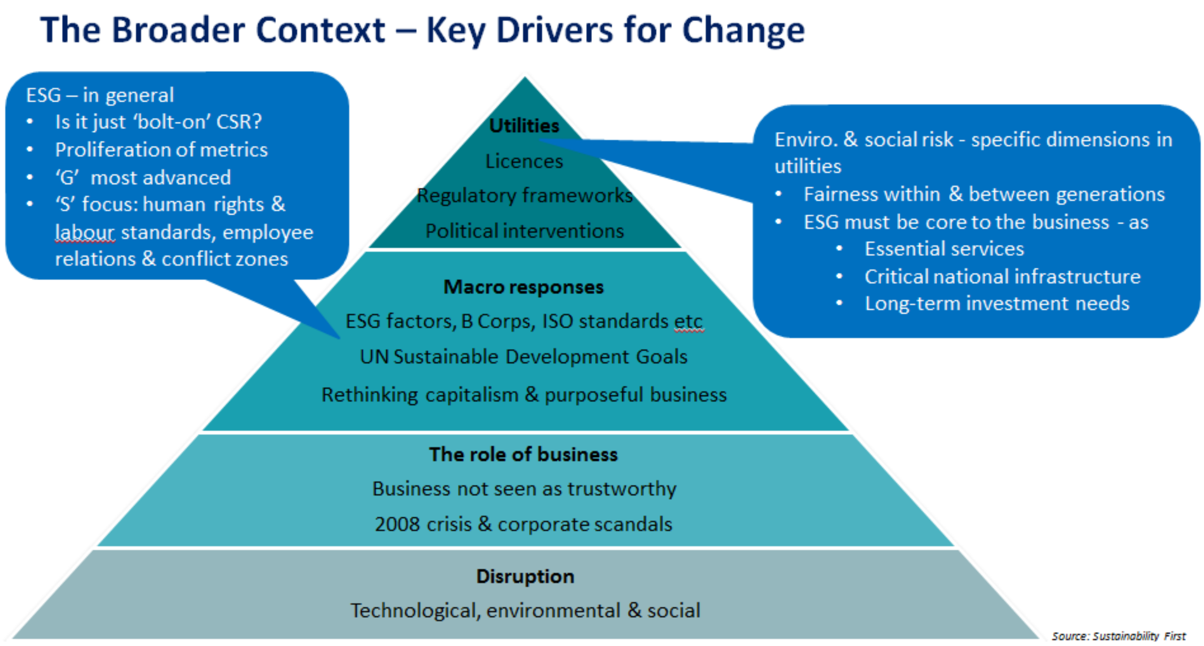
How is Political and Regulatory Risk and Uncertainty around Fairness and the Environment Viewed by Investors in the UK Energy and Water Sectors?

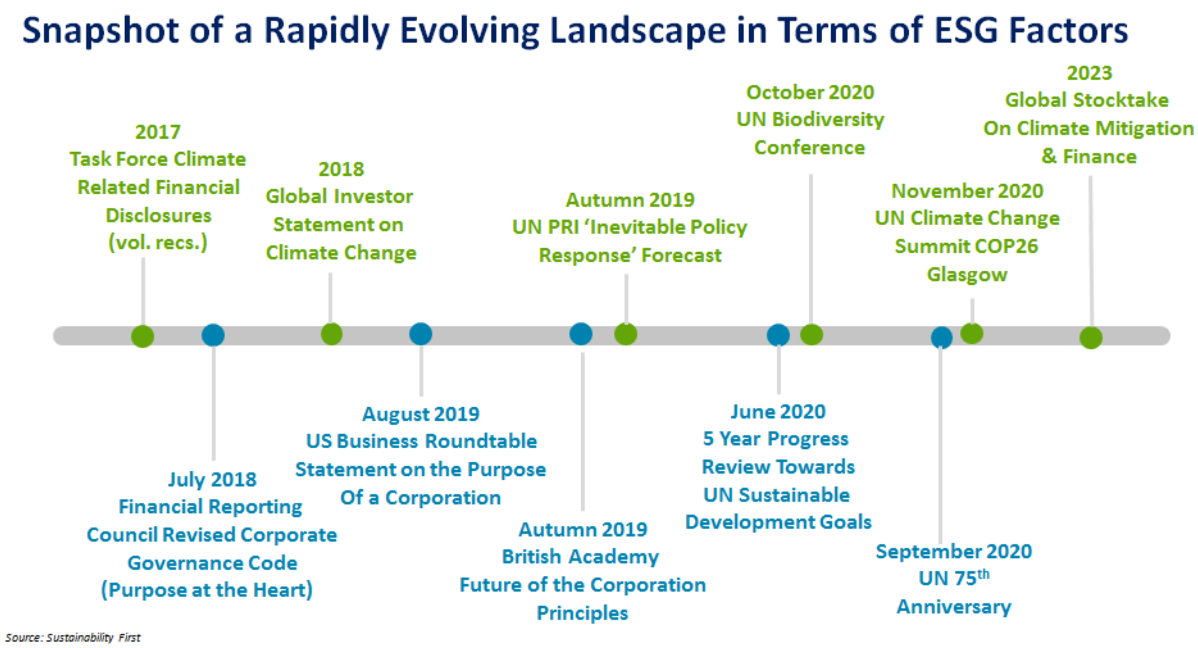
Sustainability First - Fair for the Future Project

