Risky business? Life in the pressure cooker

How do UK energy and water companies and their investors currently view political uncertainty and regulatory risk around fairness and the environment?

Sustainability First: Fair for the Future Project
Discussion Paper
February 2020

Sustainability first

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The situational challenge

The fieldwork which this paper reports took place before the 2019 election. That election has been characterized by two things for utilities: the Labour Party's proposals on nationalisation; and commitments from all parties, but with varying degrees of ambition, to address the climate emergency. As 2020 unfolds and all sides digest the election results, some may consider that they have 'dodged the bullet' on the former and that with Brexit still occupying political minds over the next few years, apart from the need to show global commitment at COP26 in Glasgow in November, they can now get back to 'business as usual'.

We would argue (and the recent history very much bears this out) that **political uncertainty and regulatory risk around fairness and the environment in the utilities are not going to 'go away'**. On the social side, the deep inequalities in our society will not be overcome overnight. On the environment, the climate science and evidence on the ground is changing every day, as is the public focus and stakeholder action. **Who pays for net zero** (bill payers or tax payers) and **how this is done in a fair way** (in terms of customer segments and generational cohorts) are the issues that will define our age. Public utilities, as providers of essential services, key parts of our critical national infrastructure and, in the case of electricity, enablers of the move to net zero, will very much continue to be in the front line of these debates.

Most utility **companies** now realise this – even if for some this is only 'deep down'. In the energy sector, spurred on by technological change, business models and processes are transforming before our eyes. For gas networks this could even be the next existential challenge. In the water sector, the pace of change is slower, but companies increasingly recognise the importance of resilience and the need to value water and are coming under increasing pressure to adopt catchment solutions.

Changing the **policy and regulatory frameworks** in which companies operate, and which to a large extent **set the boundaries of consumer / citizen, company and government roles and responsibilities in terms of addressing social and environmental risks** is likely to take longer – in particular given the lack of political bandwidth until the final Brexit settlement is in place. Although with a new government clearly much is up in the air and to be confirmed, the action on the ground is in many ways 'running streets ahead' of policy and regulation. Even once the dust has settled, the election has highlighted deep levels of **disillusionment** with the **political process** which have accentuated existing concerns about the **ability of the 'establishment' to effectively deal with social and environmental issues and risks.**

If utility companies wait to be told what to do by policy makers and regulators, there is a real danger that the pressure behind social and environmental factors for change will continue to build - but without a structured 'outlet' for successfully enacting or embedding change. Distrust in the system and outrage that basic injustices are not being given due consideration can lead to issues 'boiling over.' This may cause **sharp and sudden political interventions.** Interventions that may not take account of the **social *and* environmental** short and long-term **outcomes** that utilities need to **balance and deliver**. In such circumstances, there could then be a risk that net zero targets are missed in the interests of equity or social inequalities go up in the drive to decarbonize.

Predicting these interventions and **tipping / inflexion points** is of course exceptionally difficult. Change can happen very quickly and can appear to come from 'left field'. However, we consider that a deeper understanding of political uncertainty and regulatory risk around fairness and the environment is key to more **proactively prepare** for these points and crucially – if all sides – companies, investors, policy makers and

regulators – are to **deliver fairer social *and* environmental outcomes.** This will be vital if UK delivery against the **UN Sustainable Development Goals (SDGs)** is to be achieved by the 2030 deadline.

Risk is the bread and butter of investors. Developing a common language around this between different stakeholders, and what social and environmental risk means in public utilities in particular, is important to avoid cross purposes, build trust and identify common interests. **Understanding who should bear which social and environmental risks and who should reap the associated rewards is fundamental to determining what a fair outcome looks like**. And, on a practical level, a risk lens can help identify why and when a 'Sustainable Licence to Operate' approach may be important. Hence the work in this report is highly relevant to the current situational challenge.

Executive summary

In this paper we examine how a **sample of utility companies and their investors currently view social and environmental risks.** In our research for the paper, we found that the utility companies and investors that we talked to take a number of potentially complementary approaches to risk identification and management. In line with most major companies, and to meet legal requirements, including **Section 172 of the UK Companies Act,** this manifests to varying extents in Principal Risk and Risk Appetite Statements, risk registers (many of which delineate between strategic and operational risks), formal risk governance (e.g. audit and risk committees), leadership behaviours and values, and in internal thinking/culture.

We examined evidence for how these are used with specific reference to environmental and social or fairness risks. In particular, we: examined public risk statements, mainly in annual reports and accounts; conducted interviews with a number of energy and water companies; and held a roundtable with and talked to other utility investors.

From our research, we judge that utility companies have moved some way in recent years to accept and to start to mitigate risk associated with **environmental** performance. This is understandably focused more on net zero in energy companies, and on the risks from discharges (licenced or accidental) and associated with climate adaptation in water companies.

Social risks are less well articulated and understood, and in many cases go little further than 'health and safety' issues or conventional definitions of vulnerability set out by the economic regulators where action, for monopolies at least, is part of the regulatory price control settlement. In the wider area of social risk, there is some confusion between 'customer service' and 'social mission'. Relatively little attention is given to the risks experienced at the community level. The fact that social outcomes are often qualitative, that expectations can vary between groups, regions and nations, and that they can also entail an element of judgement, can make assessing risk is this area particularly challenging.

The **fairness dimensions** of risk appear in company reports only in so far as they relate to broader operational and regulatory factors, if at all, and in this sense are **not treated as material to the core business**.

A number of **investors** are very cognisant of the need to move to more formal Environmental, Social and Governance ('ESG') approaches, in part from a risk standpoint: to better address future policy and regulatory pressure; through fear of some form of more or less direct action; or, if they are a 'universal owner', a recognition that due to their size they need to 'own the externalities' associated with their investments.

All investors, and many companies, are struggling with the issue of **metrics** in this area. There is some recognition of the tension between the need to track performance and risk mitigation on the one hand and avoiding a tick-box mentality (ESG as a rebranding of CSR) on the other. There is also acceptance that the approach to E, S and G needs to vary. This is particularly true in a utility context where the 'hurdles' to be met may be higher due to the public functions being provided, the extent of monopoly and the higher standards of 'engagement, loyalty and care' that may be expected.

Some companies clearly do have a robust risk approach in certain areas. We have seen cases in particular where a strong culture is well on the way to being established for environmental risks from the top of the organisation throughout the business. It seems that such approaches have more often been the result of committed **leadership**, perhaps 'sensing' a growing risk, than from formal risk assessment. Where successful, such **approaches have been more often embedded in strategy functions than in regulatory interfaces** – which seems to us right; where nested in regulation departments, there can be an excessive focus on compliance/regulatory incentives. However, even when companies are doing many of the right things, the relationship between formal risk tools and governance,

company strategy and culture can be somewhat opaque.

