

Watertight investments? How investors can influence the global water crisis

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A seminar convened by Sweden's Sustainable Investment Forum (SWESIF) and Swedish Water House.

Main points and conclusions from the seminar

- The main water risks for business are: Increased water stress, increased competition over scarce resources, tougher regulations and the fact that corporate brands will be increasingly dependent on sustainable development.
- By identifying opportunities related to water there are benefits to be made for investment managers and capital owners, and they are important stakeholders for the sustainable management of water resources.
- Investors and businesses need to find good ways of communicating around water issues in order to improve management of water related risks.
- Investors should actively engage with companies and set clear expectations on the type of information they need.
- The critical role for investors in tackling the water challenge is to understand the whole picture, not just rising prices but also including the supply chain. Companies need to hear from investors that water is important.
- Companies should improve their understanding of the water-related risks in their supply chain and should disclose local and contextualized water-related data.
- There is a need to identify and value ESG (environmental, social, and corporate governance) – including water issues – in loans, equities and bonds, and to work towards pricing water and other ESG issues in financial products.
- *Asset managers* must engage with corporate clients to mitigate water-related risks, and *asset owners* should require asset managers to engage and factor in water and other ESG issues through investment management agreements.
- Better disclosure is needed for companies to be better analysed and valued in ESG risks.

Introductions to the seminar were made by Karin Lexén, Director, Swedish Water House and Henrik Malmsten, Chairman, SWESIF, as well as the moderator Johan Kuylenstierna, Centre Director and Deputy Director Operations, Stockholm Environment Institute (SEI). Below is a resumé of the seminar:

Opening remarks on the global water crisis

Karin Lexén, Director, Swedish Water House

Let us be specific about the concept of water scarcity. The lack of water supply is mostly due to bad management, while the lack of water resources can also mean physical scarcity. Already today there is water scarcity in many areas of the world. Climate change increases our uncertainty about rainfall patterns and other weather events, requiring well-functioning storage of water ahead. Most of our freshwater goes to agriculture and industry, only 10 % is used by households. Also, agriculture will need even more water in the future. So if water is not well managed, we will see an increased competition between agriculture, industry and people's access to water and sanitation; their human rights. This makes it necessary to invest in resource efficient business and skills. The future will also bring an increased conflict between water use in the countryside and in growing cities. The megacities of the world are growing in number and size to contain 60% of the global population by 2030. They are situated mostly in growing economies, displaying large gaps between rich and poor inhabitants but also providing opportunity for investments in sustainable solutions.

The amount of water used in production constitutes a risk for investors to consider. *Virtual water* is a concept urging us to reflect on our responsibility for the water that is used in producing goods that we consume. Water intense goods should not be produced in countries with water stress. *Water footprint* is another concept tailored to calculate how much water was used for a specific product. One example of a company taking on water issues is Nestlé, named the winner of the 2011 Stockholm Industry Water Award for its leadership and performance to improve water management in its internal operations and throughout its supply chain. Despite controversies in the company's past, the prize jury judged that a company of this size can make a significant difference to the world's water resources. Another example is the Sweden Textile Water Initiative, hosted by Swedish Water House and aiming to develop guidelines for sustainable water use in the production and manufacturing processes of textiles and leather. In conclusion, the main water risks for business are: Increased water stress, increased competition over scarce resources, tougher regulations and the fact that corporate brands will be increasingly dependent on sustainable development. By identifying opportunities related to water there are benefits to be made for investment managers and capital owners, and they are important stakeholders for the sustainable management of water resources. Finally, investors and businesses need to find good ways of communicating around water issues in order to improve management of water related risks.

NBIM Investor Expectations on Water Management - Why Water is a Concern for Us as an Investor.

Loïc Dujardin, Senior Analyst, Norges Bank Investment Management (NBIM)

Norges Bank manages the large Norwegian pension fund, with a 2010 projected fund size equivalent to 125% of the country's Gross Domestic Product. Important to note, decisions on exclusions or observations of companies are made by the Ministry of Finance

based on recommendations from the Council on Ethics. While aiming to achieve the highest possible return over time, Norges Bank stresses that long-term returns depend on sustainable development in economic, environmental and social terms, as well as good corporate governance and environmental and social issues in investment and ownership activities. Water Management is a priority area for Norges Bank. Population growth results in increased demand for water while pollution and changed weather patterns brought on by climate change weakens the supply of water, causing an imbalance in supply-demand which means increased costs for companies. It impacts on the cash flow and the value of a company. Water intense sectors invested in are mines, food and beverages, pharmaceuticals, water utilities and power generation. Therefore the bank engages in a continuous and active dialogue with 15-20 of its key companies.

