Driving ESG Reporting Progress through Dialogue

Key insights from NAEM's
"Measuring Corporate Sustainability"
conference

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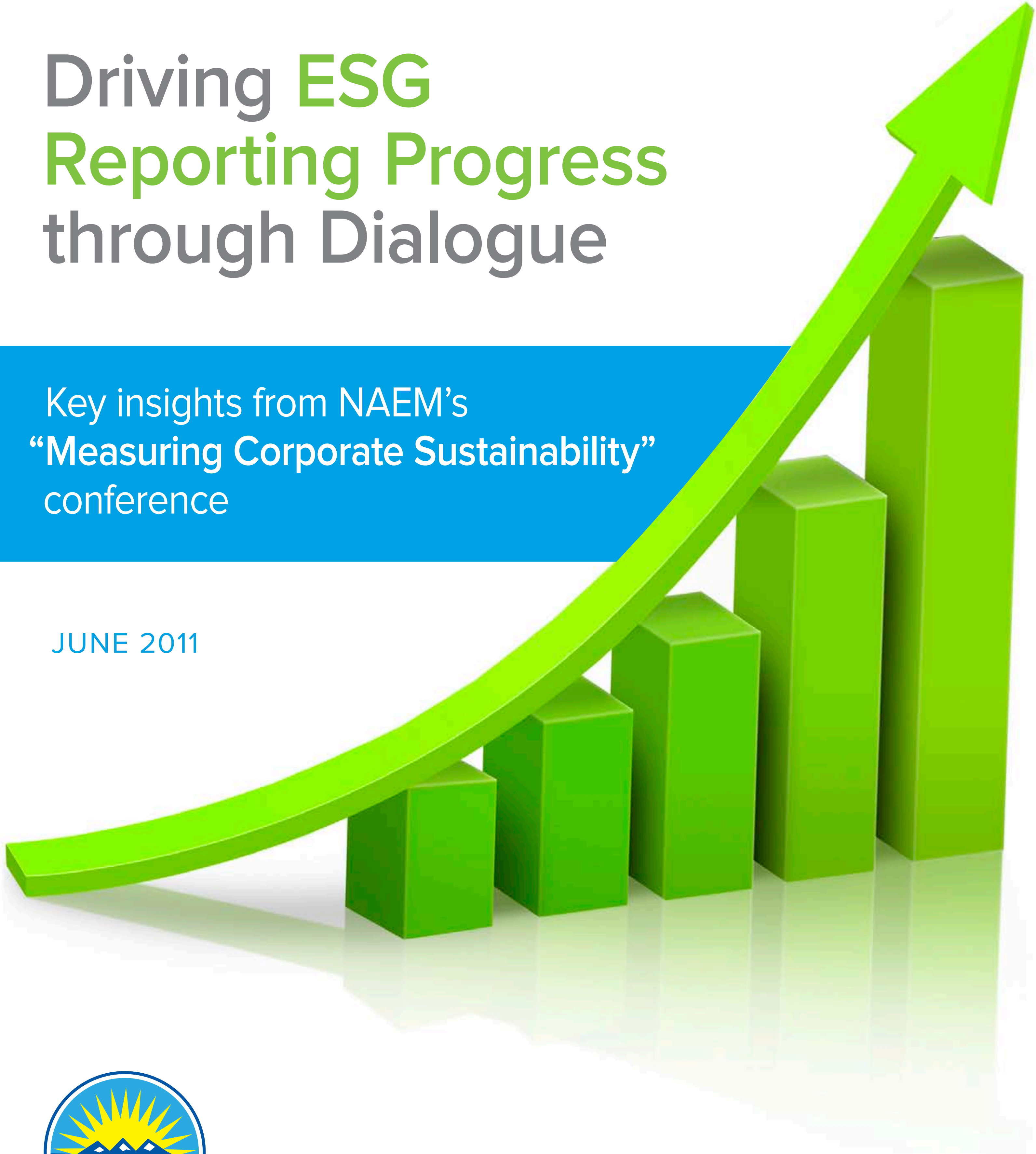

NAEM

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Contents

About NAEM

The National Association for Environmental Management (NAEM) empowers corporate leaders to advance environmental stewardship, create safe and healthy workplaces, and promote global sustainability. As the largest professional community for EHS and sustainability decision-makers, we provide peer-led educational conferences and an active network for sharing solutions to today's corporate EHS and sustainability management challenges. Visit NAEM online at **www.naem.org.**

About this Report

This report is a summary of the key takeaways from the “Measuring Corporate Sustainability” conference; a stakeholder dialogue hosted by the National Association for Environmental Management on May 5, 2011 in Fort Lauderdale, Fla. The purpose of the event was to discuss the challenges of the emerging field of environment, social and governance (ESG) research from the perspective of business leaders, research analysts and the investment community.