This Discussion Paper concludes with some early proposals on **how companies and investors might start to 'shift' the dial on how they deal with social and environmental risks going forward**. Our forthcoming paper on '**Risk in the disrupted world'** will flesh these proposals out in more detail.

We identify three key shifts that are needed in **the current treatment of social and environmental risk:**

- A shift in time horizons from a static short-term perspective to a dynamic, cumulative and long-term perspective.
- A shift in scope from treating social and environmental issues as vertically separate, ad-hoc and one-off externalities to a more holistic and integrated view that understands the inter-dependencies between risks.
- A shift in approach from a reactive, compliance and process-based approach to one which is more proactive, strategic and focused on risk and opportunity.

Finally, the energy and water sectors face the challenge of dealing with heightened social and environmental risks at the same time as having legacies of high returns. This leads many to consider claims of increased risk with suspicion. This is an undoubtedly an uncomfortable place to be in, but it is also a place where leadership is possible; a place to develop forward facing good practice in terms of addressing social, environmental and fairness risks and – if this can be evidenced and demonstrated – to ask others to follow.

Background and methodology

Sustainability First's major **Fair for the Future Project is** helping the energy and water sectors to better address the politics of fairness and the environment. The Project has two workstreams: developing a **'Sustainable Licence to Operate'** (we produced a Strawman[1] in October 2018 to stimulate and provide a framework for discussions) and **mapping political and regulatory risk and uncertainty in terms of fairness and the environment**. We are half-way through this project and have recently published a mid-way project report ***'Delivering on fairness and the environment: An agenda for responsible business in UK regulated utilities'***.[2]

This note is part of our workstream for **developing a framework to map political and regulatory uncertainty and risk around fairness and the environment in the energy and water sectors**. As part of this workstream, we have to date published six papers, this being the latest.

The first of these papers covered political and regulatory risk and uncertainty in *today's* world. This discussion paper featured notes from Professor George Yarrow on the distinction between uncertainty and risk from an **economics** standpoint, and from the Sustainability First team on how **government and regulation** shape risk in energy and water and how the **capital markets** have so far seen uncertainty and risk in the sectors. In this paper, we noted:

To date, much of the debate about political and regulatory uncertainty and risk in respect to fairness and the environment in energy and water has been narrowly framed as a technocratic discussion around capex and cost of capital. The apparatus of government, regulation and capital markets have dealt with risk and uncertainty in a relatively 'closed' environment. Although consumer engagement mechanisms have started to bring in new voices, this interaction has largely been part of a 'managed' process.

The environment in which the energy and water sectors operate is changing significantly. Technology change/digitisation and societal change and new consumer/citizen expectations are challenging existing ways of doing things. Technical framings around capex and cost of capital are now being challenged by the politics of the 'disrupted' world.[3]

To **baseline** how companies are currently addressing social and environmental risks, we have reviewed how social and environmental risk feature in the **publicly available annual reports** of nine major utility companies, in addition to some further company sustainability and vulnerability reporting.

We have also carried out a series of bilateral interviews with representatives from UK energy and water companies in which we have discussed: **company purpose**; the **tools and processes** companies use for addressing social and environmental risk; **how to learn and transfer lessons** in this area; the **constraints for companies** in addressing these risks; and the nature of the relationship between **different parts of the company decision-making chain** when considering political and regulatory risk and uncertainty around fairness and the environment.

To assess how **investors** currently perceive and treat social and environmental **risks in their companies and sectors, in October 2019 we held a roundtable**, hosted by Macquarie, and also held subsequent bilateral discussions with investors.

Chapter 1 of this Discussion Paper centres on the current publicly available information on how

[1] Sustainability First, 'Sustainable Licence to Operate' strawman: framework and issues, October 2018

[2] Sustainability First, Delivering on fairness and the environment: An agenda for responsible business in UK regulated utilities, January 2020

[3] Sustainability First, Political and regulatory uncertainty and risk relating to fairness and the environment in the energy and water sectors, October 2018

organisations report on their **principal risks and uncertainties**.

Chapter 2 outlines the key themes from our energy and water **company interviews** on their treatment of environmental and social risk.

Chapter 3 of this Discussion paper explores some **investor perspectives** on social and environmental risk in the sectors.

Chapter 4 summarises our conclusions and puts forward some proposals on how companies and investors might start to 'shift' the dial on how they deal with social and environmental risks going forward. This will feed into our work framing how political and regulatory risk and uncertainty are changing in the context of the **disrupted world**. We have already produced four separate working notes in this area covering the roles played by **civil society**, **the media**, **the consumer lived experience**, and **climate and the environment**)[4] in both escalating and mitigating social and environmental risks for energy and water companies. These notes will form the basis of a forthcoming programme of work on *risk in the 'disrupted world'*.

[4] Sustainability First, Papers on the roles of civil society (February 2019), the media (April 2019), the consumer lived experience (October 2019), and climate / the environment in terms of political and regulatory uncertainty and risk regarding fairness and the environment in the energy and water sectors.

Chapter 1: How do UK energy and water companies currently report on their principal risks and uncertainties?

Principal risks and uncertainties

This chapter documents and analyses publicly available annual 2018/19 reports of **nine major utility companies,** in addition to some further company sustainability and vulnerability reporting. This reporting includes both formal statements about corporate risk and its treatment, and wider material of relevance to analysis of ESG performance and risks. Our analysis is not intended to be either comprehensive or a full statement of the risks which any company may be considering; indeed this is only to be expected with regard to some commercially sensitive risks, and perhaps to potential existential risks such as a wholesale move away from gas. Rather, we present a snapshot of how companies currently deal with what they identify as their **principal risks and uncertainties** in order to **'baseline' where the energy and water sectors are** in their reporting of social and environmental risks.

Financial Reporting Council (FRC) guidance states companies' annual reports ought to set out '*those [risks] material to the company, or where the impact of its activity poses a significant risk.*'[5] We consider that **climate and environmental risk should sit firmly in this category of materiality**, especially for energy and water companies given the environmental impacts of their operations and the central role they will play in the net zero transition. Consideration of these factors should therefore be given considerable weight in utility principal risk reporting.