A joint conclusion coming out of this collaboration is that water is not just a risk but also an investment opportunity. It is also clear that in general, the communication between companies and investors needs to be improved. While companies should inform investors on the risks they face on the ground in a meaningful way and how they manage it, investors should clarify what level of information on water related risks that they expect from the company. Apart from its closer relationship with 15-20 key companies, Norges Bank has done this by selecting 450 companies from different sectors to assess them against a set of indicators on what the bank thinks is a good water management system (including strategy, action plans, supply chain management system, governance system including disclosure of precise information etc). The bank is also involved in peer cooperation and standard setting by being a lead sponsor for the Carbon Disclosure Project's *Water Disclosure*, the main platform for promoting a standardization of corporate water reporting to financial institutions. In conclusion:

- Companies and Investors need to better understand water-related risks and to improve communication between them.
- Investors have to set clear expectations on the type of information they need.
- Companies should improve their understanding of the water-related risks in their supply chain and should disclose local and contextualized water-related data.

Questions from the audience:

Have companies improved their communication with you since you started engaging with them?

Loïc Dujardin: We have seen great improvement especially in some companies which were not looking at the issue at all before. Identifying risks is already a great achievement. We do engage with companies because we want them to influence their peers, suppliers or regulators to improve overall performance. Not the ones that are already great performers.

Mining companies pose great environmental risks and can display a lack of maturity. If you have problems communicating with companies, what do you do?

Loïc Dujardin: We own large parts of many companies. They listen because they want to keep our shoulder to lean on. If companies are not willing to talk to us, the Ministry of finance can exclude the company from the fund.

Developments in Water Disclosure

Marcus Norton, Head of Investor CDP (Carbon Disclosure Project) and CDP Water Disclosure

Water is complicated and this is why reports in a consistent way are needed. The CDP Water Disclosure sends a questionnaire to companies in sectors such as metals and mining, power generation, pharmaceuticals and chemicals. The goal is to provide financial institutions with information on how companies manage water including water withdrawals and recycling and how they handle related risks and opportunities. The ambition is to also include companies from emerging economies among the respondents.

Water is a current and worsening risk. 39% of the companies in the questionnaire have already suffered detrimental water related impacts. Companies spend large amounts of money to remediate mainly droughts or floods. Costs to improve water quality are high. There has been an increase in prices, and companies also have high costs for litigation and pollution. 59% of the companies report current or future risks. However, the awareness of risks in supply chains is limited. Half of the companies simply do not know if their suppliers are at risk. It is difficult for companies to assess what their position is – if they do not measure water nor look at supply chains they simply do not know. One clear example of water risk was the dramatic drop in profits for H&M in the first quarter of this year, when cotton prices rose because of droughts in the Yangtze River. There were power cuts and rivers closed down for shipping which hindered distribution in the area where most of H&M's production is. An overview of the findings in the 2010 CDP Water Disclosure Global Report shows that opportunity is everywhere. Improved water management leads to reduced costs and the demand for infrastructure and products to serve growing populations and adapt to climate change especially in Asia is increasing. However, corporate responses to water risk vary in sophistication and effectiveness.

- 89% of the companies have developed specific water policies, strategies or plans.
- 60% of the companies have set water-related performance targets
- 86% of the companies have reported a figure for total water withdrawal

Water disclosure is here to stay. Dow Jones' sustainability index and Norges Bank Investment Management sets clear expectations on corporate water management. The trend is more disclosure, an expanding number of targets and greater focus on supply chains. Emerging economies need it the most, with their growing economies, growing populations and weaker infrastructure. Better disclosure is also necessary in order to reach greater comparability, something that the UN CEO Water Mandate is working on. A range of initiatives are emerging to help us understand water risk, such as Aqueduct and Water Footprint Network for better data sets and WWF-DEG Water Risk Filter and Ceres Aqua Gauge for better tools.

The critical role for investors in tackling the water challenge is to understand the whole picture, not just rising prices but also including the supply chain. Investors should actively engage with companies. Companies need to hear from investors that water is important.

Recent International Trends in Water Management for Investors

Ivo Mulder, Programme officer, United Nations Environment Programme Finance Initiative (UNEP-FI)

Water related pressures are increasingly becoming financial risks, relevant for banks and investors. Water related risks affect *debt servicing ability* by creating resource bottlenecks with immediate adverse effects on company turnovers, factor costs, and ultimately profitability and solvency. The *creditworthiness of clients* is also affected when an increased lack of water restricts water-dependent companies or companies with a large water impact. The reputation of companies, increasingly important because of social media, and vulnerable to e.g. litigation damage, can backfire on lenders and investors. Even in Brazil, where water constraints are not as bad as in India, Mediterranean basin, Australia and South Africa, companies are already seeing economic constraints linked to water access in the form of increased costs for water. Water risk in these regions has so far been low for investors and lenders, due to regulatory protection by many governments. But it will be more costly to sustain this over the long-term. Also, dwindling water quality impacts on water availability for industries. One example is India's power sector, where most of the new planned capacity of 60 GW will be built in water scarce or stressed areas. This causes a delay of commercial operations and a loss of plant load. A recent analysis calculated that a 5% drop in power plant load factor will result in nearly 0.75% drop in a project's investment return.

