PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES
INQUIRY INTO CORPORATE RESPONSIBILITY

Submission on behalf of participants in the BT Governance Advisory Service:

- → The Public Sector and Commonwealth Superannuation Schemes,
- → The Catholic Superannuation Fund,
- → The Northern Territory Government and Public Authorities Superannuation Scheme;
- → VicSuper; and
- → Emergency Services Superannuation.
- → Northern Territory Police Supplementary Benefit Scheme

Background

The BT Governance Advisory Service (GAS) advises institutional investors on social, environmental and corporate governance risks in the S&P/ASX200 companies in which they invest. Our mandate is to research the risks our clients are potentially exposed to across their Australian equities portfolios and then engage companies on our clients' behalf to encourage effective governance of risks. This is done to protect the performance of companies over time by forestalling the need for additional regulation in response to public concern, expensive litigation or other sources of higher costs arising from community, regulatory or litigation risks. These risks are potentially material financial risks for the following reasons.

1. Community risk: community stakeholders often determine what is referred to as a 'social license to operate'. If companies do not manage the expectations of the communities in which they operate they will not retain or gain the social license necessary for operation. Companies that do not manage community, customer and employee expectations are exposed to boycotts, protests and negative media attention all of which lead to reputation damage for the company. Similarly regulation risks can arise from companies not managing community expectations and therefore provoking regulation that either directly prohibits - or increases the costs - of operations.
2. Regulatory risk: Regulatory risk arises when community risks are so great governments respond by developing policies and regulatory mechanisms to curb a particular activity or introduce taxes or pricing incentives to restructure the burden of the costs away from external stakeholders and towards the business. This not only has the potential to create direct cost imposts on a company but also increases the transition costs through compliance with the regulation.

3. Litigation risk: Litigation risk increases with regulatory and community action. Risk of litigation arises through exposure to civil or criminal suits including class actions, industrial relations actions or ‘watchdog’ proceedings such as action taken by ASIC and the ACCC. By managing stakeholder expectations, many litigation risks can also be managed.

GAS advises on A$7 billion of Australian equity investments for the superannuation funds listed above.

This submission is written from the view of our investor clients’ expectations in relation to the consideration of CSR issues.

GAS response

a) The extent to which organisational decision-makers have an existing regard for the interests of stakeholders other than shareholders, and the broader community.

Long term investors expect organisational decision makers to have a regard for the interests of stakeholders other than shareowners when those stakeholder interests have the capacity to influence shareowners’ interests.

We believe that companies that manage their stakeholders’ interests are managing their shareowners’ interests, especially over the long-term. This arises from the fact that risks to companies arise not just from typical financial risks but also from regulatory, community and litigation risks. By managing stakeholder expectations, companies begin to manage many of these risks.

Research undertaken by GAS and our social and environmental sub advisors, Monash Sustainability enterprises suggests companies do not always consider these risks and stakeholder interests. Where these risks are managed, this is often not adequately reported to the market. Our research has found that:

- In 2004 public reporting by companies:
    - More than half of S&P/ASX200 companies did not publicly disclose information on their processes to protect against violations of consumer privacy.
    - Nearly half (46%) of S&P/ASX200 companies made no mention of staff or contractor training with regard to product safety or the handling of materials hazardous to public health.
    - Nearly half (46%) of ASX200 companies did not publicly disclose policies protecting whistleblowers.

    - In 52% of S&P/ASX200 companies, codes of conduct did not address the company's adherence to responsible marketing and promotion issues such as fair trading and truth in advertising.

- → In 2003 in relation to workplace health and safety we found:
    - nearly two-thirds of S&P/ASX200 companies did not publicly disclose their policy and strategy for workplace safety management.
    - only 10% publicly report a lag indicator of WH&S performance and
    - 2% of companies specify their management system applies to contractors.

- → In 2003 in relation to energy and greenhouse risk we found:
    - as few as 14 S&P/ASX200 companies had integrated energy and greenhouse has (GHG) mitigation into corporate environmental management systems;
    - only 18 S&P/ASX200 companies had publicly disclosed commitments to reduce energy use or GHG emissions; and
    - only one in 17 S&P/ASX200 companies had disclosed GHG reductions at or below Australia's Kyoto targets.