Briefing Note – October 2019

Introduction

- Political uncertainty and regulatory risk are hot topics in the utilities space. These are in part shaped by wider questions around the role of companies in delivering social and environmental outcomes.
- The investor landscape is rapidly changing in terms of a growing interest in responsible business and increasing weight being attached to Environmental, Social and Governance (ESG) factors; for example, on the environmental side, the 2018 Global Investor Statement on Climate Change, or, on the governance side, August 2019's Business Roundtable statement on the purpose of the corporation.





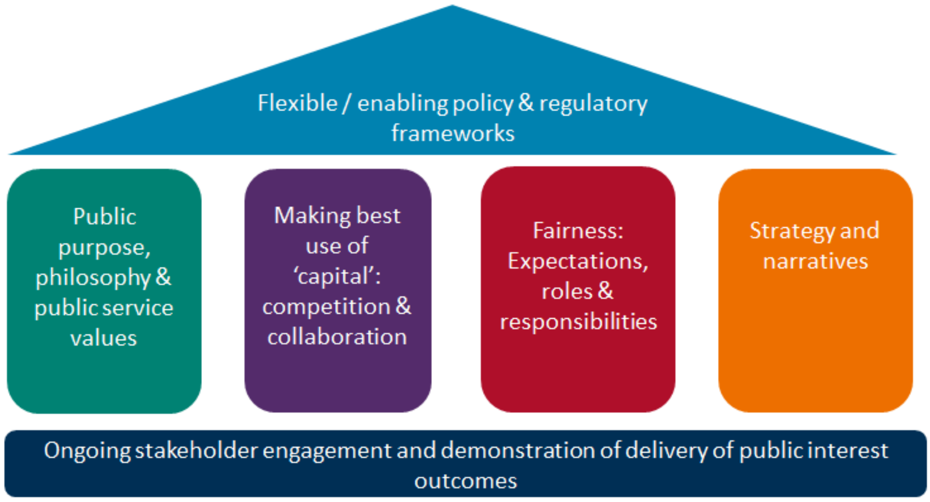
- On **14th October 2019**, Macquarie Infrastructure and Real Assets (MIRA) Europe kindly hosted an investor roundtable with Sustainability First on how political and regulatory risk and uncertainty around fairness and the environment are viewed by investors in the UK energy and water sectors.
- MIRA has extensive experience of investing in utilities. Sustainability First, an environmental think-tank and charity grounded in longstanding experience of the UK energy and water sectors, specialises in areas of economic regulation, innovation, and social justice.
- Representatives from nine different asset managers and investor groups attended the discussion. The roundtable was held under the Chatham House rule. This briefing note is designed to provide interested stakeholders with an insight into the issues raised.

Background to Sustainability First's 'Fair for the Future Project' and work on political and regulatory risk around fairness and the environment in energy and water

- Sustainability First's Fair for the Future project works within this broader social and environmental picture, aiming to help UK energy and water companies better address the politics of fairness and the environment. It is doing this through two workstreams: 1) Developing the concept of a 'Sustainable Licence to Operate' in the sectors; 2) Producing a more inclusive and dynamic map of political and regulatory risk in terms of fairness and the environment.[1]

[1] Fair for the Future project papers can be found here.