Our view here is in line with the growing global emphasis on climate reporting as highlighted by the **Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD)**, Bank of England Governor Mark Carney's recent warning that climate reporting rules could be imposed within two years,[6] BlackRock CEO Larry Fink's recent insistence that 'climate risk is investment risk',[7] and again with the **FRC's October 2019 guidance**, which outlines the importance of:

- *companies articulating how, and whether, their business model remains sustainable;*
- *what the risks and opportunities are, including the prioritisation of risks and their likelihood and impact;*
- *what changes they might need to make to strategy in order to respond to climate change;*
- *what scenarios might affect their sustainability and viability; and*
- *how they measure the success of their strategy through strategically aligned, reliable, transparent metrics.*[8]

Our work in this area indicates that **the vast majority of energy and water companies that we studied do appear to give weight to climate and environmental risk** in their principal risk reporting, although its materiality might in some reports be more clearly stated. This is in part because **'transparent metrics'** can be found relatively easily and be made actionable in the environmental space. **This is much more difficult for social or fairness risks – *but these can equally prove material to a utility business***. Perhaps as a partial consequence of this challenge, risks around vulnerability, wider social and community impacts and fair treatment of stakeholders, while mentioned in company reporting, rarely feature

[5] Financial Reporting Lab, Business model reporting; risk and viability reporting, October 2018
[6] The Guardian, 'Corporations told to draw up climate rules or have them imposed', 9 October 2019
[7] Larry Fink, CEO, Blackrock, 'A fundamental reshaping of finance', January 2020
[8] https://www.frc.org.uk/getattachment/b3b6cd43-7ade-4790-959e-3b84d59a7253/Developments-in-Corporate-Reporting-2019-FINAL-Full.pdf; https://www.frc.org.uk/getattachment/85121f9f-15ab-4606-98a0-7d0d3e3df282/Climate-Change-v8.pdf

as standalone – and therefore material – risks in companies' principal risk and uncertainty statements.

What environmental and social factors do UK utility companies currently report?

Surface-level analysis shows that in the broadest possible sense, the utility companies we studied do rightly regard social and environmental concerns as integral to the sustainability of their business practices. Of the principal risk and uncertainty statements examined by Sustainability First, the overwhelming majority regard environmental factors in some sense as a material risk. Companies also report on a number of what might be determined 'social' risks; albeit in a narrow sense. This can be seen in Figure 1.1.

Figure 1.1: Environmental and fairness/social risks featured in UK energy and water company principal risk and uncertainty statements

Organisation	Environmental factors as principal risk/uncertainty? (Y/N?)	Fairness/social factors as principal risk/uncertainty? (Y-N?)	Description of risk mitigation/management ? (Y/N?)	RAG rating or trends analysis? (Y/N?)
Anglian Water	Y – Long-term supply and climate change Pollutions Water quality	Y – Pensions Customer satisfaction Health and safety Talent and succession	Y – Text description setting out controls and mitigation	Y – RAG ratings for a) direction of inherent risk position, b) risk mitigation being undertaken, c) current risk position
Cadent	Y – Health, safety and environment	Y – Health, safety and environment Failure to secure critical skills and engagement Failure to protect consumers' interests	Y – Bullet point descriptions of risk and mitigation measures	N
National Grid	Y – Catastrophic asset failure results in a significant safety and/or environmental breach	Y – Failure to predict and respond to a significant disruption of energy that adversely affects our customers and/or the public Failure to deliver our customer, stakeholder and investor proposition due to increased political and economic uncertainty Failure to build sufficient capability and leadership capacity (including effective succession planning) required to deliver our vision and strategy	Y – Text description setting out actions taken by management	Y – Risks monitored through trends analysis with categories increasing risk, neutral, decreasing risk
Northern Powergrid	Y – Environment	Y – Safety	Y – Bullet point descriptions of risk and mitigation measures	N
Portsmouth Water	Y – Water quality Environmental	Y – Human resources Health & Safety	Y – Bullet point description of risk and mitigation measures, including trends analysis	Y – Colour-coded rating of respective likelihood and impact
South East Water	Y – Water quality Water resources and climate change	Y – Health & safety Human resources and culture changes	Y – Text description of risks and mitigation measures	Y – Broader RAG rating/trends in Company Monitoring Framework
Thames Water	Y – Climate and societal Health, safety, environment and security	Y – Climate and societal Customer service People Health, safety, environment and security	Y – Bullet point description of risk and mitigation measures	Y – Risks monitored through risk climate analysis with categories climate improving, climate stable, climate deteriorating
UK Power Networks	Y – Environmental performance (under 'factors likely to affect future development and performance'); environmental risks such as severe weather induced by climate change considered by UKPN Physical Risk Forum	Y – Health and safety incidents	Y – Text description of risks and mitigation measures	Y – Environmental and social outputs RAG rated in annual Commitment Report
Western Power Distribution	Y – Negative impact of network assets on the environment	Y – On site accidents Customer dissatisfaction Lack of skilled employees	Y – Text description of risks and mitigation measures	N

N.B. The ratings ascribed in the above table represent Sustainability First's analysis of the material in the relevant reports only. They should not be viewed as an assessment of the performance of the companies themselves, nor of any wider material.

Good practice in environmental and social risk reporting

In line with standard good practice reporting across the economy, a number of the company reports that we examined explicitly demarcate their risks into strategic, operational and compliance categories. National Grid for example divides its risks into **operational**, **strategic and regulatory**, **people**, and **financial**, and in addition devotes a separate section of its report to climate-specific 'risks and opportunities', using the TCFD as a framework. These include short- to medium-term 'physical risks' such as flood defence and how rising temperatures might affect supply, but also longer-term opportunities associated with decarbonisation, EVs, and other shifts.[9] The Grid also transparently outlines the metrics it uses to assess climate risk, including GHG emission reductions and the carbon intensity of production.

In a number of cases, the link between utility companies' **strategic risks and their wider corporate strategy is made clear**; so, for example, aspects of corporate strategy are seen as mitigation to major strategic risks. In addition, **modern risk management approaches appear to be well-developed**. Examples include the three levels of assurance model and more bespoke approaches such as Anglian Water's risk management process.[10] Like National Grid, Anglian categorises its risks, in its case safety, operational, financial, regulatory and compliance with current regulations and law. The process is set out clearly as a cycle of monitoring and assurance, review, stakeholder engagement, risk identification, risk scoring and evaluation, and risk mitigation and control – all subject both to internal and external inputs and audits.