This research suggests that there are potential gaps in the assessment of governance and sustainability risks and hence shareholder and stakeholder interests. Organisational decision makers need to pay more attention to longer term sustainability and governance risks that give rise to community, regulatory and litigation risks.

There may be occasions where shareowner and stakeholder interests may appear to be opposed. In our view this conflict often disappears when companies and investors take a long-term view of profits and risks. As long term investors, our clients have a preference for a focus on long term sustainable performance.

On our clients' behalf we regularly engage listed companies to gauge the extent to which they are managing stakeholder interests. Not all companies are managing these risks as well as they could; however, **we do not believe the solution is regulation because good behaviour cannot be created by regulation.**

b) The extent to which organisational decision-makers should have regard for the interests of stakeholders other than shareholders, and the broader community.

As addressed in the response above, where there is a potential impact on long term shareowner value through not managing stakeholder interests, those stakeholder interests should be considered. Decision-makers that ignore the

interests of all stakeholders other than those of shareowners would in the medium-to-long term discover the negative consequences for shareowners in this approach.

c) The extent to which the current legal framework governing directors' duties encourages or discourages them from having regard for the interests stakeholders other than shareholders, and the broader community.

We do not believe that the present legal framework discourages directors from regarding the interests of stakeholders other than shareowners[1]. Under the Corporations Act, directors must act in the best interests of the company. For a director to act in the interests of the company they need to consider their stakeholders as part of managing risks to the company from community, regulatory and litigation risks. Many directors of major companies already adopt this approach when considering the best interests of their companies.

In considering what stakeholders' interests need to be managed in protecting the interests of the company, directors need to consider the social and environmental impacts of their organisations and the governance structures they have in place to ensure the management of longer term risks. To not manage these risks invites potential costs to the company. There is no regulation to our knowledge preventing a company from seeking to avoid or minimise costs.

If the legal argument suggests otherwise, the long term investor clients we represent have a preference for regulation that facilitates consideration of stakeholder interests as opposed to prescribing such consideration. We believe prescriptive legislation would be difficult to enforce (and we cannot anticipate who would be responsible for enforcing any such legislation). Developing legislation on many of the issues external stakeholders are interested in would also be difficult given the vastly different issues faced by many companies.

d) Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or directors to have regard for the interests of stakeholders other than shareholders, and the broader community. In considering this matter, the Committee will also have regard to obligations that exist in laws other than the Corporations Act.

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[1] The argument put forward by Mr Bill Beerworth that directors may need 'protection' from making such decisions is a point worth further legal enquiry (see DIRECTORS DUTIES AND CORPORATE SOCIAL RESPONSIBILITY, BILL BEERWORTH, MANAGING DIRECTOR, BEERWORTH & PARTNERS LIMITED, 27 July 2005

We do not believe the present legal framework creates barriers to directors considering stakeholders' interests as part of ensuring a company's long term future is protected; however we recognise the interests are not always considered adequately. A possible solution is to encourage awareness among directors, officers and shareowners of the broad suite of risks to companies associated with stakeholders' interests. This would enable a more efficient market-based solution, as an educated market is a more efficient market. As an example of 'facilitative' regulation, it may be that directors be required to state the extent to which they have considered social, environmental and labour standards under an amendment similar to the *Corporations Act* s1013D(1)(l) disclosure requirements for investment products.

e) Any alternative mechanisms, including voluntary measures that may enhance consideration of stakeholder interests by incorporated entities and/or their directors.

We believe companies can continue to enhance the consideration of stakeholder interests by considering their response to Principle 7 and 10 of the ASX Corporate Governance Guidelines. We believe there needs to be an ongoing focus on these guidelines to continue to deepen the focus and consideration of stakeholder interests over time. A greater focus by companies on their reporting (and management of risk) under these Principles should prompt more shareowners into assessing how companies in their portfolios assess and manage these risks.