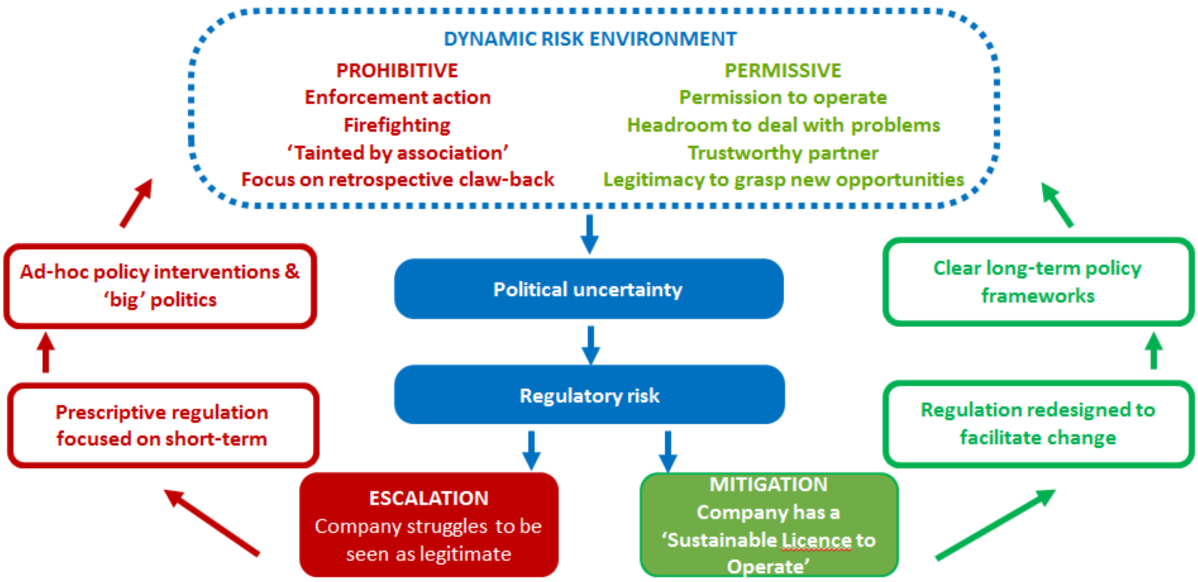
Developing the Concept of a 'Sustainable Licence to Operate' in the UK Energy and Water Sectors



Source: Sustainability First

- On risk, Sustainability First is exploring how to best create a 'permissive' rather than a 'prohibitive' environment for addressing fairness issues. Our work has highlighted that this environment is shaped by four 'dynamic risk factors': the consumer lived experience; the environment / climate; the media; and civil society. Sustainability First proposes that to get a shift towards a more permissive environment would involve companies adopting behaviour in line with their Sustainable Licence to Operate, regulation being redesigned to facilitate change, and clear long-term policy frameworks to allow 'responsible' companies to grasp new opportunities. Who provides the leadership to get this change is a key question.

Creating a 'Permissive' Environment to Address the Politics of Fairness



Source: Sustainability First

Questions raised on Sustainability First's Fair for the Future Project proposals

Q – Is the proposed Sustainable Licence to Operate seen as a **form of certification**?
A - Getting and maintaining a Sustainable Licence to Operate will be an ongoing, iterative process carried out with stakeholders. Accreditations, certification etc can all play a part in terms of demonstrating activity and locking-in purpose, but these need to be relevant to each company's position (sector, place in the value chain, risks etc). Sustainability First does not want the Sustainable Licence to Operate to become a 'tick-box exercise' that can be 'gamed'; rather, it should be more organically developed and therefore ultimately more meaningful.

Q – Do these proposals indicate preference for a '**light-touch' regulatory environment**? It could be a perilous time to reintroduce the concept of light-touch regulation given the shorter-term PR 19 and RIIO-2 stresses faced by companies.
A – Sustainability First's proposals are more in line with principles-based and ethical regulation than light-touch regulation. Regulators will want to consider the ways in which they regulate; as companies act upon the four pillars of the Sustainable Licence to Operate (purpose and values, making best use of 'capital', fairness, and strategy and narratives) the risk of ad hoc policy and regulatory interventions should be reduced. Regulators are in some ways at the centre of these debates and will be integral to any Sustainable Licence to Operate being achieved, as companies are far less likely to make changes to become a 'responsible business' if not encouraged to do so.