Again, following standard good practice reporting, many utility companies operate a **risk rating for both gross (unmitigated) and net risk (post-mitigation)**, and in many cases **scoring and analysis of risks is conducted through assessment of probability times consequence scoring**. South East Water's risk management model outlines a) the cause, event, and effects of the risk; b) the likelihood and impact of risk based on current controls; and c) mitigation measures by action, timetable, and owner, with both a current and target risk score.[11] Thorough and repeatable approaches such as these are important especially in the context of unpredictable climate risks such as extreme weather events, which can clearly pose huge problems for both energy and water companies.

On social and environmental risks specifically, it is heartening that UK energy and water **companies are increasingly using the structure of the UN SDGs to analyse baseline performance**. This to our mind has two advantages: it ensures that important impacts of utility operation are not missed, and it brings together environmental and social impacts into a common and integrated framework. This is especially important in the context of the UN Sustainable Development Solutions Network's (SDSN) findings that the UK faces major challenges in meeting three of the UN SDGs, including on climate action and partnership goals – and that the trend on reducing inequalities goal is stagnating.[12]

The majority of companies to reference their performance in relation to the SDGs do so elsewhere in the report to their principal risk and uncertainty statements, Cadent presenting a useful outline of its sustainability framework – including social and environmental priorities and how these align to the SDGs – in its safety and sustainability report.[13] Going further, Anglian explicitly aligns its goals with the 10 SDGs most relevant to its operations, providing example targets of material interest and examples of current activities which support these.[14] But **companies are not yet explicitly tying in the SDGs to their principal risk and uncertainty statements or the social and environmental risks contained within these.**

On the environment, **the vast majority of company risk statements contain at least basic attempts at climate-proofing** – both adaptation and (mainly) mitigation. Climate change is often named as a

[9] National Grid, Annual report and accounts 2018/19
[10] Anglian Water, Annual integrated report 2019
[11] South East Water, Group annual report and financial statements 2018/19
[12] UN Sustainable Development Solutions Network, Sustainable Development Report 2019, July 2019
[13] Cadent, Safety & sustainability report 2018/19
[14] Anglian, Annual integrated report 2019

principal risk, and where it is not there tends to be thorough reporting made against company performance on climate measures elsewhere in the annual report, as with the earlier cited National Grid example. Northern Powergrid's 2015 climate change adaptation strategy report is a particular case of good practice, articulating in detail the climate-related risks the company faces, as well as outlining the actions proposed to address these risks and a summary of how they are incorporated into a broader risk management framework; for example, flooding, heavy rain, coastal flooding, ice and wind, heavy snow, hurricanes and high winds, heatwaves, cold spells, lightning, gradual warming, and drought are all explicitly identified by Northern Powergrid as climate risks, with the potential impact and consequence of these scored and detailed, and this is set against a range of mitigation measures.[15]

Finally, **customer satisfaction is seen as a key metric of risk and customers in vulnerable situations are sometimes considered explicitly** in risk reporting. However, social and vulnerability risks are in some cases explicitly delegated to CSR reporting, and as identified above, a fuller suite of what might be termed fairness risks are seldom reported as material risks to the companies.

Gaps in the current social and environmental risk reporting landscape

A prior question in our analysis is the extent to which the risks which are reported – especially the 'social' risks – adequately cover the breadth of material considerations for utility companies. We have analysed this using the UN Principles for Responsible Investment (UN PRI) as the basis for defining social and environmental factors given their stated role in '[*helping] investors align their responsible investment practices with the broader sustainable objectives of society – as currently best defined by the SDGs.*'[16]

[15] Northern Powergrid, Climate change adaptation strategy, June 2015

[16] https://www.unpri.org/sdgs

Figure 1.2: UN PRI ESG factors

Environmental	Social	Governance
Climate change	Working conditions (incl. slavery and child labour)	Executive pay
Greenhouse gas (GHG emissions)	Local communities (incl. indigenous communities)	Bribery and corruption
Resource depletion (incl. water)	Health and safety	Board diversity and structure
Waste and pollution	Employee relations and diversity	Tax strategy

These social factors are clearly of fundamental importance to all companies. But for some of these UK utility companies are in a unique position as providers of essential services, critical parts of our national infrastructure, enablers of the low carbon transition and in the case of water companies and energy networks, largely natural monopolies. Their environmental and social responsibilities may therefore be said to go above and beyond the examples given in the UN PRI. As the British Academy's *Principles of Purposeful Business* report recently pointed out, '*Regulation should expect particularly high duties of engagement, loyalty and care to public interests on the part of directors of companies which perform important public functions*.'[17]

This is largely not reflected in energy and water principal risk reporting, where the social risks featured are overwhelmingly around workforce, health and safety, and customer delivery/service/satisfaction. The latter focus on customers, as opposed to the needs of communities and citizens, is perhaps to some extent unsurprising given the current framing of economic regulation in terms of protecting consumer interests. The fact that social outcomes are often qualitative, that expectations can vary between groups, regions and nations, and that they can also entail an element of judgement, can make assessing risk is this area particularly challenging.

We have also identified a number of apparent gaps in how companies report social and environmental risk, against our experience of 'best practice' in treatment of risk in these areas. **We will build on the points below in our upcoming work programme on 'risk in the disrupted world'**.

On social or fairness risks **companies seem to suffer from a lack of readily available metrics**, and therefore, as previously noted, risk reporting focuses overwhelmingly on albeit very important issues such as health and safety, workforce, and customer service.

Risks are often analysed as a series of vertical ad-hoc and one-off factors, thus potentially underplaying their aggregate significance (for example, as a trigger to a loss of stakeholder/customer confidence). **There is little discussion of the interplay between different risks or explicit dependency mapping**. This is particularly important given that energy and water are part of complex environmental systems and given the feedback loops created by social media etc.

There are a significant number of companies whose risk reporting does not feature **detailed trends analysis** or **risk RAG ratings**. This is particularly important given the **dynamic and fast-moving** nature of many social and environmental risks and the '**tipping and inflexion points'** that can exist in these areas.

In some cases, social and environmental **risk is perhaps seen mainly through the regulatory and statutory/compliance lens** – and **reputational risks tend to be underplayed**. The extent to which these risks need to be strategically and proactively managed may therefore be underplayed, particularly in the principal risk statements.

With the notable exception of health and safety, **there is little if any analysis of risks from inappropriate internal cultures** . Culture can be an issue that

[17] https://www.thebritishacademy.ac.uk/sites/default/files/future-of-the-corporation-principles-purposeful-business.pdf

economic / infrastructure regulators can struggle with – and this can shape company perceptions in terms of what is 'acceptable behaviour'. However, we would point to examples such as the recent fine of Southern Water as an indication of what can happen if cultural and behavioural factors aren't given due consideration. We would also note that **'conduct'** is a key area of focus for regulators in sectors such as financial services and the professions. As utilities merge and boundaries break down, services replace commodities and the demand side becomes increasingly important, we would expect to see directors placing more emphasis on managing risks in this area.