Example of the further risks that could be better reported under Principle 7 reporting by companies include:

- → business ethics,
- → workplace heath and safety,
- → ability to access skilled labour over time and human capital management,
- → environmental risks such as site contamination and environmental risks in the supply chain, and
- → Energy and greenhouse risk.

GAS believes how these companies consider these issues should be better reported to investors than at present. Investors need better reporting by companies because of the potential impact on company performance over time of 'CSR'-type issues. Two examples of issues that clearly have the potential to impact company performance over time are workplace health and safety and energy and greenhouse risk issues:

1. **Workplace heath and safety:** Workplace health and safety (WH&S) is an operational business risk that is both a financial and potential reputation cost. It is a cost incurred because of WH&S regulation and its enforcement, the loss of corporate credibility or corporate image

(reputation), supply chain pressures and the potential for poor performance to lead to industrial action. Likewise, WH&S is a management function that helps maximise competitive advantage through workforce loyalty, improved productivity and lower workers' compensation premiums. It also provides reputation rewards such as being an 'employer of choice' (as will as minimising industrial disputes).

Research commissioned by BTGAS clients found that in Australia the direct costs of work-related injuries are estimated to be $27 billion per year, with indirect costs potentially up to four times greater.

As a result WH&S is another example of a sustainability issue that can be a proxy for a responsible and effective management approach to risk identification, assessment and control.

Specifically WH&S reporting provides investors with information regarding:

- → WH&S as a primary financial risk;
- → a proxy for management competency;
- → intangible asset management eg reputation and employer of choice.

In the short term, the financial benefits of reducing the direct costs of WH&S can be significant. In the US, the average cost of absenteeism, often associated with poor WH&S performance, was found to be $US602 per-employee with unscheduled absenteeism considered a serious problem by 41% of US employers[2].

Like energy and greenhouse, investors are starting to recognise the potential for WH&S to give insight into how companies are managed. In December 2004 broker ABN Amro Australia released a report on the Australian mining sector. It argues that "the safety performance of an operation is an outcome of the level of control within that operation, which in turn impacts its efficiency and financial performance". The report finds a correlation between the safety performance of a company and its inventory levels; higher levels of inventory being an indicator for a poorly run business. ABN also argues that financial performance and safety performance do correlate.

2. **Energy and greenhouse risks:** Energy costs can be the most closely controllable overhead after labour costs and directly affect the bottom line. Likewise, there have been clear regulatory signals globally that we are moving to a carbon constrained economy.

[2] Taken from the BT Governance Advisory Service client position paper on workplace health and safety available at www.btinstitutional.com.au.

On energy efficiency, research repeatedly shows capital spending on energy efficiency, such as whole-building upgrades, are sound financial investments. A study conducted in the US assessed the financial risk and return from fourteen whole-building energy efficiency upgrade projects. The internal rate of return of the investment was calculated using a ten year project lifetime and the investment risk was measured as the variability in the expected investment return — the risk that it would produce more or less than the expected return on investment. The average return was more than 20%, with a coefficient of variation (risk) less than one

Other examples of cost savings driven by energy efficiency include:

- US Aircraft manufacturer Boeing reduced the electricity used in lighting its buildings by up to 90% with a two year payback (ROI = 50%). The new higher quality lighting has cut down glare, helping workers reduce defects.
- Between 1992 and 2001 IBM's US operations invested in changes to manufacturing processes and facility infrastructure, including the use of high efficiency motors and lighting, and reducing reheat energy. These changes have saved an estimated 9.0 billion kw hours of electricity, avoided 5.5 million tonnes of CO_2 emissions and reduced energy expenses by approximately US$508 million[3].

Likewise on greenhouse emissions, the business case for reducing emissions gets stronger with the increasing price of carbon and the Kyoto Protocol coming into force.

The New Zealand Government has announced it will introduce a NZ$15 (€8.45) per tonne CO_2 carbon tax for power generators and factories from April 2007. The carbon tax is expected to raise energy prices adding about one cent per unit of electricity, about four cents per litre of petrol, 46 cents to a 9kg bottle of LPG and 68 cents to a 20kg bag of coal[4].

