mining and generation, and unconventional oil and gas. Increased funding for renewables has not mitigated criticism regarding the support of new developments.
- New coal or unconventional oil and gas projects along with supporting infrastructure like pipelines have faced opposition often with multiple overlapping issues including indigenous rights, land use and water also being factors.
- To date airlines have not faced the same reputational and SLO issues related to climate change as other sectors, while for agriculture the focus has been on deforestation and further up the supply chain in food manufacturing. However, given their significant contribution to global greenhouse gas emissions this may change.

From these cases certain inferences can be drawn:

Chain of SLO and Reputational Risks Related to Climate Change

Expansion of fossil fuels has lost its SLO in much of the world

Expansion of activities with high emissions which can be substituted (e.g. fossil fuels for electricity) are increasingly unacceptable to a range of stakeholders.

Efforts by industries and companies who are expanding in these areas to highlight benefits of the activities or shift attention to positive investments in clean technology are not cutting through. This indicates a social license to operate issue for these industries.

Companies and industries connected to the expansion of fossil fuels face reputational risks

Key service providers and financiers of these companies and industries are also exposed and sometimes more intensely targeted as they are seen to have alternatives to involvement with the particular activity. This is more a reputational risk issue for these industries, but will undermine the social license for some companies and industries.

2 degree planning for high emissions sectors.

Companies from high emissions sectors who are able to transition to low carbon alternatives need to demonstrate they have a plan for decarbonisation consistent with international agreements lest they be targeted by NGOs / community groups.

Transition to low carbon also poses reputational risks which require skillful management

Closure or decommissioning of existing plants and mines is an increasing focus, however employment and community impacts of industries closing is a major concern requiring careful management. A focus on a Just Transition is very important in this regard.

Lack of substiutes or high SLO are protecting some industries, but for how long?

Activities which cannot be readily substituted for lower carbon alternatives (airlines) or with high existing social license to operate (farmers) have avoided the most intense criticism to date but this may not continue. For example deforestaion related to palm oil and food producers have come under increasing pressure.

What are the costs of Reputational Risk?

Most of the literature regarding reputational risk only quantify financial impacts in the immediate aftermath of an event. For example an Oliver Wyman report analysed 200 reputational risk incidents looking at the stock price performance in the 10 trading days post the event (Oliver Wyman, 2017), while a report by Sustainalytics looked at the five days prior and the five days after an incident (Morrow, Vezer, Apostol, & Vosburg, 2017).

While these approaches make sense for reducing noise from unrelated factors in the company's share price performance, they show the most significant impacts for events with direct financial costs such as fraud, recalls and safety incidents, but would not capture longer-term drags on competitiveness. The analysis on climate change risk covered earlier in this paper tend to show complex interactions between a company's management of the issue, its industry and its reputation. This suggests these traditional methods of analysing the impacts of reputational risks may not work as well with climate change. Approaches to understanding SLO may be more insightful in this regard.

Further research would be required to ascertain how and over what period a company's approach to climate change can result in costly reputational harm and ultimately the loss of social license to operate. These impacts could extend to a range of indirect costs including loss of customers, regulatory intervention and costs of delays and lost production for projects that face community opposition.

In the second example, research by the Harvard Kennedy School into that company-community conflict found that a "world-class mining project with capital expenditure of between US$3-5 billion will suffer costs of roughly US$20 million per week of delayed production in Net Present Value (NPV) terms, largely due to lost sales." (David & Franks, 2014)

Notwithstanding these shortcomings, both the Oliver Wyman and Sustainalytics research found significant near term share price impacts for reputational incidents. Oliver Wyman in their analysis of 200+ risk events found that:

1. More than 55% of the events tested had a reputation risk impact.
2. When an event had a reputation risk impact, the losses were significant and large, leading to the total loss over double the loss amount announced by the company.

Meanwhile Sustainalytics found that while low to moderate rated incidents showed no short-term share price impacts, severe incidents showed significant impacts in the majority of cases.

Impact level	Mean % change in market cap	% of companies with market cap decline	Number of incidents
High-Severe	-6%	69%	55
Significant	-1%	54%	795
Low-Moderate	0%	50%	13,714

Source: Sustainalytics.

Investment Implications

Current approaches to considering reputational risk and SLO do not lend themselves to considering the costs to companies of a reputation harmed by an inadequate approach to climate change. However, it is clear, as demonstrated by previous papers in this series, that climate change mixed with other issues, has had a significant impact on company valuations, earnings and project financing around the world.

Evidence of this includes case studies such as the Dakota Access and the Keystone XL Pipelines in the US, the trend in banks around world implementing policies related to lending to carbon intensive sectors (particularly coal), and the growth of finance focused climate related NGOs such as MarketForces, 350.org, ShareAction and Carbon Tracker.