As the demand for insight into a company’s ESG performance increases, companies are struggling to keep up with the flood of research requests. In a recent survey of its members, NAEM found that some companies spend up to two full-time equivalent (FTE) responding to external information requests.

This challenge is especially prevalent among publicly-held U.S. corporations, where the task primarily falls on the environmental, health and safety (EHS) manager. Often times, it is unclear who the requesting entities are, how the questions are relevant to their analysis and who the audience for this information is. Survey fatigue, coupled with the lack of transparency about ESG research methods has led some business leaders to question the benefits of participation.

To address these questions for its members, NAEM launched its ‘Green Metrics that Matter’ project in the fall of 2010, with a survey of the association’s 75 leadership companies. The questionnaire was designed to reveal how companies track metrics internally and which key performance indicators EHS and sustainability leaders report to the C-Suite. A coinciding survey also was sent to 25 key ESG firms to request specific information about their analysis, their products and their primary customers.

The May conference was an opportunity for members to ask questions and discuss the current reporting system with ESG firms, third-party verifiers, investor relations managers and nongovernmental organizations. Organized as a stakeholder dialogue, the meeting drew more than 100 participants.

While prior stakeholder dialogues have generated valuable recommendations for improving the ESG reporting process, the NAEM event was perhaps the first to initiate a dialogue on behalf of corporate EHS and sustainability managers; these are the business leaders responsible for EHS data tracking, EHS program management and external sustainability reporting.

The insights and recommendations outlined in this report reflect their perspective, but are intended to serve business leaders, ESG researchers and investors as well.

For more information about this topic, please view:

“Green Metrics that Matter,” October 2010; A study of how companies track and report ESG metrics internally by NAEM.

“Rate the Raters,” February 2011; A year-long study of environmental, social and governance (ESG) ratings by SustainAbility.

“Translating ESG into sustainable business value,” March 2010; A report from an international workshop series of the World Business Council for Sustainable Development and the UNEP Finance Initiative.

“2010 Report on Socially Responsible Investing Trends in the United States”; Annual trends report by the Social Investment Forum.

Commonly Used Terms

Companies: Publicly-held businesses that produce and sell goods or services.

CSR: Corporate social responsibility; a term often used to describe a company's commitment to environmental stewardship, workplace safety and minimizing its impact on the communities where it operates. CSR initiatives may overlap with sustainability programs, or may be used interchangeably with the term 'sustainability' in common parlance.

EHS: Environment, Health and Safety; the business function that manages environmental, health and safety programs. EHS leaders also are responsible for ensuring regulatory compliance, tracking EHS performance metrics, and reporting sustainability progress. May also be responsible for leading or contributing to sustainability initiatives.

ESG: Environment, social, governance; the term used by the investment research community to describe the three categories of sustainability metrics they use to gain insight into a company's management practices.

ESG firms: Investment research firms that collect and analyze environmental, social and governance metrics for investor clients. Firms may create ratings or rankings products based on proprietary algorithms.

KPIs: Key performance indicators; the core set of metrics that companies use to demonstrate progress against defined goals. These metrics may differ from company to company, based on the nature of their operations.

Sustainability: A term that describes a company's strategies for acting as a responsible corporate citizen, ensuring its operations are financially sustainable and minimizing its environmental footprint. Sustainability initiatives may include natural resource reduction, supply chain management, worker safety & health initiatives, stakeholder engagement and external reporting. While managed by a range of leaders within an organization, many sustainability initiatives are led by the company's EHS function.

SRI: Socially responsible investment; an investment strategy that emphasizes a company's values and how they impact employees, customers, other stakeholders or the public good. Today's investors increasingly are also considering ESG performance and strategy in their analysis.

Executive Summary

In an effort to help members understand the ESG research field, NAEM convened a stakeholder dialogue on May 5, 2011 in Fort Lauderdale, Fla. The venue provided members an opportunity to ask questions and discuss the challenges of the current reporting system with ESG firms, third-party verifiers and nongovernmental organizations. Summarized below are the facts and perspectives presented by the speakers at the event:

Interest in ESG information is growing, but is not yet mainstream

- Environmental, social and governance metrics have not yet made it into the mainstream investors' lexicon, according to President and CEO of the National Investor Relations Institute, Jeff Morgan.