In Europe the price of carbon has reached €29.35per tonne with the future cost of carbon potentially having material financial impacts on energy-intensive companies. The Carbon Disclosure Project (CDP)[5] found two-thirds of EU utilities expect wholesale electricity prices to rise by up to 20%. According to one company participating in the CDP, higher electricity prices across the EU will mean additional costs of almost €600 million per

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[3] Examples taken from BT Governance Advisory Service client position paper on energy and greenhouse available at www.btinstitutional.com.au.

[4] http://www.climatechange.govt.nz/policy-initiatives/carbon-tax.html

[5] The Carbon Disclosure project is a global initiative assessing the ability of companies to cope with the potential risks and opportunities created by climate change. The Carbon Disclosure Project reports can be downloaded from http://www.cdproject.net/report.asp. BT Financial Group is a member of the Carbon Disclosure Project.

year for the European steel industry, €500m for the pulp and paper business, and €260m for the cement, lime and glass industries. CDP analysis indicates that even a 5% increase in energy prices could impact per share earnings by as much as 15% in certain industries.

Research has also shown that the way companies manage their energy use and greenhouse risk and their approach to climate change can impact brand value. In May 2005 The Carbon Trust published the report *Brand Value at Risk from Climate Change.* The report argues that while climate change is not yet a major consumer issue it is becoming a risk for companies with strong brand value, and could become a mainstream consumer issue by 2010[6].

An example where such reputation damage has already occurred was when pro-environmental campaigners shut down Esso's 28 fuel stations in Luxembourg in protest at Greenpeace's claim that ExxonMobil contributed to the US decision not to ratify Kyoto. Deutsche Bank has warned ExxonMobil that investors should be worried about the Greenpeace-backed StopEsso campaign because of brand risk.

Reporting on issues such as energy use and workplace health and safety can also be better reported under Principle 10 of the ASX Guidelines as other stakeholders are also often interested in how companies are managing these issues. Companies need to identify and prioritise those issues of interest to stakeholders and shareowners and communicate this process and through Principle 10 reporting.

f) The appropriateness of reporting requirements associated with these issues.

The current reporting requirements for publicly listed companies do not give investors sufficient information to understand the extent to which companies are managing social and environmental risks [as suggested by the statistics outlined in response to questions (a) and (d)]. While we do not advocate prescriptive legislation that would increase compliance costs for companies, we do believe some companies lack guidance on what information should be reported to long term investors. If a simple voluntary framework could be provided to at least give investors insight into the governance processes in place to assess social, environmental and corporate governance risks, investors could make up their own mind on the these processes' sufficiency.

While many 'leaders' in sustainability reporting provide much more detailed information, we believe a voluntary framework would allow 'poor performers' on reporting to easily disclose more information to the market. There are also

[6] http://www.thecarbontrust.co.uk/carbontrust/climate_change/iocc4_3_1.html

companies that are actually managing stakeholder interests but lack guidance on how to communicate this management, and that in some cases, report that their shareowners have displayed complete indifference to how these interests - and associated risks – are managed.

As outlined in response to question d), GAS believes Principle 7 and 10 can provide a better framework for reporting. The Joint Committee may wish to consider how to best facilitate better reporting under these Principles, remembering that they are the domain of the ASX Corporate Governance Council. A better reporting framework will also facilitate better identification and management of risks.

BT GAS has produced a number of governance position papers on behalf of clients that outline what and how companies could be better reporting to the market. To view these papers go to http://www.btinstitutional.com.au/content/institutional/research.htm and scroll down to 'governance research'. We believe the workplace health and safety and business ethics papers are most relevant to this inquiry.

g) Whether regulatory, legislative or other policy approaches in other countries could be adopted or adapted for Australia.

GAS acknowledges that Australian legislative approach to CSR reporting lags that of the UK. However we do not have a firm view as to whether such an approach should be adopted in Australia at this time. We believe CSR reporting frameworks could potentially be provided under existing frameworks as outlined in the section above.

BT GAS would be happy to provide more detail either before the Committee or in any form the Committee sees appropriate.

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