Mr. Mulder also highlights the hidden water risks in US municipal bond market. A new study by Ceres, Water Asset Management shows that credit rating agencies, investors and utilities hardly account for water risks. Municipal bonds (power, drinking water utilities) are bought and sold based on credit rating from rating agencies. There are only a few rating agencies, and their staff does not have a background in environmental issues. Nor are those agencies targeted by e.g. the United Nations. Meanwhile, the water utilities' own projection of water availability is completely off track. This poses a serious risk to investors. This leads to a severe situation with reduced revenues and diminished credit capacity, in turn potentially causing lower bond prices on the secondary market. Ivo Mulder's advice is to demand from rating agencies to be more accountable.

There are several tools that financial institutions can use to work with water risk, one of these is the UNEP FI Chief Liquidity Series containing a range of performance indicators.

In conclusion, changes in our world demand ever more specialised knowledge for Financial Institutions, including on water. There is a need to identify and value environmental, social, and corporate governance (ESG) – including water issues – in loans, equities and bonds, and to work towards pricing water and other ESG issues in financial products. Asset managers must engage with corporate clients to mitigate water-related risks, and asset owners should require asset managers to engage and factor in water and other ESG issues through investment management agreements. Finally, we need to stimulate better disclosure so that companies can be better analysed and valued in ESG risks.

Panel discussion

Karin Lexén, Director, Swedish Water House

Loïc Dujardin, Senior Analyst, Norges Bank Investment Management (NBIM)

Marcus Norton, Head of Investor CDP and CDP Water Disclosure, Carbon Disclosure Project

Ivo Mulder, Programme officer, United Nations Environment Programme Finance Initiative (UNEP-FI)

Moderator: Johan Kuylenstierna

Loïc Dujardin: Meeting portfolio managers is a way to educate them. They have extensive knowledge of their sectors. We need to see the bright side too. In my day to day work, managers are interested.

Karin Lexén: Companies that work with water could show other companies that there is money to be earned in doing so. We need to be more concrete on what can be gained and what can be lost.

Johan Kuylenstierna: The finance sector is seen as something 'over there'. But it is managing our lives, our pensions.

Marcus Norton: We are ultimately the owners. Seeing water as a shared resource and pricing it properly is important. But we are part of the financial system, and I am not sure water is going to be the vehicle that will change it.

Ivo Mulder: These things should be mandatory, regulation is necessary. Voluntary work is not enough to change things, nor is simply pricing the water properly.

Johan Kuylenstierna: I noticed that banks were not interested in water in 2004-5 when I started working with this.

Ivo Mulder: Up to the 1980s finance was "boring", only serving society. Now the volatility increased a lot. But most people I work with are not worried what will happen with their own money. It shows that many do not see it as a risk in that way.

Marcus Norton: Now is an exciting time for water but we will not have the spotlight for long. But as a global trend, water will not go away, the problems will increase.

Karin Lexén: The financial crisis is also an opportunity to discuss the foundations of welfare and society. People want something concrete and sustainable to hold on to. The earth is a system that needs to be managed well. Let us communicate that water will bring growth and prosperity. And that it makes a difference what you do with your money, such as pension funds.

Loïc Dujardin: Yes, we can see that when markets are down as in financial crises, traditional funds usually lose their clients. But the fact is that funds that include ESG aspects when investing are still gaining clients in turbulent times.

Questions from the audience

Many investment portfolios are not company specific. Do regulations work well?

Marcus Norton: Companies know that to be able to continue producing in a water-stressed area they need to consider water issues. Some companies see regulation as a risk; some see the lack of it as such. Companies are realizing more and more that it is necessary to engage on the basin level.

If investment managers take water on board as a risk, they need information to digest quickly. Is there a water index on risk at national or sub national level?

Marcus Norton: We do not score companies in the first 2 years. WRI Aqueduct attempts to take disclosures by companies and score. It will come.

We are only talking about business and investors. Where are the independent, regulatory institutions in this? Is there a danger in cutting them out?

Loic Dujardin: Investors do not engage with regulators, only with companies. However, long term perspectives are getting more attention. Pollution is now at the top of China's agenda. The legislation existed even before but it was not followed. The same will happen for mining companies where regulation is becoming an issue. They will be scrutinized by governments.

Ivo Mulder: UNEP FI is like a global environment ministry. In order to really change national policies you need to reach environment ministries.

In Central America Coca Cola bought a huge piece of land for water supply. In a sense they are avoiding water risk. Is it acceptable?

Karin Lexén: Managing a diminishing water resource does not necessarily justify buying up land. But the results of it depend on how they manage the land, what happens to people who live there, what access to water they have.

Ivo Mulder: It is a logical step for them as a company. How to prevent it? Governments should not allow concessions.

How about companies' awareness about their exposure to risk?

Loic Dujardin: Companies that are polluting upstream will increase the costs for companies downstream. This affects our investment in both these companies which motivates the first company to deal with the pollution since they want us to stay in their company.

There are only a small number of companies that have huge water problems. As an investor it is not relevant to see every one of them report.

Marcus: How do you know only a small number of companies have big problems? It is a sliding scale from high to low risk. A more targeted questionnaire is also good. We are working on that.