- Some companies do a great job of reporting on their ESG progress, but they are still in the minority among publicly-held companies:

    - Of the approximately 45,000 publicly-held companies worldwide, only about 2,000-3,000 have produced some form of CSR report.
    - Less than 200 companies within the Russell 3000 disclose their total energy use.

- Although still only a small slice of the overall investment universe, the amount of money in social responsible investments is significant. And demand for ESG information is growing.

    - Since 2005, SRI assets have increased more than 34 percent while the broader universe of professionally managed assets has increased only 3 percent, according to the Social Investment Forum (SIF).
    - 12.2 percent of the $25.2 trillion in total assets under management tracked by Thomson Reuters Nelson—is involved in some strategy of socially responsible investing, SIF found.
    - Pension funds are active, influential and increasingly interested in these issues.
        - CALPERS, TIAA-CREF and Parnassus have increased their involvement in sustainability.

Information requests are often redundant and consume considerable resources

- As the type and number of requests continues to increase, the task of responding to surveys is consuming significant resources within companies, without a clear value proposition.

    - In the year 2000, there were about 20 ratings; in 2010, that number had exceeded 100.
    - The corporate EHS or sustainability manager plays a pivotal role in responding to external data requests, according to NAEM's 'Green Metrics that Matter' research: In some companies, responding to ESG surveys requires the equivalent of two FTE.

- Internally, companies only track about 40 sustainability-related performance metrics, while ESG surveys may request information on several hundred variables.

- Each ESG survey tends to use its own terms, units of measure and contextual framework, yet much of the information they request is very similar in nature.

In some companies, responding to ESG surveys requires the equivalent of two FTE, according to NAEM's 'Green Metrics that Matter' research.

Executive Summary

- The number and variety of ESG information requests makes it difficult for companies to understand the relative differences and benefits of participating.
- Business leaders want the ESG community to be more transparent about their business model, who their audience is, the criteria they use to rank companies and how investors are using this information, according to SustainAbility's research
  - Transparency=Trust=Value

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ESG researchers often start with publicly available information

- Many rankings and ratings are based on publicly available information such as its GRI (Global Reporting Initiative) report, its public website and a search of publicly accessible databases (those maintained by regulatory agencies).
  - 63 percent of the ratings depend on public disclosure, according to SustainAbility's 'Rate the Raters' research.

Challenges for ESG researchers

- ESG firms may be reluctant to share their methodology either because it's difficult to communicate complex methods or because they're concerned about inconsistencies in the analytical model applied across ratings products, according to SustainAbility.

> Responding to surveys can drive business value by strengthening brand reputation and attracting new investors.

  - Additionally, each firm's methodology is essential to the final product and therefore generally requires some degree of confidentiality.

- Because overall disclosure rates are low, some ESG research models tend to measure disclosure more so than performance or impacts, according to IW Financial.
  - To properly capture a company's performance (versus disclosure as a proxy for performance), research firms need information from all industry participants.

There may be business benefits to disclosure

- As a means of obtaining maximum value from stakeholder engagement and EHS management, many leadership companies have a business strategy and process for responding to these requests. Others are starting to develop their business strategy to avoid creating a potential competitive disadvantage.
  - Some companies respond to many (10-20 or more) survey requests per year, while others focus their efforts on the selected few they deem most relevant to their business. Cardinal Health, for example, participates only in those surveys that provide a strong benefit, given the time and effort involved.

Executive Summary

- Responding to surveys can drive business value by strengthening brand reputation and attracting new investors.
    - Cardinal Health attracted two new European Union investors, thanks to its solid CSR scores.

Context is valuable and necessary

- Dialogue with ESG firms is becoming a key tactic for companies such as Johnson & Johnson to effectively tell their sustainability story. It allows the company to correct inaccuracies that sometimes arise when an ESG firm incorrectly applies publicly available data, and helps researchers better understand J&J's progress.
- Within most companies, it's not yet clear how the ESG issues affect the core business or its ability to create financial value.
    - Greater clarity in this area is essential to expanding the value proposition for companies around ESG reporting.
    - ESG researchers and investors need guidance from companies to identify the most material metrics for both businesses and investors.