Q – Can company executives themselves embed a Sustainable Licence to Operate or is it really down to **employees** who are the ambassadors of a business, and if they are not empowered to know what the organisation is doing, the work will not filter down?
A – There needs to be a cultural piece of work operating alongside more top-down measures – bottom up and top down approaches are both important – but it needs to go beyond just being a communications exercise.

Q – What is the **investor role** and what can they do to drive societal change given the limited time spent with management teams and a tendency to be more focused on the 'here and now'.
A – There are many different types of investors. Some are close to management teams. Corporate reporting and getting the right metrics so investors and other stakeholders can assess how a business is performing on all fronts – including on social and environmental issues – is vital.

Discussion - three key questions for investors in the UK energy and water sectors in terms of social and environmental risk

1. 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?
2. 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?

3. 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)?

Points raised in discussion

National variation: A survey of investors in private markets across **Europe, the United States, and Asia** found very definite regional variations in terms of investor engagement with ESG issues. While Nordic and Dutch investors are 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. Some fossil fuel companies now exclusively fundraise outside of Europe.

ESG measures: 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 **United Nations Sustainable Development Goals (SDGs),** however, are the 'common currency' in this investor dialogue, but there is very little coherence and agreement with regard to the metrics against which progress is measured. It was considered that 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.

The different aspects of ESG: There was an agreement 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 ('the 'S' metrics are squidgy'). One investor said in their experience there was not consideration by investors of intergenerational social / fairness issues. 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 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 isn't good governance.

There were a difference of views on the **environment** side; some considering that the material benefits of this are less clear and others noting that there are 'more reference points' on environmental issues and still others seeing it as a 'huge money maker'. Despite this, for most investors present, **climate change** was seen as being absolutely embedded in their long-term forecasts. UK water and electricity corporates were considered to be starting to cost climate change, albeit in 'broad brush' ways.

One investor pointed to the importance of social and environmental metrics to current and future employees.

Different motivations for focusing on ESG: There is capacity for large, public, active manager shareholders to influence these issues. Regarding the division between equity and credit, one participant noted that a more 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.'

An 'ESG' industry: There were a range of views here. Some thought there is a danger that 'ESG people talk to ESG people – not CFOs' without this ultimately making a difference to the most important decision-making; ESG therefore risks becoming an industry 'on the side' of the real investment decisions leading to social and environmental issues not being embedded in decision making. Some investors in funds therefore tend to see ESG as a tick-box exercise which currently does not have to be properly embedded in organisations. Others considered 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. However, it was also noted by one investor that the regulator often offers asymmetric incentives on environmental and social issues, which can create problems.

Social and environmental policy costs: Some participants noted that what tends to drive added cost on bills are government policies and commitments, but customers are not educated about this or aware of how these costs can build up and accumulate over time. Communications on its own cannot be the answer to all of these problems, but both the regulator and government should step up to educate consumers of the reality of the industries, especially because where operating companies attempt to do this, they are not likely to be well received.

Ownership and nationalisation: 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. Many members of the public were considered not to understand the full complexity of how regulated models work, or even possess a thorough understanding of how their energy and water bills are constituted. As a result, they learn their 'truths' from the media.

In the context of the possibility of nationalisation, one could pose the 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 needs 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 millions of UK citizens are invested in utility companies through their pensions, and that journalists have often reported negatively on companies even where their dividends are justifiable or lower than the national average.

A comment was also made that support for further state intervention in utilities has spanned both Labour and Conservative parties and is part of a broader societal and public shift in attitudes. While this will not inevitably lead to nationalisation, the reversal of this trend will only come from industries taking meaningful action to demonstrate their value to society, including through action on ESG.

Board directors: Private investor-appointed directors sitting on company boards have exactly the same duties as all other board members. One participant said that in board meetings customer engagement, efficiency, outcome incentives, and affordability are talked about far more than shareholder returns. Boards try to produce a balanced plan that will meet all stakeholder needs, including boards with investor representatives.

Leadership and a Sustainable Licence to Operate: 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 and how this will be paid for.
It was agreed that there needs to be a combined effort from policymakers, regulators, and companies to push environmental and social factors up the agenda. Many of those present considered that it is company executives who are 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. Several participants considered that getting a better grasp of 'what a Sustainable Licence Operate looks like in practice' would be helpful in making the transition.