The idea that **improved corporate culture** – or indeed a **Sustainable Licence to Operate** – may act as a potential mitigation to operational risks is **significantly underplayed** by both water and energy companies.

The coverage given to risks arising from insufficient adaptation to climate change is variable. Perhaps understandably given their greater susceptibility to drought and flood, this issue is covered more thoroughly among water companies than energy companies.

Cross-company risks and the **danger of contagion between sectors** might also be said to be **underplayed** in companies' risk reporting. Examples might include: the fact that while mutual aid in water can be a mitigation to losing supply from one water treatment works, it is probably insufficient to cope with catchment-wide flooding; and the risk that more frequent extreme storm events may cause, for example, energy outages which could trip water supply plants.

There is little publicly available information on boards' risk appetite, which may better inform stakeholders as to why companies have taken the decisions on risk contained in their principal risk and uncertainty statements.

Chapter 2: Key themes from Sustainability First's bilateral risk discussions with UK energy and water companies

Bilateral risk interviews

This chapter reports and analyses Chatham House interviews with seven water and energy companies – Anglian Water, Cadent, Northern Powergrid, Shell Energy, South East Water, Thames Water, UK Power Networks and Western Power Distribution – on their treatment of social and environmental risk. The **briefing note at annex 1** sets out the full list of questions covered during these interviews. Below we set out some of the key high-level findings emerging from these discussions.

It is important to note, however, that **responsibilities for risk are spread widely** in utility businesses, and who one talks to can have an impact on the perception of how social and environmental risks are dealt with in a company. To date, we have mainly talked to our regulatory director contacts in the sectors, and there is perhaps a need to view these crucial issues through a wider range of lenses. To this end, we will hold further discussions with stakeholders, including audit and risk committee chairs and company secretaries, in Year 3 of the Fair for the Future project.

Trends on social and environmental risk

There is broad acknowledgement in energy and water companies that **social and environmental risks are of growing concern** in the sectors, and that these are now key considerations in the day-to-day operations of utility businesses. In particular, **shareholders** are seen to have become much more interested in these topics over recent years, to the extent that some companies have been surprised by their shareholders' steer in the aftermath of serious 'bad news' events.

Social risk

Companies appear to be in different places when it comes to their treatment of social or fairness risks.

Some companies appear to continue to think about these issues as ones of **regulatory compliance** on specific issues (such as the priority services register and social tariffs) and costs (for example cost-to-service debt). However, even these companies are now on a journey towards incorporating more meaningful assessments of social risk into their businesses.
Other companies are looking at the **big picture** and recognise how both public and political expectations are changing when it comes to perceptions of fairness, with this feeding down into a range of good practice initiatives, for example around customers in vulnerable situations.

The dynamic nature of vulnerability and differences in views about executive pay, dividends, etc. – and how these shape opinion-formers' views – make social risk **difficult to quantify**. This can make it more difficult to protect spend in this wider space – beyond compliance – particularly in a **tough price control environment**. Companies stressed that this lack of common and meaningful metrics in the social space is a significant blocker to rolling out best practice across both the energy and water sectors.
However, those we spoke with did recognise **mitigations** which could be put in place to better deal with social or fairness risk, going beyond simply getting operational delivery right or complying with regulatory goals. These include ensuring companies hear directly from customers to identify issues – and not only through 'expert' customer challenge groups – and other forms of customer contact and communications.

Environmental risk

There is **much greater agreement** between companies on how to view and treat environmental risk – even if for regulation directors this can still be mainly **through the lens of compliance**. Indeed, there is concern from some companies that compliance is being put at risk by **price controls not funding basic asset maintenance**, with one company stating that they have been at a 'maintenance cliff edge' for some years.
Companies stressed that there are still also areas where developing metrics on environmental risk is difficult, preventing companies from taking more holistic approaches to their risk portfolios.

Reputational/brand risk

Organisations noted that it has been **difficult to protect spend** on addressing reputational and brand risk, especially in a tough price control environment. In addition to these regulatory 'blockers', there sometimes also appears to be a **mismatch** between what causes a reputational hit and the operational impact. For example, leakage among water companies can in many cases have a negative impact on reputation that far outweighs its operational impact. Nevertheless, companies are considering innovative **mitigations** in the reputational space to demonstrate how they are different from the slowest performers in their sector; one idea mooted was the creation of sub-company regional brands, for example. Companies are also using a range of **measures and metrics** to assess reputation, including those which may seem more informal; one company told us how they recorded the amount of times their CEO featured on TV and radio, with a higher number clearly correlating with newsworthy events and therefore potential reputational damage.

Political and regulatory risk

While some companies appear to view political and regulatory risk as more or less one and the same, others treat it as something separate. One organisation for example noted that if a regulator is independent of government, political and regulatory risk ought therefore to be distinct categories; however, with political and regulatory risk actually more closely aligned perhaps than ever before, this is not a necessarily healthy situation.

While for some, prior to the election, the overwhelming political risk was seen as possible **nationalisation** for others there are wider sectoral problems – often reputational – and the perception that the public are 'falling out of love' with capitalism. This was viewed by some as leading to **a vacuum in decision-making and an absence of leadership** (for example, in terms of who pays for net zero), and more widely manifesting in both major political parties promising greater state intervention in the economy and in particular in the utilities space (price caps, for example).

Companies also voiced concern that they do not wish to go outside of their licence in these areas as this could be deemed anti-competitive in an environment where they need to operate within the boundaries of a monopoly.

Risk in a regulated environment

Some interviewees felt that regulatory frameworks largely dictate what companies can and cannot do in the social and environmental risk space, and whether companies can 'get ahead' of these risks in their business plans.

One network operator expressed their belief that the RIIO-1 framework in this area is sufficiently flexible, noting that the company's social and environment plans fed into its annual Ofgem **Stakeholder and Consumer Vulnerability Incentive (SECV)** submission – a stakeholder-led process and a dynamic incentive aimed at delivering for vulnerable customers. However, there was concern that under RIIO-2 fewer outputs will blur the clarity of reporting.

Many water companies felt that **regulatory relationships with companies need to be reset**, within the current regulatory framework, **some companies are pushing the boundaries**, for example through cross-sectoral work on resilience. There were some calls from both water and energy companies for regulators to look more widely in these areas and make use of broader sources of information than regulators have hitherto.