Future predictions

- In the future, the demand for transparency will continue to increase, according to CRD Analytics' Michael Muyot. He had several predictions for how the issue of ESG reporting and analysis may evolve in the coming 5-10 years:
    - ESG disclosure is going to be mandatory for a company to be listed on an increasing number of international stock exchanges. (There are already examples of this in Latin America and Europe; other exchanges are actively discussing it.)
    - A global, centralized database of ESG data will likely develop, given the sheer volume of information.
    - eXtensible Business Reporting Language (XBRL) will be used for financial and nonfinancial reporting such as GRI report elements because it allows data to be easily tracked, audited and assured.
    - Full supply chain reporting on ESG may also be coming, although it may vary by industry and market. One example is Patagonia. Big apparel retailers also are working on an initiative to develop the necessary data and reporting conventions
    - We will see a retail investor revolution; 30 percent now do nothing in terms of managing their assets. Social networking will change this and promote more personal involvement in company-level evaluation. With ESG issues being of greater importance to the younger generation, this revolution will likely have an elevated impact on the importance of ESG reporting (thereby increasing the value proposition to both companies and ESG firms).
    - New mobile apps will supply ESG information. Consumer-oriented companies will need to have a heightened awareness and strategy around these matters.
    - CSR reporting will grow the fastest in the U.S. and Asia, driven in part by the new GRI G4 guidelines being developed, regulatory requirements and/or shareholder activism.

> Within most companies, it's not yet clear how the ESG issues affect the core business or its ability to create financial value.

Recommendations

The recommendations outlined below are intended to support continued corporate disclosure, address survey fatigue and drive toward greater standardization in the research process going forward.

Recommendations for ESG firms

- There should be an effort to identify the metrics that are material to a company's sustainability progress.
  - The information should be used to rank companies according to their risks, impacts and relative progress (e.g. natural resource consumption relative to net sales).
  - The metrics have to be material from the standpoint of managing the EHS footprint, dealing effectively with social issues and becoming stronger financially.
- To improve the value of rankings, researchers should do a better job of reflecting the fundamental differences between industries in their evaluation models.
  - Many rankings do not take the company's business model into adequate account. This often results in evaluations that reward industries which inherently require fewer resources. As a consequence, diversified manufacturers and utilities rarely make it to the top of a ranking.

Each survey uses its own terms, units of measure and contextual framework. Simplifying and standardizing the process could lead to more widespread disclosure and allow for a more accurate comparison between companies.

- Rankings should include a stronger focus on the future since investors are forward-looking.
  - The leadership companies of tomorrow are investing in new products, new processes and new relationships today.
- The ESG community should address the core issues inhibiting more acceptance and responsiveness to information requests, including:
  - Audience: Who is the audience for corporate ESG data and analysis?
  - Funding model: What is the right funding model? Is there a bias inherent in a for-profit model vs. an independently funded NGO?
  - Quality Assurance: Is there a quality standard that could apply?
  - Potential conflicts of interest: Can raters be consultants? If so, under what conditions?
  - Transparency: Can companies be open without taking on too much commercial risk? How can they balance transparency with business integrity?
- Each survey uses its own terms, units of measure and contextual framework. Simplifying and standardizing the process could lead to more widespread disclosure and allow for a more accurate comparison between companies.
- ESG firms should share the results of their ratings and rankings with participating companies, free of charge. Those research firms that ask companies to pay for their analysis prevent businesses from understanding areas for improvement, and limit constructive dialogue.

Recommendations

Recommendations for Companies

- Companies should make as much information public as possible through:
  - Public website
  - Annual reports
  - GRI report
  - Integrated reporting

- Companies should manage expectations about ratings by building buy-in at the C-Suite and among those who are responsible for collecting the information. This is supported by the proper understanding of the value proposition, developed in conjunction with ESG firms.

- Business leaders and ESG researchers should build relationships to ensure more accurate, efficient and timely reporting. These relationships are also critical for the dialogue and development of a more clear value proposition for all parties involved.

- Companies should develop a strategy for disclosure by:
  - Articulating the benefits of responding
  - Researching the requesting entities
  - Prioritizing surveys based on their fit with business goals
  - Telling stories to put context around the numbers
  - Engaging research firms and investors to address any lingering questions or misinformation
  - Committing to long-term performance improvement and reporting objectives

- Companies should identify which ESG metrics demonstrate financial benefits. Since companies have access to both ESG and financial information, they should be able to make linkages if such linkages exist. If leadership companies are able to do so and make these relationships public, then ESG firms will be able to ask better questions.

- Companies should try to issue thorough EHS policies that reflect the company's values and important ESG issues, according to IW Financial. This could involve:
  - Addressing major material risks such as greenhouse gas emissions, water use, labor practices and energy use;
  - Including a commitment to stakeholder engagement and
  - Identifying who is responsible for implementing the policy across the enterprise.

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Participating Companies and Stakeholders

The following are the companies and stakeholders who attended the "Measuring Corporate Sustainability" conference on May 5, 2011:

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Archer Daniels Midland Co.
AMCOL International Inc.
American Electric Power Co.
Baxter Healthcare Corp.
The Boeing Co.
BNSF Railway
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