Linking Environmental Performance to Business Value
A North American Perspective

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EXECUTIVE SUMMARY
Cognizant of the need to develop a baseline analysis of the current state of
the business value case (i.e., the profitable financial performance for spe-
cific companies, industries, and the people who invest in and extend credit
to these companies) for environmental performance, Environment Canada,
supported by the CEC, created a network of organizations, experts and
practitioners from the finance, business, academic and nongovernmental
sectors to participate in developing business value case projects, review-
ing their results and providing recommendations on how to communicate
findings. This report is the first of these projects.

This report aims to help build a solid foundation on which the CEC and
Environment Canada can foster understanding of linkages between en-
vironmental and financial performance (the “business value case”) and
engage the business and financial service sectors of society in wider use
of those links.

The CEC and Environment Canada would like to thank the network for its
support and review of this report. We would also like to thank all of the
participants in the expert review process (listed below) for their comments
and guidance, which have increased the relevance and credibility of this
report. The CEC and Environment Canada would like to thank the authors,
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Stefan Quenneville of Metamorphoses Consulting, for their contribution
to examining and distilling this information on the business value case
for environmental performance. Finally, we would like to acknowledge and
thank our three countries’ ministers of the environment (the CEC Council) for listening carefully in the discussions on this subject, then taking an interest in this line of work and supporting it at the North American level.

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The Commission for Environmental Cooperation (CEC) of North America and its Parties, the governments of Canada, Mexico and the United States, are working strategically to influence all sectors of the economy to improve environmental performance and move toward sustainable development. Demonstrating the relationship between environmental and financial performance (the “business value case”) is a critical first step to supporting the work in this direction. The “business value case” refers to the financial bottom line impact of environmental issues and variables—in laymen’s terms, how a company’s environmental performance affects its financial performance. Previous work by the CEC, Environment Canada (EC) and their partners in the business and financial sectors suggests that engaging business and the financial sector in integrating environmental information into financial market decisions hinges on identifying, measuring, analyzing and communicating how and where improved environmental performance can lead to increased business value. A research study was therefore undertaken to review and analyze international research examining the linkages between environmental performance and business performance, with an emphasis on the North American context. This report communicates the findings of the study and is intended for individuals and organizations from a variety of sectors that have an interest in understanding how environmental performance contributes to business value and financial performance. This report also recommends where further research and analysis is required on this issue, and it is hoped that it will contribute to additional engagement.
The report blends a review of existing research on the business value case with interviews with a small group of recognized experts\(^1\) in order to establish a baseline of business value case information, enhanced by the experience of expert practitioners.\(^2\) The report was also enriched through being reviewed by experts from the financial sector, nongovernmental organizations and industrial corporations. It is hoped that this extensive review process with practitioners will help refine the understanding of the business value case for environmental performance and move forward from debating whether the business value case exists to measuring where and how it is established and engaging in areas where more work is needed.

As a review of existing business value case literature, the findings of this report capture a broad spectrum of analytical and conceptual approaches and indicators for environmental and financial performance. While this approach to the research precludes broad definitive conclusions about the business value case for environmental performance, it provides valuable direction on where future efforts are needed. Indeed, among the key findings of this report is that there is a need for a clear conceptual framework to more systematically link indicators of environmental and financial performance and thereby enable companies to integrate environmental information into management, operation and capital investment decisions and to communicate the risks and benefits to stakeholders in the financial sector.
A large part of the research reviewed suggests a positive correlation between environmental and financial performance; however, a rigorous conceptual framework to systematically link environmental and financial indicators is needed.

Overall, the business value case research indicates a positive or, at minimum, neutral correlation between environmental and financial performance. The strength of observed correlations depends on timing, sample set and which financial and environmental variables are examined. Business value case research is strongest when aggregating information at the sector and portfolio level and weakest at linking specific environmental performance metrics with specific financial value metrics (e.g., emissions to return on investment). In either case, the specific mechanisms behind observed correlations are not yet documented and causal links have not been established. A conceptual framework to systematically capture statistically rigorous relationships between specific environmental and financial indicators is needed to improve understanding of the appropriateness of specific indicators and to identify where correlations are strongest at the sector, firm and issue level.
Documenting the financial implications of specific environmental initiatives at the company level is needed to facilitate corporate measurement, integration and communication of environmental performance information into financial decision-making, internally and by external stakeholders.

Most companies are not disclosing and may not be gathering environmental information and data in a fashion that is usable for making financial decisions. The interviews, literature review and expert review carried out as part of this research suggest that most companies do not have the measures of their environmental impacts needed to allow them to quantify the related costs and/or benefits to their business. This lack of information could be potentially significant to both companies and the financial sector, as suggested by some research indicating that companies can face divergent levels of financial exposure to the environmental issues relevant to their sector. Business value case research must establish specific measures that can be integrated into management, operational and capital investment decisions and facilitate the communication of risks and benefits to stakeholders in the financial sector.