Investors

Given the political risk landscape, companies noted that their shareholders are to some degree **nervous about the future of their investments –** even if the investment performance of UK utilities infrastructure has been strong compared to other asset classes. This is investigated further in chapter 3. But it was explained in our interviews that some investors are accepting that companies need to fundamentally rethink their business models around this to incorporate the purposeful business agenda (for

example through changing their company's memorandum and articles of association).[18]

Tools to help address social and environmental risk

Leadership

Executive teams, and particularly **chief executives**, can steer and shape the seriousness with which social and environmental risks are treated in the businesses. **Executive remuneration** can also be linked to social and environmental issues such as the business's carbon footprint.

Business purpose and principles and brand identities training, as well as a strong corporate emphasis on a company's **values**, are perceived to help drive through change in this area. **But further consideration is needed as to how 'lock in' / embed leadership and positive treatment of social and environmental risks**, perhaps through changes to business models or by ensuring that there is a 'golden thread' such that business leadership in these areas cascades down into a company's frontline staff.

Culture

An **open and learning** culture in which staff have a **'licence to challenge'** on social and environmental initiatives is deemed to help embed change in businesses, and also to promote innovation in historically difficult areas.

Lessons learned and **root cause analysis** of incidents and near misses is another means of instituting such a culture, while open discussions with the **right people in the room** are seen as key by many. Again, this requires both space and time, and for staff to be empowered to speak up.

Where companies do institute an open and learning culture, the risk function can then 'hold a mirror up to the board'. Reporting lines of those in the risk function and in charge of sustainability to the Chief Executive or other suitably senior Directors (and with a dotted line to relevant Non-Executive Directors such as Audit and Risk Committee Chairs), are clearly important here.

Traditional risk tools/requirements

There is space for the kinds of traditional risk reporting tools covered in the first chapter of this paper, ensuring for example, that social and environmental risks are more fully considered as part of the **company risk** and **risk appetite statement** processes.

Companies are also looking to **bring together bottom-up and top-down views** of risk in a comparable way to triangulate / check against one another; one business mentioned how it uses monthly KPIs to monitor risk aligned to its RIIO business plan, and that this risk register is then escalated to its management council. This can be combined with **deep dives** on social and environmental risks, as well as specific **scenario analysis** in these areas.

It also appears that more can be done to share learnings across the business and develop **best practice** manuals for mitigating and responding to social and environmental risks, with even forward-thinking companies recognising that there is still a way to go in this area. Sharing best practice ought also to be encouraged at a sectoral and cross-sector level, with some companies indicating a desire to use their influence to change regulatory requirements around sharing data, particularly on customers in vulnerable situations, and set expectations around the future direction of the sectors. Others have said that they think the greatest learning they may get may come from looking at best practice from outside the utilities sectors.

[18] https://www.anglianwater.co.uk/news/anglian-water-becomes-first-water-company-to-embed-public-interest-at-its-core/

Chapter 3: How do UK energy and water investors currently see social and environmental risks in their companies and sectors?

At our investor roundtable hosted by Macquarie in October 2019 and through subsequent bilateral discussions with investors, we have sought answers to three key questions on social and environmental risk:

- What **pressures** are investors currently under in relation to social and environmental issues (including specific ESG issues), what are their **mandates** from Trustees in these areas, and how are these changing?

- How do these pressures currently **influence** investors' 'asks' from companies – particularly in terms of questions of social risk, fairness and who pays – and how do investors encourage companies **to interact with regulators, policy makers and other stakeholders** on these issues?

- Would a '**Sustainable Licence to Operate**' make investors more confident about investing in the sectors in the future and **what would they as investors do differently as a result** (e.g. in terms of social and environmental risks)?

The investors we spoke to pointed out the significant degree of **national variation** in perspectives on social and environmental risks, with a survey of investors in private markets across Europe, the United States, and Asia finding very different degrees of investor engagement with ESG issues. While Nordic and Dutch investors can be said to be more in the 'vanguard' of embedding Sustainable Licence to Operate principles in their day-to-day businesses, such issues are rarely brought up in the US and Asia – where some investors are only at the start of this analysis. Investors are however generally finding themselves under more pressure to provide ESG information to their members and policyholders, to the extent that some fossil fuel companies now exclusively fundraise outside of Europe.

Metrics clearly play a key part in successfully integrating environmental and social aims into energy and water companies, but there is a plethora of these at present. The **UN SDGs** are the possible 'common currency' in this investor dialogue, but there is very little coherence and agreement with regard to the metrics against which progress is measured.

A Sustainable Licence to Operate that coalesces the means of measurement against the SDGs could be helpful and allow more progress to be made on ESG. Currently, there are over **120+ different metrics** and lots of different measurement organisations; some leaders will need to emerge from these if ESG demand is not to dissipate. And some metrics are clearly more important than others (and this may potentially vary by sector). There is also a significant cost to accessing some of this ESG data. Even Nordic investors can struggle to grapple with the right ESG metrics. There is a 'fear factor' amongst some investors of getting these metrics wrong – leading to burnt reputations. However, benchmarks such as GRESB do offer a more systematic way of measuring ESG factors than has been available in the past.

Investors spoken to mostly agreed, as explained in chapters 1 and 2, that **social factors** tend to be much less understood than environmental or governance factors in most ESG discussions, and that even where there are metrics in place – as with GRESB – those social metrics are often less clear, often coming down to job creation or, in a utilities context, specific regulatory measures around vulnerability. This could in part be due to the fact that social performance is not seen as being directly financially beneficial. Differences between countries as to how social issues are and should be dealt with may also reflect fundamental differences of political philosophy and therefore make agreement on global social metrics more challenging. From an equity perspective, **governance** has achieved more focus because it is seen as financially positive – and an investor's ability to influence corporate performance is hampered if there is not good governance.

A range of different views have been expressed by investors on the **environment** side: some considering that the material benefits of environmental investing are less clear, others noting that there are 'more reference points' on environmental issues and still others seeing it as a 'huge money maker'. Despite this, the majority of investors considered **climate change** to

be absolutely embedded in their long-term forecasts, and UK water and electricity corporates were considered to be starting to cost climate change, albeit in 'broad brush' ways.

Regarding the division between equity and credit, one participant in the investor roundtable noted that an important **distinction between 'virtue ESG' and 'worry ESG'** could be drawn – the former acting out of genuine ethical concerns, and the latter out of concern for the material impact of not acting on ESG – where ESG becomes little more than a new type of CSR. Indeed, we also heard some concern that ESG risks becoming an industry 'on the side' of the real investment decisions, a 'tick-box exercise' leading to social and environmental issues not being embedded in decision-making. Others did however consider that **ESG is increasingly being seen as a matter of survival for companies and investors**; as a result, a great deal of hard work goes into company plans on the environmental and social side – even if the regulator is perceived often to offer asymmetric incentives on environmental and social issues.