Integration of reputation and SLO into investment decision-making

The best way to understand a company's current and future SLO is three-fold:

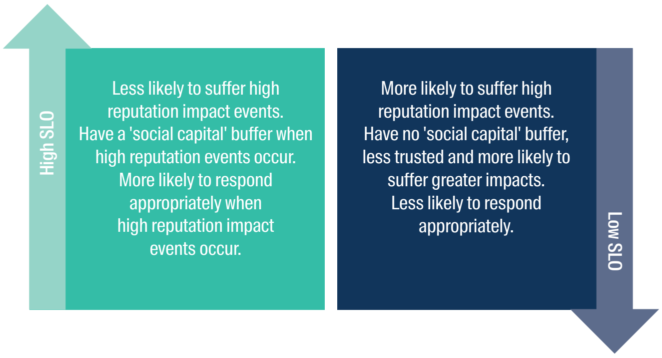
1. Considering the positive and negative impacts on different stakeholder groups and the environment that may be caused by the company;
2. Assessing the potential impacts on the company that would be caused by lost or diminished reputation and SLO (caused by adverse stakeholder/climate impacts identified in step 1); and
3. Evaluating how the company is managing these issues.

In this regard, SLO and reputation risk events analysis fits well and can help validate assessments of management and business quality that many active investors routinely consider.

While not fully measurable, tools exist to help investors understand the impact of climate and other ESG issues on reputation and SLO. While the event driven nature of how reputation risk is normally defined may make it seem a lagging indicator, in aggregate these events contribute to a company or industry's social licence to operate which is a lead indicator of the ease or difficulty by which a company or industry can continue to operate. Also a series of smaller negative events may point to weak management and higher likelihood of larger events occurring.

As the diagram below illustrates, SLO can be thought of in a number of ways. It is an indicator of risk but is also a buffer of 'social capital' that can reduce the impact and recovery time after a negative reputation event occur.

SLO analysis as a forward-looking indicator



Investors are able to distinguish the level of risk by considering where companies sit in the Chain of SLO and Reputational Risks tool described earlier in this paper. The higher up the chain the greater headwinds a particular company or industry faces. For some investors continued exposure will present an unacceptable risk, while others will prefer to capture and integrate these issues into regular company and industry analysis. For most bottom-up active investors it will be a mix depending on the nature of the issues.

Investors who do seek to integrate weak or declining SLO into company analysis and valuations can apply discounts, include higher cost of capital and lower growth assumptions or can even remove entire projects from valuations if the analyst determines the risks puts a particular project in danger of not proceeding. Even where a project does proceed, continued community opposition could result in costly delays that can be factored into valuations.

For fixed income investors, who are generally focused on downside risks and default, reputation and SLO is also an important consideration. For quantitative investors, controversy research can be an important additional factor to include and has the benefit of being close to real-time as opposed to having the long lags common in other ESG ratings.

Stewardship and engagement

Engagement and stewardship is important for all investors when it comes to reputation and SLO. The attitude and conduct of senior management and the governance of ESG concerns by a company board provide powerful insights into whether a company is more likely to nurture and grow its SLO or destroy it. Equally, setting expectations for companies through engagement (individual and collaborative), advocacy and proxy voting is a critical accountability measure. Some investors will see engagement on low-carbon transition as offering long-term value creation in some sectors if they are able to influence companies.

As described in the third paper in this series on transition risks, investors who focus on engagement need to understand how difficult any transition might be, the risks that it introduces and the willingness and skill of the management of the company to achieve it. It is important that investors critically consider the likely effectiveness of any engagement effort, for example, utilities are much better placed to transition to a low carbon economy than a pure play coal company is. The willingness and sincerity of company management and boards in their engagement is an important indicator of this.

Similarly as discussed in the fourth paper in this series on director duties, proxy voting, particularly on shareholder resolutions but also on director elections and remuneration votes is an important and public demonstration of investor support for climate action. Even where 'behind closed door' engagement seems to be progressing, the power of a collective and transparent shareholder voice on critical issues in non-binding votes should not be ignored.

Internal governance – preventing blow back

The increasing concern and focus of clients, employees, regulators and NGOs on the management of climate risk by finance and investment organisations means that scrutiny of investment decision-making and ownership practices will continue to increase. As we have seen with the financing of coal projects by international banks, the SLO of underlying investments and business relationships can be transmitted back to the investor.

The previous paper in this series discussed governance frameworks, which address climate risk from a fiduciary and director duty standpoint. Reputation and SLO are also relevant to the investment organisation in this regard. The potential for campaigns, boycotts and other activities can damage the reputation of a financial institution and cause members and clients to leave.

Accordingly, reputation risk reporting of underlying assets may be a useful albeit incomplete tool for boards and senior management to monitor these risks.