Poor communication and dissemination of research on the business value case are barriers to financial sector engagement; where links between environmental and financial performance are found, they must be presented in a more consistent, coherent and coordinated way.

While the quality and sophistication of research and analysis on the business value case have improved, infiltration of the information into mainstream business and finance communities continues to be inhibited by poor documentation, communication and dissemination. Interviewees and expert reviewers note the overall lack of compatibility and comparability of environmental data and difficulty in demonstrating a causal link between disparate environmental and financial performance metrics as key communication barriers. However, most financial analysts, particularly in North America, are not actively looking at the business value case, even where research demonstrates that one exists. This is in part a result of a lack of consistent, coherent and coordinated communication of links between environmental and financial performance and because the communication of environmental risks, liabilities and opportunities has generally not been aligned with the lexicon of mainstream finance. In addition to addressing these issues, some have suggested that there is a need to ensure that information on the business value case is disseminated through business and financial channels, rather than environmental and corporate responsibility outlets.
Business value case researchers may not be examining the right questions.

Financial sector engagement and interest in the business value case is not just a question of terminology and communication, it is also a matter of whether researchers are asking the questions that meet financial analyst and investor information needs. For example, most business value case research is backward-looking (asking whether past stock price movements are correlated with past TRI releases, for example) and therefore does not respond to the forward-looking needs of financial analysts. More research is needed to test whether observable environmental variables can predict superior or inferior future financial performance. More research is also needed to identify financial analyst and investor information needs.

Despite pockets of leadership, North American financial institutions, industrial firms and governmental agencies are, by and large, not proactively supporting the link between environmental and financial performance.

European leadership in corporate social responsibility has resulted in the support of banking and institutional investors, who are actively working on the development and application of environmental business value metrics. The same cannot be said in the North American context. While there is a growing and increasingly well-coordinated private and public sector effort to enhance understanding, development and communication of the business value case in the North American context, coordination is limited to specific environmental (most notably, climate change) and corporate governance (most notably, transparency and disclosure) issues rather than the integration of the full range of environmental issues into overall business strategy.
In North America, the socially responsible investment (SRI) community has been one of the key drivers of analyses and communication of the business value case. The SRI community has been particularly effective in identifying areas and cases where there is a direct correlation between business value and environmental and social issues. However, SRI represents only about 3.3 percent of total combined retail and institutional assets in Canada (Social Investment Organization 2002) and 11.3 percent of assets in the US (Social Investment Forum 2002).

Governments have an important role to play in supporting the development and communication of the business value case. An integrated and coordinated approach across a number of departments and agencies, specifically including industry, finance and commerce ministries, is needed. The main roles for governments identified in this review are:

1. Supporting efforts to identify and address research and communication gaps;
2. Increasing use of market mechanisms and tax incentives and disincentives;
3. Supporting the availability of transparent and comparable environmental information;
4. Effecting stronger regulatory control and better enforcement of current environmental laws and regulations, with stiffer penalties for noncompliance;
5. Setting and enforcing corporate governance standards;

Role of the Public Sector
through strengthened securities regulators, enforcing and increasing disclosure of environmental risks, costs and liabilities, as well as other aspects of environmental performance;

catalyzing and leveraging partnerships, especially with financial and business/industry departments, agencies and nongovernmental organizations in order to engage effectively the financial sector; and

in the case of environmental agencies in particular, working on making environmental information available to the financial community in useful formats, and cooperating more effectively with securities regulators and accounting oversight bodies.

Endnotes

1. A list of interviewees is available in Annex A.
2. A list of expert reviewers and their unedited comments is attached as Annex B.
3. Business value case data may be gathered internally and not published.
The purpose of the CEC’s work on financing and the environment is to explore established and innovative ways of involving the financial service sector in the environmental agenda. Such involvement takes various forms. It can include greater awareness among credit-risk managers about environment risks and liabilities, interest among investors about opportunities in the environmental area, and more specific project finance opportunities involving the environment.

Indeed, one of the crosscutting issues that the CEC and environmental agencies encounter is how to harness the power of private financial markets in creating and sustaining financing for the environment. The question of financing is of direct relevance to a number of other CEC projects as well: opportunities for small and medium-size enterprises in environmental goods and services; work on renewable energy, energy efficiency, and shade-grown coffee; encouraging sustainable tourism; and trade in sustainable palms.

The financial service sector is the fuel of our economies and could have considerable impact on the way business incorporates environmental concerns. Currently, however, many security analysts do not use environmental information disclosed by companies to rate companies they will invest in, due to information gaps, lack of data comparability, and the difficulty of linking corporate environmental programs and activities to business strategies and financial performance, metrics, or models.