The issues of **ownership and nationalisation** were discussed at some length at the roundtable. One investor cited what seemed almost to be an 'inbuilt' belief held by the public that monopolies belong in national ownership regardless of external political factors. One way of responding to this question might be to pose the related question, 'What is broken that nationalisation will fix?'; this could act as a 'way in' for educating the public about how individual problems within the industries can be resolved under a range of existing models. However, in order to do this successfully, **the often-negative sentiment between regulators and owners will be required to change**.

It was noted that the majority of criticism of the current model has resulted from the specific way that companies are owned and operated, including **convoluted and complex ownership and leverage structures whereby dividend streams are prioritised**, the majority of which go overseas. One of the core aims of privatisation had been to move from 'abstract' state ownership to more meaningful local ownership, but this has not been borne out. However, it was also pointed out that some of these issues are now **historic** ('the dividends have left the country') and that **UK citizens are invested in utility companies through their pensions**.

It was noted that further state intervention in utilities has spanned both Labour and Conservative parties and is part of a **broader societal and public shift in attitudes**. The reversal of this trend will, it was argued, only come from industries taking meaningful action to demonstrate their value to society, including through action on ESG.

There is an outstanding question as to who must take the **leadership** role in enabling a more transparent societal discussion about the scale of change needed for net zero and wider sustainability, how this will be paid for and the potential role to be played by a **Sustainable Licence to Operate**. Investors recognise that there must be a combined effort from policymakers, regulators and companies to push environmental and social factors up the agenda – but also that company executives are those best positioned to push forward with Sustainable Licence to Operate principles and drive change in these areas; investors, by contrast, were perceived to be less well-equipped to communicate these messages

Chapter 4: Conclusions and recommendations

Conclusions

UK energy and water company reporting is increasingly cognisant of the importance of achieving meaningful and just environmental and social outcomes, with headline climate and fairness initiatives often front and centre of companies' annual reports and accounts. However, **this only variably feeds down into company principal risk reporting**, and then mainly on strategic risks (as opposed to operational, financial risks, etc).

These indicate that **much good is being done within companies to better drive fair, sustainable outcomes – and this is starting to be reflected in company reporting**, for example aligning business strategies with the UN SDGs. However, we would caution that such action is not yet often embedded in the businesses, it can often be driven by regulatory directives, and it is still seen by some as just an extension of corporate social responsibility (CSR). As we enter the next stage of macro political uncertainty – and with the push for net zero continuing apace – this will need to change.

Our bilateral risk calls with companies highlight that **interest in social and environmental risks is growing, particularly from shareholders**, but responsibilities for risk in the business are spread widely, and who one talks to in the business has an impact on the perception of how social and environmental risks are dealt with.

The calls reinforce the point above that **companies are in different places with regards to how they see social risk**. Some still see this as a matter of regulatory compliance on specific issues and costs, but even these companies are on a journey, and others are trying to look at the 'big picture'. However, the lack of quantifiable metrics for social risk is a huge barrier to embedding action in this area. **There is more agreement from companies on environmental risk**, but there are similar albeit less pronounced problems with how to measure and monitor such risks. Even here there is some difference between those companies which vest environmental risk in regulation and those which see it as a more strategic and overarching theme.

There is clearly a **significant interrelationship between a) social and environmental risks and b) operational, reputational, and broader political and regulatory risks**. Social risks are inevitably tied up with risks to the reputation of a company in not being seen to be fair to customers and citizens, leading to legitimacy and nationalisation challenges. Similarly, regulatory frameworks largely shape what companies can and cannot do on social and environmental risks, even if some companies are pushing at these regulatory boundaries.

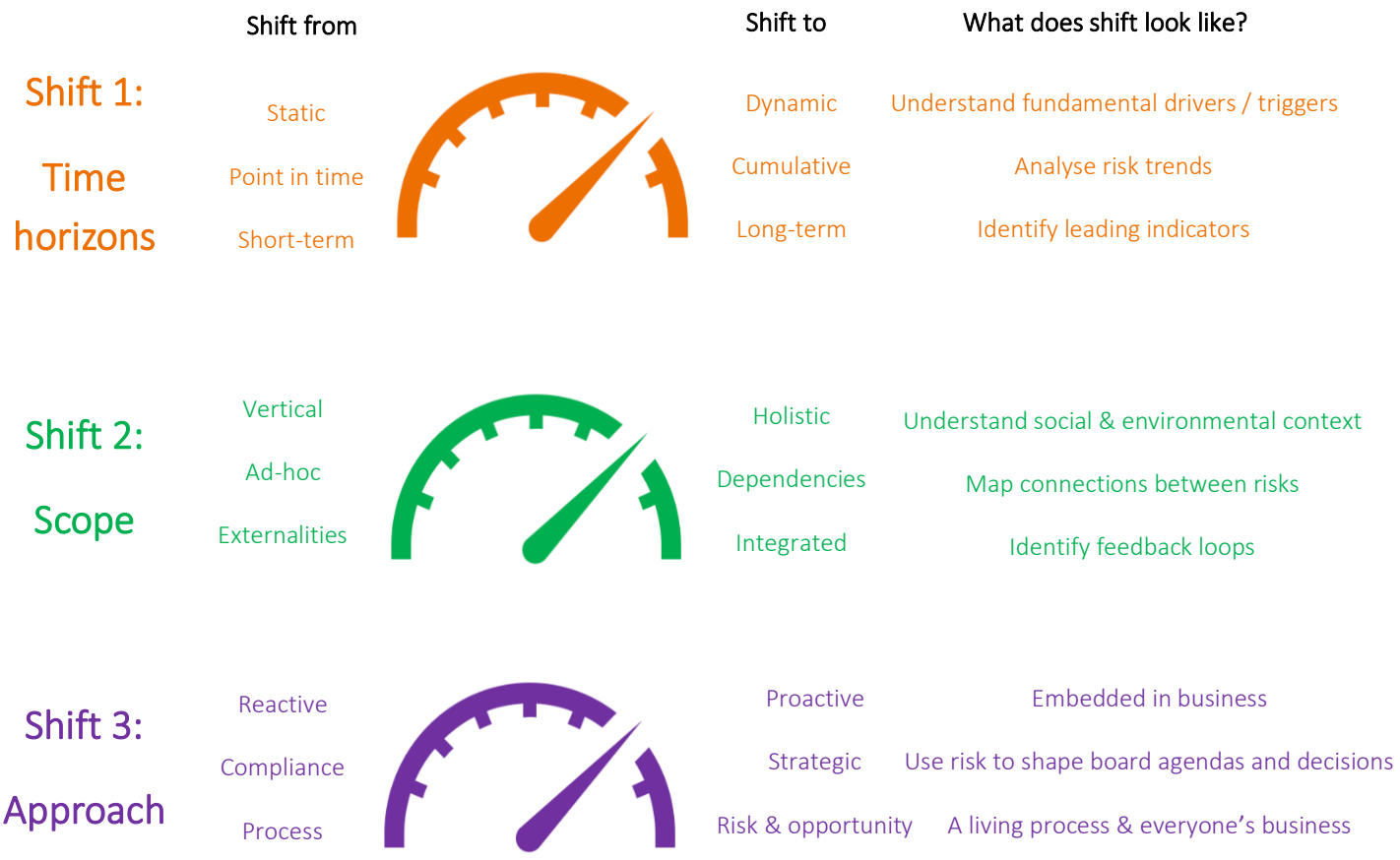
Companies observed **three main tools and processes** to help navigate and address social and environmental risk within these current regulatory frameworks, namely **(i) traditional risk tools** such as root cause analysis and scenario planning to ensure social and environmental risks are considered as part of company risk reporting, **(ii) leadership**, with top-down drive from Boards and Executive teams to lock in and embed progress against these risks, and, related, **(iii) culture**, so that there is an open environment of learning and shared best practice, with meaningful and positive upward and downward communication of the actions being taken in social and environmental areas.

Finally, in our investor roundtable and in bilateral meetings with investor colleagues, investors shared with us that while the appetite for considering social and environmental factors in their investments is growing considerably, **there is often geographic variation in the level of interest shown by investors to these matters**, and where there is interest, it is often framed in **ESG** terms. Again, there is a need for leadership to drive change in this area – but this can often be hindered, as in the companies themselves, by the difficulty in quantifying environmental and particularly social risks.

Early recommendations on risk and Sustainability First's next steps in this area

At this stage in the Fair for the Future project, we conclude that to deliver fairer social and environmental outcomes, the approach to risk in the sectors for a 'Sustainable Licence to Operate' needs to see three shifts. These are illustrated in Figure 4.1. We will be exploring these in more detail in our forthcoming programme of work on '**risk in the disrupted world'** and seeking to identify where this paper's analysis may require some changes to this model.

Figure 4.1. Shifting the dial on social and environmental approaches to risk in the energy and water sectors



Source: Sustainability First

Annex 1

Bilateral risk interviews

Briefing note

How can energy and water companies better integrate their approaches to social and environmental risk and uncertainty into future-facing business strategy and decision making?

Briefing for company interviews

This briefing sets out some background on social and environmental risk and uncertainty in the energy and water sectors, identifies the needs case for change, outlines the objectives of our research and then sets out our research questions that we would like to discuss with you in your bilateral interview.

Background

- While individual energy and water companies are clearly in different places (regulated / nonregulated, water / energy, resources etc.) in how they view social and environmental risk and uncertainty, questions are being raised across the economy as to how 'fairness' is addressed by corporations.
- This has been publicly recognised, by amongst others, the Financial Reporting Council in its work on corporate governance reform (Section 172 of the UK Companies Act) and its recent consultation on stewardship.
- Investors are also increasingly looking at how to define 'Environmental & Social' factors in their 'ESG' analysis.
- This has implications for how energy and water companies think about risk, uncertainty, opportunity and strategy.
- There are specific reasons why key parts of the energy and water sectors need to be on the front foot in terms of their approach to social and environmental uncertainty and risk; they are on the front line as essential services and are part of the UK's foundational economy and critical national infrastructure.

Needs case

- Given the disruptive challenges the sectors face, it is clear companies cannot wait for regulators to 'tell them what to do' in these areas.
- Environmental and social risks are fast-moving, interconnected, and dynamic.
- Regulators are increasingly moving to principles-based regulation and there is a public expectation that companies need to go further in the social and environmental space.
- There is also a recognition in the sectors that locking oneself into time-limited, static views of risk can be problematic.

Objectives of this research

- To help energy and water companies better integrate their approaches to social and environmental risk and uncertainty into future-facing business strategy and decision making.
- Sustainability First's aim is to use this work to help companies shift the dial on how they address social and environmental issues from being:

- reactive → proactive;
- purely risk based → risk and opportunity → these issues being key part of strategy;
- treating environmental and social issues as separate → operational / strategic issues → being integral to service delivery / company purpose;
- short term → long term;
- regulatory/compliance mindset → a strategic mindset;
- companies' own views → a sector-wide view.

- We want to identify the implications of this thinking for the interplay between culture, leadership, process, and wider relationships to policy and regulation.
- We will use this research to identify any gaps in terms of how risk and uncertainty on social and environmental issues are currently dealt with and where we might be able to add value in any further work. E.g. this could be commissioning some social / fairness scenarios or a critique of existing uncertainty / risk tools etc.

Research questions on social and environmental risk and uncertainty for bilateral interviews

1. In a few sentences, can you describe your company's **social and environmental purpose**?
2. What **tools and processes** are currently employed by your company in addressing your principle social and environmental risks and uncertainties and your risk appetite around fairness related issues?
3. What more can we do to **learn and transfer the lessons** from your company in the areas where you already have a good handle of environmental and social risk and uncertainty in your *core* business?
4. How can we identify the **genuine constraints** that exist in your company in terms of addressing social and environmental risks; how do you overcome these, and what has stopped you from going further?
5. How can we understand the **relationship between the different parts of the company decision-making chain** in this area; e.g. board, executive, non-executives, strategy team, regulatory team, investors, compliance and operations, and consumer challenge / engagement and stakeholder groups.

Thanks to sponsors

We would like to thank the sponsors of this project for their continued support: Anglian Water, BT*, Cadent, National Grid, Northern Powergrid, Ofgem, Ofwat, Portsmouth Water, South East Water, Thames Water, UK Power Networks, United Utilities*, Western Power Distribution.

*denotes companies sponsoring the final year of the project only; these companies came on board after the analysis for the present paper was undertaken

About Sustainability First

Sustainability First is a think tank that promotes practical, sustainable solutions to improve environmental, economic and social wellbeing.

We are a registered charity that primarily works in the public utilities.

Registered Charity Number: 1078994

February 2020

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